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- Mohammed Jaffar: Gulf Banking, Gulf University, 2000

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I declare that this Bachelor work has been done independent with using Some Literatures and Knowledge of Supervisor and Consultation.

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Meanings

1. **Riba:** The interest of the loan

2. **Aqidah:** Faith and Belief

3. **Sharia:** Practices and Activities

4. **Akhlaq:** Moralities and Ethics

5. **Ibadat:** Man to God Worship

6. **Mumalat:** Man to Man Activities

7. **Murabaha:** Cost Plus Financing

8. **Mudarabah:** Profit Sharing Agreement

9. **Musharaka:** Equity Participation

10. **Ijarah muntahia bittamleek (or ijarah wa Iqtina):** Leasing

11. **Salam and Parallel Salam:** Deferred Delivery

12. **Sukuks:** Islamic Bonds

Introduction

Twenty-Five years ago Islamic banking was virtually unknown. Today the market size is estimated, by some commentators, to be growing at the rate of 15% per annum. Islamic banks currently operate in approaching 75 countries and the industry has a market size estimated at US $ 200-230 billion.

Islamic banking evolved in order to create an alternative financial system to conventional banking for Muslims, seeking to conduct their financial affairs in accordance with Islamic Sharia, to be able to do so. The challenge for Islamic banking and financial institutions, in achieving this goal, lies in the fact that the sector is obliged to develop within a global financial environment which is based on concepts revolving around the interest rate mechanism.

Content

ISLAMIC BANKING

CHAPTER ONE

AN OVERVIEW OF ISLAMIC BANKING

INTRODUCTION

While prohibiting interest, Islam permits profit-sharing. The central requirement of an Islamic banking system is the replacement of interest with profit on real activities as a means of allocating financial resources.

The purpose of this chapter is to present an overview of the development of Islamic banking and to describe the methodology and the general concepts of Islamic banking.

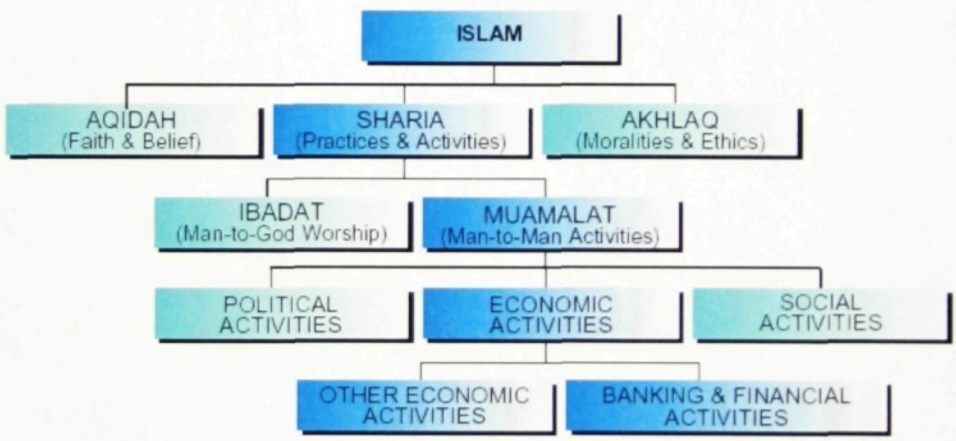

Figure (1.1) the Position of Banking and Finance within Islam

1.1 DEVELOPMENT OF ISLAMIC BANKS

The first attempt to establishing an Islamic financial institution in the modern Islamic world began in Pakistan in the late 1950s with the establishment of a local Islamic bank in a rural area. The experiment was initiated by some pious landlords who deposited funds at no interest, of which credit facilities would be made available to small landowners for agricultural development. The borrowers did not pay interest on the credit advanced, but they were levied a small charge to cover the bank's operating expenses. The charge was far lower than the rate of interest in other banking systems. Although the experiment was encouraging, two main factors were responsible for its failure to survive.

First, the deposits made were regarded by (landlord) depositors as one-and-for all deposits. With the increasing number of borrowers the gap between credit available and credit demanded was huge.

Second, the bank staff did not have complete autonomy over the bank's operations; depositors showed considerable interest in the way their money was lent out with the shortage of funds and the problems of recruiting bank staff the experiment collapsed. Outstanding loans were paid back to depositors through bilateral agreement, without financial intermediation, and they were mostly repaid by the early 1960s. (El-Ashker, 1987).

Wilson, (1983) pointed out that the second attempt began in Egypt in (1963) with the establishment of the Mit Ghamr Savings Bank in a rural area. The Mit Ghamr soon prospered, and within three years the 1000 founding depositors had been joined by a further 59000. No interest was paid on deposits but, in order to receive an interest free loan, a borrower had to have a certain minimum sum in a savings account for at least a year. Thus there was some financial motivation to deposit funds, as depositors and borrowers belonged to the same group, unlike in Pakistan. Loans were used for a variety of purposes, including house building and repairs, the purchase of simple machinery for handicrafts industries, such as hand looms for weaving textiles, or even simple sewing machines.

According to Chachi, (1989) the Mit Ghamr was so successful that it would have covered the whole of Egypt by now, if it has not been stopped for political reasons outside its control. It came to the end in February 1967 after only three and half year during which problems of rural indebtedness were reduced in the areas where this bank and its branches were operating. Soon afterwards many Islamic social, development and commercial banks started doing business following the example of Mit-Ghamr Islamic Saving Bank with some improvements. The first of such banks is the Nasser Social Bank established in 1971 in Egypt, not as profit oriented institutions but as a social bank to serve the previously (unbankable) low income group; followed by the Islamic International Development Bank (IDB) in Dubai (UAE) in 1975, the first major project of Islamic commercial bank, the success of which led to the establishment of a series of such banks elsewhere.

As pointed out by Khalaf, (1995) the industry now has more than 100 banks and financial houses. Interest is banned in the banking systems of Iran, Pakistan and Sudan.

According to the Allen, (1995) the total assets of Islamic financial institution, they proclaim, have gone from nothing to between $ 80bn and $ 120bn in 20 years.

Figure (1.2) the Islamic area

1.2 UNDERLYING CONCEPT OF ISLAMIC BANKING

The Islamic banking system can only be operational under two fundamental principles: namely the prohibition of the interest, and the introduction of profit and loss sharing schemes and other types of finance. Thus if interest is ruled out, it does not mean that Islamic banks are no more than non-profit organization. On the contrary, according to the risk reward trade off, the yield in a profit-sharing arrangement is, naturally, a legally accepted return in the Islamic economy (Chachi, 1989).

As pointed out by Chachi, (1989), "Among those who excluded banking interest on deposits from Riba and considered it as permissible are, Shaltout, Yusuf Ali, Khallaf, Dawalibi, Sanhuri and El-Fanjari. They argued that interest from bank on deposits is not Riba because the bank did not go to the depositors to borrow from them but it is the depositors who went to the bank and deposited their saving with it. They further argued that the interest given to depositors is not predetermined by the latter, as the lenders do in the case of Riba, but by the bank and so it represents the profit share of depositors in the banks profit and is just like Mudarabah profit. Others like Dawalibi, distinguished between interest on consumption loans and interest on production loans and argued that Riba is concerned only with the former because in the case there is an exploitation of the

need of the poor who need to be helped rather than oppressed. As for the interest on productive loans, they saw no objection in charging a so called 'fair and moderated rate'. Some others, like Sanhuri argued that what Islam prohibits is excessive compound interest and not moderate simple interest. They allow interest because they think it is the only way necessary for mobilizing savings for development".

Khan, (1983) pointed out that "another difficult issue involves the distinction between real and nominal returns on bank savings accounts. It was explained how the inflation may be unfair in its effects on the depositor, where there is no interest allowed. Indexation has also been advocated in the West as a means to minimize the inequities of inflation and to reduce it by changing it by changing expectation. Minimizing the uncertainty attached to inflation reassures creditors, and the functioning of long term capital markets is improved. Indexation, however, has not found ready acceptance among Islamic scholars. Their stand against it is mainly premised on the lack of approval by Islamic jurists of indexation. This opposition may be due to the negative view of hoarding in Islam, which funds forwarded to saving accounts (rather than for investment) closely resembles".

According to Chachi, (1989) "there seems to be a general consensus among contemporary Muslim scholars that all forms of predetermined interest on loans and deposits considered Riba and therefore are prohibited. The Koranic prohibition of interest is in Koran 2:261-283, prohibits it categorically with the most sever condemnation by declaring war against those who take it, and clearly defines it as any gain over and above the principal lent, be it small or large. A distinction is

Figure (1.3) One of the oldest mosque

made between interest from loan, which is prohibited and sale which is permitted and a contrast is, once again, made between acts of Infaq (charity) and acts of Riba suggesting that it is the former rather than the latter which causes prosperity.

