FINANCING INTERNATIONAL TRADE: AN ISLAMIC ALTERNATIVE

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INTRODUCTION*

With three decades of experience of Islamic banking and finance, the Islamic financing institutions have developed several modes that can be instrumental in increasing their market share in financing international trade especially trade between Islamic countries.

The 1995 figures show that the exports of 52 Muslim countries were about US$ billion 340 (including the 12 oil-exporting countries). This is less than 7% of the world exports.[1] Imports are US$ billion 350 which is also about 7% of the world imports. Of these totals the inter-Muslim countries' trade doesn't exceed 10%.[2] Comparing these figures with the abilities of Islamic banks enables us to easily conclude that the existing Islamic banks have a great potentiality to finance all inter Muslim countries' trade (less than US$ billion 70) as well as a great deal of their trade relations with the rest of the world. Consequently, if their actual share is below such amounts, there must be some laxity on their ability to compete with the other financial institutions !

This paper will therefore look into this problem and try to find out its main causes.

The first hypothesis of this paper will thus be that the principles of Islamic finance are able to be applied in such a way that can respond to all the needs of international trade financing. These principles bring new and direly needed dimension in the international financing market. This hypothesis will be discussed in the first three sections of this paper under the titles of basic foundations of Islamic

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* This paper is partially derived from my paper on "Islamic Banks at the Threshold of the Third Millennium" forthcoming in Thunderbird International Business Review, Special Issue of Islamic Banking.

[1] IDB Statistical Monograph No.17, October 1997.

[2] Ibid.

finance, emergence of Islamic banks and the salient characteristics of Islamic finance respectively. Section four will be devoted to discussing the Islamic modes of financing that suit international trade. Finally, in section five, we shall discuss the main challenges faced by Islamic banks in the process of international trade financing.

SECTION I

BASIC FOUNDATIONS OF ISLAMIC FINANCE

The basic principles of Islamic finance originate from two axioms: justice, and harmony with reality and the human nature.

Islamic financing falls in the center of the most genuine, simple and plain definition of financing, that it is the provision of factors of production, goods and services without requiring an immediate counterpart to be paid by the recipient. Islamic financing is merely a name for providing factors of production, goods and services for which payment is deferred. This definition of financing, or Islamic financing, shows its central place in the exchange and production processes; as they depend on the provision of goods to consumers and the provision of equipment, materials and other means of production to producers.

The forms of Islamic financing are also based on the principle of justice. In profit sharing, both parties share the real and actual results or output of a productive project without throwing the risk burden on one side while relieving the other. When financing is done on the basis of sale principle, the financier carries the kind of risk associated with owning goods and providing them to users. In both the cases, fair play of market forces determines the rate of distribution of profit between the financier and the beneficiary.

As the Islamic system assigns to private property a corner-stone role in its socio-economic order, the owner has a full right to the increase, growth, benefit and profit that results from one's property. This is the basis of financing in Islam. While the effect of this right is obvious in deserving profit in sale financing, the case of profit sharing may not be so clear. If a property is entrusted to someone else, through financing, it is still owned by the financier, but the user's efforts that contribute to generating growth and profit must be recognized. This is done by distributing the result or actual outcome, of such cooperation, between the two parties.

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

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

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

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

While essential in Islamic financing, direct investment does not seem to be favored by traditional banks. Quoting a recent article in the World Bank Research Observer.

> *"In the absence of full information, banks tend to allocate credit to firms with reliable track records or available internal funds, even if other firms present better investment opportunities. Financial intermediaries … can acquire information that is superior to that of outsiders by developing and maintaining close long-term relationships with their customers. They can play an important role in screening projects, monitoring behavior and outcomes, and managing corporate distress. (However,) In many countries, commercial banks favor lending for low-risk activities. They are generally less willing to finance high-risk projects with long payback periods, even if these projects may yield higher overall returns. They are generally also reluctant to finance small firms that lack adequate collateral, even though such firms may be more innovative and promising than others."*[3]

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

SECTION II
EMERGENCE OF ISLAMIC BANKS

A quick reading of Islamic history tells us that practices of certain forms of banking activities go back as early as 1200 years ago in Baghdad, Damascus, Fez and Cordoba. Deposits in current accounts and use of checks were known in these Muslim cities at that early date.[4] Mudarabah was a major mode of financing not only the Mediterranean trade but also trades between Indians and Scandinavians through Arab Caravans. Inter-city transfers between traders on the two sides of the Mediterranean was a common practice by means of intermediary depositories in Alexandria, Tanjir and Genova.

