Chapter Two: The evolution of the Islamic financial system

Professor Rodney Wilson,
University of Durham, Institute for Middle Eastern and Islamic Studies

Islamic finance has become a major global industry with over 300 institutions involved in both Muslim countries and international financial markets. Assets managed in accordance with the Islamic law are worth over $200 billion, including financing facilities made available by banks and investments by mutual funds that have been screened for *shariah* compliance.[1] Just three decades ago even the strongest advocates of Islamic finance could not have envisaged that such progress would have been possible in the context of an international financial system that was dominated by western interest based methods of financing.

Traditional Islamic financing

Mudarabah, an Islamic profit sharing alternative to interest based finance, had been used throughout the Islamic world between merchants and moneychangers since the time of the Prophet Mohammed. When western commercial banks were established in the Middle East, South and South East Asia in the nineteenth century however conventional financial instruments were used. European bankers were aware of Muslim views on *riba,* but much banking business involved the financing of colonial trade, that was usually in the hands of non-Muslims. Leading institutions such as the Ottoman Bank, the Eastern Bank or the National Bank of Egypt were largely British or French owned and managed.

Although Muslim owned banks were established in the 1920s and 1930s, such as Bank Misr of Egypt and the Arab Bank of Palestine, these institutions adopted the same practices as their European owned competitors and interest based dealings prevailed. It was only during the 1950s that a group of Pakistani economists and finance specialists sought to explore how traditional Islamic financing techniques could be used for modern commercial transactions. In 1958 a small rural co-operative bank was set up in West Pakistan, with a group of landlords depositing and obtaining funds on a *mudarabah* profit sharing basis.

Ahmad El Naggar, an Egyptian, instigated a similar independent experiment in Islamic banking in 1963 in the small delta town of Mit Ghamr. He established a savings bank that attracted over 10,000 depositors, with funds made available for agricultural investments. In many respects these institutions were early precursors of the Bank Grameen that expanded in Bangladesh following its independence from Pakistan in 1972. Such institutions can play an important role in the finance of smallholder farming

[1] The International Association of Islamic Banks estimated the assets of Islamic banks as $137 billion in 1996, which included all Iranian banks. Allowing for five percent per annum growth, a very conservative estimate, this figure becomes $174 billion for 2001. There are in addition the funds managed in accordance with the *sharia* law by conventional banks, possibly amounting to $20 billion and using *Islamic Banker* and fund reporting data around $6 billion in Islamic managed funds.

and handicrafts, but they are best classified as micro-financing institutions rather than commercial banks.

The Islamic Development Bank's role in promoting Islamic finance
Three factors were critical to the emergence of modern Islamic banking in the early 1970s, the first being the agreement by the finance ministers of the Organisation of the Islamic Conference in December 1973 to establish the Islamic Development Bank. (IDB) This started operations in Jeddah in 1975 following an inaugural meeting of its board of governors, who today represent more than fifty Muslim countries. The IDB is primarily a development assistance agency rather than a commercial bank, but one of its major roles has been to promote Islamic banking worldwide through its co-sponsorship with the Accounting Organisation for Islamic Financial Institutions (AAOIFI) of conferences, seminars and research.

The commitment of the governments of Muslim countries to the bank has been crucial for its success, as it has been involved in countries where initially there was much scepticism about the viability of Islamic finance. Today the paid-up capital of the IDB is almost $8 billion, and it has approved trade financing arrangements worth over $15 billion and project finance valued at more than $6.5 billion, as well as 340 technical assistance operations.

Almost one third of the trade financing by the IDB has been for oil imports, as one of the original aims of the new institution was to assist poorer Muslim countries without oil resources to pay for their essential imports, especially after the oil price rises of 1973-74. In recent years trade financing has involved a diverse range of commodities including industrial intermediate goods ($3.2 billion), vegetable oil ($900 million), refined petroleum products ($769 million), fertilisers, phosphoric acid and potash ($465 million), rice and wheat ($459 million) and cotton ($367 million). All these figures refer to cumulative financing over the 1975-1999 period.

