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RISK MANAGEMENT IN ISLAMIC BANKING AND FINANCE: THE ARAB FINANCE HOUSE EXAMPLE

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ABSTRACT

Islamic banking and finance, in its current form, is a relatively new industry. Its current asset base of one trillion USD is experiencing annual growth of 15 – 20 percent. It is categorized by being interest free and depends largely on the principles of Islamic Law (Shari’ah). This thesis will provide a brief introduction to the industry in general and explain the primary risks associated with the unique Islamic instruments. It will also mention the main challenges facing the industry and the prospects of growth. A well established Islamic bank called the Arab Finance House (AFH) in Lebanon will be studied.
ACKNOWLEDGMENTS

This thesis wouldn’t come to existence without the direct and indirect help of Dr. William Sackley from the Cameron School of Business at the University of North Carolina Wilmington. I would like to thank the other committee members as well as my classmates, my friends who constantly encouraged me to accomplish this work.

A special thanks to Dr. Fouad Matraji, the General Manager of AFH, for accepting me as a member of the AFH team. Islamic banking was something I didn’t have much information about, but thanks to the patience of my professors and committee members, I finally managed to know the direction of my thesis and the direction of my career.

Thanks to AFH staff and all the scholars, professionals, teachers and friends whom I interviewed for the survey.

Bilal Fleifel

2009
DEDICATION

To my amazing Dad, Anis Fleifel, who gave me the necessary financial and emotional support to reach my goal.

To my lovely Mom, Hoda Itani, for encouraging me always and was strong enough to send her only child to the unknown in pursuit of higher education.

To all my brothers and sisters in Islam, I hope you will benefit from this work.

سنْرِيهمْ آيَاتِنَا فِي الأَفَاق وَفِي أَنفُسِهِمْ حَتَّى يَتَبَيَّنَّ لَهُمْ أَنَّهُ الْحَقُّ أُوْلَمْ يَكفُّ

بِرَبِّكَ أَنْتَ عَلَى كُلِّ شَيْءٍ شَهِيدٌ (41-53)

“We will show them Our signs in the horizons and within themselves until it becomes clear to them that it is the truth. But is it not sufficient concerning your Lord that He is, over all things, a Witness”

The Holy Quran (41, 53)
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GLOSSARY

Bai al-dayn: Sale of debt or receivables.

Bai al-inah: A loan in the form of a sale, called inah (façade) because it is a sale in appearance only. This is accomplished by one’s buying back what one has sold for a lower price than that for which one originally sold it. The difference, ostensibly profit, is actually a loan.

Daman/Kafala: Guaranty or surety.

Fatwa: an authoritative legal opinion based on the Shari’ah (Islamic law).

Fiqh: Practical jurisprudence or human articulations of divine rules encompassing both laws and ethics. As such, Fiqh may be understood as the jurists’ understanding of the Shari’ah, or jurists’ law.

Gharar: Uncertainty in a contract of exchange as to the existence of the subject-matter of the contract and deliverability, quantity or quality of the subject-matter. It also involves contractual ambiguity as to the consideration and the terms of the contract. Such ambiguity will render most contracts void.

Hadith: The narrative record of the, sayings, doings, and implicit approval or disapproval of the Prophet, peace be upon him. The world is sometimes used in English as a collective noun; sometimes an “s” is added to make the plural.

Halal: Lawful; one the five major Shari’ah categorizations of human acts.

Haram: Unlawful; one of the five major Shari’ah categorizations of human acts.

---

1 Glossary compiled by Miss Maria Khalaf (ESA-Beirut, MeM), using various references such as: Euromoney, Islamic Finance innovation and growth. Mr. Jean-Marc Riegel Islamic finance instruments, ESA 2005, and various Islamic industry’s literature.
Ijarah: The transfer of ownership of a service for a specified period for an agreed upon lawful consideration.

Ijmaa: The consensus of jurists; considered a binding legal indicator (dalil) in the classical jurisprudence.

Ihtikar: Monopoly.

Ikhtilaf: Divergence of opinions among jurists.

Istisna: A contract of sale of specified goods to be manufactured with an obligation of the manufacturer to deliver them upon completion. It is a condition in Istisna that the seller provides either the raw material or cost of manufacturing the goods.

Khiyar al-shart: An option in a sale contract concluded at the time of signing the agreement, giving one of the two parties to the contract a right to cancel the sale within a stipulated time.

Mudarabah: A partnership in profit between capital and work. A Mudarabah is typically conducted between investment account holders, as providers of funds, and the Islamic bank as a Mudarib (see below). The Islamic bank announces its willingness to accept the funds of investment account holders, the sharing of profits being as agreed between the two parties, and the losses being borne by the provider of funds, except in case of managerial misconduct, negligence or violation of the conditions agreed upon the Islamic bank. A Mudarabah contract may also be concluded between Islamic bank, as a provider of funds, on behalf of itself or on behalf of investment account holders, and business owners and other craftsmen, including farmers, traders, etc.

Mudarib: The managing partner in a Mudarabah (see above).
Murabahah: Sale of goods with an agreed upon profit mark-up on the cost. There are two types of \textit{Murabahah} sale. In the first, the Islamic bank purchases the goods, makes them available for sale without any prior promise from a customer to purchase them, and is termed a normal or spot Murabahah. The second type typically involves the customer’s promise to purchase the item from the institution, which is called Murabahah to the purchase orderer. The customer distinguishes it from the normal type of Murabahah that does not involve such a promise. The Murabahah to the purchase order is the sale of an item by the institution to a customer (the purchase orderer) for a pre-agreed selling price, which includes a pre-agreed profit mark-up over its cost price, this having been specified in the customer’s promise to purchase. Normally, a \textit{Murabahah} to the purchase order transaction involves the institution granting the customer a \textit{Murabahah} credit facility. A \textit{Murabahah} to the purchase order transaction typically involves deferred payment terms, but such deferred payment is not one of the essential conditions of such transactions. A Murabahah can be arranged with no deferral of payment. In this case, the mark-up will only include the profit the institution will receive for a spot sale and not the extra charge it will receive for deferral of payment.

Musharakah: A form of partnership between the Islamic bank and its clients whereby each party contributes to the partnership capital in equal or varying degrees to establish a new project or to share in an existing one. Each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. Losses, however, are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.

Qard Hasan: A loan in which there is no interest. In Islamic law, all loans are gratuitous contracts.
Qur’an: The Book of Divine Revelation that was delivered to humankind by the Prophet Mohammed, peace is upon him.

Riba: Interest; sometimes, equated with usury, though its means is somewhat broader. Its prohibition is meant to distinguish an unlawful exchange (in which there is a clear advantage to one on the contracting parties) from a lawful, mutually beneficial exchange and lawful loan.

Salam: A contract for the purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions.

Shari’ah: The term Shari’ah has two meanings: Islamic law, and the totality of divine categorizations of human acts (Islam). The second meaning of the term means Shari’ah rules do not always function as rules of law in the western sense, as they include obligations, duties and moral considerations not generally thought of as “law”. Shari’ah rules, therefore, admitting of both a legal and a moral dimension, have as their purpose the fostering of obedience to the Almighty. In the legal terminology, Shari’ah means the law as extracted by the mujtahids from the source of law.

Sukuk: Participation securities; coupons, investment certificates.

Sunnah: The way of the Prophet Mohammed, peace be upon him, including his sayings, deeds, approvals or disapprovals as preserved in the Hadith literature: the second of the two sources of revelation.

Takaful: A Shari’ah-compliant system of insurance in which the participants donate part or all of their contributions, which are used to pay claims for damages suffered by some of the participants. The company’s role is restricted to managing the insurance operations and investing the insurance contributions.
Tawarroq or reverse Murabahah: In personal financing, a client with a genuine need buys an item on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party. In this way, the client can obtain cash without taking out an interest-based loan.

Urboun: Earnest money. It is the amount paid by the client (orderer) to the seller after concluding a contract of sale, with the provision that the contract is completed during the prescribed period. The Urboun amount will be kept by the seller if the buyer fails to execute the contract.

Wadia: Safe-keeping/resale of goods with a discount on the original stated cost.

Wakalah: Agency. An agency contract that may include in its terms an agent fee.

Zakat: Literally, it means blessing, purification, increase, or cultivation of good deeds. In Shari’ah, it is an obligation in respect of funds paid for a specified type of purpose and for specified categories. It is a specified amount prescribed by Allah Almighty for those who are entitled to Zakat as specified in the Qur’an. The word Zakat is also used to indicate the amount paid from the funds that are subject to Zakat.
CHAPTER 1

INTRODUCTION TO ISLAMIC BANKING AND FINANCE

Reasons for Research in This Topic

Islamic banks are financial institutions that rely totally in their operations on Shari’ah\(^2\) legislations which prohibit all kinds of interest, uncertainty, and gambling. This industry has witnessed a significant growth in the last 30 years. According to McKinsey(2007), since its revival in the late 1970s, more than 500 institutions were established in the world with an average asset growth of 15 – 20 percent each year, making Islamic banking the fastest growing industry in the financial sector (see Figure 1). Islam is the world's second largest religion after Christianity with 1.3 – 1.8 billion adherents, comprising 15 – 25 percent of the world population.\(^3\) Islamic Banking is a very attractive industry for investment and research for both Muslims and non-Muslims.

Figure 1. Growth of the Islamic Banking Industry in Billions of U.S. dollars.

Source: Booz and Company Analysis

\(^2\) For more explanations about Arabic terms check the Glossary at the end of this document.

\(^3\) [http://www.adherents.com/Religions_By_Adherents.html#Islam](http://www.adherents.com/Religions_By_Adherents.html#Islam).
Islamic banking and finance has brought major innovation to the banking sector in general. First, the Islamic financial system is based on real economic activity. It is a part of the Islamic economic system that deals with allocation of resources, production and exchange of goods and services, and distribution of wealth in fair and socially beneficial ways. Islamic banking and finance is about risk sharing that leads to a profit/loss sharing system. This manner of financing is linked to the processes of the production and exchange of real goods (Kahf, 1999, p. 448). Second, Islamic banks have changed the relationship between the bank and depositors from a lending contract to a partnership and cooperation in which the elements of commitment are clearly present (Delorenzo, 2002). This sharing relationship created a performance incentive. It is an issue that requires more careful planning than quick overnight changes in interest rates offered to depositors (Kahf, 1999, p. 447). Furthermore, Islamic banking created innovation in the world of banking because it linked ethics and moral values to investment decisions. The success of Islamic banking in the last 30 years demonstrated that businesses can grow in modern markets without the payment of interest. This created a trend to invest in Islamic mutual funds (see Figure 2).
The banking system in Lebanon is dominated by strict regulations from the Central Bank of Lebanon (BDL), which regulates most banking activities. One feature of the Lebanese banking system is the Banking Secrecy Law which made Lebanon an attractive place for depositors, especially those from the Arab world. With the current spread of Islamic banks around the world, the Arab Finance House was established and supported by the Qatar Islamic Bank in the Capital of Lebanon.

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5 Qatar Islamic bank was established in Qatar and ranks first in the country in assets. For more info check [http://www.qib.com.qa/](http://www.qib.com.qa/).
Lebanon is comprised of 59.7% Muslims. Therefore, the establishment of Islamic banks has been considered as an alternative solution for Muslims who want to liberate themselves from interest. Currently, Islamic banks are expanding to a new level of development by establishing full and innovative financial solutions that serve competitively in the financial sector and thus providing their clients with most of their financial needs. This development made Islamic banks attractive to different sectors of the society, even for non-Muslims. Some countries such as Iran and Sudan transformed their banking system to fully comply with the Shari’ah. Others such as Pakistan, Indonesia, Bahrain and Malaysia established a parallel Islamic financial system to move alongside with its current financial system. This trend encouraged major banks such as HSBC, Citibank, ABN AMRO and many others to open windows that comply with Shari’ah principles.

Some Islamic banks were slightly affected by the current financial crises while the majority of them continued to flourish and expand. The current financial crises gave Islamic banks the opportunity to express themselves as a serious challenging financial system. This considerable performance triggered the interest of global financial institutions, financial analysts, and investors to investigate and research this new and unique industry.

In order for this industry to continue prospering, unique risk management procedures should be followed to minimize the probability of facing downside turns. Islamic financial institutions face risks that are common with conventional financial institutions as well as unique risks due to their compliance with Shari’ah (Ahmed, 2008). Islamic banks constantly seek

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7 By current I refer to the credit card crunch and the crisis of 2008 until the issuance of this thesis in summer 2009.
profitability and stability to provide stakeholders with a comfortable and safe environment for their deposits and investments. Therefore, Islamic banks need to establish a sound risk management system to offer safe banking operations, profitability, stability, and to maintain their business.

Overview of Islamic Principles

To understand how Islamic finance is derived, it is necessary to obtain a briefing about Islam and its view on life. Muslims believe in One God that is the ultimate creator and sustainer of the universe. Along with spiritual practices, Islam provided a complete set of guidelines to govern man-to-man activities. “Say, "Indeed, my prayer, my rites of sacrifice, my living and my dying are for Allah, Lord of the worlds” Quran(6, 162). Islamic banking and finance is part of the Islamic economic jurisprudence, a branch of Islamic Shari’ah practices and activities (see Figure 3).
According to Muslims, the Quran or the holy book of Muslims is the primary source of laws and being the absolute word of God that has not been altered from the sixth century. An example of the Quran will be: “God has permitted trade and prohibited Riba” Quran (2, 275). It is considered a constitution for Muslims around the world.

“To Allah belongs the dominion of the heavens and the earth and whatever is within them. And He is over all things competent “Quran (6,120). Therefore, Muslims believe that money, property, businesses and investments are all owned by God. Islam looks at humans as the
stewards of God on earth. Therefore, they are encouraged to invest money in the best practices to ensure the meeting of Islamic regulations. Islam allows profit maximization, but it is also concerned with wealth distribution. Its primary goal is to ensure equity and well establishment of a society as a whole. Therefore any investment that might harm the society in the short or long term is directly prohibited.

From an Islamic point of view, ethics are derived from the principles and rules of Shari’ah. Ethics are a major component in Shari’ah, and they are categorized under integrity and the principle of stewardship of humanity on earth (Quran 2, 30). Islam highly values integrity and makes it govern all acts. Stewardship refers to the supreme authority of God. According to Shaer (2009), public welfare must not contradict with private benefits in conducting any kind of business (p. 31).

According to Karadawi (1998), money in Islam is not a commodity but a medium of exchange (p.64). Money does not generate money in itself but work and production generate money. Therefore, it is not allowed to treat money as a product. The prophet Muhammad (SAW) said “Like for like and equal for equal.” He discouraged barter transactions because of the difficulty to visualize the real equivalent price of one good to another.

History of Islamic Banking and Finance

The Islamic financial system goes back in time to the days of the prophet Mohammad (SAW) where it was applied and regulated directly by the Islamic government at that time. All Islamic countries throughout time used the Islamic model of finance in all transactions. Until the fall of the Ottoman Empire in the 19th century, Islamic finance was still applied as the only
financial and economical system which covered Turkey, the Middle East, East Asia, North Africa, the gulf region, and parts of Europe.

After the fall of the Ottoman Empire and the colonization of the west over the Muslim world, the whole financial system was transformed. Muslims did not use banks for their financial transactions but instead they used instruments that some of which are currently used in conventional banks. According to Shaer (2009), some examples of these instruments are transfers of ownerships, letter of credits, and selling/buying currencies on spot. Dr. Shaer adds that Muslims used checks, transfers and letter of credits in their transactions before the establishment of the current conventional banking system. It is believed that the word check may be derived from the Arabic word (Sak)\(^8\) which has the same characteristics as the current check (Shaer, 2009, p.13).

Islamic banks were not established until recently.\(^9\) Nasser Bank was established as the first bank denying all kind of interest-related transactions. The real interest in that area came after the recommendation of the Arab foreign ministers conference held in Jeddah in 1972 for establishing an Islamic bank. In 1974 an agreement was signed between Arabic governments to form the Islamic Development Bank which started its operations in 1977 in the Kingdom of Saudi Arabia. In 1975, Dubai Islamic bank was formed as the first fully fledged Islamic bank that offered financial services for individuals according to the Islamic legislations. From its formation until now, more than 500 institutions are offering Islamic financial services. During the past three years, more than 50 institutions were launched globally, with assets approaching a

\(^8\) Sak is the singular word for Sukuk (Islamic bonds). It will be described in details in later parts of this thesis.

\(^9\) These kinds of banks were called local saving banks and were established by Dr. Ahmad Najar in Egypt. This experiment lasted three years.
half trillion USD and expectations that may reach 1 trillion USD by 2010 (B. Khatib, personal communication, July 16, 2009). The world's top 100 Islamic banks managed to grow their assets by two-thirds during 2008, at a time when their conventional rivals were struggling to deal with the global financial crisis. Their average asset growth was 29.7 per cent and an average net income growth of 29.6 per cent was achieved.\(^\text{10}\) In the last five years, the Middle East witnessed a large transition from conventional banks to Islamic banks.

Today, some people look at Islamic banks as the entire picture of Islamic finance. The truth is that banks working under the Islamic principles occupy a small portion of the Islamic financial model. Islamic banks are established as an alternative solution for people who do not deal with interest-based banks. This Islamic financial model requires an Islamic government that regulates and supports its operations. Islam is a full system of life where all aspects of it are related either directly or indirectly with each other. For example, according to S. Shaer (personal communication, 03 July, 2009),\(^\text{11}\) the Islamic government must provide electricity water and fuel for free.

In Lebanon the interest in establishing an Islamic bank started in the mid 1990s, but it was not until the late 1990s that the first Islamic bank was established.\(^\text{12}\) The commission of Finance and Budget legalized the establishment of Islamic banks in Lebanon under the Law No 575 dated February 11, 2004.\(^\text{13}\)

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\(^\text{11}\) Samir Shaer is the head of the Shari’ah compliance unit at AFH. Check Appendix G for a list of interviews.
\(^\text{12}\) Al Baraka Bank. A subsidiary of the Dallah Baraka group, one of the largest Islamic banking groups of banks and financial institutions.
\(^\text{13}\) Appendix A.
Major Prohibitions and Reasons

In the Islamic legislation, as in any law, there are some prohibitions and regulations that Islamic banks must follow in order to function in a Shari’ah acceptable way. Therefore, in order for the Islamic banking system to guarantee the validity of their operations, a Shari'ah auditing department must be available in every bank. Islamic Shari'ah does not constrain personal freedom, but it attempts to secure the community from short- and long-term threats that cannot be foreseen. The main prohibitions in Islam are: Riba,\textsuperscript{14} gambling and uncertainty. Islamic laws that affect Muslim individuals are also applicable to Islamic banks.

The following will explain the major guidelines of Islamic finance according to the Shari’ah:

- Honesty and fair trade
  - Avoid trade manipulations (e.g., black markets, cheating.)
  - Avoid Ihtikar or monopoly
- Disclose faults and avoid misrepresentations: it is the seller’s responsibility to show the faults of his goods or else the buyer can return the product.

\begin{quote}
\textit{“O you who believe! Devour not your property among yourselves in vanities; but let there be commerce among you by mutual good will.”} (Quran 4:29)
\end{quote}

- Avoid selling forbidden items such as
  - Entertainment (adultery, casinos, etc.)

\textsuperscript{14} Defined later.
o Alcohol
o Pork
o Avoid selling weapons and arms

- Avoid Riba
- Avoid selling over and above the sale of another buyer. Once a deal is completed, no higher bid should be taken.
- Sale should be in an open market.
- Avoid selling to the deprived or needy but rather donate to them.

In the following section, the two main prohibitions in Islamic banking and finance will be explained: Riba and Gharar.\textsuperscript{15}

Riba

According to Shaer (2009), Riba is the main reason behind opening Islamic banks because of the huge punishment in the Quran for individuals dealing with it.\textsuperscript{16} Shaer defines Riba as the unjustified earning on principal where an individual will profit without giving a fair counter value (p.27). The term Riba is derived from the action “yarbu” which means addition and growing. Interest paid by banks is the forbidden Riba (Karadawi, 1998, p.59).\textsuperscript{17} Karadawi adds that some banking accounts such as saving accounts are considered a debt for the bank; therefore any return on that debt is the forbidden Riba (p.41). The majority of Muslim scholars define Riba as interest whether it is paid or received (Karadawi, 1998, p.128). Islamic banks

\textsuperscript{15} Refer to the Glossary for more explanations.
\textsuperscript{16} Refer to the Quran (4,161), (2,275), (2,276), (2,278), and (2,279).
\textsuperscript{17} Dr. Youssef Al Karadawi is the head of the Muslims council for Islamic scholars and scientist.
define and treat Riba the same interest. Although the Majority of scholars say in the prohibition of Riba-interest,\(^{18}\) some scholars some scholars intend the prohibition of interest when they say the prohibition of Riba. According to Shaer (2009), Islamic banks consider the forbidden Riba as the interest paid by conventional banks (p.32). Therefore, one of the main reasons behind opening Islamic banks is to operate in an interest-free environment. Riba is not a new tool for earning money and was known to people throughout history. To understand Islam’s prohibition of Riba, one must look at the concept of Islamic finance which rotates on the principles of Profit / Loss Sharing (PLS). No financiers are welcomed if they expect return without wishing to bear risk.

