



ISLAMIC FINANCE IN EGYPT

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Abstract

The paper discuss the concept of usury and its evolution in economic thinking. Then it discusses the economic framework of the Islamic banking system and constructs a model that illustrates the distinctive characteristics of Islamic banking. The paper also attempts to examine the performance of Islamic banks as well as Islamic branches of conventional banks with emphasis on the problems of Islamic finance in Egypt and its prospects. Moreover, the paper provides an analysis of the so-called Islamic Investment Companies (IICs) as regard to their activities, size and methods of mobilization of resources.

المخلص

تتناقش هذه الورقة مفهوم الربا وتطوره فى الفكر الاقتصادى. وتناقش الإطار الاقتصادى للنظام المصرفى الإسلامى وتحاول أن تضع نموذجاً لشرح الخصائص المميزة لهذا النظام. وعلى الصعيد التطبيقى فان الورقة تحاول ان تحلل أداء البنوك الإسلامية والفروع الإسلامية للبنوك التقليدية، مع إظهار مشكلات التمويل الاسلامى فى مصر ومستقبله. وتقدم الورقة كذلك تحليلاً لشركات التوظيف الأموال الإسلامية مظهرة أوجه نشاطها وحجمها والطرق التى إتبعتها فى تعبئة المدخرات

1. Introduction:

There has been a surge of interest since the early 1980s in the theoretical and practical aspects of Islamic banking. This has been a response to the revival of Islamic values, the Islamisation of the financial system in Iran, Pakistan and recently Sudan, in addition to the growing number of Islamic banks inside and outside the Muslim world. The first country to have an Islamic bank was Egypt in 1963.

Islamic banking is centred around the principle of the abolition of interest rate which is considered a form of *riba* (usury). The alternative method for financing under the Islamic system is based on profit and loss sharing (PLS) approach. Recent theoretical analyses have established that not only PLS is viable but it has several advantages over the conventional banking system.

In this paper we discuss the concept of usury and its evolution in economic thinking. Then we outline the Islamic stand regarding the prohibition of usury and its economic implications. We analyse the economic framework of Islamic banking system and construct a model that illustrates its distinctive characteristics. Then we determine sources of funds and their allocation under the Islamic banking. Under the case of Egypt we examine the performance of Islamic banks as we distinguish between public and private intermediaries. The case of Islamic branches of conventional banks is also considered. This section is concluded by a discussion of the problems of Islamic finance in Egypt and its prospects.

In addition to the Islamic banks and Islamic branches of conventional banks, more than 100 financial institutions claiming to be based on Islamic principles were set up in Egypt in the late 1970s and early 1980s. These institutions were called "*Sharikat Tawzeef Al-Amwal Al-Islamiyyah*" that crudely translates as Islamic Investment Companies, henceforth IICs. We provide an analysis of the IICs as regard to their activities, size and adopted mechanisms in mobilisation of resources. We also discuss the reasons behind their rise and fall during the 1980s and its repercussions.

2. A note on the concept of usury in economic thought:

Usury is a term whose meaning has undergone changes through time. It is clear, however, that usury signified originally the charge of any interest on loans. It is only recently that this meaning has been narrowed down to impute the lending of money at extortionate rates of interest.¹ Laws and moral codes regulating the charging of interest can be traced from the code of Hammurabi of Babylon, 1800 B.C., through the Old and New Testaments, to the variety of Medieval prohibitions, to the rules of the Quran and the contemporary regulations of the modern World.²

The issue of usury received a fair share of scholarly comment from Aristotle to Keynes. Aristotle pointed out that "the most hated sort of unnatural money making, and with the greatest reason, is usury, which makes a gain out of money itself, and not from

¹ See Brett (1945), p. 13.