Project finance has become increasingly important for the IDB in recent years, with much of the funding provided through leasing, (*ijara*) hire purchase (*ijara wa-iqtina*) and advance purchase financing, (*istisna*). Almost one third of project finance has been for public utilities such as power generation plants, electricity transmission, and water treatment and distribution facilities with over $1.5 billion used in this way over the 1995-1999 period. Social projects account for a further quarter of the total, including schools and hospitals, with around $1.2 billion disbursed over the 1995-1999 period. Other project funding over the same period was for transport and communications ($1 billion), industry ($850 million) and agriculture ($800 million).

The IDB has encouraged the governments of its member states to pass legislation to allow Islamic commercial banks to operate, and has advised about regulatory issues and the use of Islamic financial instruments. The IDB has also several schemes designed to support Islamic commercial banks, notably the Unit Investment Fund and the Islamic Banks Portfolio for Investment and Development. Under these schemes securities have been issued backed by the leasing and hire purchase assets (*ijarah muntahia*

bittamleek) of the IDB. These securities can then be purchased by Islamic commercial banks, which increased IDB funding, but at the same time means the banks have secure liquid assets that provide a modest return. Between $100 million and $200 million is raised in this way annually.

The spread of commercial Islamic banking
The second factor facilitating the development of modern Islamic banking was the oil price rises of 1973-74 that vastly increased the financial resources available to the Gulf countries. The Dubai Islamic Bank was founded in 1975, the Kuwait Finance House in 1977, the Bahrain Islamic Bank in 1981 and the Qatar Islamic Bank in 1983. Prince Mohammad Bin Faisal of Saudi Arabia founded the Faisal Islamic Banks of Egypt and the Sudan in 1977 and 1978 respectively. Another Saudi Arabian businessman, Sheikh Saleh Kamel, founded the Dallah Albaraka Group of Islamic banks that owns an investment company in London and banks in Algeria, Bahrain, Egypt, Jordan, Lebanon, South Africa, Sudan, Tunisia, Turkey and the Central Asian Republics.

In 1984 the Al Rajhi Banking and Investment Corporation decided to seek an Islamic banking licence. They were already the third largest financial group in Saudi Arabia, but wanted recognition as an Islamic financial institution. This was granted the following year, and Al Rajhi has become the world's largest Islamic commercial organisation with assets worth over $10 billion. Today Al Rajhi is the most profitable bank in Saudi Arabia, with 363 branches, 457 cash dispenser machines, the largest branch network in the kingdom, and 2,283 electronic point of sale facilities in retail establishments.

Other institutions have become equally successfully, with the Kuwait Finance House and the Qatar Islamic Bank accounting for over 20 percent of bank deposits in their respective markets. The Jordan Islamic Bank has 62 branches throughout the kingdom from Irbid in the north to Aqaba in the South, 695,000 account holders and over 1,400 employees.

Islamic banks have been extremely successful at the retail level, as they have a special customer appeal, by being able to satisfy financial needs, while at the same time assuring their clients that their transactions and assets are being undertaken in compliance with *shariah* law. Clients in most Muslim countries have a free choice whether to use conventional or Islamic banks, but large numbers have chosen the latter because of their religious convictions. The names and reputations of the scholars on the *shariah* boards seems to be one factor influencing client choice, especially initially when Islamic banks first open, but over time, as the banks have established reputations as solid financial institutions, name and brand image have become important.

An important advantage of Islamic banks is that they can encourage Muslims who avoid using conventional banks on religious grounds to use financial intermediation rather than relying on cash transactions. In other words savings can be mobilised and allocated productively which would otherwise not be the case. There is much evidence that this has happened, Jordan being a good example, as the Jordan Islamic Bank has many clients with

modest incomes who did not hitherto use banks. The Malaysian and Indonesian Islamic banks are also examples of this kind of operation, with large numbers of small retail depositors.

The contribution of Islamic scholars to financial innovation

The third factor promoting Islamic finance, indeed arguably the most crucial but insufficiently recognised, was the effort and vision of a number of Islamic scholars. The prohibition of *riba* is of course explicit in the Koran, as is the call for the lenient treatment of debtors, but how this should be applied to contemporary finance was much more a matter of debate. There was in particular the question of whether *riba,* an addition to a loan, constituted usury, excessive and exploitative interest, or any kind of interest. The consensus amongst Islamic economists from the 1960s was that it should be applied to all interest, which meant alternatives to interest based banking had to be found.