Although many details in the Qur’an discuss specific situations -- such as Riba -- the situations contain no specificity in time or space. It is therefore required that interpretations be offered for Qur’an guidance. From the earliest of times, Riba was clearly prohibited but could be interpreted as either usury or interest. In pre-modern times, there was insufficient commerce in Islamic countries to necessitate much borrowing, and the distinction between usury or interest was unnecessary. In modern times, sufficient need exists for lending or depositing activities that clarifying distinctions are necessary. One such set of distinctions is offered by Islamic scholar Abdul Gafoor (1995) who isolates six specific categories of banking charges (interest, services costs, overheads costs, profits, risk premium, and compensation for inflation). In modern interpretation Abdul Gafoor contends that all except the first category is permissible under interpretation of Riba from the Qur’an, as long as any charges for the five categories of expense

\(^{18}\) The Fiqh Council of the Muslim world League, Islamic Fiqh Academy, Organization of the Islamic Conference, The First World Conference of Islamic Economy, and many others said that the interest is the same as Riba.
are based upon an average of actual costs experienced by the financial institution. After the expansion of banks in the Muslim world in the 40s, some banks started to advocate that Riba is different than interest. Some scholars such as Abdul Majid Salam declared the prohibition of interest given by banks. After that Fiqh councils gathered to declare the prohibition of interest to pave the way for Islamic banks to start their operations (Karadawi, 1998).

According to Saleh (1992), capital may only bring reward when it is combined with the sort of risk inherent to business enterprises. For that, T-Bills, CDs, bonds and other interest-bearing securities are not allowed. This implies that Islam encourages investors to take full responsibility for losses as well as for gains and to participate in risk. When the elements of risk are present, people tend to take their investments more seriously and eventually increase the level of transparency and efficiency. According to M. Ikawi (personal communication, May 23, 2009),¹⁹ Shari’ah higher purpose is to reach a society where commitment and responsibility are involved to benefit the society as a whole.

Riba is the premium that must be paid by the borrower to the lender regardless of the necessity of the borrowing or his financial situation. According to Karadawi (1998), the two kinds of loans – commercial and consumption – are prohibited when accompanied with interest (p.55). In the Islamic perspective, Riba will allow the rich to control the poor in the case of a consumption loan. While in the business loan, Islam encourages partnership to decrease the losses incurred in the case of failure. This prohibition for the two types of loans shows how sharing is important even if there is no return, as in the case of the good faith loan. In certain

¹⁹ Mahmoud Ikawi is a famous Islamic scholar in Lebanon. For a list of interviews check Appendix G.
parts of the world, interest rates are high. Therefore, some people rely on Riba as their sole income instead of working and being productive.

The only type of loan accepted by Islam is an interest free loan called the “Good Faith Loan” or Qard Hasan. It will also build relationships between people who are engaging in Musharakah (partnership) instead of giving commercial loans with interest. This partnership is encouraged because profits and losses will be shared to protect both parties in short and long run.

Islam mandates its followers to pay Zakat by contributing a 2.5 percent of their wealth to charity every year. In addition to that, donations are encouraged and rewarded.

Gharar

The Arabic word *Gharar* means uncertainty, risk and hazard. Gharar is not precisely defined as Riba where it is absolutely prohibited. According to ArsalanTariq(2004), Gharar is any transaction whose consequences are hidden. A minor part of Gharar may refer to consumer protection in modern securities law. Gharar is present when an essential element of a transaction is missing such as the exact price or the ability to deliver the product. Gharar is considered to be the second major prohibition in Islamic banking and finance. The understanding of Gharar mainly differs in the conventional banking system that encourages uncertainty and gambling.

The concept of Gharar is the level of uncertainty that may cause high returns or high losses. According to H. Obeidy (personal communication, June 04, 2009), all transactions that

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20 Check glossary for a detailed explanation.
21 For additional information on Zakat, refer to Appendix D.
22 Branch manager at AFH. For a list of interviews refer to Appendix G.
may cause injustice to the related parties are clearly forbidden. The Hanafi School defined Gharar as “any bargain in which the result is hidden.” Therefore, speculation and gambling is strictly prohibited in all Islamic financial transactions. Islam encourages studying the investment and forecasting its returns according to figures and available data. Any form of uncertainty, gambling, speculation and flipping a coin falls under the Gharar category. This prohibition aims to protect both small and large investors from future risks arising from uncertainty and speculation. An example of Gharar is trading what you do not actually own. A contemporary example would be buying a house where the price or the specifications will be determined in the future.

Conventional derivatives – mainly futures and options – in their current form are forbidden in Islam according to the majority of Muslim scholars. Short selling is clearly prohibited according to Shari’ah for it meets the requirements of Gharar. According to Usmani (1996) of the Fiqh Academy of Jeddah in an article answering a set of posed questions on the topic argues that futures contracts are invalid because:

"Firstly, it is a well recognized principle of the Shari'ah that purchase or sale cannot be affected for a future date. Therefore, all forward and futures contracts are invalid in Shari'ah. Secondly, because in most futures transactions delivery of the commodities or their possessions is not intended. In most cases the transactions end up with the settlement of the difference in price only, which is not allowed in the Shari'ah." (Usmani, June 1996)

However, scholars are trying to create and modify Shari'ah-compliant products that can protect investors from various future risks. One of those products is the Salam Sale which will be
explained later. If futures and options are modified and managed to become consistent with the Shari’ah, then it will be possible to use them as hedges against loss in Islamic banks.

Shari'ah guidelines prevent Islamic banks and financial institutions from participating in certain business activities such as investing in companies which are financed with debt greater than 33 percent, and companies where their income from interest is greater than 5 percent. This indicates the desire of Islamic banking to minimize risks and not jeopardize their customers.

Primary Reasons for Establishing an Islamic Bank

The expansion of conventional financial institutions around the Muslim world and the fast development of markets encouraged some Muslim scholars to announce the prohibition of dealing with the conventional institutions (M. Ikawi, personal communication, May23, 2009). This encouraged Muslims to create primary alternatives. The establishment of the modern Islamic financial school of thought came as a result of constant demand for an efficient solution for interest-based banks. Scholars and bankers were able to make a remarkable progress in the Islamic banking industry in the last 40 years. However, concepts and practices of Islamic banking are still in their early stages of development.

According to S. Ammar (communication, September 09, 2009), Islamic banking has developed and is being categorized according to the following four types:

- Islamic banks in the private sector.

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23 Sabri Ammar is the senior operations manager at AFH. For a list of interviews refer to Appendix G.
• Islamic banks operating alongside conventional banks in both Muslim and non-Muslim countries.

• Countries where Islamic banking practices are imposed by the government as the sole system, such as Sudan and Iran.

• Conventional banks as well as non-financial institutions undertaking Islamic banking principles.

The Form of Islamic Financial institutions according to (Iqbal, 2002):24

• Islamic banks
• Islamic windows
• Islamic investment banks and funds
• Islamic mortgage companies
• Takaful companies or Islamic insurance companies
• Mudarabah companies
• International Islamic Financial Market (IIFM)

To the modern financial world, people assume that without interest, no modern economy would exist. Interest rates are raised and lowered by government and agencies in order to manage currency and control inflation. According to Delorenzo (2002), of nearly 30,000 companies whose stock is publicly listed on exchanges around the world, only about 300 are free of debt. He adds that Fortune 500 companies to local bakeries are borrowing money in order to

24 Zamir Iqbal is the Senior Information Officer at the World Bank.
stay in business. Corporate debt and borrowing have become a way of life. Islamic banks are a living example that banks may and can run without debt.

According to International Islamic Financial Market (IIFM) (September 2006), 25 countries with the most advanced Islamic financial systems are Malaysia, Kuwait, Saudi Arabia, United Arab Emirates, Bahrain and Qatar. Those countries are on the level of business innovation and continuous market expansion. Countries like Brunei, Indonesia, South Africa, Morocco, Turkey and Pakistan are at the level of matching competition, and they are trying to reach the first group. Other countries that started developing Islamic finance include Lebanon, Syria, USA, Germany and Singapore. Others such as China, India, Hong Kong and Australia are still waiting and monitoring the industry.

According to a lecture presented by Dr. Fouad Matraji, the general manager of AFH on 7 November, 2006, 26 Islamic banks are investment banks in the first place because they do not offer loans with interest. Instead they obtain a feasibility study about the project to provide funding. Islamic banks will bear the risks involved both in terms of the success of projects or in terms of the effects of the liquidity flow of these funds outside and within.

According to A. Sino (personal communication, March 05, 2009), 27 he pointed out the growth prospects of Islamic Financial institutions while stating, “A major reason for establishing an Islamic bank is the growth of the overall wealth in the middle east alongside with the awareness and competitiveness of Islamic products compared to conventional ones.”

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25 These countries are shown in rank order of most-to-least advanced.
27 Abed Sino is a business man in UAE and was visiting Lebanon at the time of the interview.
According to Shaer (2009), Islamic banks are also considered as development banks aimed at mobilizing and channeling resources to fund individuals to achieve common interest, not only between the parties, but primarily for the advancement of society (p.23). The goal in establishing Islamic banks is to create grounds for Islamic economy where the goal is not limited to “for-profit” only.

Another characteristic of Islamic banking is that it is considered social banking because it seeks to achieve the elements of social solidarity between members of the society. It aids in the distribution of returns by contributing to the lack of concentration of wealth in the hands of a few individuals or institutions in society (Shaer, 2009, 25). This leads the bank away from Riba which is based primarily on investing in projects that serve to generate a real income, an increase in effective demand, increasing production, improving employment, and increasing incomes. Thus, this increases the turnover growth in the national economy.

The reason for establishing an Islamic bank in any country will vary according to the level of development of the industry in that specific country. For example, establishing an Islamic bank in Lebanon will be primarily for launching the industry in order to provide the people with Shari'ah-compliant alternatives. Another reason would be to attract foreign investors mainly from the Gulf region. In the short run this bank will emphasize the creation of a strong client base to guarantee its survival. On the other hand, older Islamic banks in other countries such as Saudi Arabia will build their strategy on profitability and innovation.

Continuous success and innovations in Islamic banking will increase the level of trust in this industry. In Islamic countries, the transition from conventional banking to Islamic banking
is creating a need for establishing new banks and subsidiaries to meet the demands of borrowers and depositors. This will create a better relationship between the bank and society and will increase productivity and create more job opportunities.

Conventional banks depend on collateral guarantees and non participation in risk. Islamic banks rely heavily on project evaluation especially for equity oriented financing (Mudarabah). The main goal of Islamic banks is to make profits and collaborate in the social and economic welfare of the society.

Islamic Financial Contracts

The meaning of contract in Arabic is “Aqd” which literally means to bind or to strengthen. The validity of a certain contract is considered to be the prerequisite for any transaction to be acceptable under the Islamic framework. Understanding Islamic contracts is crucial in understanding Islamic finance. “O you who have faith! Fulfill all contracts” Quran (5, 1). According to Shari’ah rules and regulations, a contract only exists if the following conditions are available:

Contracting parties

For a contract to be valid, a minimum of two parties must be available. Contracting parties must be mature and mentally stable. Minors can be part of contracts under the supervision of their custodians.
Subject Matter

In order for the contract to be acceptable by the Islamic law, the underlying subject must contain the following conditions:

1. The ownership of the product being held under the contract by the seller.
2. Existence of the subject matter: selling things that do not exist is forbidden unless in the case of Salam or Istisna as discussed later.
3. The subject matter must be specific and described in sufficient details to remove any confusion. The buyer has the right to investigate the product and return it even after the delivery. The price must be specified and the currency must be known.
4. The ability to deliver and the time frame of delivery of the subject matter must be identified.
5. The subject matter must be acceptable by Shari'ah. Selling wine for example will nullify the contract.

Offer and Acceptance

Offer and acceptance between parties must be proven for the contract to be valid. There are several basic Islamic financing contracts. These contracts may seem similar to conventional banks. They differ in the core of business in the short and long term as well as in contract agreement. There are five main contracts: Murabahah, Musharakah, Mudarabah, Salam, and Wakalah.\(^{28}\) Other types of contracts such as Ijarah (leasing) or Istisna will be mentioned briefly.

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\(^{28}\)Refer to Glossary.
Islamic Financial Instruments

Musharakah and Mudarabah are considered to be the basic to elements of partnership in Islamic finance. The main instruments currently used in Islamic banking and finance will be described below.

Murabahah Model

Islamic banks were very successful using the Murabahah instrument at the retail level. It is considered to be one of the most frequently used financial tools and possibly the most profitable. This is because the Islamic bank is able to satisfy its clients’ needs and at the same time assure its compliance with the Shari’ah. It is the main source of debt generation on the liability side of the balance sheet of Islamic banks. Murabahah is a method for financing where the bank purchases an asset on the behalf of its client and sells it with immediate delivery and deferred payment with a known profit margin. In order for the Murabahah transaction to be valid, the client must request and sign a purchase order. It is necessary that the commodity be in the ownership of the bank before selling it to the client through a valid sale contract. It is also necessary that the product is non-imaginary and is acceptable and approved by the Shari’ah. The bank will own the commodity and sell it to the client upon the purchase order. The profits are generated from the service and that in turn creates certain risks.

The practical steps of Murabahah are:

1. The purchaser determines his or her needs and the specifications of the commodity.
2. The buyer signs a promise to purchase agreement. This is essential for the bank to bind the buyer legally.

3. Delivery of the commodity.

4. The Murabahah sale contract according to the terms and conditions included in the promise to purchase.

5. The client pays his installments, principal plus the bank’s profit, as agreed in the promise to purchase contract.

Murabahah may appear to be similar if not the same as the normal interest transactions issued by conventional banking institutions. In the following points, some differences between Murabahah and conventional financing will be discussed:

- In Murabahah, the product requested must be Shari’ah-compliant which eliminates the possibility to harm society or the individual. While in the conventional framework, lenders are only concerned if the borrower is credit worthy or not.

- In Murabahah, the Islamic bank has the asset registered in its name. If the borrower fails to pay his obligations, then the bank has an asset to liquidate. In conventional banks, and in the case of personal loans, many restrictions are eliminated in comparison to Islamic banks. Therefore if the borrower fails to pay his/her dues, the bank will incur maximum exposure. In Murabahah, the product purchased is a real asset which has a real value and this will reduce losses to the bank in case of buyer bankruptcy.

- In Murabahah, profits generated are used in a Shari’ah-compliant manner that will increase the depositor’s profits and the shareholders’ cut. Hence, this will increase the
prosperity of the economy. In contrast, the premium created from interest-based financing will be used to create additional loans. This will give the conventional bank more control over people and more interest will be generated on debts in the absence of any real economic activity.

- The closing date for Murabahah may be extended with no increase over the price or a penalty fee. In conventional banks, interest rates are increased on the final price of the product which may create a more difficult situation on the borrower.

Another method similar to Murabahah is called Musawamah, where the bank does not disclose the profit margin to the customer. Musawamah is preferred over Murabahah because the bank will act like a normal seller (S. Shaer, personal communication, July 03, 2009).

To overcome the risk of customers not paying their obligations under the Murabahah contract, the bank can issue two Murabahah contracts. In the first, the bank will operate as the supplier of the client and in the second, the bank will act as the buyer from the actual supplier. The bank here will not make any payments to the actual supplier before receiving payments from the buyer. The bank will be considered as an intermediary between the supplier and the end user.

**Mudarabah Model**

Mudarabah is considered an alternative for interest in the profit/loss sharing system and has been used by merchants since the time of prophet Muhammad (SAW). Mudarabah is an agreement between two parties, the investors on one side and an experienced agent on the other. It is similar to the limited partnership in a conventional system where one party provides funds and the other party runs the business. Profits are distributed according to the negotiated
percentage at the beginning of the contract. In the case of loss, the agent receives no compensation for his or her efforts and the investor bears the losses. Mudarabah is one of the primary methods used by Islamic banks for investing the money of the depositors. Depositors will bear the loss or the profit depending on the performance of the project. Therefore, governance and the experience of Islamic banks is a necessity in order to maintain the depositor’s interest. This model replaces interest by profit sharing on both the liability and the asset side of the bank.

Wakalah Model (Agent)

Islamic banks may work as agents for investors. The bank will manage funds on the basis of a fixed commission. Terms and conditions of this contract are determined by an agreement between the concerned parties. This option can be reversed and the client can be an agent for the bank. In this case, the client buys goods in his name and performs a promise of purchase contract. After receiving the goods, the bank will sell the goods under the Murabahah model.

Musharakah Model

Musharakah is an agreement between two parties where they both provide capital for a project that they both can manage. Musharakah is partnership, normally for limited duration, and is formed to carry out certain projects or investments. It is very similar to the western style of joint venture. The philosophy of the Islamic banking system is based on partnership and profit/loss sharing. As Islamic banks develop over time, they are tending to participate in the management of projects to enhance the possibilities of positive outcome. Profits are shared
according to the ratios determined in the agreement and losses are shared equally according to equity participation.

Salam sale

A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity not available with the seller. The commodity is to be delivered on a specified future date in specified quantity and quality. The difference between Salam and a conventional forward sale is that the price of the commodity must be received at the time of agreement. The commodity must be described and known for both parties.\(^{29}\) Salam is usually used in the sale of agricultural products and other non-manufactured products. If a product is manufactured, then the transaction is called “Istisna.” A Salam sale serves the interest of both parties in the agreement. The seller will receive the money he needs to deliver the commodity. On the other hand, the buyer will get the commodity on an agreed time and will benefit from the encouraging price offered by the seller.

To protect the buyer from fluctuations in price, a parallel Salam may be created. Parallel Salam refers to a second Salam contract with a third party requesting the same kind of commodity. It corresponds to the commodity specified in the first Salam contract.

The Salam sale is considered a developing hedging technique for Islamic banks and is one of the few derivatives allowed in Islamic finance. Other derivative techniques used by Islamic banks are Urboun and Khiyar Al Shart.

\(^{29}\) The prophet Mohammad said:” He who sells on Salam must sell a specific volume and a specific weight to a specific due date.”
An Urboun contract is a sale contract in which the buyer pays part of the purchase price immediately and has the right to cancel the sale within a specific period. If the buyer cancels the sale then he or she will have to give up the Urboun (down payment). While Khiyar al Shart is a contract created at the signing of the sale agreement between two parties. This agreement gives one of the two parties the right to cancel the sale contract within a specified period of time. This type of contracts is similar to put option in the conventional framework. The only difference is that there is no fee paid at the start of this contract.

Istisna Model

Istisna is a sale contract of specified goods to be manufactured with an obligation on the manufacturer to deliver them upon completion.\(^\text{30}\) It is a condition in Istisna that the seller provides the raw material. Istisna includes everything that can be manufactured from constructing buildings to tailors. It differs from Salam in two main areas, the first being that in Salam the total payment for goods must be obtained on spot while in Istisna it is upon agreement. The second difference is that in Istisna the product must be manufactured and not harvested. Therefore, Salam is used more in agricultural contracts while Istisna is used under manufacturing contracts.

Ijarah Model

Ijarah or leasing is the transfer of ownership between two parties for a limited period of time. In Islamic banking and finance, Ijarah is being used in deals such as employment, consulting and some financing transactions. The Ijarah instrument is very flexible and it is

\(^{30}\) Refer to Glossary for more information
heavily used by Islamic banks. For example, the current employment contracts at AFH are an Ijarah contract between employees and AFH. AFH will rent their skills for a certain time and for a known price and in return employees will provide them with those skills and qualifications. Another example is giving wood to a carpenter to create a chair. If the wood is provided by the ordering party then it is Ijarah because they rented his skills. If the wood is provided by the carpenter, then it is Istisna. The last example is financing university students. For example, AFH may rent a seat in UNCW for a known period and will rent it to a student for a deferred price. Ijarah is creating wonderful financing opportunities for Islamic banks as well as Shari’ah-compliant solutions for individuals.

Role of Shari’ah Board

“The Shari’ah Supervisory Board is the guiding force of the Bank that channels all the Islamic banking, finance and investment transactions in the right direction.” (S. Hijazi, communication, August 16, 2009). When Islamic banks started, depositors joined those banks because they were operating under the Shari’ah rules and regulations. Hence, Islamic banks must ensure compliance with Shari'ah principles in its products, instruments, operations, and management. Therefore, Islamic banks are required to establish a Shari’ah board that supervises the Shari'ah department and monitors the bank operations. One of the key elements differentiating Islamic financial institutions is their need to demonstrate their compliance with Shari'ah in all their financial and non-financial activities.

31 Samer Hijazi is the manager of the risk department of AFH main branch. For a list of interview refer to Appendix G.
In both conventional and Islamic banks the existence of a supervisory and regulatory system is compulsory for:

- Increasing the availability of information to investors
- Ensuring the stability of the financial system
- Improving the money policy
- Islamic banks are required to maintain one more condition, compliance with Shari’ah.

Principle 7.1 of the “IFSB\(^{32}\) Guiding principles on Risk Management” states that Islamic financial institutions must have in place an adequate system and control, including a Shari'ah board/advisor to ensure compliance with the Shari'ah principles. Shari'ah compliance is the backbone of Islamic banking and finance that gives legitimacy to its practices. The absence of the Shari’ah board will affect the confidence of the public in Islamic banking and finance and would expose the industry to major reputation and credibility risks.

The Shari'ah supervisory board is an independent body of specialized scholars in Islamic commercial jurisprudence. Their mission is to review and supervise the activities of the institution and to ensure full compliance with the Shari'ah principles. Showing compliance with Shari'ah is a difficult task. Their mission is also to innovate and find solutions to transactions that are new to Shari’ah.