² Regarding regulations in the modern World, Blitz and Long (1965), p. 608 report that "in the United States all but three of the states have laws governing interest charges..and furthermore there is a federal law [which] prohibits a charge by banks in excess of 7 per cent".

the natural use of it. For money was intended to be used in exchange, but not to increase at interest. And this term usury, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of all modes of making money this is the most unnatural"^ξ. The view of Aristotle on usury along with that of Seneca the Roman philosopher, canon law, natural law and Scripture and authentic church teachings formed the sources of principles for Aquinas (1225 -1274) and the Scholastics doctrine on usury.^ο

The Scholastic economic thought referred to a lender's intention to obtain more in return than the principal amount of the loan as usury. As a general rule any interest taking was usurious. Hence charging of interest was forbidden by law in the beginning of the 12th century and was effective throughout the Scholastic period^η. As time went on, some pardons were made regarding the charge of interest, such as the case of charging it to political enemies; using it as a penalty on the borrower if he fails to return the principal on the agreed date; using it as a compensation for the lender if he suffered damage during the lending period; compensating the lender for losing a gain because of the loan; using it in a form of gift as a reward provided by bankers to depositors in the early stages of deposit banking^υ. Such practices became numerous to the extent that they left interest prohibition an empty shell.

With the start of the era of individualism and *laissez faire* the Scholastic doctrine was abandoned. The publication of Bentham's Defence of Usury in 1787, in which he emphasised absolute freedom in determining the terms of loans reflected the growing view of his time. Attempts to apply the old usury laws failed during the 19th century which witnessed, in 1854, the abolishment of Usury laws altogether in the UK. Moreover the Code of Canon Law of 1917 permitted the creditor to accept the legal rate of interest and more than that rate in particular circumstances.^α

However in accordance with his theory of liquidity preference, Keynes argued that the enforcement of ceilings on interest rates would increase investment. This argument, despite the difference in the concept of usury, made him support the Scholastic view on usury control by moral laws and describe it as an "honest intellectual effort to keep separate what the classical theory has inextricably confused together, namely, the rate of interest and the marginal efficiency of capital"^θ.

^ξ Quoted in Melitz and Winch (1978), p. 90.

^ο See Roll (1954), pp. 47-49.

^η See Spiegel (1971), pp. 63-65.

^υ See The New Palgrave Dictionary of Money and Finance, vol 3, p. 745.

^α The Code of Canon Law of 1983 went as far as making it a 'duty' to pay interest on an administrator ecclesiastical goods incurs a debt. See *ibid*, p. 744.

^θ Keynes (1939), p. 352.

3. The Islamic ban on usury:

Until the early 1980s the literature on Islamic Economics focused on few topics. Writings were primarily on economic philosophy, principles of economic systems, Islamic critique of contemporary economic theories and systems and some modern readings of the contributions of some Muslim scholars; mainly the contributions of Abu Yusuf (731 -798), Ibn Taimiya (1262-1328), Ibn Khaldun (1332-1406), on different issues related to the operation of the economy according to Islamic principles and the role of the Islamic state.¹⁰ However the bulk of the literature on Islamic Economics and Finance has appeared since the early 1980s. Most of the work, which tackled practical issues with more appreciation of theories and tools of mainstream economics, was on the Islamic prohibition of interest rate, operational aspects of Islamic Banking and analyses of Islamisation experiments at institutional and country levels.¹¹

The concentration on interest-free banking and the scarcity of studies on other aspects of Islamic Economics can be explained by the limited economy-wide applications of Islamic rules in the Moslem World. Apart from the cases of Iran, Pakistan and Sudan, where governments claim that Islamic economic principles are fully applied, the adoption of Islamic principles does not exceed the mere establishment of few financial institutions in the rest of Moslem countries.