However, the early contemporary Islamic banking institutions came in the first part of 1960s with the Pilgrims Funds (1962) in Malaysia and the Myt Ghamr Saving Bank (1963) in Egypt. In 1974 the Islamic Development Bank was formally established with a capital of 2.0 billion Islamic Dinar (=SDR); and it started operation in mid 1976. The Dubai Islamic Bank in the United Arab Emirates was established in 1974. The number of Islamic banks and financial institutions have increased to 177 by the end of 1997.

On this kind of growth, the Wall Street Journal comments that if its present rate of growth continues, within ten years they are expected to handle around 40 to 50 percent of total savings of the Muslim world.[5] This, of course, does not include the Islamic windows and branches of traditional banks in several European and American banks as well as in many traditional banks in the Muslim countries.

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[4] In fact, the word check itself has its root in the Arabic word "cek صك ", which means record of transaction. It may also have come from Persian. (See: the Shorter Oxford Dic. on Historical Principles, V.I.)
[5] Special supplement on Islamic banking, Wall Street Journal, April 9, 1996.

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

Out of the 177 Islamic banks and financial institutions registered with the International Association of Islamic banks (1997), 51 are in South Asia, 36 in Africa, 31 in South East Asia, 37 in the Middle East, 112 in Europe, Central Asia, Australia and America. Growthwise, over the ten-year period of 1985-1995, the number of Islamic banks and financial institutions have gone up 6 and half times.

The financial indicators in table 1 show that in 1997, the total capital of the 177 banks is slightly above US$ billion 7.3 , their total assets reached US$ billion147 , total deposits surpassed the amount of US$ billion 112 , reserves are around US$ billion 3 , and net profits reached nearly US$ one and a quarter billion (=17% of shareholders' equities).

Table 1 : Islamic Banking and Financial Institutions : Summary of Financial Highlights, 1997

US$ '000' S

REGION	No.of banks*		CAPITAL		TOTAL ASSETS		DEPOSITS		RESERVES		NET PROFIT	
	No.	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
South Asia	51	29	884,048	12	39,272,976	27	25,664,913	23	1,077,163	35	249,792	20
Africa	36	20	204,197	3	1,574,346	1	730,025	1	82,087	3	19,785	2
South East Asia	31	18	149,837	2	2,332,204	1.5	1,887,710	2	160,136	5	45,659	4
Middle East	37	27	5,471,531	75	103,585,737	70	83,165,024	73	1,735,453	56	855,827	69
Europe, America & Australia	10	6	622,014	8	914,512	0.5	1,139,541	1	20,663	1	66,931	5
Central Asia	2	1	3,452	0	5,727	0	2,563	0	24	0	282	0
TOTAL	*177*	*100*	*7,335,079*	*100*	*147,685,502*	*100*	*112,589,776*	*100*	*3,075,526*	*100*	*1,238,276*	*100*

Source : International Association of Islamic Banks
* IDB is not included.

From this table, we also notice that the relative significance of the respective regions in terms of capital, assets and deposits is respectively 75%, 70% and 73% for the Middle East, 12%, 27% and 23% for South Asia and finally 13%, 3% and 4% for all the rest.

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

Table 2 : Islamic Banks and Financial Institutions Financing by Sectors/Regions- (1996)

Percent

Region	Trading	Agricul.	Industry	Services	Rl. Estate	Others
S. Asia	13.68	8.69	48.26	9.79	2.00	17.58
Africa	29.91	19.56	17.04	8.02	5.79	19.68
S.E. Asia	45.13	5.54	6.30	24.26	2.53	16.24
Middle East	27.50	9.85	28.80	5.00	21.95	6.90
G.C.C.	38.30	0.30	11.50	10.60	21.30	18.00
Europe/America	32.60	0.60	1.31	21.54	16.74	27.21
Accumulated Average	**31.17**	**7.50**	**18.82**	**13.17**	**11.67**	**17.67**

On the average, about 31% of the funds were allocated to trade, 19% to industry, 13% to the services, 12% to real estate and 25% to the agriculture and others. Since, the amount of financing given by the Islamic banks, is not available, we may use total assets as a proxy and deduct that if the average finance maturity in one year, the Islamic banks can provide financing to the amount of US$ billion 147, and their trade financing is 147X31% = 45. In other words, if all trade financing relates to exports and imports[6], the Islamic banks cover about two thirds of the inter-Muslim countries trade.