Baqir Al Sadr, an Iraqi scholar, made a notable contribution with a book on interest free banking in Islam that was first published in Kuwait in 1970 and later translated into Urdu. He distinguished between a client depositing money with a bank and the bank advancing funds to a client. Both transactions could be covered by *mudarabah,* with the depositor sharing in the bank's profits and the bank sharing in the profits of the enterprises it supported. The major practical problem with *mudarabah* was the asymmetrical nature of the risks involved. For the bank depositor the major risks were of bank failure and the uncertainty regarding the level of profits to be shared. With effective bank regulation the risk of bank failure was minimal however, and uncertainty even applies to variable interest returns, so this was unlikely to deter depositors, indeed it was the slight risk they took that justified their reward. The more serious problem with *mudarabah* arose with bank financing of business, as there was no guarantee that the bank could get their funds repaid. Furthermore the risk of getting no profits was considerable, especially with the type of small businesses that characterised many Muslim economies. There were also moral hazard problems, as businesses could potentially disguise the profits they made to minimise the profits shared, especially where full audits were not required.

Islamic financial engineering and diversification of financing methods

Sami Homoud, a Jordanian scholar, addressed the issue of asymmetric risk in the early 1970s. He believed that *murabahah,* or mark-up trade financing, could play an important role in an Islamic banking system. *Murabahah* is much less risky than *mudarabah* as the mark-up is agreed in advance between the bank and the trader, and the period until the trader has to repay the bank is also stipulated at the outset. There are still asset price and credit risks associated with *murabahah.* The asset price risk is that the purchaser may not take delivery at the due date for execution of the contract. The credit risk is that the client takes delivery, but then defaults on payment. It is these risks that justify the mark-up the bank charges. According to the Maliki School of Islamic jurisprudence it is also legitimate for the bank to add to the mark-up to cover its legitimate expenses involved in the trade transactions.

Islamic economists welcomed the spread of Islamic banking, but there was criticism of the banks' excessive reliance on short-term *murabahah* financing. There was relatively little long term funding of projects that might contribute more to development and a lack of partnership financing. To counter these criticisms many Islamic banks, having built up confidence through *murabahah,* were prepared to offer their clients longer-term finance, usually through *ijarah,* which was a leasing contract, or in some cases through *ijarah muntahia bittamleek,* a hire purchase contract. This became popular in the 1980s and remains important. Such financing applied to purchases of major items of capital equipment, where the goods themselves served as collateral, and the payment was by instalment, usually monthly or quarterly, up to a period of 5 years.

Where projects were financed, *istisna'* was used, whereby the bank made advances which could enable suppliers to be paid at each stage of the project. This method was strongly supported by one of the leading Islamic economists, Muhammad Anas Zarqa, a Syrian scholar, who believed it was suitable for the financing of large-scale infrastructure developments.

Although there was diversification in the methods of Islamic financing used in the 1980s and 1990s, *musharakah,* where the bank forms a partnership with an entrepreneur, was little used, as it was deemed too risky. The Jordan Islamic Bank has a *musharakah* scheme for new Jordanian entrepreneurs needing start-up capital, although this is classified as one of its social projects rather than a commercial facility.

Islamic banks which received most their funds through current account deposits, on which no return was payable, were often accused of accepting free money and making profits for themselves out of virtually risk free operations. Questions were still asked if Islamic banking was different only in the legal designation of the financing instruments used or if it really was a real alternative to conventional banking.

Similar criticisms were also made of the Islamic investment fund movement that emerged in the 1980s and 1990s. These funds were criticised for investing mostly in the West rather than in the emerging stock markets of Muslim countries, with investment decisions influenced largely by risk assessment rather than any notion of Islamic solidarity. Nevertheless those who manage the funds see parallels with the western ethical finance movement, as although the criteria for acceptable investments differ from what is *halal* under *shariah* law, there has been much scope for a cross fertilisation of ideas over managerial practices.

Widening the range of products to compete successfully

After the initial period of expansion many of the Islamic banks adopted a two-fold strategy to expand their market share and attract further customers. The first was to widen the range of services on offer, so that their clients could use Islamic banks for all their financing needs, rather than regarding them as savings institutions, while maintaining current accounts with conventional banks, and relying on money brokers for the international transfers of funds.

Some of the largest Islamic financial institutions, notably the Al Rajhi Banking and Investment Corporation, provided extensive foreign exchange services at competitive rates, but others were more expensive and bureaucratic with respect to such business.