However recent writings on the issue of interest-free banking, as one of the harvests of Islamic revival were inspired by the Quran and the Sunnah (teachings and traditions of the Prophet Muhammad). They comprise the two main sources of *Sharia* (Islamic Law) and strongly condemn *riba* (usury). The prohibition of *riba* is referred to in the Holy Quran in four *surahs* (chapters)¹²:

- 1) "That which you give in *riba* for increase through the property of other people, will have no increase with Allah: But that which you give for charity, seeking the countenance of Allah, will increase: it is these who will get a recompense multiplied" Surah 30, verse 39.
- 2) "O you who believe! Devour not *riba*, doubled and multiplied; but fear Allah; that you may really prosper" Surah 3, verse 130.
- 3) "That they took *riba*, though they were forbidden; and that they devoured Men's wealth wrongfully. We have prepared for those among them who reject Faith a grievous chastisement" Surah 4, verse 161.
- 4) "O you who believe! Fear Allah, and give up what remains of your demand for *riba*, if you are indeed believers. If you do it not, take notice of war from Allah and his messenger: but if you repent you shall have your

¹⁰ See the extensive survey of Siddiqi (1981).

¹¹ See for example the studies of Khan (1986) on Interest-Free Banking; Khan and Mirakhor (1990) on the experiences of Iran and Pakistan; Choudhury and Malik (1992) on the foundations of Islamic political economy; and Mannan (1986) on the theory and practice of Islamic economics.

¹² The English translation of the Quran is that of Ali, Yusuf (1990).

capital sums: deal not unjustly, and you shall not be dealt with unjustly. If the debtor is in a difficulty, Grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew. And fear the day when you shall be brought back to Allah. Then shall every soul be paid what it earned, and none shall be dealt with unjustly" Surah 2, verses 278-281.

Riba is a generic term which stands literally for all kinds of excesses above the value of a thing¹³. The technical meaning for *riba* is the premium, regardless how small or large, which must be paid by a borrower to a lender in addition to the principal as a condition for a loan or for an extension of its maturity¹⁴. It is established that all forms of predetermined fixed return which are tied with the size and the length of the loans, regardless of their purpose, are considered by Muslim scholars as *riba*¹⁵.

The prohibition of fixed predetermined interest rates can be explained by Islam's position regarding property rights. Islam recognises two groups of property rights. First those which are an outcome of the combination of individual's labour and natural resources. Second, property rights that are acquired through exchange, inheritance, grants,..etc. A loan is just a transfer of some (or all) of these rights from a lender to a borrower and providing it should not entitle the lender to an increase in his property rights. Such an increase violates the pivotal rule of transactions according to Islam that is justice. Thus interest on loans is unjustified as it indicates an instantaneous creation, of a claim for the lender on the borrower's property, once the contract is concluded and regardless of the outcome of the project for which the loan was provided¹⁶.

4. A framework of Islamic banking:

Islam permits a wide range of contracts which do not violate the regulations of Islamic law and its position on property rights. Any arrangement in which the returns of the parties involved are contingent with uncertain gains and the parties have symmetric information regarding the outcome of the project is permitted.¹⁷ Thus sharing of risks and uncertainties is the main characteristic of Islamic financial transactions.

The predetermined return on financial transaction is absolutely eliminated but an uncertain return represented by profits is not. Hence if the return of the use of money fluctuates according to the actual profits made from such use, this would be consistent with the Islamic law. Under Islamic finance the depositor is not guaranteed a predetermined return on the nominal value of his deposit. Instead he is considered as if he

¹³ Choudhury and Malik (1992), op. cit., p. 103.

¹⁴ Chapra (1985), pp. 56-57.

¹⁵ See for example Al-Qaraddawy (1990), Al-Salou (1987) and (1991) and Chapra (1985).

¹⁶ See Khan and Mirakhor (1992), pp. 15-16.

¹⁷ *ibid.*, p. 16.

were a shareholder of the financial institution and consequently he shares the profits, or losses, made by the institution.

Hence the interest-free financial system can be viewed as a variant of equity participation systems that rely on profit and loss sharing (PLS). However it is worth noting that the Islamic PLS is not completely identical with conventional equity participation schemes as it differs from them in the following aspects. First speculative activities undertaken to maximise capital gains are not allowed hence, an Islamic bank has to allocate its funds in productive investment according to a one-to-one basis between the amounts of bank's funds and the financing of the activity. Second while under conventional equity participation there is a discretion of management to determine returns distributed to shareholders it is not the case with Islamic PLS as it ties the parties to pre-agreed shares of profits or losses. Third PLS contracts are for a specified investment period and hence they are less liquid^{1^}. Needless to say funds of Islamic PLS cannot be used in financing the production of goods or services forbidden in Islam, e.g. alcohol, gambling.