[6] This is not an intolerable assumption since most of trade in the Muslim countries is external. Also, most of financing to industry, construction and agriculture in actually for imported inputs!

SECTION III
SALIENT CHARACTERISTICS OF ISLAMIC FINANCE

An Islamic bank is a full-service intermediary financial institution that abides by the Islamic law. However, some writers like to see in Islamic banks more than a financial institution. This is not true. In a recent paper, Kuran (1997) said, "Islamic banking defies the separation between economics and religion. It invokes religious authority in a domain that modern civilization has secularized." One must know the difference between Shari'ah, as a law, and religion. The only authority exercised on Islamic banks is that of their respective boards of directors and the supervision of central banks.

The commitment of Islamic finance to abide by the Islamic law determines its main characteristics. This commitment is manifested in redefining its modes of operation and relationships between the financial intermediary on one hand, and the suppliers and users of funds on the other hand, in order to make them compatible with Shari'ah.

The actual practice of Islamic banking over the past three decades and the rise of Islamic banks as a new species of banks reveal three innovations in the banking traditions: (1) a new kind of relationship between banks and depositors, (2) integration of financial and real market in financing, and (3) incorporation of ethics and moral values in investment and financing decisions.

Relations with Depositors

Since the early practices of the money exchangers in the 15th century and over the past five centuries, the relationship between depositors and bankers has been based on a lending contract. The interest paid by bankers represent the cost of money that is made available for utilization and placement by the banks. By virtue of the same lending contract, the return of depositors is determined at the time of making the deposit. Islamic banks have drastically changed the nature of this contract. The new relationship is based on a partnership type of cooperation, in which cash entrusted to bankers for investment purposes with the returns being shared between depositors and bankers, while losses are borne by fund owners. Thus, returns paid to depositors as well as the bank's own income from financing represent distribution of net profit at the closing of a financial period.

This sharing principle makes a substantial deviation from traditional practices. It brings about the principle of sharing to the financing arena and creates a performance incentive within the minds of bankers that relates their ability to attract deposits to their actual performance in funds utilization, a matter that can only be manifested by best performance as well as depth of future planning a lot more than simply an overnight change in the interest rate offered to depositors. This deepens the deposit market and makes it more stable. It reduces a bank's ability to sneak out investment deposits from other bankers by announcing a higher interest rate at the entrance of its offices. It also changes the attitude of management towards doubtful debts and other potential expenses and losses that burden the bank's balance sheet. As shares of profit are distributed to depositors, any attempt to cover up, hide, or push away potential liabilities has a future cumulative effects on shareholders and members of the boards of directors larger than their effects on future depositors.

The experience of the Pakistani banks (in which all deposits were turned into profit sharing basis since the early 1980s) indicates that the principle of profit sharing offers an important cushion for banks to lean on at times of recession. When the Pakistani Monetary Authority was putting pressure on banks to reduce their credit facilities through different policies including credit rationing, ceilings and other contractionery policies, banks were able to absorb this pressure by passing substantial part of it in terms of reduced returns to depositors.[7]

Closing the Financing Gap

The second contribution of Islamic banks, as witnessed over the last part of the 20th century, is the bridging of gap between financial and real markets. Since Islamic banks limit their financing to the three aforementioned modes or principles, Islamic financing is thus offered only to help in the creation or exchange of real goods and services, i.e. it has a one to one relationship to the real goods market. Islamic banks can finance such economic activities as: (1) the establishment of new productive projects, (2) purchase of producer/consumer goods, or, (3) lease of productive machinery and equipment and consumer durables. Two main categories of traditional financing are totally excluded from the arena of Islamic banking practices:

(a) general purpose financing that aims at simply supplementing government and/or corporate budgets, whether for seasonal or non-seasonal purposes. This financing usually depends on the trustworthiness of the finance users with complete disregard of the purpose for which funds are used; and

(b) increase in indebtedness as a result of debts rescheduling.