As for the majority of Muslim scholars, the main reason why Islam abolishes interest is that it is injustice and exploitation. In the case of consumption loans, they violate the basic function for which Allah has created wealth that the needy should be supported by those who have surplus wealth. In the case of productive loans, predetermined and guaranteed return to capital is unjust in view of the uncertainty surrounding the business. The second reason is that it transfer wealth from the poor to the rich, increasing thus inequality by making the rich richer and the poor poorer. This is against social interest and contrary to the will of Allah who ordains justice and benevolence and forbids injustice and oppression. The third reason why interest is abolished is that it creates an idle class of people who neither work nor participate in bearing the risk of losses that might occur to the borrowers. If, instead of lending their surpluses, they have

themselves invested them directly, they would not be certain of getting profits; they even might suffer losses, so why should they get predetermined returns on their lent capital?"

ISLAMIC BANKING

CHAPTER TWO

ISLAMIC BANKING OPERATION SYSTEM

One area which should receive more attention from economists engaged in theoretical and empirical research on Islamic banking is the profit-sharing ratio. This is because it is the ratio which has to replace interest rate in a Riba-free economy and undertake the function of allocation of scarce investible resources.

Islamic banks offer their customers the choice of a number of different deposits accounts which are either interest-free or profit and loss-sharing based, depending on the purpose and commitment of the depositor and depending also on the security or risk involved in each of these types of deposits. Concerning the allocation of finance, Islamic banks may use a number of different methods of finance.

In this section, the sources and uses of funds of Islamic banks are discussed. We will focus on the determination of profit-sharing ratios.

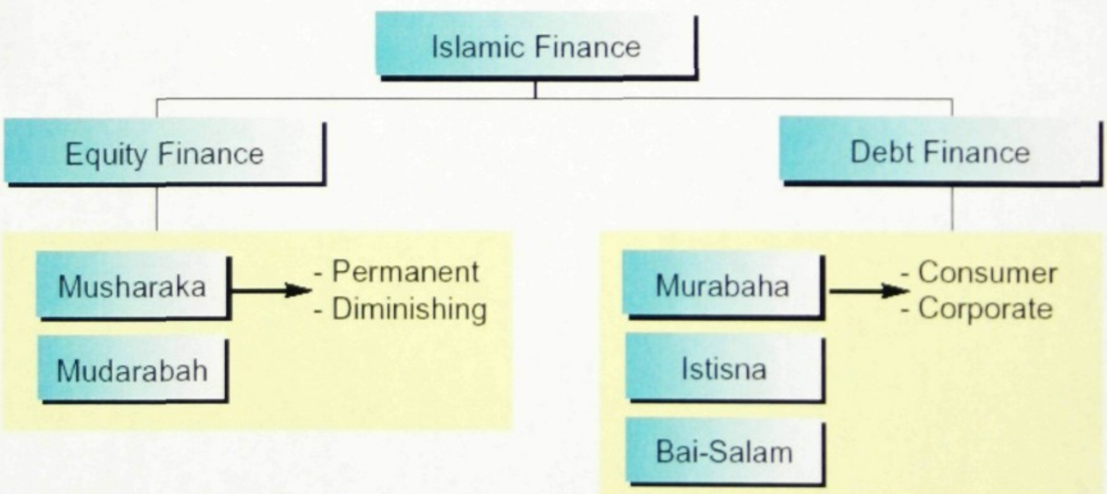

Figure (2.1) Islamic Finance

2.1. Deposit Operations

Deposit taking is the major source of funds in Islamic banks as with conventional banks. Islamic banks currently offer, the following types of deposit accounts:

A) Current Deposits:

These accounts are payable on demand, and the Islamic bank does not pay any return on these deposits and may charge fees, if necessary, for running and maintaining these accounts. Banks request the permission of customers to use their money so long as it remains held with the banks at their own risk. If any profits are generated from the use of money in the current accounts, they belong completely to the bank. Customers have the right to withdraw part or the whole amount of their money at any time without notice and the bank guarantees to honor all demands.

B) Saving Deposits:

Depositors entrust their money to the bank and authorize it to invest their money. It can be pointed here that any return on funds is Islamically justified only if it participates in the risk. If the savings of depositors are guaranteed these amounts are refunded in full, if and when they want them, because they are not participating in the risk.

C) Investment Deposits:

Investment deposits operated by Islamic banks are the counterpart of fixed deposits in conventional banks. Most Islamic banks accept funds for a specific period ranging from one month to 5 years. Generally speaking, depositors do not have the right to withdraw money held in this type of account.

Investment deposits are operated on the basis of Mudarebah. In this case, the bank acts as the "entrepreneur" (Mudareb) and the customer as the "provider of capital" (Rabb-al-mal). Both parties agree on the proportion in which profits are to be hared. So the bank acts as the agent manager, while account holders acts as the fund supplier.

2.2. The Basis of Calculating the Return on Deposits Accounts

The saving deposits are not Islamiclly entitled to any return. If the bank pays a portion of its profits generated from using saving deposits, this will be absolutely at the discretion of the bank and it must be treated as a gift. By contrast, some banks call this account a saving account with the authorization to invest it. Depositors are allowed to withdraw their savings, but profits are shared between the bank and depositor. The return could be calculated on the minimum monthly saving balance or on the average saving balance at a sharing rate lower, of course, than the sharing rate of investment deposits.

El-Ashker (1987) outlines the basis of calculating the return on deposit accounts as follow:

"The agent manager returns to the fund supplier (the investor) his capital and a previously agreed on share in the profit, while the agent keeps the remainder profit for himself as a reward for his labor and effort. In case there is no profit, the agent returns the capital to the investor, having forfeited his time and effort. If a loss is incurred, it is deducted from the capital, and the remaining capital is returned to the investor, and again the agent manager forfeits his time and effort".

As pointed out by El-Ashker (1987), the allocation of profit between the agent manager and the capital supplier can be expressed as follows:
First: the agent manager participates by labor only:

RG = E+M
RC = GP- (E+M)
Where:

RG = the agent's share of profit for expenses and management
E = a portion of profit to cover expenses
M = a portion of profit for management
RC = the capital supplier's share of profit for capital
GP = gross profit

The expenses are calculated arbitrarily, using guidelines from the practice of merchants, which might vary from one trade to another. If accounting records are kept properly, the expenses can be calculated more accurately. In such cases the gross profit in the above equations is substituted by net profit taken from accounting records. Actual investment expenses are deducted from investment revenues and the actual net profit is used in the above calculations".

As pointed out by El-Ashker (1987), Faisal Islamic bank of Egypt has emphasized the principles of the above relationship of distributing investment profits. The bank uses the following basis in the calculation of investment returns:

A. Accounting records are kept in such a way as to distinguish between banking services, activities, investment activities and commercial operations.

B. The bank, in its capacity as a Mudareb (agent manager), is entitled to a portion of the net profit of investment and commercial operations.

C. The net profit of investment and commercial operations is apportioned between investment accounts and the bank, according to the ratio between the value and duration of the investment account the one hand and the financing contributed by the bank from its own resources.

Eligibility for profits differ from one bank to another. In Faisal Islamic Bank of Egypt, and Faisal Islamic Bank of Bahrain, profits are paid on a monthly basis, whereas in the Faisal Islamic Bank of Sudan and Islamic Bank of Dubai, profits are paid on quarterly and yearly basis respectively. In the Islamic Bank of Pakistan, profits are calculated on the points products methods. (see Chachi, 1989) Kabbara (1987), pointed out that the method of profit distribution as currently applied in the Islamic banks, with the exception of Pakistan, is not in favor of small or short-term severs. The banks argue that the calculation of profits for short-term deposits (e.g. less than a month) is tendious and costly. This allegation is not convincing and does not secure equitable treatment among savers who have the right to profits whatever their balances may be.

2.3. Financial Operations and the Basis of Calculating the Profit-sharing Ratio in Finance

Under the conventional banking system, personal or corporate loans are performed through a simple financing mechanism. The banks, acting as financial intermediaries, accept deposits from the surplus units and lend them to the deficit units. The profit of the bank is mainly attributed to the difference between the loan rate and the deposit rate.

Islamic banks differ greatly from commercial banks in their use of funds. They provide financing on the basis of the financial transactions permitted by the Shari'a.These financial practices include: Marabaha, Masharakah, Madarabah, Deferred Sale, Ijarah, Lease Purchasing,Financing and social services. These financial operations are explained below (Ahmed, 1988)

Islamic Financial Instruments :

1. **Murabaha:**

According to Bokhari, (1995) "Murabaha is a sale of goods at a specified profit margin. The term is used for describing a sale agreement where the seller buys the goods for the buyer and sells them on at a fixed price that includes a mark-up. The payment has to be settled within an agreed period either in installments or as a lump sum".

The contract normally caters for short-term financing requirement of clients through legitimate trading practices. Under this contract, an Islamic bank purchases goods, raw materials, equipment, machinery or any other items of economic significance from a third party at the request of a client and sells such goods to the client on spot or deferred payment basis at its own price. The difference between the purchase cost of the Islamic bank and the sale price to the client is the profit available to the Islamic bank from this transaction. After the Islamic bank and the client enter into such contract, the bank issues a latter of credit or any other relevant document ordering the purchase of the goods in question from the manufacturer or supplier for onward delivery to the client.