Due to the Islamic prohibition of predetermined fixed interest rates, Islamic banks have developed on the basis of profit and loss sharing either in the case of borrowing from depositors or lending to investors. Two conditions should be satisfied for a transaction to be Islamic. First net return on capital should not be predetermined. Second it is not only profit which is shared between the two parties of the transaction but loss as well. The distribution of profits is done according to bargaining between the depositor and the bank on one hand and the bank and the investor on the other.

4.1. The distinctive characteristics of Islamic banking:

We illustrate the difference between a traditional bank and an Islamic Bank by constructing the following model:

In the traditional banking system a person deposits (D) with the bank at a point in time (t_0) in return for a predetermined guaranteed nominal interest rate ($r_d > 0$) at (t_1). In contrast with the traditional bank, an Islamic bank offers its depositor a rate of return (s_d) on his deposits (D) based on the profit of its operations (π) which are distributed between the depositor and the bank according to mutually agreed share (α) fixed in the contract, then

$$s_d = \alpha E(\pi) + (1-\alpha)r_d$$

where $E(\pi)$ is the expected value and α can either be ≥ 0 or ≤ 0

Thus the nominal value of (D) can increase or decrease by the amount of (s_d) depending on the value of (π) which can be positive or negative or zero.

In the lending side of a traditional bank, if a person receives a loan L_0 at a point of time t_0 and agreed to return to the bank $L_1 = L_0 + r_l$ in t_1 . The difference between L_1 and L_0 is interest;

$$r_l = L_1 - L_0 \quad (2)$$

where $r_l > r_d$

^{1^} See Khan (1987), pp. 326-327.

As in borrowing from depositors, the Islamic bank lends according to profit and loss sharing scheme in which uncertainty is involved. The bank takes an agreed share α in the profit or loss of the joint project and the investor takes $(1 - \alpha)$. Thus if the bank funds the project by F in (t_0) it will receive in (t_1) :

$$S_b = \alpha E / (1 + r) \quad (3)$$

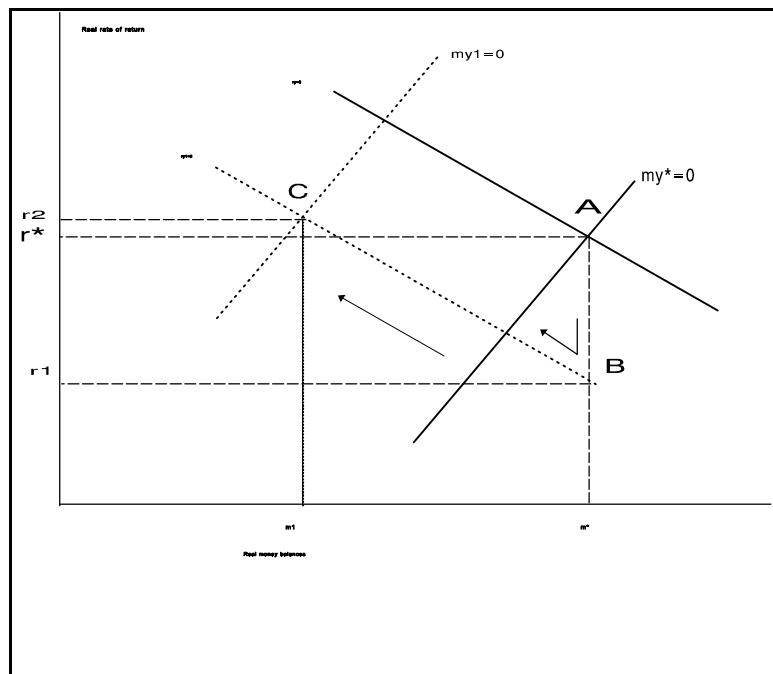
while the investor receives:

$$S_i = (1 - \alpha) E / (1 + r)$$

where $\alpha \leq 1$ and E is the expected value.