From the 1980s Islamic retail banks expanded their personal financing facilities, with for example the Kuwait Finance House offering a car purchase scheme. As state financed housing banks and real estate development funds could no longer meet the demand for housing loans in most Arab countries, Islamic banks expanded into this area, with houses being purchased on behalf of clients who repaid the bank through rental payments related to the initial value of the property. Islamic banks also provided additional transactions instruments, with the Kuwait Finance House for example offering a debit card to current account holders that was accepted internationally in retail outlets taking Visa payments.

Competition has increased in recent years for Islamic banks, especially in retail markets. During the 1970s and 1980s Islamic banks had to compete with conventional banks, but there was only one Islamic bank in most national markets. While they could not behave like monopolies, clients who wished to manage their finances in accordance with the *shariah* law had little or no choice in their service providers. The Jordan Islamic Bank enjoyed a virtual monopoly in Jordan and the Kuwait Finance House was the sole provider of Islamic finance in Kuwait. In Saudi Arabia Al Rajhi had a virtual monopoly of Islamic banking services from 1985 and in Malaysia Bank Islam Malaysia was in a similar position from 1984 onwards.

By the 1990s however competition was increasing for Islamic banking services, especially as conventional banks started to open Islamic “windows” and then dedicated Islamic branches. Even those who did not offer Islamic investment accounts and financing started to offer Islamic managed funds to their conventional clients. In Egypt for example, where the privately owned Faisal Islamic Bank was the major Islamic finance provider in the local market, the major state owned banks started to offer Islamic deposit facilities. Banks involved included Bank Misr and the National Bank of Egypt. In Saudi Arabia the National Commercial Bank offered a range of Islamic mutual funds that were subject to screening for *shariah* compliance.

Elsewhere, new Islamic banks opened to provide even greater competition. For example, in 1990 the Qatar International Islamic Bank joined the Qatar Islamic Bank. The latter had enjoyed a virtual local monopoly from 1983, and had captured almost a fifth of all deposits in the years after its establishment. In the United Arab Emirates, the Dubai Islamic Bank, the first Islamic institution established in the Gulf in 1975, faced competition from the Abu Dhabi Islamic Bank from 1997. Although the latter was originally focused on Abu Dhabi, it soon opened a Dubai branch. In Kuwait the Kuwait Finance House has continued to enjoy a monopoly of retail Islamic banking services, but The International Investor competes in fund management and investment banking services.

The pioneering Malaysian market
Malaysia has in many respects seen the most ambitious development of Islamic banking in terms of the range of products offered. The Central Bank, Bank Negara Malaysia, is committed to encouraging the development of the Islamic finance industry, and has developed instruments and assets that have facilitated the industry's expansion. Bank Islam Malaysia Berhad was the first institution to be established under the Islamic Banking Act of 1983. On 17th January 1992 it was sufficiently strong to be floated on the Kuala Lumpur Stock Exchange. By 2000 it had a paid up capital of $244 million, and total assets of almost $1.8 billion, making it the fourth largest Islamic financial banking institution globally. It had a network of 80 branches throughout Malaysia with 1,200 employees.

In order to encourage the expansion of Islamic banking in Malaysia and increase competition in the market, the central bank, Bank Negara, decided in 1992 that existing conventional banks would be permitted to offer Islamic products. On 4th March 1993 the *Skim Perbankan Tanpa Fardh* (SPTF) interest free banking scheme was introduced, with 14 commercial banks, 10 finance companies, 5 merchant banks and 7 discount houses participating in the scheme. Some of the largest financial institutions in Malaysia became involved including the local offices of multinational banks such as HSBC Bank Malaysia Berhad, Standard Chartered Bank and Citibank. Leading local institutions opening Islamic counters included Hong Leong Bank Berhad, Malaysian Banking Berhad, RHB Bank Berhad and Southern Bank Berhad.

The regulations governing Islamic financing operations were developed and refined by Bank Negara in 1996 and 1997 acting in its capacity as central bank. In October 1996 a model financial statement was issued for banks participating in the interest free banking scheme that required disclosure of Islamic banking operations as an additional note to the annual accounts. The balance sheet and profit and loss account had to quantify the extent of Islamic banking operations such as *mudharabah, musharakah, , ijarah*, *istisna* and *bai bithaman ajil.* The latter is similar to *murabahah,* as it involves the sale of goods on a deferred payments basis. It is a particularly popular Islamic financing instrument in Malaysia.