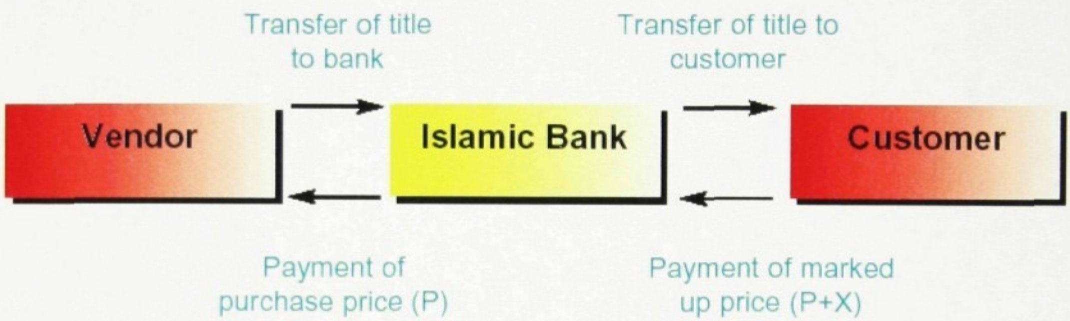

Figure (2.2) the structure of a Murabaha Contract

The sale price, which is agreed upon in advance, is calculated as follows:

Purchase price (including cost of transportation)	A
Add: mark up	B
Sale price	CC

According to El-Ashker (1987), calculation takes various factors into account, such as:

1. The profitability of the commodity; the higher the profitability the higher the mark-up.

2. The necessity of goods to the average consumer; mark-ups on alimentary goods (e.g. foodstuffs) are lower than those on other goods.
3. The amount of work involved; imported goods have higher mark-ups than locally purchased goods.
4. The degree of risk involved; risk from buying goods abroad is higher than risk from buying locally.

El-Ashker (1987), pointed out that the average annual mark up rate for Faisal Islamic Bank of Egypt is between 10 and 15 percent, which is still lower than 15 percent or more annual rate of interest in conventional banks on Egypt.

Pervez (1993) pointed out that since Marabaha entails fixed predetermined rate of return to the Islamic bank, arguments have been raised as to its similarity with conventional interest. As will be observed from the following characteristics of Murabaha contract, an Islamic bank deals in goods and not in documents, and bears several risks until the contract consummation. Because it is tantamount to trading, the contract is an legitimate Islamic banking operation. The Murabaha contract has the following implications:

a. The customer has the right to reject the goods should they not conform to the required quality.

b. The Islamic bank is not permitted to assign the benefits of and resources under manufacturer's warranty to the client if this should entail extra costs to the client. The Islamic bank is responsible for providing services under such warranty to the client and may, therefore, have to act as an intermediary between the client and may, therefore, have to act as an intermediary between the client and the manufacturer and/or supplier.

c. The Islamic bank is obliged to provide the break-down of its cost and profit and all other expenses involved as are charged to the client under the sale price.

d. Under the Murabaha contract, client only promises to purchase the goods and is not under legal binding to necessarily take their delivery upon arrival of goods at the port of destination. Although Islam requires that promises be invariably fulfilled, the client may have reasonable and justifiable excuse for refusal.

e. The Islamic bank always obtains title to the goods before passing these on to the client.

f. In countries where imports are subject to duties and taxes, the Islamic bank's profit is treated as a part of the purchase price and is, therefore, subject to such levies and taxes as are charged on imported items, which increases cost of import to the Client. This is because financing by Islamic bank is treated as trading and not generally recognized as ´debt´. Due to this problem, trade financing by Islamic banks with such countries, where import taxes and duties on imported are charged, has not developed satisfactorily.

Kabbara (1987) pointed out that the purchase price should be declared to the client especially when the bank succeeds in obtaining a discount or rebate. Since the mark-up is calculated on the net purchase price, any discount or rebate obtained has to be acknowledged and accounted for to the benefit of the client. This procedure is a strict adherence to Murabaha rules.

According to El-Ashker (1987), although the method, is in conformity with Shari´a, it is received with great caution by Islamic bodies. It is feared that the method might open the back door for dealing on a fixed interest basis; mark-up which is determined by the bank might be a mere replacement for interest. The report of the Council of Islamic Ideology of Pakistan has restricted the use of this method to´only inescapable cases ´, and has suggested that the mark-up should be observed by the State Bank of Pakistan in order to specify, review from time to time and vary by the sub-sectors item for which banks may provide finance under this method as well as the profit margin applied. Moreover, Islamic banks, which apply this method in financing commercial and industrial enterprises, have the following argument:

1. Murabaha is not a risk-free operation, it involves a twofold risk: (a) risk during the purchase transaction which incorporates physical losses, unacceptable quality, delivery delay, etc., which lie entirely with the bank, and (b) risk during the collection of debt, which might arise as a result of payment failure partly or entirely.

2. Banks undertake all proceedings prior to purchase, including inquiring, studying the market and choosing the best purchase offer. The client benefits from these services which be would have to undertake himself if he relied on fixed-interest finance.

3. The client is not in the same position as the bank in obtaining discounts from suppliers, either quantity discounts or payment discount. This makes the sale price offered by the bank to the client lower than the price the client would pay if he depended on Western style banking finance.

4. The mark-up is variable-based and takes into account various factors which are not considered in the interest finance.

5. The client benefits from the speed at which these transactions take place. Goods suppliers, particularly exporters, would be pleased to deal with Islamic banks in these transactions because they get paid quicker and without risk and it saves them from having to arrange trade credit themselves on behalf of their Islamic clients with their ordinary banks.

6. There is a great demand for these operations by clients, which suggests that the method is still cheaper than the fixed interest finance.

2. Musharaka Financing

Musharaka (participation) is a form of joint venture between the bank and the client, a partner, where both participate in the capital and the client manage the business. The liability of both the bank and the client is limited to the amount of capital put into the business.

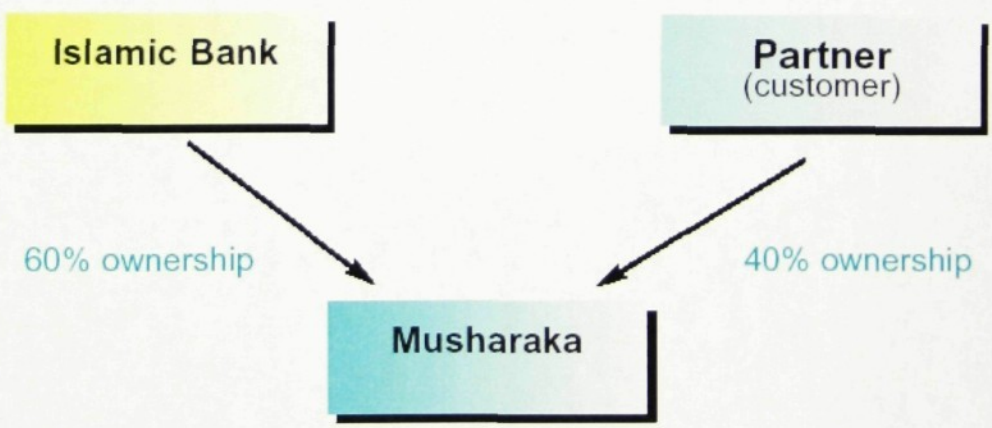

Figure (2.3) the structure of a Musharaka Contract

According to El-Ashker (1987), the basis of profit distribution between the bank and the partner is as follows:

1. The profit is defined as net profit after deducting all expenses, except any remuneration to the partner.

2. A portion of profit is given to the partner for his labor and effort.

3. The remaining profit is distributed between the bank and the partner in proportion to the capital.

4. In case of losses, these are distributed in proportion to capital. The portion of profit is not an overall fixed percentage, but rather it varies from one Musharaka to another depending upon the amount of work involved and the level of expertise required from the partner.

3. Mudarabah:

Mudarabah is very similar to Musharaka except that in Mudarabah the partner does not participate in capital in the joint venture. The bank provides all the capital and the partner provides his work and expertise. The profit from Mudarabah is distributed according to proportions determined in advance, while the loss is borne entirely by the bank. Ahmed (1987) pointed out that the rationale is that the capital provider is exposing his capital to business risk and that makes him entitled to a share in profit. Both parties have an equal position in the determination of ratio in which profits shall be shared between them. In case of loss, if the provider of capital suffers a reduction of his principal amount, the provider of labor is deprived of any reward of his labor, time and efforts.