4.2. Merits of Islamic banking:

It is argued that an equity based interest free system would be more stable in the context of shocks that can result in banking crises. This argument is supported by Khan's IS-LM model¹⁹. In this model there are no bonds and banks are pure intermediaries. Further there are no transaction deposits and banks do not hold reserves. As shown in figure (1) below, following an IS shock the real values of deposits (shares) held in Islamic banks adjust



instantaneously.

Point A represents the steady state equilibrium which yields the values of m and r . Following an IS shock, e.g. a fall in export volume, real income falls from y to y^1 . A new steady state equilibrium is reached at point C, following an adjustment by shifting the schedules of $r_y = 0$ downward and $m_y = 0$ upward respectively. The instantaneous short run equilibrium at point B occurs because of the decrease of real rate of return from r to r_1 in order to maintain equilibrium at the assets market at m and r_1 . Given that there is excess demand for goods at point B, prices increase and real money balances will

¹⁹ See Khan (1986), op. cit., pp. 10-18.

decrease. Thus the real rate of return increases to reach equilibrium in the money market. Such increase reduces excess aggregate demand. The process continues until the new steady state at point C is reached where $r=r_2$ and $m=m_1$. The reason behind the adjustment path from A to C through B is slow adjustment of prices in the goods market. A direct move from A to C in the economy is possible if the goods market adjust instantaneously.

However the adjustment to the shock, as described above, is possible under the Islamic system as the nominal values of deposits are not guaranteed. Hence, the real values of assets and liabilities would be equal at all points in time. In contrast to the conventional system with guaranteed values of deposits, in the short run there would be a divergence between real assets and liabilities. While the Islamic system adjusts to shocks without the need for government intervention, the conventional system is in a need for such intervention in order to correct the disequilibrium between assets and liabilities. If this did not happen divergence will continue with a possibility of a banking crisis.²⁰

Moreover from the previous analysis we realise that the Islamic system is immune from the myopic behaviour of banks in times of crisis. Such behaviour can take the form of competing for deposits by bidding up interest rates, or the form of rapid reduction of loans to increase reserves at the expense of other banks. This behaviour may lead to insolvency and bankruptcies.

4.3. Some practical problems:

PLS schemes may be compatible with the requirements of depositors who happen to be risk-lovers and apparently the requirements of those who are risk averse are not necessarily served by PLS. This problem, if not resolved by innovating less risky financial instruments, can result in negative impact on the ability of Islamic banks in the mobilisation of savings²¹ at given incomes and propensities to save. The point is that predetermined fixed interest rates are better measures than the ex-post determined rates of return provided by Islamic banks in improving the size of aggregate savings. Rather it indicates that in a society with significant percentage of risk aversion the distribution of a given amount of savings would be in favour of conventional banking instruments and at the expense of the Islamic ones.

Moreover the establishment of Islamic banking implies changes in its relation with the government and the central bank, which may have practical difficulties. For example an Islamic bank cannot participate in financing budget deficits by lending to the government at interest, regardless how low its rate is. Moreover if the whole financial system become Islamic, the reliance on interest rate as an instrument of monetary policy has to be abandoned in favour of other measures, like direct credit control, a modified form of open market operations under PLS principle, liquidity ratio requirements (without interest bearing securities in banks portfolios).²²

²⁰ ibid., pp. 17-18.

²¹ See Pryor (1985), pp. 208-210.

²² On the functions of the Central bank in an Islamic system see for example the report of the council of Islamic Ideology (1983).