[7] The application of sharing principle in resource mobilization in Islamic banks has always been associated with creating an investment-risk reserve fund or provision to stabilize the actually distributed returns (profits) to investment- deposit holders. With the help of such funds, Islamic banks were practically able to stabilize the return on deposits from year to year. Furthermore, investment-risk funds were also utilized to support distributed profits at low-return times in order to maintain a competitive status of Islamic banks vis-a-vis interest-giving banks within the same market environment.

Linking bank financing to the processes of production and commodity circulation not only reduces the size of financing and makes it tailored-cut to the size of production and exchange, but also eliminates "parasitic" financing that aims at servicing already existing debt. All that reduces the cumulation of upside down financing pyramids and increases the stability of a banking system.

Ethics and Banking

It has been noted for a long time in all societies that banks are institutions that deal with money, not with *ethics*. The very idea of Islamic banking brings in ethical values to the center of banking practices. Islamic banks are bankers that abide by the Islamic law. The *Shari'ah* itself is loaded with moral values. Since the establishment of the first Islamic bank in 1973, it became apparent that Islamic banks are not permitted to establish any financing relations with commodities, services and individuals whose moral practices are dubious. Thus, financing of tobacco, gambling, casinos, drugs, alcohol, weapons, environmentally harmful commodities, etc. are completely excluded from the working map of Islamic banks.

One can hardly claim any link between the new movement of observing moral values in investment as we start seeing in some Western funds and the moral commitment of Islamic banks, to an extent that allows to conclude that the recent Western moral movement towards financing is an outgrow of Islamic banks. This moral movement came about for different reasons. But at the same time, one has to recognize that Islamic banks' commitment to moral values as well as their actual observance came many years before the early signals of moral commitment in Western investment funds and that the recent spread of Islamic mutual funds and investment companies, with their obvious moral commitment, is, in fact, a mere extension of the Islamic banking ideas and principles to the area of mutual funds.[8]

In addition to the above three contributions, the Islamic banking movement was able to extract deposits mainly from cash *"kept home"* by tens of millions of religious persons in the Muslim countries who never wanted to deal with traditional banks because of the religious prohibition of interest. In other words, the establishment of Islamic banks served to pull the legs of many new comers in the financial market; those with whom traditional banks working in Muslim countries failed.

[8] Especially, since 1995 onward at least 10 new mutual funds were established in several parts of the international tax shelters by Middle Eastern (Islamic) investors in collaboration with American and European funds managers, such as Willington of Boston and Fleming of London; all such funds have declared moral commitments.

SECTION IV
ISLAMIC FINANCE MODES FOR INTERNATIONAL TRADE

Islamic financing modes are known to be based on three principles: sharing, sale and leasing. These modes and their different variants serve international trade in financing exporters, importers and producers.

Sharing Modes

The principle is simple as much as it is natural. Islamic banks provide financing to projects on the expectation of a share in the return. Obviously, if a project loses, all capital providers and finance contributors lose proportionately together. There are two forms of applications of this principle: **full equity sharing** and **non-voting equity financing**. In full equity sharing, the bank sits on the board of directors and participates in formulating policies and managerial decisions, while in non-voting financing, the bank fully entrusts managerial decision-making to the fund user. Both forms of sharing modes may be formulated to share **net income** or **gross output**. They may also be **permanent**, **declining** or **timed.**

Sharing modes serve international trade financing in providing working capital for producers through simple Musharakah and simple Mudharabah. A producer enters in Musharakah or Mudharabah with the financier who supplies liquid funds to be used in paying for raw materials and production expenses. This kind of Musharakah/ Mudharabah can be timed for a given period, say one year, at the end of it the producer takes charge of selling the remaining output or takes it as his share of the assets of the partnership upon dissolution.

Producer financing on sharing basis may also be applied for financing the production of an agreed upon quantity of output like a given order by an importer and the dissolution date of the partnership will then be the date the order becomes ready for delivery or it is actually delivered to the importer.