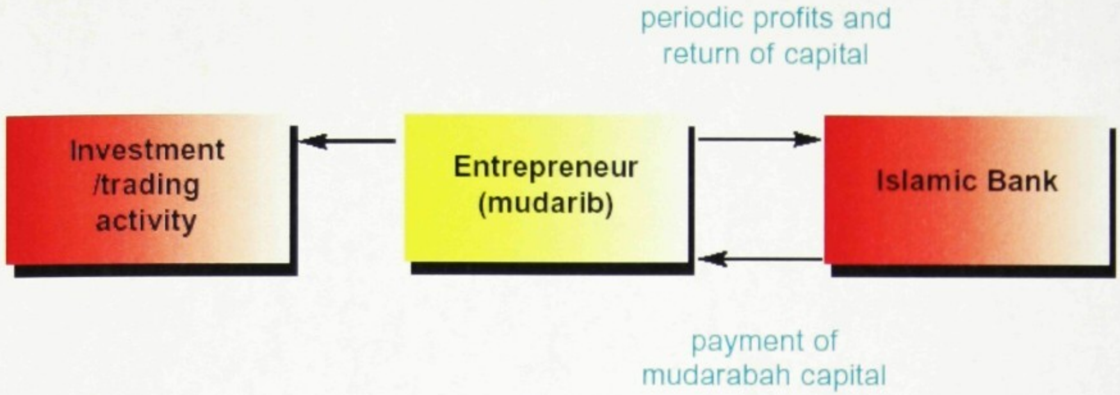

Figure (2.4) the structure of a Mudarabah Contract

The Islamic bank allows all costs of production including management expenses of the client himself and his labor as deductible expenditure. In addition, the client is permitted a fixed percentage of profit as fee for his labor, time and efforts. It is normally 15-30% of the profit (see Perves,1993) depending on the extent and quality of technology, management efforts and expertise involved.

Pervez (1993) pointed out that Mudarabah remains to be a high risk financing mode. Although client has sufficient incentives to make the unit a success, he has no capital committed to the enterprise. Islamic bank, therefore, puts in extraordinary efforts to carefully scrutinize feasibility and projections provided by the clients using the most sophisticated credit risk evaluation, analysis techniques and criteria for its decision-making process. Following credit approvals, the Islamic bank takes necessary steps to guard, as far as possible, against completion and operational risks and such common causes of project failures, changes in regulatory risk factors, raw material shortages and ineffective marketing while it requires the enterprise to be managed to the highest standards to ensure that the projections are achieved. After the project's completion, the Islamic bank maintains strict check on operational risks such as the quality, quantity, availability and price of raw materials, changes in the regulatory and environmental conditions, productivity and effective output at desirable cost levels, adequacy of infrastructure and continued availability of qualified and skilled labor and managerial personnel. If required, Islamic banks may put a member on the client's board of directors to keep abreast of the developments taking place within the enterprise.

According to Kabbara (1987), the application of Mudarabah in financing current Islamic banking operations is very limited owing to the restrictions on Mudarabah transactions. These restrictions inhibit its wider application to cover many sectors in the economy. The argument for this based on the terms and conditions applied in Mudarabah contracts. These are:

a. The majority of jurists limit Mudarabah to trading activities, principally buying and selling;

b. The entrepreneur has no right to commingle the Mudarabah funds with his own funds. However, the Mudareb can share in the equity of the Mudarabah venture.

c. Before liquidation and distribution of profits, the Mudareb processes an uncontested right not only to his share in the profits but also to any gains or appreciation in the value of output or assets of the joint venture that might occur during the life of the Mudarabah contract. Furthermore the determination of the partner's rights requires detailed calculation which is time consuming, especially if such an exercise has to be done several times a year. However, this is not, in itself, an obstacle, particularly when computerization is possible.

d. The Mudarabah accounts must be recorded properly and audited independently, a rather dubious task especially for small businesses when the cost involved may be significant.

Kabbara (1987) suggests a broader definition of Mudarabah so that it may be applied in various economic activities by further research and thorough analysis. New instruments or alternative financing modes can be created to conform to Islamic principles. Islamic banking and finance is a new concept in many respects and it will not be impaired if new approaches are adopted, provided always that it serves the needs of modern societies, and concurrently it is in compliance with Shari´a.

4. Deferred Sale:

Islamic banks finance trade on the basis of deferred sale (Al-Bai-Al-Ajal).The bank agrees to sell a certain commodity on a fixed price for a limited period and delivers the commodity to the client and has control of the commodity. The price charged by the bank includes the cost of commodity to the bank and the bank's profit margin. After the expiry of fixed period the client should pay the agreed price. However, the bank may allow the client to pay by installments in any mutually agreed manner.

5. Ijarah:

Under this mode, Islamic banks acquire certain assets such as machines, buildings, or equipment and allow customers to use them for a certain period, at an agreed price. This is known as "leasing". The terms of lease are decided by mutual consent.

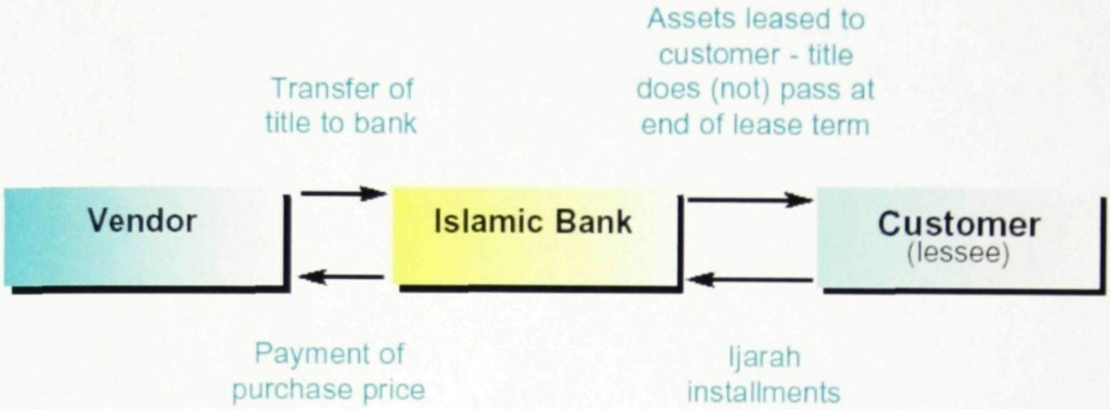

Figure (2.5) the structure of an Ijarah

6. Lease-Purchase Financing

The bank acquires an asset and leases it to the client. The client undertakes to deposit agreed capital installments over a definite time period, into a saving account with the bank. Which an authorization to invest, the profits accrued may also be credited to the saving account. The contract is terminated when the full price is paid and ownership is transferred.

7. Social Services of Islamic Banks:

Social services are considered an integral part of Islamic banking operations. These services may be classified into three main areas: Benevolent loans (Qard-e Hasan), overdrafts, collection and distribution of the Zakat fund, Sadaqat (donations), and finally the preservation of Islamic culture and heritage.

8. Guarantees, Transfers and Collections:

These services include performance bonds, letter of guarantee, letters of credit, traveler's cheques, money transfers, foreign exchange transactions, safe deposits, etc. An Islamic bank may collect a service fee corresponding to the exact expenses incurred by the bank on the services rendered.

ISLAMIC BANKING

CHAPTER THREE

BAHRAIN ISLAMIC BANKS

3.1) ISLAMIC BANKING AND FINANCIAL SERVICES IN BAHRAIN

Development of Islamic Banks in Bahrain

Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts. In fact, the emergence of Islamic banks in Bahrain drew on the same environment that led to the development of Bahrain as an international financial centre. The BMA affords equal opportunities and treatment for conventional as for Islamic banks.

The birth of Islamic banking services in Bahrain dates back to 1978 as already indicated, when Bahrain Islamic Bank was established to provide commercial banking services. Islamic banking in Bahrain gained momentum in the early 1980s, with the issue of four new licenses, one of which was an offshore banking unit license, while the rest were investment banking licenses. The creation of an Islamic offshore bank was the first of its kind, an illustration of the innovative approach to regulation pioneered in Bahrain. The 1990s marked a turning point in the development of Islamic banks in Bahrain. The Bahrain Monetary Agency (BMA), during the 1990's, issued a total of eight licenses to a diverse group of institutions to enable them to pursue Islamic banking services. As of mid-2002, the total number of Islamic banks operating in Bahrain reached 26, of which four are full commercial banks,
three are offshore banking units, six are investment banks with the remainder being a representative office, an investment advisor and an Islamic Infrastructure Fund.

Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts.

The BMA, during the 1990's, issued a total of eight Islamic banking licenses. As of mid 2002, the total number of Islamic banks and financial institutions operating in Bahrain reached 26, of which four are full commercial banks, three are offshore banking units, and sixteen are investment banks with the remainder being a representative office, an investment advisor and an Islamic Infrastructure Fund operating in Bahrain.