Under profit and loss sharing the fractional reserve requirement system also has to be revised as depositors of the central bank are *de facto* investors who have to share the outcome of the operations of their banks. Further under an Islamic system, credit creation allowed under the fractional reserve system is considered inequitable for the society as a whole, as only the banks and their customers benefit from it leaving the rest of the society suffering from the inflationary effect of credit creation.^{۲۳}

Some of these arguments are not alien to western economic thinking as we can realise some similarities in the writings that analysed financial crises and questioned the stability of the capitalist economies. Actually the argument of 100 percent reserve requirements was raised by Fisher (1945) and Simon (1948). According to their proposal for the maintenance of 100 percent reserves, the banks' power of creating or destroying effective money will disappear. This power granted to banks under the fractional -reserve system made the financial system inherently unstable as a result of switching from a high powered money to deposit money. Under a 100 percent reserve requirement such a switch will only change the composition of money supply leaving its total constant. This was the reason behind Friedman's (1969) support of this argument as he found in it a way of reducing government intervention in the operation of banks and hence a way to increase economic freedom.^{۲۴}

5. Sources of funds and their allocation under Islamic banking:

5.1. Liabilities side of the Islamic bank: sources of funds

Obtaining sources of funds and the acquisition of assets by an Islamic bank are undertaken according to the PLS.

The sources of funds for a typical Islamic bank are:

- i. Bank's own capital and equity.
- ii. Transactions deposits which can be considered like demand deposits in the conventional system. Although the nominal value of such deposits is guaranteed, there is no return on them. As such deposits cannot be used by the bank for its investments, usually a services charge for managing such accounts is imposed.
- iii. Investment deposits form the main source of funding and they are considered like shares. Investment accounts are held by depositors whose motives are not limited, theoretically at least, to transactions or precautionary purposes as in the case of transactions deposits. Investment deposits are normally subject to minimum deposit size and fixed duration determined by the Islamic bank. Moreover, in contrast with conventional banks, where the nominal value of deposits is guaranteed by the bank or the government explicitly or implicitly, such deposits with an Islamic bank are not guaranteed. The depositor in an Islamic system is considered a shareholder who receives an agreed proportion of pooled profit (or loss) incurred by all of the projects of the bank, net of administrative costs, taxes and reserves^{۲۵}.

^{۲۳} See the comment of Zarqa on Al-Jarhy (1983), p. 98.

^{۲۴} See Khan (1985), p. 8 and on the inherent instability of the capitalist economies see Friedman (1969) and Minsky (1986).

^{۲۵} Khan and Mirakhor (1987), p. 167.

The Islamic bank can provide its clients with a special investment account as an instrument offered to relatively big depositors. In such accounts the depositor has the option to share the outcome of a particular project to which his contract is exclusively tied. The share can differ from a depositor to another according to the size of participation.^{٢٦}

5.2. Assets of the Islamic bank: allocation of funds

In the absence of interest Islamic banks in generating their incomes resort to fees for services, profit sharing from equity participation, trading in commodities and foreign currencies, establishing and managing industrial, agricultural and services projects, in addition to real estates and rental businesses. An Islamic bank cannot keep fixed rate assets on its portfolio. Thus certificates of deposits, government bills and bonds and corporate bonds cannot be dealt in by an Islamic bank^{٢٧}.

The three main forms of Islamic bank financing are *mudarabah* (trust finance) and *musharakah* (partnership or joint venture financing), both are versions of PLS, in addition to *murabaha* (markup contract or differed payment sale).

- i. Under *mudarabah*, funds are provided by the bank to an investor in return for a predetermined percentage of profits. If the project incurs loss, the bank bears the financial loss exclusively and the investor loses the reward for his time and effort but does not bear any financial loss given that he is not negligent. In the past, even before Islam, *mudarabah* provided the means of combining the owner of capital and the entrepreneur in common ground as it coordinates the interests of the two parties without a contradiction with the Islamic system. In modern times it has been applied to include the depositor as a financier, the bank as entrepreneur, if the bank invest directly in its own projects, and has been extended to include three parties if the bank acts as intermediary and provides the funds to an investor who requires funding. Practically the Islamic bank aggregates profits, and losses, from different direct and indirect investments and shares net profits, or losses, with the depositors in strict relation to their capital contributions. *Mudarabah* has been used in projects with short gestation periods, e.g. trade projects^{٢٨}.
- ii. In *Musharakah* two or more parties contribute, in equal or variable proportions to the joint capital of the enterprise. In contrast with *mudarabah*, this financing form is used in long term investments, like industrial and agricultural projects. In *musharakah*, profits are distributed between the parties according to their respective capital and as in the case of *mudarabah*, losses are born by all parties and not just by the lender alone^{٢٩}. Companies under this form of finance can raise funds by offering certificates, as transferable corporate instruments secured by the companies assets, in the market which would determine their price.