These disclosure regulations increased confidence in Islamic banking in Malaysia, which was to prove important in view of subsequent financial developments. Bank Islam Malaysia Berhad comfortably weathered the Asian financial crisis in 1997, increasing the confidence of the authorities in Islamic banking. Following that crisis there was a re-organisation of many of the conventional banks in Malaysia. Bank Bumiputra Malaysia Berhad was merged with the Bank of Commerce (Malaysia) Berhad. A new Islamic financial institution was created, Bank Muamalat Malaysia Berhad, which commenced operations on 1st October 1999. It was given the Islamic financial assets of the major Malaysian commercial banks, and it inherited a network of 40 branches and 1000 staff.

Development of Islamic securities markets
An Islamic securities market makes liquid asset holding more profitable for Islamic banks and reduces reliance on inter bank deposits. As Islamic banks cannot hold short-term interest yielding assets such as treasury bills because of the prohibition of interest under the *Shariah* Islamic law, they have always had a problem in profitably managing their liquidity.

The first attempt to overcome this problem was taken by Bank Negara Malaysia in July 1983 after the first Islamic bank in Malaysia began operations, as it was realised that Bank Islam Malaysia could not hold government securities or treasury bills which paid interest. Therefore non-interest bearing paper was issued, Government Investment Certificates and Government Investment Issues. Bank Islam Malaysia could acquire these certificates, which represented a beneficial loan (*Qard Hassan*) to the government. There was no pre-determined rate of interest on these securities, rather instead the rate of return would be declared by the government at its "absolute discretion". A dividend committee was established to regularly declare the rates, the committee comprising representatives of the Ministry of Finance, Bank Negara, the Economic Planning Unit and the Religious Affairs Section of the Prime Minister's Office. There was no fixed formula for determining the rate of return, the stress being on qualitative rather than purely quantitative considerations. Those setting the return considered a range of indicators including macroeconomic conditions, the inflation rate and the yield for similar instruments.

Following the decision in Malaysia to allow conventional banks to accept Islamic deposits and offer Islamic financing facilities, Bank Negara recognised that these developments would be helped if an inter-bank money market could be established. On the 18th December 1993 guidelines were therefore issued on how a new Islamic inter-bank money market would operate. The market was opened on 3rd January 1994 in Kuala Lumpur, its main functions being to facilitate inter-bank trading of Islamic financial instruments, notably *mudharabah* interbank investments (MII). The MII scheme provides a mechanism whereby a deficit Islamic banking institution (the investee bank) can obtain funds from a surplus Islamic financial institution (the investor bank) by issuing a *mudharabah* certificate for a fixed period of investment ranging from overnight to 12 months.

The investor bank in the MII scheme does not know in advance what the actual profit will be, as it depends on the gross profit of the investee bank. The profit sharing ratio is however agreed in advance, and the principal is repaid at the end of the loan period. To increase certainty further Bank Negara introduced a minimum benchmark rate on February 2nd 1996, which is the prevailing rate on Malaysian government investment issues plus a spread of 0.5 percent. Investee banks are not obliged to declare profit shares based on this benchmark, rather it is a guide to investor banks to the sort of return they can reasonably expect, and therefore can be taken into account in the negotiations on the profit sharing ratio.

On June 13th 2001 the Bahrain Monetary Agency offered for the first time in the Gulf government bills that were structured to comply with the *shariah* Islamic law. The bills were worth $25 million, and were in the form of three-month paper, referred to as *Sukuk Salam* securities. Although the Malaysian government has offered Islamic bonds since the 1980s as already indicated, governments in the Gulf have been forced to borrow in international markets rather than locally because of Islamic objections to trading in debt and interest based securities. Governments have issued paper that the local commercial banks have held to maturity, but not traded. This however restricts the liquidity of bank assets, and makes it more difficult for the government to raise finance directly from the public.

With its new *Sukuk Salam* Securities Bahrain has overcome this problem, by providing a fixed return, equivalent to 3.95 percent at an annualised rate, for the first Islamic bill issue, which is not based on interest. The return has been calculated in relation to the real benefit the government expects to obtain on the funds, rather than with reference to market interest rates. The first securities matured on September 12th, and a new issue was launched, a process that will be repeated every three months.