Bank Name	Date of Establishment
Full Commercial Banks (4)	
Al Baraka Islamic Bank	21.10.2001
Kuwait Finance House – Bahrain	09.12.2001
Bahrain Islamic Bank	29.10.1978
Shamil Bank of Bahrain	23.02.1993
Offshore Banking Units (3)	
Kuwait Turkish Evkaf Finance House	13.02.2002
Al Baraka Banking Group	06.01.1998
Shamil Bank of Bahrain	19.01.1982
Investment Banks (16)	
ABC Islamic Bank	20.07.1985
ABC Islamic Fund	31.10.1989
Al-Amin Bank	19.05.2001
Al Baraka Islamic Bank	30.09.1983
Al Khaleej Finance and Investment	04.02.1981
Al Khaleej Islamic Investment Bank	06.04.1999
Arab Islamic Bank	14.12.1989
Citi Islamic Investment Bank	17.03.1996
Faysal Investment Bank of Bahrain	22.02.1994
Gulf Finance House	02.08.1999
International Credit Company	19.05.2001
Investors Bank	03.09.1997
First Islamic Investment Bank	20.08.1996
International Investment Bank	09.12.2001
Liquidity Management Centre Company	11.06.2002
Noriba Bank	04.05.2002
Representative Offices (1)	
International Investment Group	09.05.1995
Investment Advisors/Brokers (1)	
Islamic Finance Consultants	25.03.1999

Table (3.1) Islamic Banks and Financial Institutions In Bahrain June 2002

Figure (3.1) The geography of Bahrain

The Islamic banking and finance industry in Bahrain encompasses a unique blend of institutions of different categories. Some are dedicated fully to Islamic banking services; examples of these are Bahrain Islamic Bank, Shamil Bank of Bahrain and Al Baraka Islamic Bank. Other Islamic banks are resident banks with originally conventional banking activities that saw potentially profitable opportunities in diversifying their services to Islamic banking. Arab Banking Corporation is a notable example of this. A final category of Islamic banks operating in Bahrain is represented by major multinational banks. A good example here would be Citi Islamic Investment Bank, a subsidiary of Citicorp. It is important to emphasize here that all financial institutions that provide conventional and Islamic financial services have to abide by the appropriate BMA regulations.

The consolidated balance sheet of Islamic banks operating in Bahrain (excluding restricted accounts) shows total assets of US$ 2.65 billion at March 2002. This compares with US$ 1.3 billion at end 1998. The consolidated total assets of Islamic banks has almost doubled in less than three years. Including the restricted accounts the total assets of Islamic banks operating in Bahrain reached $8.4 billion by the end of 2001. Tables 3.2 and 3.3 provide the consolidated balances sheet of the Islamic banks in Bahrain. These tables include full commercial banks, offshore banking units, and investments banks.

Islamic banks employed a total of 834 staff at the end 2001 of which 91% were Bahraini. This high ratio of Bahrainisation reflects the high quality training provided by the Bahrain Institute of Banking and Finance.

Islamic banks operating in Bahrain are diversified regionally and globally. The main markets for their product are the Gulf Cooperation Council (GCC), the European Union and the North America.

As illustrated above Bahrain is host to a considerable number of Islamic banks and other financial institutions. This reflects Bahrain's role as the international financial centre of the region.

Islamic Securities

Historically Islamic banks have had difficulty in matching profitable assets with their liabilities. This was due to the short term nature of most deposits and to the limited availability of Islamically acceptable short term securities yielding an interest-free return. Islamic banks have, of necessity, had to concentrate on short term assets. This has been especially so as there has been no well organized, liquid, secondary market into which they could deposit overnight, or from which they could borrow to cover a short term funding gap.

Islamic ban growth of Islamic banking reduced the volume of funding, which may be available to local or internationally productive projects. Islamic banks do not have marketable securities on the asset side of their balance sheet. This difference has knock-on effects not only in terms of profit and loss but also in terms of liquidity ratios.

Liabilities
U.S. Dollar Million

Domestic Liabilities							Foreign Liabilities						
End of Period	Banks 2/	Private Non banks	General Gov't	Capital & Reserves	Other	Total	Banks	Non-Banks	H.O. & Affiliates	Capital & Reserves	Other	Total	Total Liabilities
1998	68.7	472.0	20.6	210.6	17.2	789.1	69.9	138.1	44.4	306.5	0.0	558.9	1,348.0
1999	183.9	516.3	20.6	352.5	15.7	1,089.0	61.3	102.9	87.0	334.9	2.1	588.2	1,677.2
2000	140.9	576.9	33.2	281.4	38.5	1,070.9	72.7	124.5	122.9	525.4	1.1	846.6	1,917.5
2001	117.1	654.4	18.4	403.9	22.8	1,216.6	311.4	173.0	223.2	530.9	3.0	1,241.5	2,458.1

1/ Includes Unrestricted Investment Accounts.

2/ Includes Head Offices and Affiliates.

Source: Bahrain Monetary Agency

Table 3.2: **Consolidated Balance Sheet of the Islamic Banks: Full Commercial Banks, Offshore Banking Units and Investment Banks**

Assets
U.S. Dollar Million

	Domestic Assets						Foreign Assets						
End of Period	Cash	Invest. with Banks 2/	Invest. w/ Private Non-Banks	Invest w/ Govt.	Others	Total	Invest. with Banks 2/	Invest. w/ Private Non-Banks	Securities	H.O. & others Affiliates	Others	Total	Total Assets
1998	3.4	468.3	202.3	0.0	54.2	728.2	85.0	372.5	72.2	80.4	9.7	619.8	1,348.0
1999	5.1	598.0	242.4	0.0	55.5	901.0	110.4	446.7	85.1	120.0	14.0	776.2	1,677.2
2000	4.2	713.1	285.3	0.0	69.2	1,071.8	186.8	370.0	88.3	184.1	16.5	845.7	1,917.5
2001	4.3	733.9	333.9	21.5	67.9	1,161.5	172.1	489.3	94.5	529.9	10.8	1,296.6	2,458.1

1/ Includes Unrestricted Investment Accounts.

2/ Includes Head Offices and Affiliates.

Source: Bahrain Monetary Agency

Table 3.3: **Consolidated Balance Sheet of the Islamic Banks: Full Commercial Banks, Offshore Banking Units and Investment Banks**

Development of Islamic Securitization in Bahrain

Some of the earliest attempts to create tradable Islamic securities were undertaken in the mid 1980's. Pools of Islamically acceptable assets were packaged together for sale on a shares or unit basis to investors. These investors had the right to sell their holdings back to the pool. This created at least an impetus for a liquid market.

This 'pool' idea was picked up by most of the Islamic financial institutions in Bahrain and large scale syndicated Murabaha transactions were arranged with billions of dollars, raised mainly in the Gulf, and channeled into Pakistan, India, Turkey and other countries. As debt transactions, there was no opportunity to securities them and so no secondary market could be created.

Islamic Syndicated Financing in Bahrain

Syndicated financing techniques were first used by the British and other European banks in the 17th century. They were originally created to facilitate the mobilization of financial resources to meet growing trade and development needs.

A syndicated credit is usually a large financing facility granted to a key industrial or trading organization and lead-managed by an international bank of standing which also often acted as the "agent". Since the amount of funds involved is large, a number of financial institutions participate by lending money and-or by taking one of several different management functions.

It has not been possible to accurately ascertain the history of Islamic syndicated finance. In so far as such commercial agreements are concerned, Islamic syndicated finance was, for the first time, introduced by Faisal Islamic Bank of

Bahrain E.C. (now the Shamil Bank of Bahrain) through a US$ 50 million short-term trade finance facility for Turkish Petroleum Refinery Corporation (TUPRAS), in August 1987. This transaction was followed by a number of similar facilities. The Shamil Bank of Bahrain itself has concluded over 20 Islamic syndicated transactions for a total amount of over US$ 2 billion, participated in by 56 Islamic and traditional financial institutions. Some other Islamic financial institutions in Bahrain, including the Al-Baraka Group, are also highly involved in Islamic Syndicated Financing.

The structure and documentation of an Islamic syndication, originally developed and launched by the Shamil Bank of Bahrain, is conducted through the following composite structure that has, over the past years, gained acceptability and popularity among many Islamic and conventional financial institutions worldwide.

Structure of an Islamic Syndicated Credit

Agent

The Agent acts on behalf of the participating banks and performs its stipulated functions strictly in accordance with the terms of the Special Mudaraba contract.

Special Mudaraba

Special Mudaraba is equivalent to the Mudarabah contract applicable to restricted investment accounts. It is established by the Agent Islamic bank acting as manager where other financial institutions, Islamic and conventional, join with their participation amounts. The Special Mudaraba contracts stipulate not only the conditions of participation but also sets out the use of funds, the contract documentation, the Client, the guarantor to the Client's obligations and all other legal documentation required in the relationship of the various parties involved in the transaction.

Murabaha Agreement

Being usually short-term, it is a Murabaha financing contract as provided for under the Special Mudaraba contract and is signed between the Agent and the Client for the transaction relationship.

Guarantee Document

If stipulated, this is a guarantee on the approved legal form obtained by the Agent from the guarantor to the Client's obligations.

Other Legal Documents

The Agent obtains the documents stipulated in the Special Mudaraba contract. Also included, are legal opinions of the Agent's lawyers specializing in the law of contract and the law of the country of the Client, legal opinion of the guarantor's lawyer, conditions precedent and any other relevant terms of the relationship as will satisfy the requirements of the participants.