The sharing principle may also be applied in different other variants for financing either the exporter or the importer. Export financing may be done on the basis of Musharakah/Mudharabah for financing an already produced quantity whereby the importer seeks commercial credit from the exporter. The Islamic Bank (IB) may enter with the exporter in a Musharakah/Mudharabah in which the IB principal will be an amount equal to the cost of the goods ordered from the exporter and ready to be shipped. The exporter contributes these goods, and the partnership will be 50/50 for each. The active partnership (exporter) shall manage the partnership, both cash and commodities, and export the commodity. The obtained promissory notes and other guarantees, like bank acceptance, etc., shall be kept until maturity where profit will be distributed between the two parties. Meanwhile, the active partner shall, in fact, use the partnership's cash for his own benefit rather than for the benefit of the partnership. This obviously makes him a guarantor of this cash that was not used for the partnership affairs. This provides the IB with an additional security.

Importers financing on sharing basis can also be done either the simple way as stated above or a Musharakah with a promise to buy. This variant of Musharakah/Mudharabah creates a partnership between importer and the IB with a promise from the importer to the effect that once imported goods are received, he/she will buy out the financing partnership at a mark-up price. This variant of sharing spares the active partner (importer) the pain of having imports done in the name of the bank and being acting as the IB agent in receiving delivery of the imported goods as in the case of Murabahah.

Sale Modes

In this group of modes, the bank is asked to buy goods and sell them to users (producers/ consumers) against future payment. Sale modes may take several forms. The simplest of them is derived from regular sale contract in which the bank sells goods, equipment and machinery to users at an agreed upon marked-up deferred price.

Islamic banks also practise two other forms: **construction/ manufacturing contract** and **deferred delivery contract**. The construction/ manufacturing is usually employed to finance land development, infrastructure, and industrial and residential construction; while deferred delivery is generally an agricultural financing contract that provides farmers with funds needed for their operations against delivery of grain at the season.

All sale-based modes can end with one lump-sum deferred payment or in installments spread over a period of time.

The application of sale mode in international trade financing is as old as Islamic Banks themselves. Financing importers through documentary credit is done on the basis of Murabahah with a promise to buy. This is the traditional mark-up approach in which the bank acts as an importer of the ordered goods, delivery of the goods is taken by the importer on the basis of proxy/agency from the bank and a sale contract with deferred payment is concluded between the importer and the IB.

Some Islamic Banks are taking another approach which is similar to Murabahah in its basic features, yet it takes the name of Istisna' financing. Financial Istisna' consists of two Istisna' sale contract, one between importer and the IB and the other is between the IB and the exporter. The latter is implemented by means of irrevocable letter of credit while the first contact is given on mark-up with deferred payment. Also the same mark-up is sometimes taken through two parallel Salam contracts in which a Salam sale is concluded between exporter and the IB with cash payment and deferred delivery. After the desired finance period another Salam contract with same delivery date is done between the importer and the IB on mark-up basis in implementation of a promise given for it.

Salam and a parallel Salam concept is sometimes applied in financing inventory replenishment for future delivery of goods in the international market. It is utilized in standardized contracts for main commodities. A practice that has been utilized for a few years by certain Islamic Banks, including Islamic Development Bank, in its management of liquidity and short term commodity financing.

Financing the exporter can also be done on the basis of two sale contracts one on cash basis between the exporter and the IB and the other on mark-up, deferred payment basis between the exporter as an agent of the IB and the importer.

Leasing Modes

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

Leasing modes are essentially used in financing the importation of equipment, machinery and other fixed assets. The variant of leasing usually utilized is **purchase to the lease orderer**. Equipment are purchased by the IB and leased to the orderer (the importer) usually under the name of Ijarah Wa Iqtina or diminishing lease in which the

IB recovers its principal and desired return on installment. Each installment represents a part of the principal and a rental of the equipment.

SECTION V
CHALLENGES FACING ISLAMIC BANKS

As an invention of the last four decades of the 20th century, Islamic banking represents a movement of development and renovation of the banking profession and practices. By their very presence, Islamic banks exemplify the practical potentiality and the empirical success of the idea of creating a banking system that is morally friendly; a system that relates to the actuality of the real market of production and exchange. In other words, the ideals of Islamic banking are becoming entrenched and well established, but the same is not necessarily true about Islamic banks s they face several challenges.