The success of the Bahrain market

The establishment of the Islamic money market in Bahrain will, it is hoped, result in the emergence of markets in longer tern Islamic securities, notably bonds, with Bahrain playing a similar role in the Gulf and West Asia to that of Kuala Lumpur in South East Asia. So far prospects look encouraging, as the initial offer of bills in June worth $25 billion was oversubscribed, with almost $60 million being offered. The minimum subscription was fixed at $10,000, which meant that relatively small financing houses could participate, as well as private investors seeking a non-banking home for their dollar denominated liquidity. The same minimum subscription limit was set for the longer-term *ijara* leasing securities worth $100 million that were offered in August. These were issued on 4th September 2001 and will mature in five years time. They offer a rental return of 5.25 percent per annum, guaranteed by the government of Bahrain.

Bahrain hosts the *High Council for Islamic Banking* that has taken over from the Jeddah based International Association of Islamic Banks. The Islamic Development Bank spearheaded the establishment of the Council, and its membership of Islamic banks is growing rapidly. The Islamic Development Bank has also chosen to locate its Infrastructure Fund in Bahrain because of the island's position as an Islamic financial centre. The Infrastructure Fund is a private equity fund that is being managed by the Emerging Markets Partnership of Bahrain. The Islamic Development Bank has agreed to set up an International Islamic Rating Agency that will be located on the island. This agency will rate Islamic securities that should help ensure their international acceptability. Islamic and conventional banks that purchase and hold such securities will have a clear indication of the risks involved. This should enable them to compare risks versus returns for different categories of Islamic securities, increasing transparency and the potential efficiency of the market.

Establishment of national Islamic banking systems

In most Muslim countries Islamic banks have been established alongside existing conventional banks so that there is a choice of financing methods, with those who wish to manage their affairs in compliance with *shariah* law able to do so, but no obligation on all bank clients to follow this example. Two Muslim countries have introduced more comprehensive Islamic legislation however with the ambitious aim of ensuring that all domestic financial transactions comply with the *shariah*. The two countries are Iran and the Sudan, with Pakistan also planning to Islamise its entire financial systems.

In Iran's case in the aftermath of the Islamic revolution of 1979 there was an ambitious plan to apply the *shariah* law in the financial sphere, but the revolution itself undermined the stability of the existing banks, resulting in the state taking over control in order to maintain depositor confidence rather than because of ideology. Once a degree of stability was re-established, the state drafted Islamic banking legislation, and following consultation with those in the industry, the government implemented Islamic banking legislation in 1983. All banking operations were henceforth to be conducted in accordance with Islamic law, with no interest based transactions permitted. Deposits were accepted on a *wakala* basis, and financing was provided through *murabahah* mark-up trade finance, leasing and beneficial loans. Transactions with foreign banks outside Iran were still conducted on the basis of interest but this was seen as a necessary pragmatic approach forced on the authorities because of international circumstances beyond their control. Open market operations involving the central bank and the commercial banks were also conducted using discount rates as a proxy for interest, but this was viewed as a technical issue, rather than a practice that would have any implications for practising Muslim clients of the banks.

Difficult economic conditions prevailed in Iran in the period after the Islamic banking law was passed in 1983, as there was a continuing decline in oil prices and disruption to oil production, and most other industrial sectors of the economy, as a result of the war with Iraq. The adoption of Islamic operations did not appear to be a handicap for the major banks, as they survived the economic recession and continued financing business, although the level of deposits and financing was depressed. Bank Melli continued as the dominant Iranian bank, with Bank Mellat, Bank Saderat and Bank Tejarat as the major second tier banks, although Bank Sepah, the smallest of the banks, expanded its share of deposits. Bank Sepah is the only bank in Iran to have a *shariah* board and *shariah* advisors, but most of its financing is for real estate. In contrast Bank Melli is mostly involved in trade and industrial financing, but although its assets exceed $20 billion, twice the size of the largest Arab Islamic Bank, the Al Rajhi Banking and Investment Corporation, many observers outside Iran have doubts about its Islamic banking credentials. Deposits are placed on a *wakala* basis, the returns being set by Bank Markazi, the Central Bank. Around 11 percent of financing involves *musharakah* and 6 percent leasing. There is no *murabahah* financing however, but much of its trade financing is nevertheless different from that offered by conventional banks. Iran's banks have been nationalised since the revolution, but there are now plans to privatise, starting with Bank Saderat.