After documentation is completed, the Agent maintains a relationship with all parties according to and for the duration of the Special Mudaraba contract. Participating banks do not act directly with the client.

The entire management responsibilities are carried out by the Agent except in the beginning when the participating institutions decide on the credit risk and legal documentation. Thereafter, little administrative work, and in turn costs, are incurred by the participating institutions in the duration of the Special Mudaraba contract. The simplicity of the operation and its efficiency has allowed the completion of a large number of Islamic syndicated credits in Bahrain.

The Record with Respect to Islamic Syndicated Credits

The successful record of some Islamic financial institutions in Bahrain in providing syndicated financing indicates the viability of Islamic financial products among Islamic and conventional financial instruments alike. Provided that the legal requirements of today's complex environment are met effectively and loopholes adequately plugged, there is no reason why other modes of Islamic finance will not be accepted by financial institutions, investors and clients, in the foreseeable future.

On the other hand, Islamic banks look to conventional financial institutions for participation in such financing instruments and portfolios that fulfill the principles of Islamic financing. Islamic banks in Bahrain are always willing to cooperate with conventional institutions in order to produce new products and portfolios as long as the structures are Islamically legitimate.

Islamic Collective Investment Schemes

Collective investment schemes can be simply defined as agreements whereby funds are pooled and investments are made by professionals on behalf of individuals and institutions with similar investment goals. Within the international capital markets, pension and mutual funds make up the highest proportion of collective investment schemes. By pooling funds from a large number of investors in order to purchase a diversified portfolio of assets, mutual funds can provide individual investors with a low cost method of diversifying their asset portfolio.

Shares in mutual funds are ideal for small investors who want diversified risk and professional money management. Within the international capital markets a mutual fund investor can choose from an investment in an individual or in a combination of money market, bond, FX, commodity and equity funds in order to meet investment goals. Mutual funds provide earnings to investors through dividends and capital appreciation. Shares are easily redeemable and many funds offer other conveniences such as sequel writing facilities.

Mutual funds however bear risks that distinguish them from bank deposits. In particular investors can incur capital losses, when mutual fund shares fall in value. Such capital losses are not normally possible with bank deposits. In contrast with investing in a bank deposit mutual funds, however, offer investors several benefits. Firstly, investors

can diversify their portfolios and spread risk by buying shares in a mutual fund because each share represents a small amount of each financial asset the fund owns. Secondly, because mutual funds pool the money of many investors they offer access to large denominations of securities that individual investors could not afford to buy themselves. Thirdly, mutual funds can purchase investments in large amounts incurring relatively low transaction costs. This cost saving can then be passed onto fund shareholders. Finally, many mutual fund companies hire investment experts to manage the portfolio of investments. These professional portfolio managers can often generate higher returns for mutual

fund shareholders than the shareholders could have achieved if they were selecting investments by themselves.

Pension and mutual funds have also played a key role in the securitization of mortgages and consumer loans. Securitization within conventional finance began in the 1970's with the development of a government-sponsored market for mortgage-backed securities. The basic idea behind mortgage securitization was

to package individual illiquid mortgage loans held by US saving institutions into marketable securities. These securities could then be sold to investors such as pension and mutual funds to increase the flow of funds into housing.

Islamic teachings are not in principle against the idea of collective investment schemes. As a matter of fact, the early history of collective investments in Islamic banking can be dated back to the Muslim traders who opted for financing their business activities, especially the trade ventures, in some form of commercial partnership, over fourteen centuries ago.

The practice of partnership within the caravan trade goes back to the Arab traders before Islam. In pre-Islamic days a trustworthy and honest person could find someone to provide him with the finance which he needed to travel from one place to another for trading, on the basis of obtaining a share of the profit.

How Islamic Banks Can Mobilize Investment Funds

Islamic teachings forbid interest (Riba) whilst encouraging investment in trade and business for the benefit of the individual and society. This presents a dilemma for the majority of Muslims in modern society. While Muslims endeavor to save money on one hand, many of them have had to keep their savings idle either in current accounts of conventional banks or in some form of chattel investments. Islamic banks, although growing, do not yet offer all the conveniences and choices available from conventional banks. Today, several Muslim countries are characterized by low saving and low investment. Hence the

necessity of developing suitable collective investment schemes to enhance the role of Islamic banks in this field, a factor generating a wave of innovations.
One of these innovations has been in the area of Islamic collective investment schemes.

There are number of Islamic financial institutions in Bahrain which have specialized in Islamic collective investment schemes. Examples of such institutions which manage a number of collective investment schemes are Al Amin Bank (a subsidiary of Al Baraka Group) and ABC Islamic Bank (a subsidiary of ABC).

Requirements for the Launch of an Islamic Mutual Fund in Bahrain

In order to launch an Islamic mutual fund in Bahrain a number of conditions must be satisfied. First it has to be acceptable from the Sharia point of view. Second, it should comply with the requirements of the Bahrain Monetary Agency, (the Regulations Governing Collective Investment Schemes in Bahrain). Third, the activities of the Fund must be in compliance with the directives of the authorities where the money will be invested. Fourth, the activities of the Fund must be in compliance with the prevailing Fiduciary rules.

In order to establish an Islamic collective investment fund, the following general guiding principles need to be observed:

(a) The fund can only deal with real assets or Islamic securities which are based on real assets.

(b) The fund, its holding company or the trustee, cannot pay or receive interest in any form, on behalf of the investors in the fund.

(c) The fund cannot buy or sell debt, or securities based on debt.

(d) The fund should avoid transactions with significant uncertainties (gharar) between the contracting parties.

(e) The fund should avoid speculation and excessive (undisclosed) risk.

Islamic Collective Investment Schemes in Bahrain

The Islamic collective investment schemes in Bahrain differ only slightly from the conventional ones. They are normally called "Islamic Investment Funds" or "Issue Funds" and sometimes called "Issues" only. By their nature they are very close to the mutual fund type of non-Islamic collective investment schemes.

The main differences are in three areas, namely:

1. The investment policy
2. The persons involved in managing/operating the Scheme
3. The pricing of shares or units.

Turning to these differences one by one.

1 - The Investment Policy

This may differ from the non-Islamic (conventional) collective investment scheme in three respects. These are:

(a) Different methods of finance

As mentioned earlier Islamic investment companies deal with different Islamic methods of finance (Murabaha, Musharaka, and other methods) in order to provide the capital necessary for initiating any investment. These Islamic methods of finance normally involve different profit-sharing methods. Accordingly,

the valuation and pricing of units of Islamic collective investment schemes will be different from those in conventional ones.

(b) Different investment opportunities

As a result of the different Islamic methods of finance, Islamic investment companies deal with different types of transactions and different investment opportunities. They carry on all kinds of activities related to the ownership of various types of investments. Such activities include the following:

1. The purchase of, or participation in, various types of commodity transactions.
2. Contracts to lease different types of assets on a long, medium, or short term basis.
3. The participation in the establishment of companies and the purchasing and sale of shares.
4. Acquiring projects and/or premises for profit-making purposes.

The characteristics of such investment policies facilitate most types of investments listed in the principles established by the BMA for collective investment schemes. Of course, some of the investment opportunities which the BMA might consider appropriate for collective investment schemes in general might not be applicable to Islamic financial institutions, e.g. investment in debt instruments, investment in warrants & options for hedging purposes, financial lending, and others.

(c) Islamic Investment Fund Companies have a Different Capital Structure:

Establishing the prior ownership of the investment(s) is an important step in establishing any Islamic collective investment scheme. After the ownership of the

investment(s) has been decided, then Islamic financial institutions can establish "the fund" and issue it to the market. For this reason, Islamic companies managing collective investment schemes are normally formed with a fixed capital,

equivalent to the ordinary share capital, normally called the "Management Capital", and variable capital, normally called the "Participation Capital". The fixed capital is used to purchase the investments, which will form the fund. The variable capital is designed to substitute for the fixed capital once "the fund" is issued to the market.

The BMA 'Regulations Governing Collective Investment Schemes in Bahrain', however, cover all types of mutual fund investment companies with fixed or variable capital. This gives sufficient room to include the Islamic investment companies that refer to the capital raised from the public as 'variable capital'. Such capital would, of course, need to be approved by the BMA.

2 - The Persons Involved in Managing/Operating the Collective Investment Schemes

In the conventional collective investment schemes, the parties involved would include the management company, the investment company and the trustee. Islamic investment funds in Bahrain differ slightly in this context. In many such funds the Islamic company stands itself as the investment company and the management company and, if the fund is not guaranteed, there will be no equivalent of a trustee. As a result, there could only be one person in the management and operation of such schemes.

The regulations, however, do not specify the different relevant persons. The BMA has the authority to allow one person to perform this role (like the Islamic Investment Company).

3 - The Pricing of Shares or Units

Islamic financial institutions follow different methods for pricing the shares or units of funds, which they manage. They use different formulas taking the following variables into consideration:

(a) The value of the assets of the fund.
(b) The opportunity cost (as indicated by the prevailing profitability ratios).
(c) The duration of the fund.
(d) The remaining period of the fund.
(e) Other relevant factors.