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\(^{32}\) The Islamic Financial Services Board (IFSB) is explained in Appendix D.
There can be no progress if there is no risk. Without risk some societies might turn passive in the face of the future (Bernstein, 1996). Islamic banking is a relatively a new industry, and risks inherited are not yet well comprehended. Islamic Banks need to establish sound risk management as a standard practice in modern banking to guarantee safe banking operations and maintain their business. Islamic banks construct risk management to be with accordance to Shari'ah regulations and unique banking features. Risk management is the process of measuring or assessing risks and developing strategies to manage it. To manage risks, Shari'ah requires Islamic banks to share risks with their clients and to encourage investors to be responsibly aware of risk and not just receiving return. This is accomplished by getting their clients involved. Under this Profit/Loss system, risk will be minimized by distributing it among investors (Figure 4). In order to mitigate risk, human behaviors such as trust are taken into consideration. Islamic banks are structured upon the principle of risk sharing. Islamic banks are seen as financial intermediaries that maintain and assist investors and depositors by becoming a trusted partner. There are two crucial steps that must precede the development of a robust risk management capability. The first step is proper identification of risks, and the second step is accurate measurement of risks. Figure five explains the main risks surrounding Islamic banks.
Risk Mitigation in Islamic banks

Understanding what risk means, and how people or organizations are ready to take risks, is essential to appreciating the basis upon which Islamic banks operate in their purest form. When risk is handled properly, it can provide the institution with opportunities and higher returns. The five main techniques used in challenging risks are retention, adaptation, avoidance, reduction, and transferring. In the Islamic framework, investors are allowed to use risk as an incentive for higher profits but this shall not be accompanied with any type of gambling or speculation (Gharar). The following steps will give a brief understanding of the previously stated techniques:

- Risk Retention: If risk is avoidable without losing any benefit, then the risk must be avoided.
- Risk Adaptation: The investor will modify his investment to include more stable markets and less volatile currencies. There are no restrictions on investing in any
equity market if it is acceptable by the Shari'ah. This type of risk is also called risk absorption and can be treated by adding some conditions by the credit department. The Islamic Shari’ah allows collateral, which is a good source of securing the debt. It is also permissible to have guarantees by third parties. Islamic banks also are creating a loan loss reserve (LLR) to protect against credit losses. These reserves are additional to those mandated by the central bank. Hence they help in minimizing the withdrawal risk that Islamic banks might face.

- **Risk Avoidance:** If the risk is very high, the Shari'ah will reject the investment and consider it as gambling regardless of the expected return. The Shari’ah board will contact the investment and treasury department to measure the degree of risk before deciding on any investment.

- **Risk Reduction:** Investors can invest in different stocks and firms that are acceptable by the Shari'ah. The bank may diversify its share in the stock market or it might build its reserves in different currencies and stable metals.

- **Risk Transferring:** Risk in Islamic banks may be transferred by hedging techniques as will be mentioned later. Another method will be through the Islamic insurance companies (Takaful).  

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33 There is debate between scholars about the prohibition of the conventional insurance because it contains interest. Refer to the Glossary at the end of this thesis for the definition of Takaful.
The major steps employed in management of risks faced by any investment are (Khandelwal, 2008):

- Identifying the source of risks
- Identifying the type of risks
- Measuring the degree of risk
- Evaluating and ranking risk
Determining the method and responses to be used

It is not possible to avoid taking a certain degree of risk, and no human action or human behavior is absolutely assured. Therefore, there is a large trend in risk awareness not only in institutions but also at the individual level.

According to S. Shaer (personal communication, July 07, 2009), Islamic banks incurred huge losses in the early stages of development. This was because of many factors such as lack of experienced employees, mismanagement, poor corporate governance, no clear strategy, and no specific benchmarks to follow. The first generation of bankers in this industry were concerned with spreading this industry rather profitability. Therefore, they covered losses using their own capital in order not to damage the industry’s reputation. This crucial phase of industry development dictated their strategy.

Like any institution, Islamic banks must have efficient and developed corporate governance. Governance of banks is crucial for growth, development, and risk management. The IFSB’s Corporate Governance Standards (IFSB, 2005) deal with four areas:

- General governance of the Islamic Bank
- Rights of Islamic banks in terms of governmental and legal issues
- Compliance with Islamic Shari’ah rules and principles which will affect the confidence of investors in the bank
- Transparency of financial reporting in respect of investment accounts
Islamic banking is a relatively new industry. After the tragic events of 9/11, one of the essential battles was to dry the resources of suspicious terrorist groups performing money laundering. Therefore to evade problems, Islamic financial institutions are requested to provide a higher transparency level than their peers in conventional banks, especially through the employment of strict money laundering prevention system. Transparency of financial reporting, implementation of accounting standards, and practices are vital for a sound governance structure (Iqbal, 2002). For an effective transparency system, Islamic Banks are expected to have accounting and auditing standards set by AAIOFE and IFSB or other regulatory institutions. They also need the following:

- A well developed corporate governance framework with updated enhancements

- External auditing companies such as Deloitte and Ernst & Young to improve the efficiency and transparency of the various transactions

- Continuous training programs for investors to increase their knowledge and awareness about the functionality of Islamic banks.

- Legal and institutional arrangements for insolvency, investor rights, investor protection and asset recovery, etc.

- Specialized training programs for employees.

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34 Refer to Appendix D for more details.
The main difference between Islamic and conventional banks exists in complying with the Shari’ah rules and regulation. Therefore Islamic and conventional banks face similar risks that might lead to a collapse. Zaher and Hassan (2001) states that the main types of risks that cause a systemic risk which can lead to a systemic failure are categorized into four types: 1) Credit risks, 2) Market risks, 3) Liquidity risks and 4) Operational risks.

Islamic banks may permit risky investments if they are not categorized as having any gambling or uncertainty. Wealth creation must be based on the principle of no pain, no gain which the Shari’ah has well recognized. The legal maxim, “No reward can be obtained without risk,” is a fundamental principle in Islamic law of transactions.

According to Basel Committee on Banking Supervision (BCBS) recommendations of managing specific risks (BCBS 1999 and 2001), a risk management system should be divided into three components, which are: 1) establishing an appropriate risk management environment, 2) maintaining the risk management process, and 3) creating specific internal controls. The establishment of risk management should be stated in the strategy of the bank. Maintaining this strategy relates to the internal control department which will set and assess the bank performance in following its risk management guidelines. The above components are either specific or common with commercial banks.

To establish a sound risk management environment, the top management board of the bank must review the risk management system. This is done by having a full reporting system that is guided by the internal control committee which will provide appropriate control over the exposure of the different categories of risk. Any suggested risk management procedures must be
derived from the Shari’ah principles. This internal committee shall provide the board with an appropriate risk management assessment. The following is a suggested model for such assessment:

- Legal professionals in the Shari'ah board integrate methods of compliance between the Islamic legislation and the local law.
- Establishing a risk department for monitoring and controlling various kinds of risks.
- Guidelines about risk management tools categorized according with the various bank departments.
- Independent audits for monitoring the financial and accounting system.
- Special training programs to monitor the progress of employees.
- Standardization of measurement tools for risk management purposes.
- Internal rating systems to maximize and monitor enhancements.
- Assigning a team responsible for reviewing the bank's commitment to the ethical, Shari'ah, performance, and risk management guidelines issued by the Regulatory institutions (e.g., AAOIFI, IFSB).
- The ability to liquidize unpaid obligations from financing instruments.
- Periodic review for international loans and monitoring their respective country rating.
- Monitoring business performance and analysis after each increase of debt.
- Reporting system to top/senior management for possible or current risks.
• Does the bank have PER and IRR?  

• External sources to help in the risk assessment process.

• Worst-case scenarios to prepare contingency plans for different situations.

According to B. Khatib (personal communication, July 16, 2009), Islamic banks should issue monthly reports assessing the following risks:

• Foreign exchange risks

• Operational risks

• Liquidity risks

• Credit risks and market risks

According to Iqbal (2000), Islamic banks and financial institutions should formulate a strategy for risk management in Islamic financial markets that will include:

• Comprehensive and detailed discussion about derivatives within the framework of the Shari’ah.

• An expanded role of financial intermediaries with special emphasis on facilitating risk sharing.

• Applicability of Takaful to control financial risk.

• The application of financial engineering to develop synthetic derivatives.

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35 Profit Equalization Reserve (PER) and an Investment Risk Reserve (IRR) are internal reserve funds created from stakeholders’ contributions to back-up the bank in the case of loss or in the case of unexpected returns.
Types of Risks Facing Islamic Institutions

According to Figure 6, the main financial and business risks faced by Islamic banks are:

- Financing Risks such as liquidity risk and credit risk.
- Market Risks such as foreign exchange risk, benchmark risk and securities price risk.
- Operational Risks such as people risk, technological risk and legal risk.

In the section below, the major types of risks will be identified with possible solutions. After that, some of the hedging techniques will be discussed from an Islamic perspective.

Figure 6. Main business and financial risks

Source: (Khan, T. and Ahmed, H., 2001); with modifications
Liquidity Risk

According to Maroun (2002), the most vulnerable weakness of Islamic banks is the limited tools available for their liquidity management and the lack of secondary markets. Once a debt is created it cannot be sold or transferred except at par value. Liquidity risk is the potential loss due to the incapability to meet obligations or to fund increases in assets. The two major types of fund providers are the current account and the PLS\textsuperscript{36} accounts. Because the current account generates zero profit, it is considered as a debt or a loan that will be paid instantly upon the client’s request. Therefore, Islamic banks must provide enough funds to support potential withdrawals. In addition to that, the central bank of Lebanon mandates banks to keep 25 percent of their deposits as a legal reserve. The PLS accounts also are subject to withdrawals upon clients’ request unless it is an investment account and conditions are predetermined. Some of the reasons that may cause such withdrawals are:

(a) A lower rate than expected rates of return 
(b) Rumors and concerns about the financial status of the bank 
(c) Non-compliance within the Shari’ah in various bank activities.

The slow development of Islamic instruments constrains the ability to raise funds quickly from the markets. Insufficient inter-banking communication between Islamic institutions makes the threat of obtaining a liquidity risk more likely to happen in Islamic banks. Islamic banks also cannot benefit from the facilities offered by the lenders of last resorts because they are based on interest. Today, Islamic banks are developing ways to manage liquidity risk by

\textsuperscript{36} PLS refers to Profit/Loss Sharing.
creating Shari’ah-compliant inter-banking solutions such as commodity Murabahah and reverse Murabahah. Other solutions were developed by issuance of Islamic bonds (Sukuk). Sukuk are similar to bonds in conventional finance, but they differ in the prohibition of interest.

According to Yaqoobi (2008), liquidity risk in Islamic banks is reduced internally and externally. It is reduced internally because it goes through the Shari'ah board principles that treat bank management, shareholders, and stakeholders as trusted business partners. It is reduced externally, because it is regulated and connected with the real sector underneath the Shari’ah regulations. Risks such as rate of return, withdrawal, and treasury risk will all lead to liquidity risk.

To protect against liquidity risk in Islamic banks, it is essential to set a liquidity management framework and a reporting system to measure the liquidity exposures in the various types of accounts (Ismail, 2008). Figure 7 explains some of the sources of liquidity under the Islamic framework.
Commodity Risk/ Price Risk

Islamic banks tie their financing contracts to real assets and this is typically another unique attribute of their operation (Kahf, 2000). This may lead to other risks such as pricing risk, depreciation and amortization, or maybe asset loss. Commodity risk is mainly caused by the Salam contracts because of the possible price fluctuations in the future. It also happens when Islamic banks bear the risk of price variations after the delivery. To solve this issue, Islamic banks may enter in a parallel Salam contract to hedge against this risk. The bank is also bearing risk in parallel Salam when the first party fails to deliver on time.
Credit Risk

According to various bankers interviewed, credit risk is defined as the prospect that the counterparty fails to meet its obligations in accordance with agreed terms. This type of risk is considered to be the main risk associated with Islamic as well as conventional banks. The lending in conventional banks is replaced by investment and partnership in the Islamic banking system. Therefore, Islamic banks have a chance of experiencing credit risk because the value of the traded commodity is volatile and may change. Islamic banks have to bear market risk and commodity risk on the asset side of the balance sheet (Tariqullah, 2007).

In Murabahah financing, Islamic banks are making a contract called purchase order accompanied with another contract called promise to purchase. This is done in order to guarantee the purchase of the asset when it is transferred to the bank's ownership. If the bank delivers the commodity to the client who fails to pay his term payments, the Islamic bank cannot impose any additional fees on the contract. To prevent this from happening, Islamic banks should maintain a portfolio database about their clients. Also, they are required to investigate about any potential Murabahah client to ensure his or her ability to pay. Relatively risky clients should be screened upon the following criteria:

- Monthly installment must be less than 30 percent of the monthly income
- Credit rating
- Reason for purchase

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37 Dr. Shaer, Mr. Omeich, Mr. Baadarani and others.
• Binding orders
• Down payment
• Collaterals and guarantees when available

Although it is prohibited to charge any fees, if the client fails to pay his obligations, some Islamic scholars developed an alternative to impose penalties. The alternative states that if the bank proves the client’s ability to pay and yet the client is not paying his dues, then the bank may impose penalty fees on the client. To eliminate any similarity to interest imposed from conventional banks, Islamic banks must donate the money to charity (Shaer, 2009). Another method to reduce the credit risk in Murabahah financing is by using cash collaterals and personal guarantees.

As mentioned earlier, partnership in Islam allows the distribution of profits upon agreed percentages while losses are shared equally depending on the contributed proportion. In the case of Mudarabah, if the bank is the silent partner, it cannot participate in the management of the investment. To minimize the risk of loss, Islamic banks may follow certain criteria and procedures before trusting a partner. For example, the bank may not enter in partnership with a partner with little or no experience. Also the bank must be totally aware of the type of investment and the environmental factors surrounding it. In the other type of Mudarabah where the bank is using depositors' money, risky investments are eliminated or reduced to protect them and to keep the bank’s reputation.

In Musharakah, the bank is also exposed to a high degree of loss because of the partner. The bank may chose its partner of Musharakah investment in a manner similar to that
explained in Mudarabah. On the bank's part, a specialized team must be monitoring, managing, and reviewing the investment. If the bank does not have the specialized workforce in that kind of investment, then an external consultant company may be deployed. Similar to Mudarabah, screening of investments may be done to protect the depositor's money.

To minimize the exposure to credit risk, Islamic banks are advised to test the bank’s levels of risk. Islamic banks may identify a list of possible items to finance in order to guarantee full compliance with Shari’ah. Islamic banks must have appropriate methods for measuring, reporting, and assessing the credit risk exposure taking place under the various Islamic contracts. In Murabahah financing, the bank determines its profit and sells the product to the client by installments. The bank cannot in any phase change any condition of the contract by setting a higher rate or decreasing the term of the contract.

To minimize credit risk, Islamic banks may include an Administrative Credit Department which is responsible for the following:

- Negotiating and following-up pro-actively with the counterparty through maintaining frequent contact with the counterparty.
- Hiring agencies for the collection of debt.
- Obliging penalties in accordance with the Shari’ah unit approval when a customer refuses to pay.
- Rescheduling the debt when necessary without any increase in the amount to be paid.
• If the debt obligation is high, Islamic banks often enforce a third party to guarantee or to provide personal collaterals.

Islamic banks try to offer competitive rates and still meet with the Shari’ah rules and obligations. An Islamic bank does not sell what they do not own. Therefore, the cost of funds in Islamic banks is higher than in conventional banks. They compensate by selling the real asset that will keep its value when the clients fails to pay their obligations. When that is done, Islamic banks take their contribution and profit of the sold asset and return to the client the remaining cash. Islamic banks use the depositor’s money for financing under the PLS, therefore any loss will be distributed equally among them.

Market Risk

Different from conventional banks, the market risk in Islamic banks is concentrated in the banking book due to Murabahah, Ijarah, Salam, Musharakah and Murabahah. Therefore credit risk and market risk must be managed together. The market risk in Islamic banks refers to the potential impact of adverse price movements such as benchmark rates (mark-up risk), price risk, foreign exchange (FX) risk, as well as price fluctuations in Sukuk and securities price risk. The market risk may also arise from a decrease in the returns of investment accounts (saving). To protect against this, Islamic banks are creating special funds (IRR and PER) aimed to support the clients in the case of non-desirable outcomes. These funds are created from the contribution of some of the bank’s profits, investors, and Takaful companies (Islamic Insurance).

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38 Banking book is an accounting book that indicates investments that are not recorded on the balance sheet of the bank. The banking book may refer to the off-balance sheet accounts that are awaiting results.
Mark-up Risk

Under Murabahah, the pre-determined profit rates in Islamic banks are fixed for the entire period of the contract. Therefore Islamic banks cannot benefit from upward movement in rates. On the other hand, clients will not benefit from any decrease in the market rate. Clients will pay the same in their last month as in the first one.

Foreign Exchange rate risk

The majority of Islamic banks use the US dollar as their base currency. The volatility and weak performance of the dollar may expose the bank to high currency risks. Similar to conventional banks, Islamic banks are subject to FX risks when dealing with international correspondent banks who deal with stronger currencies. Islamic banks are neither allowed to deal in FX futures or options, nor permitted to buy currency on a short or long basis. The only option allowed is buying and selling on the spot. It is mandatory to have the money in their accounts and receive a receipt for this transaction.

To protect against FX rate risks, Islamic banks may diversify their base currencies by a pool of the major currencies available. Another method is to set their base currency in diversified stable currencies such as the Saudi Riyal. In Lebanon, the currency is stable at 1507.5 LBP/USD and is backed by the government and not by the rule of supply and demand. Banks in Lebanon are required to put 25% of their client’s deposits as reserves in the Central bank. Those reserves are in several currencies and are updated on regular basis.

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39 The Saudi Riyal is supported by the government of KSA and is considered a fixed currency.
Securities Price Risk

Islamic banks are allowed to invest in the stock market if the company is selling Shari’ah-compliant products and has less than 5 percent prohibited business or less than 33 percent of debt. Like conventional banks, in the stock market, Islamic banks are exposed to the same level of risks. Stocks are considered a very controversial subject according to a variety of scholars. Some consider dealing with stocks prohibited and others allow it if it meets the Shari’ah standards. Islamic banks are not allowed to use options, futures, forwards, short, or long selling. They are also required to bring proof of ownership whenever a stock is bought or sold to guarantee dealing with real assets in a real economy. The current use of stocks in Islamic banks is limited to some businesses, and there is a trend to replace dealing with stocks to dealing with Sukuk that contain similar attributes as stocks.

Reputation Risk

Reputation risk will affect the industry as a whole. This risk takes place when an Islamic bank fails to meet its business strategy; shows weakness in corporate governance and business operations; or lack of performance in the Shari'ah department which regulates the validity of operations in the Islamic bank. To eliminate or reduce reputation risk, Islamic banks are supposed to maintain a high level of transparency and a well established Shari’ah department. Islamic banks are competing with banks that can offer cheaper services and higher returns therefore reputation is a key element in the success or failure of any Islamic bank. To minimize this risk, Islamic banks are supposed to have the following:
• Clear business strategy
• Marketing campaigns
• Experienced workforce
• Known Shari’ah board

Interest Rate Risk

Despite the fact that Islamic banks do not deal with interest in all their business operations, they are indirectly affected by interest rates because they are located in a market oriented economy triggered by interest rates. Interest rate risk is related to the market risk discussed earlier. Islamic banks are not directly affected by fluctuations in the interest rates. This risk may be hedged by selling fixed income assets, by securitization of existing illiquid financing facilities, or by the sale of participation certificates that are already held.

Operations Risk

According to BCBS (2001), operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and technology or from external events (p.2).

The novelty of this industry exposes the bank to the risk of not having the capacity and capability of qualified individuals who are able to perform operations efficiently and effectively. Another risk is the scarcity of Islamic financial software in the market. This will expand the information technology risk of developing and using experienced technologies. Operational risks are more significant in Islamic banks than conventional ones due to their specific features such
as Shari’ah requirements and legal environment. The main operational risks associated with Islamic banks are people risk, technological and system risk, and legal risks (VicaryAbdullah, 2007).

People Risk

People risk in Islamic banks is characterized by the scarcity of experienced personnel in the industry. Therefore, lacking the experienced workforce decreases efficiency and trust in the industry which may lead to reputational risk.

Islamic banks are known as religious and ethical banks therefore their employees have an ethics code and a certain level of religious understanding which helps them gain the trust of their clients. To protect from people risk, Islamic banks must always train their personnel and encourage them to achieve expertise and qualifications in the Islamic banking industry.

Technological and System Risk

Technology risk is the second type of operational risk and is related to the use of software and hardware systems that are not designed for Islamic banking needs. Islamic banks face risks associated with providing secured and efficient systems that are in compliance with the Shari'ah rules and obligations. The scarcity of a Shari'ah-compliant management information system puts the industry under a huge risk of security, compatibility, and functionality. Today Islamic banks are using software designed for Islamic banking operations, but they still lack the desired efficiency and the required technical support. Therefore, a serious attempt must be made
by Islamic banks in cooperation with software companies to develop a secure, efficient, and reliable system for the various operational needs of the bank.

Legal Risks

Legal risks are very important in Islamic banks because of certain conditions that the Shari’ah board requires for the contract to be valid. These conditions may contradict with the common laws and legislations enforced locally. Islamic banks that operate in countries with no Islamic court have an increased legal risk. In an environment with no Islamic courts, Islamic financial contracts include choice-of-law and dispute settlement clauses (Vogel and Hayes 1998, p.51). To minimize this risk, Islamic banks are hiring top lawyers and legal professionals to find possible exits when contradictions occur between Islamic law and common law. Islamic banks are also trying to attract religious and governmental figures to affect the decision making process when certain banking laws are negotiated.