There are already two recently established private Islamic banks in Iran, Bank Karafa and Bank Eqtesad-e-Novine or Modern Economic Bank, both of which function more like the Islamic banks on the Arab side of the Gulf rather than as Iran's state owned banks.

Islamic finance in Pakistan

The experience of Islamic banking in Pakistan has also been a disappointment to many advocates of *shariah* compliant financing, as although many of the most distinguished Islamic economists are of Pakistani origin, the implementation of religious law in the financial field has become embroiled with the country's complex politics. The Islamisation of banking has been discussed since the 1960s and the prohibition of *riba* was even written into the 1973 constitution, but ironically it was only when the constitution was suspended in 1978, following General Zia's *coup d'état,* that any real progress was made. General Zia commissioned the Council of Islamic Ideology to write a report on the elimination of interest from the economy, and as a result of their recommendation that *modaraba* certificates could operate as a viable alternative to debt finance, several institutions decided to offer Islamic financial services. (*Mudaraba* is transliterated as *modaraba* in Pakistan.) These included the House Building Finance Corporation, the Investment Corporation of Pakistan and the National Investment Trust, which changed all their transactions from 1979 to conform with the *Shariah* law. In addition a new company was founded, Bankers Equity Limited, which provided only Islamic financial products. From January 1981 all banks in Pakistan offered Islamic banking "windows" as an alternative to conventional finance, and by 15th July 1985 all new bank deposits were to be accepted only on an interest free *modaraba* basis. This was never implemented due to the death of General Zia and subsequent political developments.

The progress made in the Zia years was not sustained during the Butto years, as although the Pakistani Peoples Party did not attack Islamisation directly, it stifled the business sector and much private economic activity, which made it difficult to generate the profits to sustain the Islamic profit and loss sharing operations. Furthermore corruption, always a problem in Pakistan, became endemic, with businesses having to make illegal payments to politicians, political parties and bureaucrats if they were to stand any chance of winning government contracts or speed up import clearance. The Butto administration was not entirely responsible for these developments, but they must bear some responsibility. With the overthrow of the Butto government in 1996 and the election of Nawaz Sharif more progress was hoped for, especially as the International Institute of Islamic Economics in Islamabad was invited to produce a blueprint for an Islamic financial system in the country and the elimination of *riba*. This was written under the chairmanship of Sayid Tahir and published in 1999. On December 23rd of that year, the Supreme Court, under Justice Khalil-ur-Rahman, recommended that that the system should be implemented by 30th June 2001. The government of General Musharraf was cautious over this ruling, as there was opposition to its implementation by conventional bankers, notably from those in the United Bank. They argued for a five-year delay in implementing the law on *riba* free banking until December

31st 2005, but the Supreme Court has only authorised a one-year delay until 30th June 2002.

The most interesting experiment in Pakistan involved the *Modaraba* Companies and *Modaraba* Control Ordinance of 1980. The legislation provided for the establishment of multipurpose *modaraba* companies with a minimum capital of Rupees 7.5 million or single purpose *modaraba* companies with a minimum capital of Rupees 5 million. The companies were not allowed to participate in any activity that conflicted with the *shariah* law, but they could distribute dividends and make rights issues like any other company. Management charges were limited to 10 per cent of total annual profits. The *modarib* (manager or agent in the Pakistani case) must contribute at least 10 per cent of the capital, the remainder coming from the *rab al-maal* as financier, with the provision that not more than 50 per cent of the sponsoring directors of the companies should be from the same family.

Apart from their Islamic character of the *modaraba* companies, the main attraction for founding the companies was the tax exemptions granted. No companies tax was payable for the first 3 years of operation, and for the following 2 years only half the full rate of 25 per cent was payable. Although the *modaraba* companies got off to a slow start, with only 2 founded in 1985 and a further 2 in 1987, by 1991 there were 30 companies. This was the peak year for their establishment, with 15 *modaraba* companies founded. By 1995 there were 52 companies, but there have been no new companies set up since then, reflecting the recession in Pakistan and the depressed state of the stock market. By November 2001 only 37 remained active, but approval is being sought from the Religious Board of Pakistan and the Securities Commission to allow *modaraba* companies to issue Islamic term finance certificates that will be comparable to the Islamic bonds issued in Malaysia. If permission is granted, this should help revive the *modaraba* companies.