^{٢٦} See Kazarian (1991), pp. 74-76.

^{٢٧} See Abdeen and Shook (1984), p. 185.

^{٢٨} See Khan and Mirakhor (1990), p. 355, Kazarian (1991), pp. 69-73 and Abdeen and Shook (1984), pp. 188-189.

^{٢٩} Khan and Mirakhor, op. cit., p. 355.

- iii. *Murabaha* financing implies that the bank purchases certain commodities for clients on a pre-agreed profit, under a cost-plus contract. The client may pay the price in instalments and the commodity is used, in this case, as collateral until the price is fully paid. This method of finance has recently become a popular method of finance at the Inter-Muslim Countries level as it has been adopted by the Islamic Development Bank (IDB) since 1977. Member countries of the IDB purchase commodities, usually from other members and the IDB pays the costs on their behalf. The bank is paid subsequently in instalments and generates profits through the agreed markup^{۳۰}. Although this form of finance is widely used by Islamic banks it does not have the same ecumenical acceptance under Islamic law that is enjoyed by *mudarabah* and *musharakah*. As discussed below, *murabaha* is considered by some Muslim scholars as a measure based on implicit *riba*.

5.3. Other forms of finance:

Although *musharakah*, *mudarabah* and *murabaha* are the dominant financial instruments employed by Islamic banks, there are some other instruments frequently used by such banks among them:

- *Bai' Salam* (purchase with differed delivery). In this transaction the bank pays the seller in advance the full agreed price of a specified quality and quantity of a commodity that the latter promises to deliver in the future. This form of finance, that is similar to forward purchase, has been employed in the case of agricultural products as their seasonality signifies the need for such finance. It has been applied as well to purchase other goods, e.g. manufacturing products, when the producer require working capital before delivery time.
- *Ijarah* (leasing). Under this form of finance the Islamic bank, as in the conventional system, purchases an asset and leases it to a client, for a fixed period, in return for a monthly or annual rent. An extension of this form is known as *Ijarah wa iqtina* which is similar to a lease-purchase contracts under which the ownership of the asset is transferred eventually to the client by making payments in instalments into a savings account over an agreed period of time.^{۳۱}
- *Qard Hasan* (beneficence loan). This form of finance is a solution to consumption loans from an Islamic perspective. These loans are provided by the bank at a zero return for those who need them. A service charge is paid by the recipient to cover only the administrative costs of providing the loan under the condition that this charge is not related to the size of the loan or its time length.^{۳۲} Part of the funding of such loans can be obtained by using of the revenues of *zakat* (alms tax)^{۳۳}

^{۳۰} Abdeen and Shook (1984), op. cit., pp. 189-190.

^{۳۱} ibid., pp. 190-191.

^{۳۲} Khan and Mirakhor (1990), p. 355.

^{۳۳} *Zakat* is the third of the five pillars of Islam which are: Believing that there is no god but Allah and Muhammad is his messenger; performing prayers, paying *zakat*; fasting the month of Ramadan and the pilgrimage to Mekah. *Zakat* is a compulsory levy imposed on all possessions, like cash, agricultural products, gold and silver, etc. The rate of such tax is 2.5% per annum on the accumulated wealth and net income that exceed the minimum exemptible level. The aim of *zakat* is to achieve social justice. For a detailed analysis of the economic role of *zakat* see Choudhury and Malik (1992), op. cit., pp. 63-101. It is worth noting that the collection of *zakat* is the responsibility of the state not the bank under an Islamic system, and due to the absence of this system Islamic banks took over this responsibility.