Benchmark risk

Benchmark risk is the possible loss due to changes in interest rates in conventional banks locally or globally. Islamic banks are indirectly affected by interest rates when determining the rate in instruments such as Murabahah (cost-plus financing). The benchmark rate is crucial for Islamic institutions to be competitive in a market full of experienced conventional banks. Normally, Islamic banks use the London Interbank Offering Rate (LIBOR) to determine the mark-up rate.
Another type of benchmark risk, similar to interest rate risk, is the capability of the Islamic bank to provide depositors with competitive profits. To protect from this risk, Islamic banks must increase the public awareness about the true message of the Islamic bank. On the other hand, they may decrease the cost of operations to be able to lower rates offered on Murabahah.

Withdrawal and displaced Commercial Risk

Since the rate of return in Islamic banks is variable, Islamic Banks are under the risk of withdrawals. Displaced commercial risk arises when under commercial pressure banks forgo a portion of profits to pay the depositors in order to prevent withdrawals due to lower returns than conventional banks (AAOIFI, 1999). While conventional banks try to minimize, eliminate, or transfer loss to save their financial statements from downturns, Islamic banks try to minimize loss because investors and depositors are the main parties that will bear loss. Islamic banks do not tend to invest in risky projects using depositor's money because the chance of loss is relatively high. Although the returns may be higher in risky investments, Islamic banks in concept tend to invest in less risky investments due to lack of deposit insurance and guaranteed return. Some central banks mandate Islamic banks to keep a legal reserve in order to cover any capital loss of depositors. Having a low risk profile does not protect the bank from losses or lower returns. To keep depositors interested, Islamic banks should create alternatives to compensate depositors and to keep competitiveness with conventional banks. To minimize the risk of having low returns or incurring losses, Islamic banks must create special pools for reserve
funds such as a Profit Equalization Reserve (PER) and an Investment Risk Reserve (IRR). Those reserve funds are to adjust returns in case of less than expected results.

Fiduciary Risk

Fiduciary risk is the risk caused by the breach of contract by depositors. This risk may occur when:

- Islamic bank provides a lower rate of return than its competitors in the Islamic banking industry or in the conventional banking industry (benchmark risk).
- Islamic banks do not manage funds properly or show weakness in operations. (operational risk).
- Rumors about the bank in specific and about the industry in general (reputation risk).

Islamic banks’ main revenue comes from investing its client’s on-balance sheet capital along with its off-balance sheet fiduciary capital. Those investments are mainly from long-term investments, customer financing, and inter-banking transactions such as commodity Murabahah. The Islamic bank needs those funds to be accessible to honor its contract in any investment. Therefore when customers withdraw their capital, the bank ought to cover the exact amount from its own capital (also called fiduciary capital). Islamic banks are facing an increased exposure to fiduciary risk each time a client withdraws capital. To protect against that risk, Islamic banks decrease expenses and form reserve funds to support the rate of return when the bank is offering lower rates. Islamic banks are also required to improve their operations by providing effective

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40 Capital here refers to accounts such as unrestricted accounts, restricted accounts, long-term investments and commodity Murabahah accounts.
and efficient solutions to customers. The lack of transparency or Shari’ah commitment in abiding by the Islamic law may lead to reputation risk which will cause a withdrawal and loss of confidence in this bank.

Hedging Risks and Alternatives in Islamic banks

Islamic banking does not engage in risky investments and is more attracted to projects with a low risk profile to minimize the probability of loss. Islamic banks do not deal with conventional derivatives or with many future contracts, for Shari’ah-related reasons. This will minimize the risk of volatility, speculation, and will increase the pursuit of productive investments. In conventional banks, hedging occurs by using derivatives such as futures and options. According to Swan (2000), these instruments will provide a competitive over Islamic banks in the cases of economic turbulences. Islamic banks are prevented from mitigating the risk or selling of debts (Bai al-dayn). This will make it very difficult for them to hedge like conventional banks. In addition to that, Islamic banks question whether they should measure risk and create hedging techniques for the following reasons:

- They believe that they are not exposed to interest rate risk.
- They do not believe in the need to measure those risks because the risks are perceived as immeasurable given the lack of available risk management tools.
- Even if hedging tools are available, they are considered to be excessively costly.

In the following sections the focus is on some of the hedging techniques that are permitted for use in Islamic banks:
Immunization

Islamic banks can minimize the possibility of exposure to foreign currency fluctuations by hedging in a Shari’ah-compliant manner. Suppose AFH has to pay the amount of two million USD in three months. The current spot exchange rate is LBP 1500/USD. There is a risk of dollar appreciation. AFH can raise the PLS deposits in LBP for the value of two million USD and buy dollars with this amount at the spot rate and keep them in deposit accounts for three months. At maturity, the bank will share the earnings on the dollars with LBP deposit holders and thus the three months period is fully hedged by the bank.

Selling Debts

Selling of debts (Bai al-dayn) under the Shari’ah is restricted if those debts are sold with higher prices than the original debt. For example, if a customer owes an Islamic bank under a Murabahah contract the sum of 10,000 USD, under the Shari’ah, the customer cannot seek another bank to close the deal and pay the liability with a higher rate – even to another bank. That bank cannot pay any amount more than the 10,000 USD even if the maturity and terms are extended. Shari’ah allows the transfer of debt with no additional cost. Islamic banks can hedge themselves against this by asking for a person that can guarantee the customer. It is possible for Islamic banks to accept a lesser amount than the actual debt if they are at risk of losing the whole debt.

Debt-asset Swap

While the debt generated by Islamic banks cannot be sold, it can be used to buy assets. If bank A owes 2 million USD to bank B with maturity set to three years, and bank B decides to
buy assets worth 2 million USD from company X. Bank B lacks the liquidity needed. The company X will charge a Murabahah profit of 5 percent. Installments will be paid now from bank A directly to company X. Company X may supply products worth 1.9 million USD, and the supplier will receive cash of 2 million USD after 2 years. Another option would be receiving 2 million USD from bank A and the 5 percent (0.1 million) directly from bank B. This method is totally accepted by Shari‘ah and minimizes the liquidity risk.

Forwards/Futures

As discussed earlier, futures contracts are prohibited when payments and delivery of goods are postponed. Therefore Islamic banks may develop contracts based on the Salam sale contracts, the Urboun and the Khiyar al Shart Sale (put option).

Options are a powerful tool for hedging risks in conventional banks. However Shari‘ah prohibited trade in conventional options (Shaer, 2009, p.162). Currently researchers and scholars are developing new methods for hedging reasons. Salam is a contract between two parties where the buyer pays the price of a product on spot and agrees on a delivery later. Salam contracts are vulnerable to price fluctuations. To minimize this risk, a new contract is generated between the two parties in the Salam contract. This contract will be provoked by the seller of the Salam if the price appreciated to a certain level. In Sudan, this contract is becoming a regular practice under the name of a beneficence clause.
Financial Engineering and Product Innovation in Islamic banks

Al-Aghar (personal communication, April, 24 2009)\(^{41}\) states that financial engineering involves the design, development, and implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in finance. The main reason behind financial engineering is to lower transaction costs and maximize return. The major trend in this area for Islamic banks is importing enhancements from conventional banks and gathering their abilities to find innovative solutions to the various Shari'ah regulations.

The growth of Islamic finance largely relies on innovations in Shari'ah-compliant products for investment and risk management purposes. The future of this industry will promote financial engineering of Islamic products and will introduce new innovative financial tools. The area of development will expand to reach issuance of new types of Sukuk, Shari'ah-compliant stocks, Islamic funds, Islamic brokerage, better risk management tools and efficient Islamic Insurance (Takaful).

The importance of innovation and development of Islamic banking and finance includes the participation of the main regulatory firms in the industry. According to (Humayon Dar, 2005)\(^{42}\), the Islamic Development Bank is spearheading the world-wide movement of Islamic banking, the AAOIFI aims at developing accounting and Shari'ah standards for Islamic financial institutions, and the IFSB is undertaking the task of devising an internationally acceptable regulatory regime for Islamic financial services.

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\(^{41}\) Wasim Al-Aghar is the operations manager at AFH. For list of interviews refer to Appendix G.

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Product innovation is continuing to be an essential part of every Islamic bank development program. It is the key factor for Islamic banks to sustain their growth and extend their competitive advantage. Innovation refers to the development of new Islamic financial tools that meet with today's consumer’s needs and businesses. Innovation improves the efficiency of Islamic products and services as well as the bank’s performance in general. This can be applicable in technological development to reduce operational costs and provide consumers with more convenience. It will also create new markets, or it might expand those products to different markets.

Islamic financial engineering examines strategies and techniques for developing financial products. Three primary scenarios are applicable in establishing a strategy for product development.

I. Starting from conventional banking products (Imitation)

II. Starting from Islamic banking products (Mutation)

III. Developing a product from the real need of clients (Innovation)

Starting From Conventional Banking Products (Imitation)

According to Iqbal (2000), the purpose of reverse engineering in the context of Islamic banking is to have a conventional product as a reference, and then use Islamic contracts to construct a similar product with identical properties. An example of this would be lending on Tawarroq\textsuperscript{43} to pay an interest-based loan. Tawarroq is a non-desirable tool used by Islamic banks

\textsuperscript{43} Refer to Glossary
when it is absolutely necessary for the bank to raise cash. There are many kinds of Tawarroq, but only three will be explained. The first is, when a client needs cash, it is not convenient for Islamic banks to give money without earning any return. Since this return is considered interest which is strictly forbidden, the clients asks the bank to buy the products under a Murabahah contract on deferred terms and then sell them on spot in the market to earn cash. Islamic scholars allowed this method if the client does not sell it to the supplier.\footnote{Refer to the resolutions of the 15\textsuperscript{th} Islamic Fiqh Council about Tawarroq.} The second method that some Islamic banks use is called the banking Tawarroq. In this method, the client follows the steps as the first scenario, but instead the bank will act as the agent and sells the products on the behalf of the client to the bank or in the market. The client takes the cash and returns to the bank the amount deferred. This method is prohibited by the Islamic Fiqh council.\footnote{Refer to the resolutions of the 17\textsuperscript{th} Islamic Fiqh Council about Tawarroq.} The third method is when a client asks the bank to buy on his behalf Shari’ah-acceptable stocks from the market on spot price. The Islamic bank here adds its commission to the purchase price of the stock and treats the client as a borrower. After that the client asks the bank to sell the stocks and credit his/her account with them. In this method the client will have the cash requested and will return it upon agreement. The client in this case may profit or lose depending on the fluctuation in the price of the stock, but he will attain cash and the bank will gain the commission.

Banks that follow the strategy of imitation cannot envision the reason for having banks operate under the Shari'ah. Islamic banks adapted this strategy in the early stages of their development to perform banking operations in an effective way. Their aim was not to create products identical to conventional banks with a different name. It is done to provide similar

\textsuperscript{44} Refer to the resolutions of the 15\textsuperscript{th} Islamic Fiqh Council about Tawarroq.  
\textsuperscript{45} Refer to the resolutions of the 17\textsuperscript{th} Islamic Fiqh Council about Tawarroq.
products to ensure better acceptance by the audience. This strategy helps Islamic banks benefit from the marketing and experience provided by conventional banks about this product. The Islamic bank’s main objective is to create Islamic alternatives for their clients. One of these alternatives is by encouraging productivity and sharing on the basis of Profit/Loss Sharing (PLS). The Islamic banking model is that of a whole unit, therefore using the imitation strategy irresponsibly might lead to problems not known for the Islamic banking industry.

Islamic banks must start from the Shari'ah regulations in problem solving and product innovation, rather than approaching the problem from the opposite perspective. Too much imitation will lead Islamic banks to lose their identity as unique financial institutions. This exposes the industry in general to a large reputation risk and eventually causes a systemic risk.

Starting from Islamic banking products (Mutation)

Islamic banks and regulatory institutions recognize the uniqueness of the Islamic banking industry; therefore they are aware that any product advancement in one bank is indirectly related to the whole industry. Knowing the relatively small size of the industry, Islamic banks are more interrelated than conventional banks. A mutation strategy implies analyzing Islamic financial products, and performing modifications on them.

This strategy mandates the research to start from previously developed Islamic acceptable products which is why the realm of possibilities is large and very rich. Scholars and Shari'ah board members are always studying, monitoring, and performing modifications using
this strategy. It is more convenient for scholars and financial engineers to use this strategy to enhance Islamic-financial products and to create solutions to raised issues.

Islamic banks nowadays are using this strategy in product development to prove themselves as independent and mature financial institutions. The research and development team in regulatory institutions and some Islamic banks such as the Islamic Development Bank established in Jeddah is a vital component to enhance the productivity and efficiency of Islamic financial tools. An example for that would be the commodity Murabahah discussed later.

Creating a New Product (Innovation)

The third and final strategy is to derive innovation from real customer needs and try to develop products that might satisfy these needs. As this industry is growing, customers will largely determine its direction. Islamic banks in countries with developed Islamic Financial Systems such as Pakistan and Sudan are more aware of the need to innovate products designed solely for Islamic banks.

Development of Sukuk

Sukuk are asset-backed, stable income, tradable and Shari’ah-compatible trust certificates. Sukuk are an excellent solution to raise money for funding projects and investments. They are Islamic bonds with special features and, of course, not interest dependent. According to ArsalanTariq (2004), investing in Sukuk issuances involves the funding of trade or production of tangible assets. Sukuk are directly linked with real sector activities.
The issuance of Sukuk is a relatively recent phenomenon. It began in Malaysia in 1990 with the small issuance of RM120 million (30 million USD) by Shell Malaysia and has progressed to approximately 32 billion USD at the end of 2007 (Figure 8). Today, experts estimate that the total amount of Sukuk outstanding is currently about 120 billion USD which includes the Sukuk issuances in the GCC, Pakistan, Brunei and the 47 billion USD of Malaysian Sukuk and the outstanding securities. According to the Sukuk International Summit of 2008, in 2007 there were an estimated 180 Sukuk and Islamic certificate issuances worldwide, in seven currencies – the US dollar, the Malaysian ringgit, the UAE dirham, the Pakistani rupee, the Bahraini dinar, the Saudi riyal, and the Brunei dollar. The legitimacy of Sukuk structures in the Shari’ah lie in the fact that they do not take advantage of interest rate movements (ArsalanTariq, 2004).

Figure 8. Growth of the Sukuk Market in recent years

Source: IIFM analysis, IFIS, Booz & Company Analysis
The main types of Sukuk are described below:

Leasing Sukuk

This kind of Sukuk holds equal value and promises a predetermined income. It is based on leasing assets and on predetermined conditions. Those leased properties or assets generate a similar income each period and thus dividends paid to Sukuk holders shall be the same. This is different from interest paid on bonds because in Sukuk the property or project is already leased under a contract. This kind of Sukuk can also be used in the development of long-term governmental infrastructure projects such as airports, roads, buildings and schools. It occurs while selling tangible assets to a Special Purpose Mudarib (SPM). The SPM will rent the assets to the interested parties. The Sukuk will be issued and sold to the public with the government guarantee of rental.

Figure 9 shows the relationship between the four primary parties engaged in Sukuk. An example of funding the government is described below:

1. The government sells the title to the SPV
2. The SPV leases the asset to the government
3. The SPV issues trust certificate to investors
4. The SPV pays to the government the price of the asset
5. The government pays periodical leasing fees to Sukuk holders
6. On maturity, the government buys its asset back and pays the agreed price to the SPV, who will pay to investors
Mudarabah Sukuk

The Mudarabah Sukuk follow the principles of the Mudarabah instrument which implies that one party will provide the capital (Sukuk holders), and the other party will provide the necessary workforce and management. Sukuk holders and the Mudarib will agree on certain profit ratios, but the losses will be on the Sukuk holders only. This type of Sukuk is suitable for the various types of investments to raise money.

Musharakah Sukuk

The Musharakah Sukuk are instruments based on the rules of the Musharakah contracts discussed before. They are issued and sold to the public to generate the required capital to finance a project or an investment opportunity. It is considered more secured and safer than the
Mudarabah Sukuk, because the fund manager and the certificate holder will share the profits and the losses equally according to their capital participation in the project. The fund manager tries to acquire more shares to enhance his or her management abilities of the fund. The holders of those certificates may allow the central bank or other agencies to manage the investment on their behalf. This approach will give those agencies the full right to prepare and sign the necessary documentations. This ensures full compliance with the Shari’ah and will provide smoother operations with full transparency and efficiency (Maroun, 2002).

Salam Sukuk

The Salam Sukuk is based on the principles of Salam which imply buying a commodity on spot with delivery on a later specified date. For example, when the Central Bank of Bahrain issued Salam Sukuk, it acted as the Mudarib. In this case, the Special Purpose Mudarabah buys a commodity such as gold or crude oil and pays on spot for the entire amount. Another promise to purchase is issued by the interested parties to buy the commodities on maturity. This type of Sukuk cannot be listed in the market or sold because it is considered as a debt. Therefore, it must be held until maturity, and it is issued for a short duration (Maroun, 2002).

Other types of Sukuk

Other types of Sukuk can be developed by Islamic banks or Regulatory institutions to expand options of investors who wish to use their money in a Shari’ah-compliant manner.
Secured Murabahah Sukuk, Islamic Development Sukuk, and Istisna Sukuk are other types of Sukuk.\textsuperscript{46}

Challenges

Is it really Islamic? Is it not the same as conventional banking? Those among others are the common questions faced each time in a debate about Islamic banking and finance. Islamic banks have performed very well. In the rapidly changing global environment, sustaining this growth is becoming one of the main challenges Islamic banks are facing. As a new industry targeting a large segment of people, Islamic banks are facing challenges both internally and externally. This industry has a scarcity of resources, knowledge bases, trained human resources, publicity, state support, and societal support (B. Khatib, personal communication, July 16, 2009). This section will focus on some of the challenges and problems faced by Islamic institutions mainly in a mixed environment.\textsuperscript{47}

Islamic financial institutions have higher cash ratios than conventional banks. This is because Islamic banks are not supposed to use what they do not own. On the other hand, Islamic banks are not allowed to sell their debts to others and charge higher or lower rates. Instead they can transfer the ownership of debt without any change of price. Also, it is noted that the main stream of profits or losses in Islamic banks is directed mostly from their investments in Murabahah, Musharakah, and Mudarabah.\textsuperscript{48} It is also noticed that conventional banks depend mainly on loans and rarely allow depositors to participate in the bank’s investments. While in

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{46}] For more info about other type of Sukuk refer to “Liquidity Management and Trade Financing. In Islamic Finance Growth and Innovation” (Maroun 2002).
\item[\textsuperscript{47}] Mixed environment refers to the existence of both Islamic and conventional banks.
\item[\textsuperscript{48}] The three primary PLS instruments are Murabahah, Mudarabah, and Musharakah.
\end{itemize}
\end{footnotesize}
Islamic banks, the only acceptable type of loan is Qard Hasan or free-interest loan and is rarely used by Islamic banks.

In theory, the depositors of an Islamic bank share in the bank’s losses. If there are no profits, they should not make money. If there is a loss of capital, they can be at risk of losing their capital. This has never happened according to Abdul Kader Thomas.49 A main condition by the Shari’ah laws is that the probability of profits must be larger than the probability of loss. In addition to that, investors must obtain various studies on the project to visualize the outcomes. Hence, after meeting the previous conditions, it is clear that this approach by Islamic banks lessens the possibility of loss. In the case of profit, the system distributes wealth and income to a larger portion of the society because of the concept of the Profit/Loss System (PLS).

Islamic banks cannot guarantee a specific rate of return. This forces them to face more difficulties in attracting depositors than conventional banks. The conventional bank depositors are interested in a short-term rate of return with a zero possibility of loss. The Islamic perspective clearly points to long-term gains as well as the well being of the society as a whole even if that means sharing losses. Therefore, Islamic banks are at a huge risk of keeping deposits if the returns are not similar to conventional banks. Some Islamic banks working alongside with conventional banks are giving rates similar to the conventional ones to prevent the outflow of funds to the majority of conventional banks. According to B. Khatib (personal communication,

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49 Abdul Kader Thomas is the President and CEO of Shape Financial, a consulting and training group in Kuwait and USA.
July 16, 2009), when the returns are lower than the expectations, the bank and its shareholders may agree to cut a portion of their profit and donate it to depositors.\textsuperscript{50}

This practice unfortunately neutralizes any risk sharing advantage to the bank from operating according to a strict interpretation of Shari’ah law. It depletes the shareholders’ funds in periods for which realized asset returns underperform the market. It is believed that Islamic banks must increase the public awareness about the goals of Islamic finance, and it must recruit important religious figures to explain how Islamic banks work to prevent the flow of funds in the case of a bad financial year. In addition to what was mentioned above, Islamic banks face the following challenges:

Shortage of Experts in the industry

One of the main challenges facing Islamic banks is the shortage of trained experienced bankers associated with that field. Islamic banks, especially those in new and mixed markets, are facing difficulties in finding the right bankers. Islamic banks are attracting their workforce mainly from conventional banks and this might cause reputation and operational risk. AFH is currently following a strategy to train its team periodically and equip them with Islamic qualifications and certifications such as IFQ.\textsuperscript{51} AFH also attracted a significant portion of its employees from existing Islamic banks in Lebanon such as the Baraka Bank.