The regulations, however, do not specify any particular pricing system. The financial institution always has the power of accepting one or several different pricing models for Islamic collective investment schemes.

The potential for Islamic collective investment funds

Although the following list is not fully exhaustive, it comprises many of the major fields where Islamic collective funds can be expected to expand in the future.

Trade Finance

Islamic mutual funds are required to invest in transactions based on the exchange of real assets. Short-term trade finance transactions are particularly suitable for this purpose. Inventory financing, work in progress, export and import financing, are commonly used by Islamic banks under Murabaha investment agreements.

Real Estate Developments

Real estate developments may require substantial cash outlays at the very early stage of development. Islamic collective investment schemes are useful and efficient means for mobilizing the necessary capital, since the link between the underlying asset and the investment is quite clear.

Leasing

Parallel to the development of the Western leasing industry, similar transactions have been adopted by Islamic banks after having made the necessary amendments to make them compatible with the Sharia. Large scale leasing transactions underwritten by Islamic banks can be usually funded from collective investment funds and accounts.

Agriculture

The core need for agriculture is medium to long-term finance, which can be mobilized efficiently through collective investment funds and accounts.

Project Finance

This mode of financing requires substantial amounts of capital, which needs to be committed for the longer term. Collective investment schemes are beginning to be used for this purpose but obviously require a great degree of trust in the experience of the Mudarib (manager) and the long-term outlook by Rab-ul-maal (the financier or the financial institution).

All indications point to the fact that collective investment products are popular among investors around the world, as evidenced by their rapid growth over the last few years. Islamic financial institutions in Bahrain are becoming more active in this field in order to meet the investment needs of investors, especially in the provision of liquidity and the diversification of risk. More work needs to be done to develop the secondary market to help in the trading of Islamic collective investment products. Securitization will also play an important part in developing this growing market.

Many joint efforts are currently being devoted by Bahraini Islamic financial institutions to develop such trading and secondary market activity.

To the extent that it is possible, and falls within their own scope, Islamic banks are endeavoring to iron out problems and weaknesses - operational, structural, and legal – to maintain the viability of Islamic instruments. Coordinated and concerted research by Islamic economists, jurists and bankers continues to take place to accelerate and further extend the scope of Islamic banking and financial markets.

3.2) THE REGULATION OF ISLAMIC BANKS IN BAHRAIN

In order to understand the framework of regulation, as applied to Islamic banks, it is essential to go back to the basic principles, discussed earlier, which underlie Islamic banking.

Distinguishing Characteristics of an Islamic Bank

Three key characteristics distinguish Islamic banks from conventional banks:

Figure (3.2) Bahrain map

1. Islamic Banks cannot Pay or Receive Interest.

Firstly the contractual relationship governing the relationship between an Islamic bank and investment account holders (depositors) is different from that with conventional banks.

Islamic banks are fundamentally different from conventional banks in that financial products involving 'Riba' are strictly avoided. As an alternative to the receipt and payment of Riba, which is strictly prohibited by the Sharia, Islamic banks use Mudarabah financial instruments in order to mobilize funds into investment accounts.

Mudarabah as already discussed, is an agreement between the Rab al Mall (the bank) and the Mudarib (client), in which the bank, as a provider of funds, agrees to finance the Mudarib with a certain amount of money, the purpose being to invest it in an activity stipulated in the Mudarabah agreement. Mudarabah is a profits sharing contract derived from the Sharia.

The capital of the Mudarabah should be provided in cash. However, it is considered permissible by some Islamic jurists that the capital of a Mudarabah can be provided in the form of trading assets (e.g., inventory). At the inception of the initial contract the value of such assets or their historical cost will be considered as the Mudarabah capital.

Differences Between Investment Account Holder (IAH) at an Islamic bank and Depositor at a Conventional Bank

In the Mudarabah contract, the Islamic bank acts as mudarib, and cannot guarantee the capital of Investment Account Holders (IAH). The IAH receives a pro rata share of the profits after deducting the Mudarib fee, this being a pre determined percentage of the profit generated. In the case of a loss, which is not due to negligence or misconduct of the mudarib, the IAH will suffer a loss proportionate to the capital invested.

The depositor with a conventional bank has no risk of loss due to the failure of the investment decisions made by the bank and is subject only to the risk of the bank itself going bankrupt. Even in the case of a conventional bank being liquidated the depositors will be paid before the shareholders.

If an Islamic bank goes into liquidation the Investment account holder (IAH) will be on an equal footing with the shareholders.

2. Existence of the Sharia Supervisory Board (SSB)

As was referred to in earlier chapters Islamic banks are supervised by a Sharia Supervisory Board (SSB). The members of the SSB are appointed by the bank's shareholders. The main reason for establishing Islamic banks is to allow Muslims to conduct their financial transactions in accordance with Sharia precepts. In order to give credibility and to satisfy the ethical expectations of their customers, the majority of Islamic banks have developed a control process in the form of in-house religious advisors, commonly called the Sharia Supervisory Board (SSB). The membership of the SSB is drawn exclusively from very knowledgeable Sharia scholars.

Under Sharia Law lending to certain types of companies is prohibited (haram). As mentioned in Chapter two these activities include:

a) companies involved in the production or distribution of alcoholic liquor (such as breweries)
b) companies involved in gambling (such as casino related activities)
c) companies involved in the conventional financial services industry, including banks, securities houses and insurance groups
d) companies involved in the production and sale of armaments
e) companies active in the production of pork products and all non-halal food items;

Moreover Sharia advisers are reluctant to approve investments in hotel and leisure groups that derive substantial profits from bar sales, nightclubs and casinos. Mechanisms have been developed for cleansing smaller streams of revenue through charity donations. One example here would be in the case of airlines.

3. Asset Structure of an Islamic bank

Thirdly the assets of Islamic banks are different from those of conventional banks. Islamic Jurisprudence allows financial transactions that are associated with tangible 'real' assets as an alternative to the interest based 'financial' assets. The

effect of this is that the structure of assets of Islamic banks is totally different from that of interest based conventional banking.

REGULATORY ISSUES ASSOCIATED WITH ISLAMIC BANKING

Some Islamic banks offer both unrestricted and restricted investment accounts. Some banks specialize in retail banking operations and thus offer unrestricted investment accounts which are essentially retail savings products in which clients can park excess liquidity to earn a return. Other banks specialize more in wholesale banking operations and services to high net worth clients and offer restricted investment accounts to such clients. These are tailored to their investment objectives and risk appetite.

Given that regulatory regimes need to encompass all the different models of Islamic banking it is useful to distinguish between two groups of Islamic banks but still bearing in mind the paragraph above.

The first group commingles the IAH funds with their own funds and invests both sets of funds together. The financial outcomes of the investments are shared between the bank and the IAH, proportionate to their respective capital.

The second group of Islamic banks separate the funds of the IAH from the banks own funds. The investment of the IAH may be spread over different funds based on the risk appetite of the investor. In this instance, the bank maintains separate income statements and balance sheets for each fund.

What risks do Islamic Banks face which are different from those of Conventional Banks?

The supervision and regulation of Islamic banks has to take into account their special nature, whilst also subjecting them to the core principles issued by the Basel Committee. In applying capital adequacy regulations to Islamic banks it is essential to remember that finance extended by Islamic banks is asset backed. In other words it is connected to the value of tangible assets, buildings, machinery, aircraft, etc, which are subject to asset valuation volatility. This is quite apart from natural depreciation. Clearly this creates a problem for the provider of the funds in the event of the need to realize the assets. This is in addition to the possibility of the recipient of the funds also defaulting.

The current methodology for capital adequacy recommended by the Basel Committee, covers credit risk based on the assessment of counterparties and market risk based on the efficiency of the liquidation of financial assets. It does not, however, take into account the fact that Islamic bank transactions are asset backed.

In addition as is made clear by various AAOIFI pronouncements, the call on the capital of an Islamic bank can only be made when the bank acts with negligence or misconduct in managing the investment account holders funds.

There is another risk again referred to in various AAOIFI pronouncements, which is associated specifically with Islamic banks. Islamic banks find themselves under commercial pressure to pay a rate of return to its investment accounts holders which is lucrative enough to induce these investors to maintain their funds with the bank. If this return is higher than the rate which would be payable under the normal terms of the investment contract then the bank may be under pressure to forgo some of the share of its own profits to make up the rate thereby utilizing profits attributable to its shareholders (i.e. part of the Mudarib's share). Failure to do this may result in a large enough volume of withdrawals of funds by investors, which may jeopardize the banks commercial position and competitiveness. This risk is termed as 'displaced commercial risk'.

The above specific aspects and risks of Islamic banking means that they require a separate regulatory framework from that of conventional banking, when devising suitable capital adequacy criteria. The Bahrain Monetary Agency is the first country to adopt such criteria, discussed further below, with implementation having commenced from March 2002.