Islamic banking in the Sudan

The Faisal Bank of Sudan was licensed by the government of President Nimeiri to operate from 1978 on terms which were very similar to those granted to the Faisal Islamic Bank to operate in Egypt the previous year. The bank's expansion was rapid, and it soon became the second largest bank in the country, especially as it had close ties with Hassan al-Turabi, the head of the National Islamic Front. A rival group of businessmen associated with the Khatmiya, a sufi sect with widespread support from those with small trading businesses, established the Sudanese Islamic Bank in 1982. The following year the Tadamon Islamic Bank opened, an institution that was to become one of the most successful banks in the country, with a network of 22 branches by 1999. Given the popularity of these new institutions President Nimeri decided in 1983 to pass comprehensive Islamic banking laws, converting the entire financial system to Islamic banking methods. Consequently all the banks moved to accepting deposits on a *mudarabah* basis, and conducted financing through *murabahah* and *musharakah*, and to a lesser extent through *ijara*. All the banks also established *shariah* committees, which was preferable to the situation in Iran in the view of most Islamic scholars.

By the 1990s there were 25 banks providing Islamic financing in the Sudan the largest institution being the state owned Agricultural Bank and the second a former conventional institution, the Omdurman National Bank. The Sudanese Islamic Bank and the Faisal Bank had become relatively small players in the local market for financial services, although the Tadamon Islamic Bank had grown relatively. All of the banks would have grown more if the Sudanese economy had performed better, but the country has suffered from civil strife, relatively high levels of military expenditure, drought, heavy external indebtedness and sanctions imposed by the United States. The economy has improved since 1996 however, with an end to the drought and increased agricultural production. Gross domestic product growth has averaged 5.5 percent, and inflation has fallen from 133 percent to 16 percent. Economic conditions are much better than for many years to facilitate the expansion of Islamic finance. The Bank of Sudan, the central bank, has issued with the help of the International Monetary Fund, Islamic government certificates, which are used for liquidity management purposes.

The future of Islamic banking

The number of major multinational banks offering Islamic financing facilities demonstrates the viability of Islamic finance. HSBC, ABN-AMRO, Deutsche Bank, Citibank and Arab multinationals such as the Arab Banking Corporation all offer Islamic financing products. Their financial resources and brand strength helps ensure that Islamic finance becomes better known to the global financial community. At the same time this competition poses a challenge to the dedicated Islamic banks, with fewer resources and more limited global reach.

The consequence has been a series of mergers, such as that between the Faisal Islamic Bank of Bahrain and the Islamic Investment Company of the Gulf, and the subsequent creation of the Shamil Bank, a much larger institution. The International Investor of Kuwait, headed by Adnan Al Bahar, and the Dallah Albaraka Group, headed by Sheikh Saleh Kamel, agreed to merge their operations as part of a $300 million deal. The Investment Banking expertise of the International Investor combined with the retail reach of Dallah Albaraka should create a formidable new force in the industry. There is little doubt that with its loyal customer base and track record of providing profitable financial products, the Islamic banking industry is well positioned to weather the present downturn in global markets, and take advantage of the upturn when it arrives.

In increasingly global financial markets, Islamic banking can increase its credibility by introducing common reporting standards. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established in 1991 to prepare and issue auditing, good governance, ethical and *shariah* standards, as well as *shariah* rules for investment and financing instruments. The Bahrain Monetary Agency and the Central Bank of Sudan require all Islamic banks under their jurisdiction to meet these standards, and Islamic banks elsewhere comply voluntarily with the AAOIFI standards, often because their *shariah* advisors sit on the AAOIFI board. In 2000 the Saudi

Arabian Monetary Agency told Islamic banks and Islamic subsidiaries of conventional banks operating in the Kingdom to use AAOIFI standards. To date AAOIFI has issues eighteen accounting standards, four auditing standards, four governance standards, five *shariah* standards and four *shariah* rules, in addition to a code of ethics. Increasing convergence in Islamic financial practice will undoubtedly increase client confidence in the industry and facilitate inter-bank transactions between *shariah* compliant institutions.