\textsuperscript{50} The term ‘donates’ means to give without any return. This type of donation is called “hiba” or a gift.
\textsuperscript{51} IFQ refers to Islamic Finance Qualification and it aims to explain the industry in a detailed approach. AFH require all employees to obtain this qualification.
Accounting Standardization

Institutions like Islamic Development Bank (IDB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), and an increasing number of organizations are working towards the development of Islamic financial and capital markets. They still need major enhancements and development to reach a standardization approach for Islamic banks. Another aspect of standardization efforts is to have a strong regulatory body to assess, monitor, and judge the performance of Islamic banks; with Islamic banking still in its infancy, it is important to convince people of the legitimacy of Islamic banking operations. AAOIFI tries to set standards for Islamic banks. However, it has no binding power to implement and impose its standards and regulations on banks.

Islamic Banks and Central Banks

Islamic banks have an uncertain relationship with the central bank and other conventional banks in their respective countries. Therefore, some are acting as sole legal entities in their countries due to restrictions from the central bank. In most countries, Islamic banks are put under the supervision of the central bank. Hence the relationship between central banks and Islamic banks must continue to be strengthened. If an Islamic bank is established in a non-Muslim country, then there is a significant legal risk concerning that country's rules and regulations that may contradict with the Shari'ah. In Lebanon, AFH and the Central Bank are not facing major problems due to the Shari'ah-based solution created by the general management and the Shari'ah board that complies with Law No 575.
According to Dr. Ahmed Jachi (2006), there is a need of a future road map for this industry to grow and integrate into the global financial system. He adds “Remarkable progress has been achieved in the field of Islamic Banking since its inception thirty years ago. However, despite a wide geographical expansion and significant growth, the industry continues to face tremendous challenges, primarily its need to be fully integrated in the global financial system. Such integration requires that the concerned authorities, including central banks, Shari’ah scholars, legal and tax specialists, and experts of Islamic financial institutions, combine their efforts in establishing a roadmap, in order to strengthen the industry, enable it to meet the challenges, and achieve the appropriate status.”

Islamic banks, as mentioned earlier, operate only on certain conditions. Therefore, Islamic banks require differential treatment on the part of the central banks. In the case of a financial problem, central banks under certain conditions lend to conventional banks to provide liquidity. This treatment is not applied to Islamic banks due to the prohibition of interest. Islamic banks may use the method of Tawarreq or reverse Murabahah where they buy a commodity from the central bank on a Murabahah basis and then sell this commodity for a third party on spot. This method will provide the Islamic bank with cash and will not expose the bank to interest loans. Another method is by creating a private reserve for each bank or a common pool by Islamic banks in the country under the supervision of regulatory institutions or the central bank. This reserve provides those banks with interest-free loans (Qard Hasan).

52 Vice President of the Central Bank of Lebanon.
53 Dr. Ahmad Jachi’s speech, delivered at the 3rd Islamic Financial Services Board Summit held in Beirut on 16-18 May, 2006.
In some countries, Islamic banks and commercial banks are required to keep a reserve of their deposits with the Central Bank. Those reserves are not interest free therefore Islamic banks must donate this money to charity or to other channels without benefiting from them. Currently the AFH R&D department is working on a commodity-based reserve based on precious metals rather than cash (W. Al-Aghar, personal communication, April 23, 2009). This method will provide Islamic banks with the necessary tools to act as an agent to the central bank and sell the commodity on the basis of Murabahah which generates profit instead of interest.

Another problem facing Islamic banks is the general lack of understanding of how they function. This may lead to the issuance of inappropriate laws. Therefore, central banks and Islamic banks must work together, for example through forming workshops and conducting regular meetings before imposing new laws.

Are Islamic banks really Islamic?

There is an argument between Scholars as to whether Islamic banking is really Islamic. The first part of the argument is whether Islamic banks are the same as conventional banks in terms of operations. This argument creates doubts that Islamic banks are only changing the names by which they operate. The second part of the argument deals directly with the main objectives of the Islamic financial system. It states that the most common Islamic financial instruments such as Murabahah, Musharakah, and Mudarabah are being used on a fixed-return basis. They also claim that even the Musharakah- and Mudarabah-based products are designed in a way that will generate a fixed rate of return.
Another aspect of challenges facing Islamic banks is the benchmark rate used in Murabahah transactions. Some critics, including economists and researchers, strongly object to the method of Islamic profit on the basis of the current interest-rate benchmark, usually LIBOR. Those critics believe that Islamic banks are making their transactions similar, if not the same, as conventional banking. Hence, from a Shari’ah perspective they become doubtful of adherence to appropriate standards.

To protect Islamic banks and their clients, governments and large Islamic banks should gather resources in order to form a strong Islamic inter-banking market to provide their own benchmarked rates. Currently the inter-banking market between Islamic banks is weak because of the following reasons:

- limited information on the traded commodity
- weak trading standards
- unqualified market makers
- no credit rating agencies
- lack of official supervision and regulation
- instruments which are largely questioned by the Shari’ah.

Islamic banks may provide the same outcome from a service as a conventional bank but, according to Shari’ah, this service might be prohibited if performed under the conventional framework. People might not understand the differences between an Islamic contract and a conventional one, especially when they have the same results. When Shaer was asked about the real difference between Islamic and conventional banks and if they attain identical outcomes he
replied, “It is all about contracts and their respective conditions.” He gave this example; “Imagine a couple sleeping together before marriage, and a couple sleeping together after marriage. What is the difference? It is all about contracts” (S. Shaer, personal communication, July 03, 2009). From a conservative society the message was clearly delivered.

Attacking Challenges

Although Islamic banks and conventional banks are different in many aspects, they are both structured in a similar way. For Islamic banks to function properly, they must have a proper organizational framework, a legal framework, accounting standards, and supervisory framework to be able to perform the various tasks.

Islamic banks can benefit from the design of the organizational framework of conventional banks, and they may arrange innovation and financial engineering when it is necessary. Problems may arise in countries where there are no laws set by the government for Islamic banks. In Lebanon, it was not until 2004 that the Central Bank of Lebanon issued a legal framework for Islamic banks.54 As the demand for the industry grows, Islamic bankers become more focused and determined to adapt.

54 Refer to Appendix A.
CHAPTER 3

LEBANON AND THE ARAB FINANCE HOUSE

Islamic Banks Requirements According to the Lebanese Law

According to Chammas (June 2006), establishing an Islamic bank in Lebanon requires the following:

• The minimum capital required is 100 million USD, but a Minimum of 20 million USD is accepted if the new institution is a member of a group which provides backing for the remaining 80 million USD. This is the case of the Lebanese Islamic bank, backed by Credit Lebanese. As an example, the AFH started with 60 million USD but raised the amount to 100 million USD in 2008.

• Each Islamic financial institution is to appoint its own Shari’ah Board

• A maximum of 30 percent of the IFI capital is allowed to be represented in fixed assets

• 12 percent of net investment profit should be placed in reserve until it reaches an amount which is double the amount of the IFI capital. This requirement is additional to the prudential reserve of 15 percent of total deposits held at the central bank.

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55 Ghassan Chammas is a professor at the Lebanese American University and has conducted significant research about Islamic banking and finance.
• An IFI cannot finance a company belonging to its group in an amount which exceeds 30 percent of its capital, maintaining a maximum of 10 percent of its capital with each of its group companies.

• A minimum of 50 percent of the total investment portfolio of an IFI should be invested or placed in Lebanon

• Murabahah, Mudarabah, Musharakah, Ijarah, Istisna, and Salam operations are allowed and regulated

• Islamic collective investment funds, operations, and establishment are allowed and regulated.

• Sukuk instruments are, to the date of this document, under study and a draft of the regulation is already under final revision by BDL legal department.

The Economic Situation in Lebanon During the Last Five Years

Lebanon suffered a huge setback in 2005 after the assassination of the former Prime Minister, Rafic Hariri. The annual rate of GDP growth, according to the Institute of Statistics and Research, dropped from 4 percent to 0.39 percent, with an increase in the debt to 37.7 billion USD in November 2007. The level of debt continued to increase during 2005 and through 2006 until it reached, according to the latest estimates, around 50 billion USD at the end of 2008. Lebanon is ranked third in the world in public debt in relation to economic activity, at 163.5 percent of GDP. The budget of Lebanon consists of 7 billion USD in revenues and 10 billion
USD in spending. In July of 2006, Israel attacked Lebanon for 33 days, causing total deaths of 1,300 civilians and a huge damage to the infrastructure. This attack cost Lebanon billions of dollars and destroyed the tourism season. The Arab world helped in the rebuilding process, lead by the Kingdom of Saudi Arabia and Qatar. Despite what was mentioned and the internal conflicts followed by the war, Lebanon is still attractive to Arab and foreign investors. Arabs consider Lebanon attractive because of its open political and banking system and its location on the Mediterranean Sea. A report issued by the US Department of Commerce identified some investment opportunities in Lebanon. The main points discussed in the report are:

- Lebanon is in the center of the Middle East on the Mediterranean Sea.
- Absence of control on capital flow and foreign exchange
- Minimum or no restrictions on foreign investment
- Extremely low taxes
- High quality of life standards
- Experienced and educated labor
- Experienced and developed banking sector with secrecy system

Lebanon is also famous for tourism with an average of 1.7 million tourists arriving each year, mainly from the Gulf. For the reasons stated above, the availability of a secure and developed banking system is a must. The banking secrecy law is desired by most if not all Gulf

57 Tourism is considered the main industry in Lebanon after banking with a total of 1.7 million tourists is expected in summer 2009. Lebanon’s total population is 4 million.
investors and tourists. Most Islamic banks in Lebanon are supported by major Islamic banks in the Gulf. In addition to that, many Gulf investors and tourists are interested in a Shari’ah-compliant bank. Therefore, opening a large Islamic bank is desired by most if not all the gulf tourists and investors.

According to the Chairman of Byblos Bank, Mr. Francois Basil, “Our sound banking system, our traditional experience in international finance, our respected banking secrecy law, and our highly trained and educated human resources confirm once more that Lebanon is set to play a leading role in the development of Islamic financial industry at large (personal communication, May 05, 2009).”

SWOT Analysis of the Banking Sector in Lebanon

Lebanon was the second country in the world after Switzerland to adopt the Banking Secrecy Law on the 3rd of September, 1956. This system encouraged many foreign investors to save their money in Lebanese banks to protect them from possible governmental intervention.

This section will study the Lebanese financial and economical system using a SWOT analysis.

Strengths

- A liberal economic system
- Mature central banking authority
- Developed banking system and advanced technological enhancement in information security

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60 Refer to Appendix A.
• Support from BDL in case of a crisis
• Enhanced BDL regulations and supervision
• A healthy banking system that is considered the strongest sector in Lebanon with the highest liquidity
• Banking Secrecy Law is the most distinct in the region
• Improved risk management and reserve requirements set by BDL for 25 percent for each bank
• Diversity in bank funding activities, core deposits, certificate of deposits, preferred shares, and IFC Syndicated loans
• Overall confidence and trust in Lebanese banks
• Safety of depositors’ funds is a priority. Lebanese banks are well connected with the local police department.

Weaknesses

• Unstable political environment
• Internal\(^{61}\) and external threats\(^{62}\)
• Very weak corporate governance
• High level of corruption\(^{63}\)
• Economic recovery fundamentals – lacking

\(^{61}\) Internal threats: Hezbollah is heavily funded by Iran and Syria and it is heavily armed. Lebanon is the only country in the Arab world with much diversity (19 religious sects).
\(^{63}\) Lebanon is Rated 102 in the world in the Corruption Perception Index as of 2008 with a corruption score of 3 over 10, 1 being the worst.
• Annual Reports of many banks needing more transparency, information, and analysis.

Opportunities

• Privatization will create generous opportunities for economic growth (e.g., electricity, telecommunication)
• Lebanese banks have expanded to Arab and European countries and found new markets

Threats

• A huge debt of over 50 billion USD.
• Basel II requirements might challenge the viability of several smaller banks in the system.
• Lebanon is ranked the second highest in the world with public debt, as a percentage of GDP.

Arab Finance House development

According to Z. Baadarani (personal communication, June 06, 2009), the Arab Finance house has witnessed a significant advancement from its formation in 2004 until today. The main branch moved to a tower of ten floors and six other branches have opened so far. For an Islamic bank in a disturbed country like Lebanon, this shows the fast and steady development of the bank. The Global Finance Awards awarded the AFH as the best Islamic bank in Lebanon for the second consecutive year, and it announced that the AFH controls over 60 percent of the Islamic banking industry in Lebanon. This success was the outcome of hard work by the upper management, lead by Dr. Fouad Matraji, the general manager of AFH.64

64 Dr. Fouad Matraji is well known between Arab banks as one of the most influential figures in banking. He was awarded the Cedar award (the highest presidential award) by the president of Lebanon for his extraordinary contributions in the banking system of Lebanon.
The Lebanese banking sector is developing at an accelerated pace, and it plays a vital role in the progress of the national economy. The AFH is proud of its leading position in the Islamic banking sector (S. Ammar, personal communication, October 09, 2009).

The Organization of the AFH

AFH depends on the capital and labor to generate products and services that meet the clients' demands. It has a set of rights, privileges, responsibilities, and obligations guided by a hierarchy of authority. The management of AFH is divided between managers and decision makers who interrelate in various tasks. AFH responds to the speed of the industry by developing a powerful information system that improves the overall performance of the bank.

Managers are responsible for planning, organizing, coordinating, deciding, and controlling the bank. The managerial roles at AFH are categorized into the following:

- Interpersonal roles: The manager acts as figurehead and leader at the same time.
- Informational roles: The manager receives critical information and develops personnel capable of using it.
- Decisional roles: Managers act as decision makers in their departments. Examples of their tasks are allocation of resources, negotiating of conflicts, and initiating activities.

Decision makers are managers with higher authorities who are classified in the AFH into the following:

- Strategic Decision Making: They determine the long-term objectives, policies, and strategies of AFH. The General Manager and the board of directors form this council.
- Management Control: It is the auditing and quality-control department in the AFH. They are responsible for monitoring how efficiently and effectively resources are utilized and how well operational units are performing. They are also responsible for evaluating and producing new ideas for products and services as well as new procedures in performing tasks.

- Operational control: They are responsible for applying tasks specified by upper- and middle-management teams.

AFH's decision-making team’s ultimate goal is to help the bank gain competitive advantage by competing effectively and efficiently in the market. AFH’s business strategy is a combination of two strategies, cost leadership and differentiation. Because it is new in the market, AFH is trying to become the low-cost producer of the various banking transactions. On the other hand, AFH is trying to provide differentiated Islamic products and services with higher quality to meet and attract the demands of its clients. One example of differentiation is opening investment opportunities for clients who wish to invest their money in Mudarabah basis.

Marketing

For AFH to continue its success and growth, its mission in the coming years should focus on how to promote the bank locally and internationally. This helps the bank to be more recognized as a pioneer in Islamic banking. AFH must market itself as a leading, innovative, and global Islamic bank adhering to the highest Shari’ah and ethical principles. This is achieved by meeting international banking standards, partnering with the development of the global economy, and participating in the advancement of the Lebanese society.
Each organization that sells or offers products and services is required to have a formal marketing plan. This marketing plan should be clear and should also focus on the strategies that AFH undertakes. AFH must prepare this marketing plan once a year or prior to a significant new marketing initiative that requires an investment of the budget and/or internal resources.

The reason to create a marketing plan could be any or all of the following:

- Provide greater discipline in the planning process
- Provide strategic direction for the organization
- Provide an action plan for marketing-related activities
- Provide a formal record of marketing-related decisions
- Request the budget
- Create dialogue with the senior management
- Communicate marketing priorities to other parts of the organization

AFH can improve its existence in the market by these following plans:

- Advertisement: It is the best way to develop attitudes, create awareness, and transmit information in order to gain a response from the target market.\(^6^5\) AFH should use all sources of advertisement such as TV, radio, newspaper, magazine, boards, Internet marketing etc.
- Sponsorship: The AFH has the opportunity to spread its name by sponsoring teams, events, fairs, causes and ideas.

\(^6^5\) Source: [http://www.marketingteacher.com/Lessons/lesson_promotion.html](http://www.marketingteacher.com/Lessons/lesson_promotion.html).
- Social interaction: As mentioned earlier in this thesis, Islamic banks are ethical and social institutions with an ultimate goal of social development. AFH can improve its social appearance by enhancing the public relations department and building strong ties with the Lebanese society. Example of social ideas will be:
  o Blood donation
  o Supporting orphans
  o Educational advancement:
    ▪ Building a school for the poor
    ▪ Establishing institutions for teaching Islamic finance courses
    ▪ Series of lectures in the various universities and schools about the industry
    ▪ Trying to impose courses that teach principles of Islamic banking and finance in schools and universities
    ▪ Educate the society about the environment and establishing ideas for the bank to be environmental friendly
  o In the conservative culture of Lebanon, AFH can support marriage by building residential compounds and selling them on margin while covering the capital and the time cost of money.
- Religious support:
  o Inviting religious figures to speak and lecture about the industry
  o Sponsoring religious events
  o Building a mosque or participating in it
Creating a Zakat program in the bank to show commitment to Islamic principles

To continue gaining a competitive advantage and to increase the current market share, AFH must continue to respect the values and the strategies of the organization that are mentioned below by Mr. Badih Al-Khatib (personal communication, July 16, 2009):

Values
- Integrity
- Transparency
- Justice
- Co-operation and Teamwork
- Loyalty and Commitment
- Excellence

Strategies
- Enhance the good reputation in the Islamic financing services industry and sustain a pioneering presence in the local market
- Continue to develop operations in a manner that yields maximum returns for partners, investors and shareholders
- To satisfy the objectives of clients by offering innovative Islamic banking solutions
- Encourage the professional development of employees and develop a very efficient and productive workforce

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66 Refer to Appendix E.
• Utilize the latest technical know-how in order to upgrade the scope and efficiency of operations and services
• Enhance the geographical reach of products and services by ensuring that the product base satisfies the needs and aspirations of all demographic and economic customer profiles
• Achieve new strategic alliances and accomplish both horizontal and vertical expansion of activities

Lebanon is considered as one of the most developed countries in the technological infrastructure in the region. Therefore, banks are developing their information system infrastructure to extend their geographical reach, offer new products and services, and to minimize costs and time. Also, information systems help in establishing an efficient and secure way in conducting business. As AFH is growing in a relatively fast pace, information technology is crucial for linking various departments and branches. Currently the head of information technology and his team are working to develop the E-Banking system that will save money and time for both the bank and customers.

Financial Figures and Analysis for AFH

Research Methodology

During 2008, AFH recorded a phenomenal performance despite the critical financial circumstances that were affecting the world economy. AFH released exceptional figures and has reflected positively in a series of performance indicators. In order to see how AFH is performing, the balance sheet and financial income statement for the years 2006, 2007, and 2008 are
examined. This study will also measure the profitability and liquidity ratios to know their performance and significance level.