In applying the new regulations Islamic banks and financial institutions in Bahrain are required to adhere to all the pronouncements issued by the Sharia Board of AAOIFI.

THE REGULATION OF ISLAMIC BANKING IN BAHRAIN

As discussed earlier the Islamic banking industry has been growing at an increasing rate. Bahrain is at the heart of the Islamic banking industry growth and the BMA recognizes the importance of this industry to Bahrain and is fully committed to the growth and development of the industry. At the same time the BMA has a responsibility to ensure that Islamic banks are adequately regulated and supervised so as to maintain and enhance the confidence of the participants in the financial services industry, in their dealings with Islamic banks. With this in mind the BMA has developed what is known as a Prudential Information and Regulatory framework for Islamic banks (PIRI). The first set of returns applying the PIRI principles were submitted by March 2002.

The objective of PIRI is not only to provide an Islamic banking regulatory framework but also to use the information contained in the returns to monitor the operations of the banks and to help identify any signs of the deterioration of a banks performance.

The regulatory framework is monitored through the assessment of Capital Adequacy (C), Asset Quality (A), Management of Investment Accounts (M), Earnings Quality and Profit and Loss (E), and Liquidity Management (L). The acronym CAMEL will be familiar to bankers trained in the principles of conventional banking.

Capital Adequacy (C)

Islamic banks, like their conventional counterparts, are expected to maintain an adequate level of capital. The BMA, in line with the Basel Committee guidelines, has set this to be at 12%. To cater for the fiduciary and displaced commercial risk, associated with Islamic banking, the BMA has accepted the recommendations contained in the 'Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks' issued by The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The BMA, therefore, requires 50% of the risk-weighted assets of the Profit Sharing Investment Accounts to be included in the denominator of the Capital Adequacy Ratio.

The AAOIFI Statement on Capital Adequacy focuses on two main issues:

a) Investment Accounts are not liabilities, but are used to finance assets managed by the bank as Mudarib;

b) Whereas legally the bank's own capital is not exposed to the risk of the assets under management (except where they are attributable to the bank's misconduct or negligence), commercially the bank may be under pressure to absorb some of that risk in order to compete (displaced commercial risk). There is also the risk of misconduct or negligence and its implications for risk to the bank's own capital (fiduciary risk).

Asset Quality (A)

In line with conventional banks Islamic banks are expected to maintain assets which are of sound quality. Banks are also expected to have policies and procedures in place to ensure that any impairment of assets is identified in a timely manner and provisions are maintained to reflect such impairment. Furthermore the BMA has also laid down criteria for the banks in their monitoring and control of large exposures. Banks are required to notify the BMA where an exposure to a counterparty will be equal to or exceed 10% of the eligible capital base. Where the exposure will exceed 15%, prior approval of the BMA to accept the exposure is required.

Management of Investment Accounts (M)

It is the responsibility of the banks management to ensure that there are adequate policies and procedures in place to safeguard the interests of not only the shareholders of the bank but also those of the Profit Sharing Investment Account holders (PSIA). The BMA monitors the exposures and the related provisions through the regular returns made by the institutions. Financial Accounting Standard (FAS) No. 11, issued by AAOIFI, which covers the provisions and reserves recognition measurement and disclosure for Islamic banks, applies. Full disclosure of the bank's Profit Equalization and Investment Risk Reserve is required in accordance with the requirements of the standard.

Banks must agree a policy statement with the BMA as to the policies in place to safeguard the interest of the profit sharing investment account holders.

The policy statement must also include the profit allocation basis for making provisions and reserves and indicate to whom the banks revert to in the case of write-back or recovery. Furthermore the banks are not permitted to transfer funds from restricted investment accounts to corporate books (carrying self-financed assets and those financed by unrestricted investment accounts) without the prior approval of the BMA.

Figure (3.3) Islamic currency

Earnings Quality (E)

Maintaining a consistent level of quality earnings is essential for the long-term growth of a financial institution. Risks of economic losses, or losses as a result of poor investment decisions are readily apparent in the earnings trend of a bank. Economic losses not only would be reflected in the depreciation of the value of investment account holders wealth, but also in a bank's profitability. If not corrected in due course, such an economic downturn could threaten a bank's soundness.

The information required to be provided here to the BMA assists the BMA in assessing the soundness of any bank, through monitoring the trend of its earnings quality. The BMA requires disclosure of earnings based on the amounts received with a breakdown of the ageing of the accounts receivable. In addition to this a further breakdown of earnings is required, such as those of a banks earnings from the ten largest customers, related parties, and by geographical segments.

Liquidity (L)

Monitoring and controlling liquidity is one of the most critical responsibilities of bank management. Maturity transformations, e.g. taking short-term investments to make comparatively long-term investments may expose the bank to the risk that investment account holders demands for payment might outstrip its ability to transform assets into cash. It is of even greater importance in Islamic banks due to the interpretation of some Fuquha Sharia scholar that Mudarabah contracts are nonbinding in terms of maturity. The BMA requires banks to monitor their liquidity mismatch position for both corporate books (carrying self-financed assets and those financed by unrestricted investment accounts) and restricted investment account holders.

The BMA has laid down the criteria for reporting inflows and outflows from 0 to 6 months on a cash basis and from 6 months to 5 years on a maturity basis.

Furthermore, the BMA has set mismatch limits for the unrestricted investment accounts of 10% for the 0 - 8 days time band and 20% for the 8 days to 1-month band. The bank management is also required to agree a mismatch monitoring policy for the restricted investment accounts. However, on a consolidated basis, meaning for both corporate books (carrying self-financed assets and those financed by unrestricted investment accounts) and restricted investment accounts, the BMA has set a ceiling of 15% for the 0-8 days time band and 25% for the 8 days to 1 month time band.

Corporate Governance for Islamic Banks

Recently there has been a great deal of attention given to the issue of corporate governance in various national and international arenas. Effective corporate governance significantly influences the creation of quality assets. The BMA, in a circular dated 8 November 1999, emphasized the importance of creating the requisite infrastructure to institutionalize good governance. A paper on enhancing corporate governance in banks, published by the Basel Committee on Banking Supervision in September 1999, was attached, with the above mentioned BMA circular, to direct banks in this process.

The BMA believes that effective corporate governance can only be instituted if three fundamental steps are initiated:

a) Human resources – individuals with the required qualifications and necessary experience should be recruited for key positions such as the Managing Director and department heads.

b) Structural transparency - the organizational structure should be clearly delineated and reporting lines completely transparent in order to promote full disclosure. It is the General Managers responsibility to ensure that this occurs.

c) Proactive board of directors - the latter should be made responsible for appointing an effective Audit Committee and for overseeing the implementation of the necessary infrastructure in order to affect good corporate governance. It is imperative that the board's composition equips it with the ability to effectively discharge its responsibilities towards this end.

As part of on-going efforts to address supervisory issues the BMA is committed to foster effective banking supervision that would contribute to a collaborative working relationship between the management of Islamic bank and the BMA. To encourage sound corporate governance, the BMA requires Islamic banks to submit the following supplementary information:

• A statement of strategy and objectives for a minimum period of three years.

• Details of their organizational structure as approved by the board of directors, which notes the designations and responsibilities of its key management personnel, highlighting their qualifications and relevant industry experiences. New recruitment of key management require prior approval of the BMA and should be reported immediately. The bank must also have an independent Sharia Supervision Committee complying with the AAOIFI's Governance Standard for Islamic Financial Institutions No. 1: Sharia Supervisory Board: Appointment, Composition and Report, and No. 2: Sharia Review, as well as all other relevant standards issued in the future by AAOIFI.

Figure (3.4) The popular mosque in Bahrain (Al faith)

• Details of how they satisfy the BMA's requirement for maintaining an independent function for Risk Management and Internal Audit. The bank should also have separate independent functions with a Compliance Office and an internal Sharia review. The internal Sharia review should be carried out in accordance with AAOIFI's Governance Standard for Islamic Financial Institutions No. 3: Internal Sharia Review.

The first set of supplementary information was submitted to the BMA, along with the returns, in January 2002. Any changes to the information contained with the supplementary returns has to be reported to the BMA immediately. If no changes have occurred to the bank corporate governance structure, during the reporting period, the bank must include a statement to that effect with each of its quarterly returns.

In addition to the information submitted in the supplementary information, banks must comply with the BMA's circular SC/20/99 dated 28 September 1999 on Islamic Bank Transparency.

Conclusion:

Islamic banking is a very young concept. Yet it has already been implemented as the only system in two Muslim countries; there are Islamic banks in many Muslim countries, and a few in non-Muslim countries as well. Despite the successful acceptance there are problems. These problems are mainly in the area of financing.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. All the necessary ingredients are already there. The modified system will make use of only two forms of financing -- loans with a service charge and Mudaraba participatory financing -- both of which are fully accepted by all Muslim writers on the subject.

Such a system will offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist. Additionally, such a system will have no problem in obtaining authorization to operate in non-Muslim countries.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service that Islamic banks offer over and above the traditional services provided by conventional commercial banks.

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