Some writers perceived Islamic banking as financial intermediation that **must** work on the basis of a profit sharing paradigm in both funds mobilization and funds utilization.[9] They theorize two versions of this presumed paradigm. Paradigm version one requires the financial institutions to receive funds on profit-sharing basis and to distribute funds on the same basis of profit sharing. This, they call, the two-tier Mudaraba version. The second paradigm version is called the two windows. It requires banks to hold a 100% reserve on the demand deposits that are guaranteed by the bank and a zero percent reserve on the investment deposits that are used by the bank to finance risk-bearing investments. According to this perception of Islamic banking, all Islamic banks have, actually, deviated from the basic feature of their paradigm, as their main actual financing mechanism took the form of Murabahah (mark up) sale. Consequently, the essential challenge faced by Islamic banks in the mind of such writers centers around their ability to abide by the

[9] See, for instance, Mohsen Khan and Abbas Mirakhor, "Monetary Management in an Islamic Economy" in Journal of Islamic Banking and Finance, V.10, July to September, 1993, and Mohammad Anwar, Modelling Interest-Free Economy, the International Institute of Islamic Thought, Hernden, Va, 1997.

"presumed" Islamic banking paradigm, i.e., increasing profit sharing financing and reducing sale financing.[10]

This approach is not supported by the methodology of social sciences. In Islamic banking operations, sale and leasing based financing represents more than 80% while the profit sharing financing takes less than 20%,[11]. Social scientists are supposed to study the phenomenon of Islamic banks with an analytical approach that attempts to find rational explanations of this behavior rather than attempting to judge them by pre-conceived dogmas. Islamic banks gained their Islamic character because they abide by the Islamic law, which accommodates three sets of modes of financing. If some writers happens to prefer one of these sets over the other Islamic banks cannot be described as deviating, or diverging,[12] from their normal path because they used their assets wisely and profitably!

Hence, the presumed challenge to "use funds on the basis of profit sharing" does not carry sufficient weight to attract the appetite of Islamic bankers.

The real challenges to Islamic banks must focus on their competitiveness in local and international markets. Their future ability to compete in very much affected by the trio of the new economic order: liberalization, deregulation, and globalization of financial services, all are coming with the third millenium. The reason is simple. It is the environment in which they gained their working experience. Although Islamic banks and financial institutions were able to enter some Western markets,[13] their base markets remain in

[10] Abbas Mirakhor, "Progress and Challenges of Islamic Banking", Review of Islamic Economics. V.4, No.2, 1997, pp. 1-11.
[11] Directory of Islamic Banks, 1996.
[12] Luca Errico and Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulation and Supervision, IMF Working Paper No.WP/98/30.
[13] The Directory of Islamic Banks cites 8 of them.

the Muslim countries, many of whose economies are narrow, small and loaded with restrictions and other market distortions.

As deregulation gives room to newly introduced relationships in the management of fund mobilization and fund utilization, functional liberalization of the banking activities must serve the objective of Islamic finance, at least, theoretically. Functional liberalization allows traditional banks to take up these new forms for their own financing transactions and benefit from the innovation of Islamic banks, and carry them further, especially, with the help of their longstanding experience. Liberalization of banking practices would allow the reformulation of banks' lending to be in accordance with the above mentioned three principles of Islamic financing and to benefit from remodeling some of their deposits on share-holding basis too.

On the other hand, Islamic banks will be faced with rigorous competition as a result of the geographical openness of globalization and regionalism. Islamic Banks are still new, small and dispersed, and globalization puts them face to face with the international banking giants. At the same time, because of several historical and sometimes personal reasons, Islamic banks were not able to benefit from the trend of regionalism like that which empowered several European banks with muscles and abilities to compete at the international level, depending on a strong and vast regional market.

By a quick look at the statistics of the 177 Islamic banks and financial institutions referred to early in this paper, we will find them tending to be small and contained within small markets from Table 3.

Table 3: Distribution of Islamic Banks and Financial Institutions (1997)

Islamic Banks and	Number	Average	Average	Average*

Financial Institutions		Capital $ 000,000	Assets $ 000,000	Number of Branches
South Asia	51	17	770	178
Africa	36	6	44	19
South East Asia	31	5	75	9
Middle East	37	148	28252	300
Europe, Americas & Austr.	10	62	91	5
Central Asia	1	3	5	
TOTAL	**177**	**41**	**891**	**137**

Source: Derived from the Directory of Islamic Banks and Financial Institutions, 1997, The International Association of Islamic Banks, Jeddah, Saudi Arabia.

* From 1996 Directory.