Profitability

In this section, I will use two indicators, the Return on Assets (ROA) and the Return on Equity (ROE).

\[
ROE = \frac{\text{Profit after tax}}{\text{Equity capital}} \quad (1)
\]

\[
ROA = \frac{\text{Profit after tax}}{\text{Total assets}} \quad (2)
\]

Table 1. ROA & ROE

<table>
<thead>
<tr>
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<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
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<tbody>
<tr>
<td>ROA</td>
<td>1.76%</td>
<td>2.02%</td>
<td>2.75%</td>
</tr>
<tr>
<td>ROE</td>
<td>2.61%</td>
<td>3.48%</td>
<td>5.11%</td>
</tr>
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The figures shown above indicate that the ROA figures are attractive and high. On the other hand, the ROE is low, due to lower leverage used in Islamic banks. The noticeable growth from 2006 until 2008 is showing that the AFH is following firm steps improves its statistics.
Liquidity Ratio

In this section I will measure the Financing to Deposit Ratio (FDR) for the years 2006, 2007, and 2008.

\[ FDR = \frac{\text{Total Financing}}{\text{Total Deposits}} \] (3)

Table 2. FDR Ratios

<table>
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<tr>
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<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDR</td>
<td>91.06%</td>
<td>93.86%</td>
<td>101.45%</td>
</tr>
</tbody>
</table>

Financial Highlights

In spite of the adverse global financial conditions in the last four months of 2008, admirable growth has been realized by the bank’s balance sheet as shown below:

- Net profit: 5.047 billion LBP in 2008 compared to 3.3 Billion LBP in 2007 (Growth: 53 percent) (Figures 15 and 16).
- Assets: Increased to 183.889 billion LBP in 2008 from 163.06 billion LBP in 2007 (Growth: 13 percent)
- Deposits: 16.6 billion LBP in 2008 compared to 12.2 billion LBP in 2007 (Growth: 36%)

Table 3. Financial Figures of AFH for the years 2006, 2007, 2008

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<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Cash Compulsory Reserves and Central Banks</td>
<td>7,641,433</td>
<td>12,720,587</td>
<td>16,362,078</td>
<td>66%</td>
<td>29%</td>
<td>114%</td>
</tr>
<tr>
<td>Deposits with banks and financial institutions</td>
<td>16,082,924</td>
<td>11,293,873</td>
<td>12,248,807</td>
<td>-30%</td>
<td>8%</td>
<td>-24%</td>
</tr>
<tr>
<td>Financing Facilities-Central Bank</td>
<td>N/A</td>
<td>N/A</td>
<td>4,715,915</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Financing Facilities-Financial institutions</td>
<td>70,735,395</td>
<td>41,468,390</td>
<td>15,964,621</td>
<td>-41%</td>
<td>-62%</td>
<td>-77%</td>
</tr>
<tr>
<td>Financing Facilities-Customers</td>
<td>204,459</td>
<td>7,491,067</td>
<td>35,982,978</td>
<td>3564%</td>
<td>380%</td>
<td>17499%</td>
</tr>
<tr>
<td>Available for Sale Investment Securities</td>
<td>22,994,080</td>
<td>20,968,894</td>
<td>24,058,147</td>
<td>-9%</td>
<td>15%</td>
<td>5%</td>
</tr>
<tr>
<td>Held-to-Maturity Investment Securities</td>
<td>4,068,533</td>
<td>35,525,017</td>
<td>32,376,962</td>
<td>773%</td>
<td>-9%</td>
<td>696%</td>
</tr>
<tr>
<td>Customers' liability under acceptance</td>
<td>588,151</td>
<td>995,066</td>
<td>2,064,486</td>
<td>69%</td>
<td>107%</td>
<td>251%</td>
</tr>
<tr>
<td>Other assets</td>
<td>5,821,346</td>
<td>8,400,442</td>
<td>6,568,393</td>
<td>44%</td>
<td>-22%</td>
<td>13%</td>
</tr>
<tr>
<td>Income receivables from credit contracts</td>
<td>N/A</td>
<td>1,508,688</td>
<td>3,771,078</td>
<td>N/A</td>
<td>150%</td>
<td>N/A</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>450,250</td>
<td>335,785</td>
<td>213,843</td>
<td>-25%</td>
<td>-36%</td>
<td>-53%</td>
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<tr>
<td>Property and Equipment</td>
<td>6,850,880</td>
<td>20,629,879</td>
<td>26,018,105</td>
<td>201%</td>
<td>26%</td>
<td>280%</td>
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<tr>
<td>Real Estate Investments</td>
<td>N/A</td>
<td>1,722,389</td>
<td>3,509,893</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

88
<table>
<thead>
<tr>
<th>Investments in Subsidiaries</th>
<th>N/A</th>
<th>N/A</th>
<th>33,956</th>
<th>N/A</th>
<th>N/A</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Bank Assets</td>
<td>135,437,451</td>
<td>163,060,077</td>
<td>183,889,262</td>
<td>20%</td>
<td>13%</td>
<td>36%</td>
</tr>
</tbody>
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</thead>
<tbody>
<tr>
<td>Current Accounts with Central Bank of Lebanon</td>
<td>1,457,186</td>
<td>1,968,302</td>
<td>653,298</td>
<td>35%</td>
<td>-67%</td>
<td>-55%</td>
</tr>
<tr>
<td>Deposits with Islamic banks-Income Earnings</td>
<td>N/A</td>
<td>678,750</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>Financing Activities-Central Bank</td>
<td>N/A</td>
<td>6,105,000</td>
<td>18,287,812</td>
<td>N/A</td>
<td>200%</td>
<td>N/A</td>
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<tr>
<td>Financing Activities-Financial Institutions</td>
<td>11,330,414</td>
<td>12,414,489</td>
<td>3,486,693</td>
<td>10%</td>
<td>-72%</td>
<td>-69%</td>
</tr>
<tr>
<td>Financing Activities-FI-Restricted</td>
<td>10,271,823</td>
<td>67,960,871</td>
<td>74,832,780</td>
<td>562%</td>
<td>10%</td>
<td>629%</td>
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<tr>
<td>Financing Activities-Customers</td>
<td>N/A</td>
<td>11,551,583</td>
<td>32,204,472</td>
<td>N/A</td>
<td>179%</td>
<td>N/A</td>
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<tr>
<td>Financing Activities-Customers-Restricted</td>
<td>18,708,016</td>
<td>32,571,134</td>
<td>72,335,191</td>
<td>74%</td>
<td>122%</td>
<td>287%</td>
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<tr>
<td>Available for Sales Activities</td>
<td>1,658,250</td>
<td>1,658,250</td>
<td>1,658,250</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Debit Balance with Bank's Own Accounts</td>
<td>3,238,918</td>
<td>8,010,397</td>
<td>818,856</td>
<td>147%</td>
<td>-90%</td>
<td>-75%</td>
</tr>
<tr>
<td>Total Fiduciary Assets</td>
<td>46,664,607</td>
<td>142,918,776</td>
<td>204,277,352</td>
<td>206%</td>
<td>43%</td>
<td>338%</td>
</tr>
<tr>
<td>Total Bank Assets and Fiduciary Assets</td>
<td>182,102,058</td>
<td>305,978,853</td>
<td>388,166,614</td>
<td>68%</td>
<td>27%</td>
<td>113%</td>
</tr>
<tr>
<td>Total Financing</td>
<td>40,310,253</td>
<td>130,603,077</td>
<td>201,146,948</td>
<td>224%</td>
<td>54%</td>
<td>399%</td>
</tr>
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<tr>
<td>Customer's Current Accounts</td>
<td>14,470,418</td>
<td>21,545,611</td>
<td>40,246,831</td>
<td>49%</td>
<td>87%</td>
<td>178%</td>
</tr>
<tr>
<td>Related Parties Accounts</td>
<td>819,749</td>
<td>1,366,083</td>
<td>3,096,419</td>
<td>67%</td>
<td>127%</td>
<td>278%</td>
</tr>
<tr>
<td>Parallel Murabahah</td>
<td>22,862,928</td>
<td>33,088,071</td>
<td>30,195,054</td>
<td>45%</td>
<td>-9%</td>
<td>32%</td>
</tr>
<tr>
<td>Customers’ Acceptance Liability</td>
<td>588,151</td>
<td>995,066</td>
<td>2,064,487</td>
<td>69%</td>
<td>107%</td>
<td>251%</td>
</tr>
<tr>
<td>Accrued and other Liabilities</td>
<td>1,317,175</td>
<td>2,976,379</td>
<td>8,513,824</td>
<td>126%</td>
<td>186%</td>
<td>546%</td>
</tr>
<tr>
<td>Provisions for Risks</td>
<td>481,571</td>
<td>119,430</td>
<td>209,549</td>
<td>-75%</td>
<td>75%</td>
<td>-56%</td>
</tr>
<tr>
<td>Due to Fiduciary</td>
<td>3,238,918</td>
<td>8,010,396</td>
<td>818,856</td>
<td>147%</td>
<td>-90%</td>
<td>-75%</td>
</tr>
<tr>
<td>Total Bank Liabilities</td>
<td>43,778,910</td>
<td>68,101,036</td>
<td>85,145,020</td>
<td>56%</td>
<td>25%</td>
<td>94%</td>
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</thead>
<tbody>
<tr>
<td>Share Capital</td>
<td>30,000,000</td>
<td>30,000,000</td>
<td>30,000,000</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
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<tr>
<td>Cash Contribution to Capital</td>
<td>58,038,750</td>
<td>58,038,750</td>
<td>58,038,750</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Reserves</td>
<td>769,115</td>
<td>863,733</td>
<td>1,140,155</td>
<td>12%</td>
<td>32%</td>
<td>48%</td>
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<tr>
<td>Retained Earnings</td>
<td>N/A</td>
<td>N/A</td>
<td>-1,059,274</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>Change in value of Available</td>
<td>462,323</td>
<td>2,756,058</td>
<td>5,576,622</td>
<td>496%</td>
<td>102%</td>
<td>1106%</td>
</tr>
<tr>
<td>Investment Securities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Profit for the Year</td>
<td>2,388,353</td>
<td>3,300,500</td>
<td>5,047,981</td>
<td>38%</td>
<td>53%</td>
<td>111%</td>
</tr>
<tr>
<td>Total Equity</td>
<td>91,658,541</td>
<td>94,959,041</td>
<td>98,744,234</td>
<td>4%</td>
<td>4%</td>
<td>8%</td>
</tr>
<tr>
<td>Total Bank Liabilities and Equity</td>
<td>135,437,451</td>
<td>163,060,077</td>
<td>183,889,254</td>
<td>20%</td>
<td>13%</td>
<td>36%</td>
</tr>
<tr>
<td>----------------------------------------------------------</td>
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</tr>
<tr>
<td>Deposits with banks-Wakalah Agreement (Agent)</td>
<td>10,252,152</td>
<td>52,532,501</td>
<td>55,241,288</td>
<td>412%</td>
<td>5%</td>
<td>439%</td>
</tr>
<tr>
<td>Deposits of Related banks-Wakalah Agreement</td>
<td>N/A</td>
<td>15,075,000</td>
<td>22,612,500</td>
<td>N/A</td>
<td>50%</td>
<td>N/A</td>
</tr>
<tr>
<td>Customers’ Deposits-Fiduciary Accounts</td>
<td>30,868,354</td>
<td>52,116,918</td>
<td>68,984,946</td>
<td>69%</td>
<td>32%</td>
<td>123%</td>
</tr>
<tr>
<td>Customers’ Deposits-Fiduciary Accounts (Restricted)</td>
<td>N/A</td>
<td>11,022,321</td>
<td>29,094,827</td>
<td>N/A</td>
<td>164%</td>
<td>N/A</td>
</tr>
<tr>
<td>Related Parties deposits-Fiduciary Accounts</td>
<td>634,342</td>
<td>2,627,989</td>
<td>13,834,352</td>
<td>314%</td>
<td>426%</td>
<td>2081%</td>
</tr>
<tr>
<td>Related Parties deposits-Fiduciary Accounts (Restricted)</td>
<td>N/A</td>
<td>581,443</td>
<td>2,720,240</td>
<td>N/A</td>
<td>368%</td>
<td>N/A</td>
</tr>
<tr>
<td>Blocked Deposits against facilities-Fiduciary Accounts</td>
<td>2,510,707</td>
<td>5,186,157</td>
<td>5,780,016</td>
<td>107%</td>
<td>11%</td>
<td>130%</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>2,399,052</td>
<td>3,776,447</td>
<td>6,009,183</td>
<td>57%</td>
<td>59%</td>
<td>150%</td>
</tr>
<tr>
<td>Total Fiduciary Liabilities</td>
<td>46,664,607</td>
<td>142,918,776</td>
<td>204,277,352</td>
<td>206%</td>
<td>43%</td>
<td>338%</td>
</tr>
<tr>
<td>Total Fiduciary &amp; Bank Liabilities &amp; Equity</td>
<td>182,102,058</td>
<td>305,978,853</td>
<td>388,166,606</td>
<td>68%</td>
<td>27%</td>
<td>113%</td>
</tr>
<tr>
<td>Total Deposits</td>
<td>44,265,555</td>
<td>139,142,329</td>
<td>198,268,169</td>
<td>214%</td>
<td>42%</td>
<td>348%</td>
</tr>
<tr>
<td>---------------------------</td>
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<td>-------</td>
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<td>-----------</td>
</tr>
<tr>
<td>Revenues of Banks and Financial Institutions</td>
<td>384,995</td>
<td>909,736</td>
<td>1,377,487</td>
<td>136%</td>
<td>51%</td>
<td>258%</td>
</tr>
<tr>
<td>Available for Sale Investment Securities</td>
<td>2,996,987</td>
<td>3,215,025</td>
<td>3,430,952</td>
<td>7%</td>
<td>7%</td>
<td>14%</td>
</tr>
<tr>
<td>Cash Compulsory Reserves and Central Banks</td>
<td>2,421,596</td>
<td>3,890,318</td>
<td>6,242,925</td>
<td>61%</td>
<td>60%</td>
<td>158%</td>
</tr>
<tr>
<td>Deposits with banks and financial institutions</td>
<td>-335,254</td>
<td>-1,299,136</td>
<td>-1,528,570</td>
<td>288%</td>
<td>18%</td>
<td>356%</td>
</tr>
<tr>
<td>Financing Facilities-Central Bank</td>
<td>5,468,324</td>
<td>6,715,943</td>
<td>9,522,794</td>
<td>23%</td>
<td>42%</td>
<td>74%</td>
</tr>
<tr>
<td>Financing Facilities-Financial institutions</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Financing Facilities-Customers</td>
<td>350,218</td>
<td>749,507</td>
<td>842,409</td>
<td>114%</td>
<td>12%</td>
<td>141%</td>
</tr>
<tr>
<td>Available for Sale Investment Securities</td>
<td>-67,107</td>
<td>-150,994</td>
<td>-254,668</td>
<td>125%</td>
<td>69%</td>
<td>279%</td>
</tr>
<tr>
<td>Held-to-Maturity Investment Securities</td>
<td>283,111</td>
<td>598,513</td>
<td>587,741</td>
<td>111%</td>
<td>-2%</td>
<td>108%</td>
</tr>
<tr>
<td>Customers' liability under acceptance</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Other assets</td>
<td>1,438,712</td>
<td>551,637</td>
<td>212,518</td>
<td>-62%</td>
<td>-61%</td>
<td>-85%</td>
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<tr>
<td>Income receivables from credit contracts</td>
<td>N/A</td>
<td>N/A</td>
<td>4,247,291</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>223,754</td>
<td>1,507,866</td>
<td>3,771,078</td>
<td>574%</td>
<td>150%</td>
<td>1585%</td>
</tr>
<tr>
<td>Property and Equipment</td>
<td>7,413,901</td>
<td>9,373,959</td>
<td>18,341,422</td>
<td>26%</td>
<td>96%</td>
<td>147%</td>
</tr>
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</table>
### Income from Sales of Subsidiaries

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<tbody>
<tr>
<td>Write back of provisions (E.O.S.I &amp; FX fluctuations)</td>
<td>N/A</td>
<td>2,843,059</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>Total Income and Write backs</td>
<td>215,362</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>7,413,901</td>
<td>12,432,380</td>
<td>18,341,422</td>
<td>68%</td>
<td>48%</td>
<td>147%</td>
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### Expenses

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<tbody>
<tr>
<td>Staff Costs</td>
<td>-2,923,323</td>
<td>-4,821,879</td>
<td>-6,446,197</td>
<td>65%</td>
<td>34%</td>
<td>121%</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>-1,054,110</td>
<td>-3,045,152</td>
<td>-4,588,556</td>
<td>189%</td>
<td>51%</td>
<td>335%</td>
</tr>
<tr>
<td>Depreciation and Amortization</td>
<td>-526,366</td>
<td>-834,944</td>
<td>-989,349</td>
<td>59%</td>
<td>18%</td>
<td>88%</td>
</tr>
<tr>
<td>Allocated Provisions</td>
<td>-243,879</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>-100%</td>
</tr>
<tr>
<td>Reserve for Emergency needs</td>
<td>N/A</td>
<td>N/A</td>
<td>-113,063</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>-277,870</td>
<td>-32,645</td>
<td>-260,470</td>
<td>-88%</td>
<td>698%</td>
<td>-6%</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>-5,025,548</td>
<td>-8,734,620</td>
<td>-12,397,635</td>
<td>74%</td>
<td>42%</td>
<td>147%</td>
</tr>
<tr>
<td>Profits before Income Tax</td>
<td>2,388,353</td>
<td>3,697,760</td>
<td>5,943,787</td>
<td>55%</td>
<td>61%</td>
<td>149%</td>
</tr>
<tr>
<td>Income Tax</td>
<td>0</td>
<td>-397,260</td>
<td>-895,806</td>
<td>N/A</td>
<td>125%</td>
<td>N/A</td>
</tr>
<tr>
<td>Net Profit (Loss) after Tax</td>
<td>2,388,353</td>
<td>3,300,500</td>
<td>5,047,981</td>
<td>38%</td>
<td>53%</td>
<td>111%</td>
</tr>
</tbody>
</table>

Source: Compiled by the author after an interview with the Accounting manager at AFH
Key Performance Indicators

Total Assets

According to the Balance Sheet and the chart illustrated in Figure 10, AFH increased its total assets from 135 billion LBP in 2006 to 163 billion LBP in 2007 (Growth of 20%). AFH increased the total assets at the end of 2008 to 184 billion LBP (Growth of 13%). This indicated a total increase of 36% from the beginning of 2006 until the end of 2008. This is a good indicator that the bank is tending to increase its market share in assets. Looking at the assets in Table 3, it can show the significant efforts in financing customers, and the decreasing interest for financing financial institutions.
According to Figure 11, the bank’s total deposits increased by 348% from 2006 until the end of 2008. The year 2008 witnessed an increase of 42% despite the financial crisis that hit the world financial system. The chart above shows that people increased their trust in AFH by increasing their deposits. This is the result of good management and effective marketing plans.
In Islamic banks, the asset and the liability sides have unique risk characteristics. Islamic banks operate as investment companies that use the Mudarabah model with multiple investment tools. The saving and investment deposits are profit-sharing accounts that are classified to restricted and unrestricted accounts. The current accounts are treated like a good faith loan or “Qard Hasan.” This type of account puts the bank in debt to its shareholders and clients, and it must meet its obligations by returning the funds when requested. This is the only allowed loan in Islam, and it carries a 0% interest rate. Therefore, any return on these accounts is considered strictly prohibited for being Riba. Customers use current accounts mainly for credit-card services and issuing checks. The significant one-year increase of 87% in 2008 is a good

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67 Restricted accounts restrict withdrawals before maturity.
indicator that clients and businesses are interested in using different bank facilities offered by AFH (see Figure 12).

Current accounts are considered to be a liability on the balance sheet. The bank is obliged to return the exact amount of money regardless of whether or not the bank invested it. Therefore, the bank bears losses generated from using this money. The significant increase also gives good indications about the liquidity at the bank and definitely decreases the liquidity risk generated from lack of funds.

Net Profits

Figure 13. Net Profit for the Years 2006, 2007, 2008

![Net Profit Chart]

The main concern is whether or not the bank is generating profits. As AFH revenues grew, taxes grew as well. From zero tax in 2006 to 12% in year 2007 to 18% at the end of the year 2008. The net profit of the AFH increased by a significant amount at the end of 2008 to

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5.047 billion LBP recording an increase of 53% compared to the year 2007. This percentage of profits put AFH in first place in Lebanon between all types of banks for the year 2008. It is expected that the year 2009 will bring better results because of the opening of two new branches in major Islamic cities in Lebanon. The strong performance of 2008 and 2007 is increasing the confidence in the industry and encouraging more clients to switch to Islamic banks (see Figure 13).

Real Estate Investments

Figure 14. Real Estate Investments for the Years 2007, 2008

Figure 14 shows the increase in real estate investments. These results are still low regardless of the increase from 2007. Despite the fall of real estate prices in most areas of the world, the prices in Lebanon increased dramatically during this period. AFH must increase its share in the real estate market by entering in Mudarabah contracts with contractors. Beirut, the capital of Lebanon, is becoming extremely expensive therefore there is a trend to build outside
the capital. AFH can contribute in building complexes, schools, hospitals and civil facilities as well as infrastructure for these areas. Such investments can help families to buy affordable houses and providing the bank with a decent profit in the short and long term.

Net Revenue from Investments

Figure 15. Net revenues from investments for the years 2006, 2007, 2008

The financial data of the year 2008 shows that AFH also increased its revenues by 42% to 9.522 billion LBP (see Figure 15). The most significant growth recorded was in the increase of customers’ financing that amplified by 380% at the end of 2008. The total increase from 2006 until the end of 2008 was phenomenal, reaching 17499% (Figure 16). This shows that the AFH is reaching a wide number of people who demand financing under the Islamic framework. According to W. Al-Aghar (personal communication, April 23, 2009), the AFH will issue a Sukuk fund in cooperation with the Lebanese government to raise more funds. It will register its name in the Lebanese stock market to meet the demands of customers and to increase business.
The AFH was awarded by Qatar Islamic bank as the best bank in customer financing for the year 2008. This 380% increase from 2007 until 2008 can be explained according to two
scenarios. It is worthwhile to know that the AFH uses depositors’ funds to finance cars, houses, lands, etc. The first scenario is that AFH is aggressively tackling the market to earn a name and to increase profits. This might be the case when offering competitive prices and minimizing the credit and risk requirements. The second scenario tells that clients are very interested in this kind of banking and are starting to understand how Islamic banks operate. Both scenarios can be merged into one strategic plan for the financing department. Figure 17 shows the increase of the bank total revenues.

Expenses

Figure 18. Expenses Percentages
Figure 19 shows expenses with regards to staff, administration, depreciation, and amortization for the years 2006, 2007, and 2008. After calculating the ratios and obtaining the percentages with regards to the year 2007, AFH decreased its expenses rates with regards to growth by a significant rate. The staff expense was decreased from 189% in 2007 to 51% at the end of 2008 (see Figure 18). Administrative Rates also decreased as well as depreciation and amortization. This reduction of expense rates was achieved regardless of opening two new branches.

The results of the profits earned on time investment deposits, and saving investment accounts, local and foreign currency in the second quarter of 2008 are displayed in Figure 20. Those figures were very attractive compared to other conventional banks operating in Lebanon. One feature of Islamic banks is that the profit generated on USD and LBP is the same while in conventional banks the LBP interest rate is usually higher. Another feature is that in Islamic
banks, the rate is the same regardless of the amount; while in conventional banks, interest rate increases as the deposited amount increases.