Although the average capital of Islamic Banks is US$ million 41, only seventeen have a capital of US$ million 100 or more, of them nine are state owned Iranian banks, while the capital of ninety-two Islamic banks does not exceed US$ million 10. The same picture appears in their assets. The average total assets of an Islamic bank is close to US $ million 900, but only twenty three of them have total assets above US$ one billion, of them 10 are in Iran, while eighty-five have assets of less than US$ million 100.

By the same token out of total branches of 22711, only sixteen banks have 20,645 branches, eight of them are in Iran with more than half this figure and seven are in Pakistan and one in Saudi Arabia. While the average number of branches is 137 for all the 177 Islamic banks, the smallest 10 banks have an average of less than three branches and the largest sixteen banks have an average of 1291 branches.

Furthermore, except for the Islamic banks and financial institutions that work in three countries that transformed their entire banking system into an Islamic one (Pakistan, Iran and Sudan), no Islamic bank occupies the status of first or second largest domestic bank in its own country.

At the international level, some studies indicates that an adequate size for a bank to be able to efficiently compete must be at least between U.S. $500 million and one billion, in terms of assets.[14] There are only 33 Islamic banks that pass the minimum level of this test, 23 of them are state owned in Pakistan and Iran. Also a glance at the Directory of Islamic banks indicates that very few of them have capital in excess of US$ million 500.[15]

Additionally, although there are 16 Islamic banks with a large number of branches, there are only 193 branches that political boundaries. Of this number, 160 branches belong to 10 banks in Iran and Pakistan. Let alone having branches in the international financial centers. This is especially true for Islamic banks in the Middle East and South Asia.

All the above is inspite of the fact that most private sector's Islamic banks are owned by the two large international groups of Dar-al-Mal

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14 Allen N. Berger and D.B. Humphrey, "The Dominance of Inefficiencies over Scale and Product Mix Economies in Banking," *Journal of Monetary Economics*, Vol. 28, 1991, 117-148.

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[15] Actually only three banks, all of them Iranian, have a capital between 500 and 750 million U.S. dollars (Directory of Islamic Banks, 1996)

Al-Islami and Al-Barakah. It seems as if both holding companies opted for small national banks rather than big regional ones.[16]

In addition to the problems of size and economies of scale, Islamic banks and financial institutions seem to suffer from a whole spectrum of several technical and organizational problems. To mention only a few: Islamic banks suffer from lack of standardization of Shari'ah opinions; unclear and sometimes ambiguous relationship between the management and Shari'ah Advisory Board; [17] low level of know-how on the part of both management and personnel; inadequate and sometimes unsuitable supervision standards, both internally and externally by the central banks; lack of creativity in financial engineering and marketing; and inadequate sensitivity to customer satisfaction. All these problems reduce the abilities of Islamic banks to compete in the international finance market.

Islamic Banks need to exercise a sincere effort especially in the areas of economics of scale and marketing if they want to increase their share in financing international trade. Their potentials are great in this area, even with their present equities and deposits. A few suggestion in this regard may be given as a conclusion of this paper:

1. Increasing their direct contact with businesses and working more as comprehensive bankers than simple lenders.
2. Branching out, especially overseas and in trade centers that export to and import from their headquarters.

[16] The two holding groups are registered in Bahamas and Saudi Arabia respectively. They are themselves not large enough to be able to sustain large Islamic banks. According to published data, both are below the one billion dollar mark.

[17] Although the principle with regard to the power of Shari'ah Board is clearly defined; that a Shari'ah Board is not a managerial organ of an Islamic bank, the nature of its relation with the Management is not yet adequately christalized.

3. Establishing strong presence in the main international trade and financial centers.
4. Establishing an Islamic - banks' clearing house in one or more of the financial centers in the Muslim countries. Bahrain, Beirut, Kuala Lumpur, and Casablanca may be good candidates for such a clearing house, so that international Islamic financing would be settled within the Muslim countries.
5. Targeting international trade between the Muslim countries as a first step towards providing financing for all export and imports of the Muslim countries.
6. Incorporating domestic conventional banks that accept to create branches and windows for Islamic financing transactions in the effort of Islamizing inter-Muslim countries trade financing. They usually have better abilities and larger International clientele, and they will enhance Islamic financing if they could transform into Islamic their inter-Islamic financing markets.

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