Figure 20. Profit Percentage

![Profit Distribution for the second half of 2008 and Mudaraba Percentages for 2009](image)

**1. Profit Distribution Report for the Second Half of 2009:**
The Arab Finance House S.A.L. (Islamic Bank) is pleased to announce the profit distribution report of the second half of 2008 on its Term Customer Deposits and its Saving Accounts in foreign and local currencies below:

- Term Customer Deposits: Average profit percentage for the second half of 2008
  - A- One Year: 5.69%
  - B- 6 Months: 4.82%
  - C- 3 Months: 4.38%
- Demand Customer Deposits: 3.84%

**2. Mudaraba Percentages on Customer Deposits and Demand Customer Deposits for 2009:**
Based on the terms of the term and demand customer deposit contracts (articles 2 and 7 respectively), we are pleased to announce the planned mudaraba percentages for term and demand customer deposits starting the beginning of 2009 according to the following:

- A- Deposits (3 Months): 50% of realized profit to the bank.
- B- Deposits (6 months): 45% of realized profit to the bank.
- C- Deposits (12 months): 35% of realized profit to the bank.
- D- Demand Customer Deposits: 55% of realized profit to the bank.

**3. Other Investment Products:**
Information pertaining to other investment products, their respective returns, and the percentage of the banks direct and indirect contribution to these investments will be available shortly.

Source: AFH flyer

Risk Management Framework at AFH

According to S. Hijazi (personal communication, August 18, 2009), the risk management process of AFH consist of the following:

- Board and senior management oversight
- Policies, procedures, and limits
- Risk identification, measurement, and reporting
- A system of internal control

The role of the board of directors is responsible in approving major policies in conducting investment activities and establishing risk limits. The management should enforce those policies and have an understanding of the nature and level of various AFH investments. These policies identify the risk characteristics of permissible investments and outline the responsibility and authority of investment activities.

The risk division at AFH is responsible for the following:

- Identify and measure the risks associated with individuals transactions
- Examine the risk profile of AFH with regard to investment activities
- Conduct in-house analysis and external analyses to understand and manage risks
- Submit reports to the BOD through the general manager to summarize the risks related to AFH investment activities
- Report frequently to provide satisfactory information about the nature of the risk profile at AFH
- Evaluate compliance with the policies and constraints

The internal control in AFH is critical for the safe and sound management of investment activities. It is consisted of internal and external auditors to guarantee the implementation of the risk management process and control risk in investment activities. The system of internal controls at AFH consists of:
• Promote efficient operations, reliable financial reporting, and compliance with Shari’ah and country laws, regulations and institutional policies.

• Enforce lines of authority and maintain separation of duties.

• Conduct periodic risk management reviews to ensure compliance with investment policies.

• Accounting systems and procedures are treated for all securities holdings and it must be in consistent with AFH business objective, generally accepted accounting principles (GAAP), and the regulatory reporting standards.

AFH Investments

As mentioned earlier, Islamic banks do not rely on interest in any kind of business. With AFH being an Islamic bank working in Lebanon under the Shari’ah rules and regulations, it relies heavily on investment opportunities to generate profits. Other types of investments in AFH are participating in Sukuk funds and mutual funds.

Real Estate Investments

AFH engages in real estate investments in Europe, India, and the Gulf. In such types of investments, the bank plays either the role of the Mudarib in which it manages the fund provided by investors or it acts as an agent for the investors with a third party responsible for management and planning of the fund. AFH can also enter in a Musharakah agreement “partnership” where AFH contributes a percentage to the fund and co-manages the project or investment with other firms. Investors in this case issue a separate Mudarabah agreement with the bank. It is important to mention that not all customers are entitled to such projects or investments because a minimum
of funds must be provided. Usually such investments have a high expected return of a 45 percent to 55 percent in two to three years span. Some critics think that it is the bank’s right to limit the size of investment and the minimum participation amount; while others believe that it is not ethical for the Islamic bank to punish investors with cash below the requested amount by not allowing them to participate in such investments. This allows the rich to get richer and the poor to stay poor which is not what Islamic banks are about. According to the Treasury and Investment department at AFH, below are some of the investment opportunities issued by AFH in the past three years.

**Marsa El Sif – Kingdom of Bahrain:**

Marsa El Sif is a real estate investment project in the Kingdom of Bahrain, in the suburbs of Manama, in collaboration with the International Banking Company. The project is approved by the Shari’ah Committee, and consists of constructing a residential and commercial city with high-rises, luxurious shopping malls and a marina, for high income individuals.

- **Maturity Date:** 31/10/2011
- **Account Type:** Restricted Wakalah “Agent” Contract
- **Minimum Investment:** 25,000
- **Investment Currency:** USD

**Al Areen – Kingdom of Bahrain**

Al Areen real estate investment project in the Kingdom of Bahrain, in the suburbs of Al Areen, in collaboration with the International Banking Company. The project is approved by the Shari’ah Committee, and consists of constructing a residential and commercial city enjoying all modern city facilities.
Maturity Date: 31/12/2010  
Account Type: Restricted Wakalah “Agent” Contract  
Minimum Investment: 25,000  
Investment Currency: USD

Danat –India

A real estate investment project in collaboration with Khaleej Commercial Bank in the suburbs of Delhi- India. The project is approved by the Shari’ah Committee, and consists of purchasing a 500 acre plot of land, developing it as an integrated middle class city and selling portions to the public.

Maturity Date: May 2011  
Account Type: Restricted Wakalah Contract  
Minimum Investment: 25,000  
Investment Currency: USD

Bader '7’ – Paris

Investment Operation: AFH is offering a Shari’ah-compliant Ijarah Fund in the suburbs of Paris whereby selected commercial and Industrial buildings are purchased and leased to international corporations (Rated AAA) such as IBM, Airbus, and Thales.

Maturity Date: November 2011  
Profit Distribution: Quarterly  
Account Type: Specialized investment account  
Minimum Investment: 10,000  
Investment Currency: Euro
Acceptable Sukuk Investments

Qatar Islamic Bank (QIB) with the association with European Finance House (EFH) and AFH launched a new Sukuk fund. This fund is a weekly traded mutual fund which invests in global Sukuk markets. Currently AFH is negotiating with the Lebanese government the issuance of a new Sukuk fund that will act as Shari’ah acceptable T-bills. Other types of Sukuk that AFH may engage in the near future are:

- Zero-coupon Sukuk
- Fixed and floating rates Ijarah Sukuk
- Musharakah term finance Sukuk

Mutual Funds

According to S. Hijazi (personal communication, August 16, 2009), AFH may engage in mutual funds if the Shari’ah requirements are available. He adds that debt must be 33% or less by total assets and that cash and accounts receivables should represent 50% or less of total assets.

Other Types of Investments

Most of the above projects are considered as long-term investments. For clients who wish to participate in a shorter type of investments, AFH released a product called the “Commodities and Metals Murabahah.” It is known between Islamic banks as “Commodity Murabahah.”

Through this new product, customers can benefit from monthly profit returns by investing their money in one-month time deposits. This investment occurs when the bank buys and sells specific metals such as platinum or palladium on behalf of the customer through the
London Metal Exchange Market (LME). What the bank actually does is that it buys the metals for a specific price from agent ‘A’ and sells it on a Murabahah basis with predetermined profits to a bank ‘X’, who is requesting a loan. The repayment is usually guaranteed because this bank is rated BBB or above and because such loans are monitored by the central bank. Then, bank ‘X’ employs the AFH as its agent to sell those metals. Shari’ah does not allow the AFH to sell the metals to the supplier; therefore AFH sell those metals to another Agent ‘B’ who pays on the spot. Bank ‘X’ has the money and it can pay the AFH at maturity with the agreed profit. Both Agents ‘A’ and ‘B’ are usually sister companies. Therefore, those metals are sold and returned to the supplier after passing through Agent ‘A.’ The AFH and those agents sell and buy the metal certificates and exchange ownerships to satisfy the Shari’ah requirements and the lender’s demands.

According to AFH treasury operations department, the conditions of such an investment for clients are below:

Starting date of the monthly investment:

- 5 and 20 of each month in LBP
- 10 and 25 of each month in USD
- Profit Distribution: At the end of each calculation period
- Account Type: Specialized investment account
- Minimum Investment: 10,000 USD or 15,000.000 LBP
- Investment Currency: US Dollars or LBP
Critics say that the outcome is very similar to the inter-banking done by commercial banks. The methodology that is followed to answer them will rotate on the total productivity of the investment by a similar comparison.

Supposing that bank ‘X’ is requesting a 1 million dollar loan, and it has to choose between a conventional bank and an Islamic one.

A) Conventional Bank:
1. Conventional Bank uses the depositor’s money to collect the amount.
2. Give bank ‘A’ the money and request a deferred payment of the principal plus a certain percentage (interest).
3. At maturity Bank ‘A’ returns the principal + interest.

B) Islamic bank:
1. Islamic banks raise money from depositors.
2. Islamic banks buy metals from Agent ‘A’ and sells them to bank ‘A.’
3. Payment is deferred and on Murabahah basis (cost + profit).
4. Islamic banks act as an agent for bank ‘A’ and sell them to Agent ‘B.’
5. Give bank ‘A’ its requested money.
6. At maturity, Bank ‘A’ pays its obligations.
7. Islamic bank takes its share and distributes the profits to investors.

This is a comparison between the two scenarios; conventional banks seem to be more efficient in time and in paper work by finishing the operation in three steps. While the Islamic bank finishes the operation in eight steps which appears to be more time and money consuming. The conventional bank sells the depositor’s money for money without any existence of a real
product, and it maximized its profits generated from interest and does not share profits with the real money owners.

On the other hand, the Islamic bank requests the depositor’s permission and uses their money as an Agent. It also buys real products, an actual asset, and sells it to bank ‘A.’ Agent ‘B’ buys the products at spot, and it finances to bank ’A’. In the risky part, Islamic banks do not bear the total risk in case bank ‘A’ declares bankruptcy instead its losses will be distributed to investors, depending on their proportion of contribution. Therefore, loss is shared in small amounts among all. The process includes six parties the Islamic bank, depositors, bank ‘A,’ agent ‘A,’ agent ‘B,’ and the insurance company. The more parties involved the less unemployment in the society and the more share of wealth among different parties. The depositors earn their portion of distribution, which is their right. The Islamic bank earns its agency fees and bank ‘A’ get its loan. Cash circulates in the financial system which makes the system reliable.

Money Laundering Prevention

Being a new Islamic bank in Lebanon, AFH has to strongly monitor and prevent all types of suspicious cases that lead to money laundering. According to Mr. Omar Baasiri(personal communication, July 12, 2009),

68 “People might think Islamic banks are consisted of naïve personnel and that their goodness will make them accept many kinds of suspicious transactions.”

Baasiri adds, "On April 20, 2001, the Lebanese Parliament passed Law 318 on fighting money laundering. This law criminalizes the laundering of proceeds of crimes related to narcotics growing, manufacturing, and trading; organized crimes; terrorist acts and terrorist

68 Omar Baasiri is the Manager of the Compliance Unit at AFH. For list of interviews refer to Appendix G.
financing, illegal arms trade; stealing or embezzling public or private funds by fraudulent means; and counterfeiting money or public credit instruments. The said law defines money laundering operations and stipulates fines and imprisonment sanctions imposed on such operations.”

AFH defines money laundering as any act committed with the purpose of:

1. Concealing the real source of illicit funds, or giving by any means, a false statement about the said source.
2. The act of transferring or substituting funds known to be illegal for the purpose of concealing or disguising their source, or helping a person involved in the offense to dodge responsibility.
3. Acquiring, holding, using illicit funds, or investing such funds in purchasing movable or immovable assets, or in carrying out financial operations, while being aware of the illicit nature of these funds.

Law 318 established the Special Investigation Commission (SIC) for fighting money laundering as an independent legal entity with judicial status at the Central Bank of Lebanon. The Commission has the exclusive right to lift banking secrecy for it to be used by competent judicial authorities and the Higher Banking Commission. The SIC, Lebanon's Financial Intelligence Unit (FIU), receives, analyzes, and investigates Suspicious Transaction Reports (STRs) and ensures compliance of banks, financial institutions and other reporting entities with pertinent Anti Money Laundering (AML) regulations.

Board Member & General Manager of Arab Finance House, Dr. Fouad Matraji signed an agreement with the Middle East branch of the US-based IDOM which provides the Arab
Finance House with international compliance expertise and superior automated solutions for fighting money laundering and terrorist financing.

It is required by the Central Bank of Lebanon that all bank employees be trained to recognize and report any suspicious money laundering transactions. The Arab Finance House management strongly supports this incentive and has produced a handbook on money laundering prevention for its managers and employees.

Future of AFH

In order for AFH to continue the good performance recorded in the first years of its establishment until now, it is necessary to develop a strategic plan to reach as many geographical areas in Lebanon as possible. AFH must also decrease rates of Murabahah financing to attract money-oriented clients.

The top management of AFH may employ external consulting agencies to help in developing the bank's strategy, the organization design, and compare the bank performance with other Islamic banks as well as conventional ones in the common areas. The aim of such agencies is to provide audit, taxing, advisory services, investment management, and legal consultations. Those internationally recognized agencies can build a global network for banks. It can also elevate the public recognition of the bank.
CHAPTER 4

CONCLUSION

The last 30 years have shown that Islamic finance is an industry with huge potential to grow and prosper. It is a gold mine for research and future studies should be expanded to include more specialized topics rather than merely the general ones. Islamic finance faces numerous critical challenges that need experienced individuals and professional teams to solve. Creating an active “secondary market” for trading risk management products can reduce the volatility of Islamic banks’ earnings and protect depositors from being exposed to risks that can be mitigated under a Shari’ah-compliant way. The most promising potential for the creation of a secondary market is through securitizing assets by transforming them into traded security (Sukuk). Main areas of research and development for the future will be:

- External and internal audit and accounting bodies under the Islamic principles.
- Taking immediate steps, implementing proper risk management techniques, and innovating instruments to share, and transferring and mitigating risks.
- Developing the IIRA\textsuperscript{69} to perform ratings of public and private issuers of credit instruments with respect to their financial strength and creditworthiness. It may assess the compliance with Shari’ah and other agencies such as AAOIFI and IFSB.
- Centralized Shari’ah board that will provide efficient Shari’ah solutions for Islamic banks.

\textsuperscript{69} IIRA is The International Islamic Rating Agency, established in Bahrain.
- Methods to prevent double taxation imposed by Shari'ah\(^{70}\) and the government.
- Training of both the public and human resources.
- Corporate governance advice from specialized consulting institutions.
- Establishing early warning systems.
- Effective procedures against money laundering.
- Advanced IT infrastructure for more efficient results.
- Investing in marketing to build a bright image for the industry.
- Outsourcing techniques for product development and innovation.

The challenge of adapting an Islamic financial system is the ultimate goal for financial institutions in any given country. It needs major structural adjustments mainly in the fiscal and monetary areas (S. Omeich, personal communication, February 02, 2009).\(^{71}\) Islamic banks are trying to prove their existence as a real alternative to conventional banks and continue showing progress and success to gain the public trust knowing that they have the religious factor on their side.

Islamic banking has the potential, the structure, and the enthusiasm to grow and prosper in the future. These banks are already competing with conventional banks in areas like the Gulf, Eastern Asia, the Middle East, and now in the UK.\(^{72}\) Islamic banks need serious actions to be taken from regulators, governments, and Islamic organizations. To reach their full potential and Islamic banks need the existence of an Islamic government that provides the needed direct

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\(^{70}\) Such as Zakat.
\(^{71}\) Said Omeich is an accountant in the North African Commercial Bank in Lebanon. For a list of interviews refer to Appendix G.
\(^{72}\) London is said to be the center of Islamic banking and finance in the world.
and indirect support. This government will run on the Islamic economy way of life which will lead to a strong and stable Islamic banking system.
APPENDIX

Appendix A. The Establishment of Islamic banks in Lebanon Law No 575 dated February 11, 2004

The Establishment of Islamic banks in Lebanon. Single Article:

The draft law included in the Decree No 9351 of December 27, 2002, relating to the establishment of Islamic banks in Lebanon is adopted as amended by the Commission of Finance and Budget.

This law shall enter into force upon its publication in the Official Gazette. Baabda, February 11, 2004

Signed: Emile Lahoud

Promulgated by the President of the Republic

The President of the Council of Ministers Signed: Rafic Hariri

Law on the Establishment of Islamic Banks in Lebanon

Article 1:
Islamic banks are the banks whose Articles of Association comprises an undertaking not to contravene, in the operations they carry out, the provisions of Islamic Law (Shari’ah), particularly with the prohibition to pay or receive interest.

Unless otherwise specified in this Law, Islamic banks shall be governed by all legal and regulatory provisions in force in Lebanon, particularly those relating directly or indirectly to banks, including the Code of Commerce, the Code of Money and Credit and the Banking Secrecy Law.

Article 2:

The establishment of an Islamic bank or a foreign Islamic bank’s branch in Lebanon requires an authorization from the Central Council of the Central Bank of Lebanon. The Central Council of the Central Bank of Lebanon shall prescribe a special regulation comprising all the conditions required to the granting of such an authorization.

The Central Council of the Central Bank of Lebanon grants its authorization when deemed serving the public interest. The Council has discretionary power in granting or refusing the authorization and its decisions are not subjected to any ordinary or extraordinary recourse, whether administrative or judicial, including the recourse for excess of power.

Non-Islamic banks operating in Lebanon may establish or take part in the establishment of Islamic banks and may hold shares in Islamic banks established in Lebanon, provided they:
1- Obtain a prior approval from the Central Council of the Central Bank of Lebanon; and

2- Comply with the provisions of Article 153 of the Code of Money and Credit.

Article 3:

Islamic banks are entitled to offer and provide all banking, commercial, financial and investment services and operations, including the establishment of companies and the participation in established projects or projects under establishment.

Unless agreed with the client to link its deposits to the bank’s annual results or to the results of the operations according to a procedure set for this purpose by the Central Council of the Banque du Liban, cash deposits received by Islamic banks are governed by the provisions of Article 307, Par. 1 and 2, of the Code of Commerce, and by the provisions of Section 2 of Law 28/67 of May 9, 1967.

Deposits received in accordance with Article 3, Par. 2, of this Law, and in accordance with Article 307, Par. 1 and 2, of the Code of Commerce, should have a minimum term of six months.

However, Islamic banks may open current accounts in the names of their clients for recording cash deposits and withdrawals, securities purchase and sale operations, and other Islamic banking operations.
Article 4:

Islamic banks are exempted from complying with the provisions of Article 152, Par. 1 and 2, of the Code of Money and Credit. They are authorized to take participations or share ownerships without being bound by the provisions of Article 153 of the said Code, provided they use either their own capital or the deposits governed by Article 307, Par. 1 and 2, of the Code of Commerce with their owners’ written approval.

The Central Council of the Central Bank of Lebanon issues the special regulations governing each and all the operations of Islamic banks. The Council determines and modifies also, whenever it deems necessary, the working rules of these banks and the ratios required between balance sheet and off-balance-sheet items which must be maintained by Islamic banks in order to achieve their objectives, protect their depositors and clients, and safeguard their liquidity and solvency.

Article 5:

In addition to real estate rights that commercial banks may acquire, and notwithstanding the provisions of the Law implemented by Decree No 11614 of January 4, 1969, and its amendments (on ownership of real estate rights by non-Lebanese in Lebanon), Islamic banks may acquire real estate rights exclusively for investment projects. The acquisition is done by virtue of the prior authorization of the Central Council of the Central Bank of Lebanon, which must verify the seriousness of the project and fix in its authorization the time-frame for its execution, provided the said rights are acquired for a non-renewable period not exceeding
The authorization shall not become effective before the approval of the Council of Ministers.

Article 6:

Investments and placements in Lebanon must account, at least, for 50% (fifty per cent) of the assets and rights included in the balance sheet items of each Islamic bank.

The Central Council of the Central Bank of Lebanon is entitled, in conformity with public interest requirements, to increase the above-mentioned ratio and to decide whether certain balance sheet items are included therein or not. In this matter, the decision of the Council is not subject to any ordinary or extraordinary recourse, whether administrative or judicial, including the recourse for excess of power.

Article 7:

The Islamic banks must inform their clients, notably the owners of result-linked deposits, in writing and periodically every three months at least, of the kind, nature, risks and results of the operations and investments they undertake, as well as of the size of their direct or indirect participation in such projects.
Article 8:

Islamic banks must keep their clients’ accounts in a manner that separates the deposit accounts, opened according to Article 307, Par. 1 and 2, of the Code of Commerce, from the result-linked deposit accounts, opened according to Article 3, Par. 2, of this Law.

The Banking Control Commission at the Central Bank of Lebanon shall ascertain that the bank is complying with this obligation. The provisions of the Banking Secrecy Law of September 3, 1956 cannot be opposed to the Banking Control Commission in the exercise of these functions.

Article 9:

The Constituent Assembly of each Islamic bank and, thereafter, the Ordinary General Assemblies, appoint, for a renewable three-year period, a consultative body consisting of three experts in Islamic Law and doctrine, and in banking and financial operations. The consultative body opines about the bank’s compliance, in its operations, with the prescriptions of Islamic Shari’ah. For this purpose, it shall submit a report to both the Board of Directors and the Shareholders’ General Assembly. The consultative body may, on its own initiative, submit to the Shareholders’ General Assembly and the Board of Directors any proposal it deems useful for properly achieving the bank’s object pursuant to the prescriptions of the Shari’ah.

Article 10:

This Law shall enter into force upon its publication in the Official Gazette.
Appendix B. List of Operating Islamic Banks and Financial Institutions in the World

Albania

1. Arab Albanian Islamic Bank, Tirana

Algeria

2. Banque Albarakah D'Algerie, Algiers

Australia

3. MCCA (Muslim Community Co-operative, Australia)
4. MCCU (Muslim Community Credit Union)

Bahamas

5. Akida Islamic Bank International Ltd
6. Bank Al Taqwa Ltd
7. Dar al Mal al Islami Trust, Nassau
9. Istishara Consulting Trust, Bahamas
10. Massraf Faysal Islamic Bank & Trust, Bahamas Ltd.

Obtained from the “Institute of Islamic Banking and Insurance” on 5 May, 2009.
Bahrain

11. ABC Investment & Services Co EC
12. Al Amin Co. for Securities and Investment Funds
13. Albarakah Islamic Investment Bank
14. Arab Islamic Bank E.C
15. Bahrain Islamic Bank Bsc.
16. Bahrain Islamic Investment Co. Bsc. Closed
17. Bahrain Institute of Banking & Finance
18. Bank Melli Iran
19. Chase Manhattan Bank N.A.
20. Citi Islamic Investment Bank (Citicorp)
21. Dallah Albarakah (Europe) Ltd
22. Dallah Albarakah (Ireland) Ltd
23. Faysal Investment Bank of Bahrain
24. Faysal Islamic Bank of Bahrain (Massraf Faisal Al Islami)
25. Gulf International Bank BSC
26. Islamic Investment Company of the Gulf
27. Islamic Trading Company
28. ABC Islamic Bank
29. ABN Amro Bank
30. Deutsche Bank Rep office
31. Investors Bank
32. TAIB Bank of Bahrain
33. Turk Gulf Merchant Bank
34. Bahrain Monetary Agency
35. Shamil Bank
36. Khaleej Investment Company
37. First Islamic Investment Bank

Bangladesh

38. Albarakah Bangladesh Ltd (Dallah Al Baraka Group), Dhaka
39. Islamic Bank Bangladesh Ltd, Dhaka
40. Faisal Islamic Bank

British Virgin Islands

41. Ibn Khaldoun International Equity Fund Ltd

Brunei

42. Islamic Bank of Brunei Berhad
43. Islamic Development Bank of Brunei Berhad
44. Tabung Amanah Islam Brunei

Canada

45. Islamic Co-operative Housing Corporation Ltd, Toronto
Cayman Islands

46. Ibn Majid Emerging Marketing Fund (International Investor Group)
47. Al Tawfeek Co. for Investment Funds Ltd. Subsidiary of Al Baraka Group "DBG"

Denmark

48. Faisal Finance (Denmark) A/S

Djibouti

49. Banque Al Baraka Djibouti

Egypt

50. Alwatany Bank of Egypt, Cairo
51. Egyptian Company for Business and Trade S.A.E
52. Egyptian Saudi Finance Bank (Dallah Al Baraka), Cairo
53. Gulf Company for Financial Investment
54. Faisal Islamic Bank of Egypt, Cairo
55. Islamic Bank International for Investment and Development, Cairo
56. Islamic Investment and Development Co., Cairo
57. National Bank for Development, Cairo

France

58. Algerian Saudi Leasing Holding Co. (Dallah Al Baraka Group)
59. Societe General
60. Capital Guidance
61. BNP Paribas

Gambia

62. Arab Gambian Islamic Bank

Germany

63. Bank Sepah, Iran
64. Commerz Bank
65. Deutsche Bank

Guinea

66. Massraf Faisal al Islami of Guinea, Conakry
67. Banque Islamique de Guinée

India

68. Al Ameen Islamic Financial & Investment Corp. (India) Ltd., Karnataka
69. Bank Muscat International (SOAG)
70. Al-Falah Investment Ltd
Indonesia

71. Al Baraka Islamic Investment Bank
72. Bank Muamalat Indonesia, Jakarta
73. Dar Al-Maal Al-Islami Trust
74. PT Danareksa Fund Management, Jakarta

Iran

75. Bank Keshavarzi (Agricultural Bank), Tehran
76. Bank Makan Iran (Housing Bank), Tehran
77. Bank Mellat, Tehran
78. Bank Melli Iran, Tehran
79. Bank Saderat Iran, Tehran
80. Bank Sanat Va Maadan (Bank of Industry and Mines), Tehran
81. Bank Sepah, Tehran
82. Bank Tejarat, Tehran

Iraq

83. Iraqi Islamic bank for Investment and Development

Italy

84. Bank Sepah, Iran
Ivory Coast

85. International Trading Co. of Africa

Jordan

86. Jordan Islamic Bank (Subsidiary of Dallah Al Baraka Group)
87. Jordan Islamic Bank for Finance and Investment, Amman

Kuwait

88. Gulf Investment Corporation
89. The International Investment Group
90. The International Investor, Safat
91. Kuwait Finance House, Safat
92. Kuwait Investment Co - Dar Al-Isethmar Securities House

Lebanon

93. Al Baraka Bank of Lebanon S.A.L
94. Arab Finance House S.A.L. (Islamic Bank)
95. Lebanese Islamic Bank S.A.L.
96. Blom Development Bank S.A.L.
Luxembourg

97. Faisal Finance (Luxembourg) S.A

98. Faisal Holding, Luxembourg

99. Takaful S.A

100. Islamic Finance House Universal Holding S.A

Malaysia

101. Adil Islamic Growth Fund (Innosabah Securities Sdn Bhd), Labuan

102. Arab Malaysian Merchant Bank Berhad, Kuala Lumpur

103. Bank Bumiputra Malaysia Berhad, Kuala Lumpur

104. Bank Islam Malaysia Berhad, Kuala Lumpur

105. Bank Kerjasama Rakyat Malaysia Berhad, Kuala Lumpur

106. Dallah Al Baraka (Malaysia) Holding Sdn Bhd

107. Lembaga Urusan Dan Tabung Haji (Fund), Kuala Lumpur

108. Malayan Banking Berhad (Maybank), Kuala Lumpur

109. Multi-Purpose Bank Berhad, Kuala Lumpur

110. United Malayan Banking Corp. Berhad, Kuala Lumpur

111. Bank Muamalat Berhad, Malaysia

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112. Labuan Offshore Financial Services Authority (LOFSA)

113. Islamic banking & Takaful Dept, Bank Negara Malaysia
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Commercial Banks:

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115. Alliance Bank Berhad
116. Arab-Malaysian Bank Berhad
117. Bank Utama (Malaysia) Berhad
118. Citibank Berhad
119. EON Bank Berhad
120. Hong Leong Bank Berhad
121. HSBC Bank (M) Berhad
122. Malayan Banking Berhad
123. OCBC Bank (Malaysia) Berhad
124. Public Bank Berhad
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Morocco

155. Faisal Finance Maroc S.A

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157. Faisal Finance (Netherlands Antilles) N.V

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158. Banque Islamique Du Niger, Niamey

Nigeria

159. Habib Nigeria Bank Ltd
160. Ahmed Zakari & Co

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161. Bank Muscat International
162. Bank Saderat Iran, Muscat
163. Oman Arab Bank
Pakistan

164. Al Faysal Investment Bank Ltd, Islamabad

165. Al Towfeek Investment Bank Ltd (Dallah Al Baraka Group), Lahore

166. Faysal Bank Ltd, Pakistan

167. National Investment Trust Ltd., Karachi

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170. Arab Islamic Bank

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175. Islamic Investment Company of the Gulf Ltd, Sharjah

176. Qatar International Islamic Bank, Doha

177. Qatar Islamic Bank SAQ, Doha

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183. Islamic Development Bank, Jeddah.
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215. Ihlas Finance House
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220. Dubai Islamic Bank, Dubai
221. Gulf International Bank, Bahrain
223. Islamic Investment Company of the Gulf Ltd, Sharjah Subsidiary of Dar Al Maal

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224. National Bank of Sharjah
225. HSBC, Dubai
226. National Bank of Dubai

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231. Bank Sepah, Iran
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234. Barclays Capital
235. HSBC Amanah Finance
236. ABCIB Islamic Asset Management, Arab Banking Corp

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237. ABC International Bank, London
238. Europe Arab Bank Plc, London
239. Riyadh Bank, London
240. Citibank International Plc, London
242. Dawnay Day Global Investment Ltd
243. Global Islamic Finance, HSBC Investment Bank Plc
244. Gulf International Bank Bsc, Bahrain
245. Islamic Bank of Britain
246. Lloyds TSB Plc Bank
247. The Halal Mutual Investment Company Plc
248. IBJ International, London (Subsidiary of Industrial Bank of Japan)
250. Islamic Investment Banking Unit (IIBU), United Bank of Kuwait, London

Ireland

251. Al Meezan Commodity Fund Plc, Dublin
252. Jersey, UK (+534)
253. The Islamic Investment Company, St Helier.
254. MFAI (Jersey) Limited (formerly - Massraf Faysal Al-Islami Ltd, Jersey)

United States of America

255. Abrar Investments, Inc., Stamford CT
256. Al-Baraka Bancorp Inc. Chicago
257. Al-Medina Realty, Inc., Englewood NJ
258. Al-Manzil Islamic Financial Services
259. Amana Mutual Funds Trust, State St. Bellingham WA
260. Ameen Housing Co-operative, San Francisco
261. American Finance House
262. Bank Sepah, Iran

263. BMI Finance & Investment Group, New Jersey

264. Dow Jones Islamic Index Fund of the Allied Asset Advisors Funds

265. Failaka Investments, Inc., Chicago IL

266. Fuloos Incorporated, Toledo OH

267. Hudson Investors Fund, Inc., Clifton NJ

268. MSI Finance Corporation, Inc., Houston TX

269. Samad Group, Inc., Dayton OH

270. Shared Equities Homes, Indianapolis IN

271. HSBC, USA

272. MEF Money, USA

273. Islamic Credit Union of Minnesota, (ICUM)

274. United Mortgage

Yemen

275. Islamic Bank of Yemen for Finance and Investment, Sana

276. Saba Islamic Bank, Sana

277. Faisal Islamic Bank

278. Yemen Islamic Bank, Sana

279. Yemen National Investment Co., Sana
Appendix C. Major Regulators in Islamic banking and Finance:

1) The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari’ah standards for Islamic financial institutions and the industry. Professional qualification programs (notably CIPA, the Shari’ah Adviser and Auditor "CSAA," and the corporate compliance program) are presented now by AAOIFI in its efforts to enhance the industry’s human resources base and governance structures.

AAOIFI was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 1 Safar, 1410H corresponding to 26 February, 1990 in Algiers. Then, it was registered on 11 Ramadan 1411 corresponding to 27 March, 1991 in the State of Bahrain.

As an independent international organization, AAOIFI is supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide.

AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Center, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI’s standards and pronouncements.
The objectives of AAOIFI\textsuperscript{74} are:

1. Develop accounting and auditing thoughts relevant to Islamic financial institutions;

2. To disseminate accounting and auditing thoughts relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means;

3. To prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and

4. To review and amend accounting and auditing standards for Islamic financial institutions.

AAOIFI carries out these objectives in accordance with the precepts of Islamic Shari’ah which represents a comprehensive system for all aspects of life, in conformity with the environment in which Islamic financial institutions have developed. This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.

\textsuperscript{74} Source: http://www.aaoifi.com.
2) The Islamic Financial Services Board (IFSB)\textsuperscript{75}

This is based in Kuala Lumpur, was officially inaugurated on 3rd November, 2002 and started operations on 10th March, 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Shari'ah principles, and recommend them for adoption.

To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors.

As at January 2009, the 178 members of the IFSB include 42 regulatory and supervisory authorities as well as International Monetary Fund, World Bank, Bank for International Settlements, Islamic Development Bank, Asian Development Bank and the Islamic Corporation for the Development of Private Sector, Saudi Arabia, and 130 market players and professional firms operating in 34 jurisdictions.

\textsuperscript{75} http://www.ifsb.org/
Malaysia, the host country of the IFSB, has enacted a law known as the Islamic Financial Services Board Act 2002, which gives the IFSB the immunities and privileges that are usually granted to international organizations and diplomatic missions.

Adoption of Standards

Since its inception, the IFSB has issued seven Standards, Guiding Principles and Technical Note for the Islamic financial services industry. The published documents are on the areas of:

- Risk Management
- Capital Adequacy
- Corporate Governance
- Supervisory Review Process
- Transparency and Market Discipline
- Recognition of Ratings on Shari'ah-compliant Financial Instruments
- Development of Islamic Money Markets

The IFSB is also working on five new standards and guidelines such as:

- Special Issues in Capital Adequacy (currently being issued as Exposure Draft)
- Governance for Collective Investment Schemes (currently being issued as Exposure Draft)
- Corporate Governance in Takaful Operations
- Shari’ah Governance
- Market Conduct
The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines which involves, among others, the issuance of exposure draft and, where necessary, the holding of a public hearing.

Awareness Promotion

The IFSB is actively involved in the promotion of awareness of issues that are relevant or have an impact on the regulation and supervision of the Islamic financial services industry. This mainly takes the form of international conferences, seminars, workshops, trainings, meetings and dialogues staged in many countries.
Appendix D. Zakat

Definition

Zakat (Alms-giving) in Arabic language means purity, growth and blessing. The verb signifies to purify and grow, with the meaning of being blessed as described by the Qur’an verse: “Take Sadaqah (alms) from their wealth in order to purify them and sanctify them with it, and invoke Allah for them. Verily, your invocations are a source of security for them.” Quran (9, 103)

In Islamic jurisprudence it is a specified portion of money imposed by God on those who are liable from the wealthy and rich members, with the following conditions

Rules

Zakat is a pillar of Islam and a basic obligation that has its roots in the holy Qur’an, Prophets Tradition (Sunnah), and consensus. The Qur’an verse confirms “and perform As-Salat (prayer), and give Zakat and obey the Messenger (Muhammad peace be upon him) that you may receive mercy (from Allah)”. Quran (24, 56)

The Qur’an mentions Zakat in 32 different verses, which confirms its importance. The prophet, peace be upon him, says:(Islam is built on five {pillars}, the witness that there is no god but Allah, and that Mohammad is the Prophet of Allah, performing Prayers, giving of Alms (Zakat), performing Pilgrimage, and fasting of Ramadan). A consensus on the obligation of Zakat is agreed upon, and this imposition is a norm of Islamic religion.

Source: Compiled from Arab Finance House Shari’ah department with some modifications.
Zakat Obligation Conditions

- The holder of the wealth should have complete ownership.
- A complete lunar year should have passed from the date of owning then money or wealth. Zakat of fruits, plantation, metals, and sea products, have different conditions.
- The money should be intended for personal expenditure.
- The wealth should reach the Zakat limit.
- The owner should not be indebted by a value that consumes the Zakat limit (nisab) or reduces it.

Zakat Limit

The Zakat payment limit is the amount of wealth that is specified by Islam, which makes the owner liable for the payment of Zakat. Different types of wealth are subject to different Zakat limits.

- Zakat of Gold is due if its weight is 85 grams, with a grade of 24 carats, taking into consideration continuous changes in the prices of gold.
- Zakat is due in current paper money, savings, liquid cash deposits in banks, stocks and corporate shares, bonds and financial paper, and any other instruments that replace money.
- The percentage of Zakat imposed on the above mentioned, is 2.5%, on condition that the above types of wealth reach the specified limit of Zakat as evaluated by gold, and complete the one-year cycle.
• Zakat is due on trade assets. The trader should make an inventory and evaluate the business merchandise, add to it cash, savings and good receivables, then subtract from it trade payables and expenses, and finally pay Zakat on the remainder, on condition of reaching the Zakat limit as specified previously.

• Zakat is due on extractions from under-earth, whether metals or non-metals, by a rate of 20%.

• Zakat is due on plantation and fruits whenever it reaches the Zakat limit that are estimated at the equivalent of 653 kilograms. If it is arid agriculture or irrigated by rain, then the Zakat percentage is 10%. However, if land is irrigated by an irrigation system, the Zakat rate is 5%. In calculating Zakat, crop collection expenses are deducted from the value of the resulting crop.

• The Zakat cycle for all the generated money and profit, is the same as the cycle of its original principal or asset.

• Whenever Zakat is due on an individual, it cannot be canceled, neither due to the death of the owner, nor due to passage of time. The amount of due Zakat becomes a debt to be deducted and paid by the heirs from the inheritance before its distribution.

• The imposition of taxes by the government does not cancel the payment of the imposed Zakat.

Assets which do not have a specified percentage of Zakat assigned by Islamic jurisprudence or scholars, are subject to the following rules: Assets like buildings for lease, factories, cars and similar assets are not subject to Zakat. Zakat is paid only on the net generated
revenue, taking into consideration the Zakat limit and the Zakat cycle, at the rate of 2.5% from the net income at the end of the Zakat cycle.

Zakat is not applicable to the following assets:

• Houses used for residence.

• Personal clothing.

• Home furniture.

• Assets for personal use, i.e., cars.

• Kitchenware and chinaware for decoration, other than gold and silver made.

• Jewelry for personal use.

• Industrial production machinery.

• Books for non-trade purposes.
Appendix E. Frequently Asked Questions

- What Is An Islamic Bank?

An Islamic Bank is a bank that is committed to implementing Shari’ah rules in all of its transactions based on the principle of profit and loss sharing.

- What Is The Difference Between An Islamic And A Conventional Bank?

The basic differences are:

Role:

Conventional Bank: Monetary institution that plays the role of an independent intermediary between depositors and investors.

Islamic Bank: Takes on an active role, such as that of partner, buyer, seller, or investor...

View of Money:

Conventional Bank: Money is a commodity that can be sold or loaned.

Islamic Bank: Money is a tool not a commodity.

Conducting Business

Conventional Bank: Loaning and collecting money.
Islamic Bank: Financing according to the rules of Profit and Loss Sharing as well as offering guarantees on sold goods pending delivery.

Fundamentals of Financing

Conventional Bank: Financing is based on interest paying/receivable.

Islamic Bank: Financing is based on productivity according to the concept of profit and loss sharing.

The Islamic Bank also offers services not available at conventional banks such as the Qard Hassan (free loan) and Zakat payment.

- What Is The Difference Between Return And Interest Revenue?

Returns are Halal revenues resulting from a Shari’ah-compliant business contract, whereas interest revenue is the result of a non-Shari’ah-compliant contract with the bank and represents Riba that was clearly forbidden in Islam.

- Do Islamic Banks Really Abide By Shari’ah Rulings?

Islamic Banks have declared since their establishment to strictly abide by Shari’ah rulings in all of their business services and investment products, and this is the reason behind the presence of a Shari’ah Supervisory Committee in each and every Islamic bank.

The main task of this committee is to oversee the implementation of the rulings and Fatwa of the Central Shari’ah Supervisory Board.
The Committee is also responsible for submitting its reports and comments to both the bank's Board of Directors and the Shari’ah Supervisory Board.

- Some People Say That Islamic Banks Operate In The Same Manner As Conventional Banks, What Do You Say To That?

It is imperative for one to investigate the truth before coming to conclusions. It is true that Islamic Banks compete with their conventional counterparts in the same field yet; their work is based on Shari’ah-compliant contracts. Sharing the same goals as conventional banks does not imply using the same methods to reach those goals.

- Why Are Returns On Investments So Comparable To Interest Rates Offered By Conventional Banks? Is It True That Returns Are Low?

The investment fields of Islamic banks are more diverse than those of conventional banks. In the common investment fields, return rates are comparable between both the conventional and the Islamic Bank, whereas in purely Islamic investments, the returns are higher.
Appendix F. Arab Finance House / History

Arab Finance House-Holding Company was founded in Lebanon in 2003 with a capital of 60 million American dollars and a plan to raise that capital to 100 million American dollars within three years. The Company established two banks in Lebanon: the Arab Finance House commercial bank, and the Arab Finance House investment bank.

Under the decree number 9494 of the Central Bank of Lebanon dated 26/12/2006, the two banks merged to become the Arab Finance House SAL (Islamic Bank) holding the number 125 on the list of Banks (commercial register #1002082).

The Arab Finance House is an Islamic bank, and subsequently all its investments and products are Shari’ah-compliant while remaining under the realm of Lebanese banking laws.

Arab Finance House / Chairman's Message

Five years following its launch in Beirut, we can proudly say that the Arab Finance House (AFH) has become one of the leading financial institutions in Lebanon and the Arab countries. To date, AFH was able to firmly establish itself and provide revolutionary Islamic banking services in the Arab world, enabling its progress towards an ambitious future at an aggressive pace.

The concept of establishing AFH originated in Qatar based on an initiative launched by Qatar Islamic Bank (The Bank) in 2003 with the collaboration of numerous Arab investors, mainly from the Gulf region. The goal behind this initiative was to provide modern Islamic
banking services in Lebanon, given its advanced, reliable banking sector, where existing rules and regulations have historically driven accountability despite all the hardships that the country witnessed in the last three decades.

With its track record of delivery, AFH asserted its position in the marketplace, becoming a leading Islamic financial institution in Lebanon with significant presence. The local services AFH offers, from the different banking products to the investment options, attracted a significant number of key players in the Lebanese financial market. In addition, AFH continued to aggressively pursue and attract a variety of foreign investments to the Lebanese marketplace.

We, at AFH, are extremely optimistic about the near future where we are targeting unprecedented growth, God willing. Our strategy includes growing and modernizing our business in all sectors, where we expand according to a well defined, ambitious vision. This vision takes into consideration the growing demands for Islamic banking services in the Lebanese financial market, in addition to expanding our network of branches on the different Lebanese territories.

Being the first and largest all inclusive Islamic Bank in Lebanon, the Arab Finance House will strive to institute solid foundations for a better future for Islamic Banking, within the realm of the local laws that regulate the work of Islamic banks. Moreover, AFH will continue to effectively contribute to the development of the Lebanese banking sector in general.
## Appendix G. List of interviews

### Table 4. List of Interviews

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