collected annually by the Islamic bank from its investors as one of the integrated functions of the bank.^{۳۴} In an Islamic financial system the revenue of the *zakat* should increase as the government under this system have to collect them according to the Islamic Law. Thus some of its revenues can be channelled through Islamic banks to fund the *Qard Hasan*. Moreover the very nature of transactions accounts held by the Islamic bank at zero return for depositors, as discussed above, justifies the proposed role of such a bank to extend zero -return loans for consumption. Further we argue that although transactions deposits are theoretically not used in banks' projects, in practice they are. Hence the return of transactions deposits can be utilised to fund such loans and cover the cases of default if they occur.

In addition to the prohibition of transactions based on interest rates, the Islamic bank should avoid all activities that involve speculation and indulging in the production of any good or service that violate Islamic law. Further the objectives of the Islamic bank should not be limited to profit maximisation alone as it also has social and religious objectives. Needless to emphasise that most, if not all, of the proposed functions and operations of the Islamic bank cannot be suitably applied in the absence of a comprehensive application of Islamic law in all the aspects of the economic system. As shown below, the divergence in practice of many Islamic banks from the theoretical guidelines can be primarily attributed to the limited application of Islamic principles resulting in only a limited number of appropriate financial intermediaries in an incompatible economic system.

6. Islamic banking in practice:

The resurgence of Islamic values in the 20th century, especially during the last two decades has been reflected recently in the economic sphere. There was scepticism and reservations regarding the activities of Interest -based banking systems in Muslim societies which was witnessing shifts towards applying Islam in all aspects of life including financial transactions. We argue that part of the slow pace of financial development in these societies can be attributed to the incompatibility of the western -style banking model with the prevailing traditions and values. However the establishment of financial institutions with Islamic features has been a response to changes in Moslem societies and has capitalised on them to attract those who were discouraged previously from dealing with the formal financial system.

There have been two ways of forming Islamic financial institutions. The first was by restructuring the whole financial system in accordance with Islamic law. Such restructuring either took a gradualist form as in Pakistan which started a cautious programme in 1979/80 or a shock form like in Iran which adopted a rapid process of Islamisation permitted by its Islamic revolution in 1979.^{۳۵} The government in Sudan has been also experimenting with the Islamisation of its banking system since 1984. However its attempt was not supported by adequate preparation as in Pakistan or by a revolution as

^{۳۴} For a discussion of consumption loans in an Islamic system see for example Siddiqi (1988), pp. 155-165.

^{۳۵} For a comparison between the experiences of Iran and Pakistan in Islamic banking, See Khan and Mirakhor (1990) and Iqbal and Mirakhor (1987).

in the case of Iran, so initially it did not achieve its objectives. Another attempt has been initiated recently.^{۳۶}

The second way of applying Islamic financial principles took the form of establishing Islamic financial units in countries which adopt otherwise 'conventional' financial systems. This way has been more widespread than the first as is shown in table (1). There are approximately 45 countries, including most of the Muslim countries, which now have some form of Islamic financial establishments. The majority of the Islamic financial institutions were a product of cooperative efforts between private entrepreneurs and financial authorities in the countries concerned.^{۳۷}

Table 1.
The biggest Islamic banks

Bank	Location	Year	Capital (\$ million)	
			Authorised	Paid
Al-Baraka	Saudi Arabia	1982	183	..
Al-Rajhi	Saudi Arabia	1983	213	..
Bahrain Islamic Bank	Bahrain	1979	13	13
Bahrain Islamic Investment Company	Bahrain	1981	13	13
Dar al Maal al Islami	Bahamas	1981	1000	316
Bank Islam Malaysia	Malaysia	1983	206	33
Dubai Islamic bank	UAE	1975	14	14
Faisal Islamic bank of Egypt	Egypt	1977	40	38
Faisal Islamic Bank of Sudan	Sudan	1977	77	44
Islamic bank of Bangladesh	Bangladesh	1983	19	0.7
Islamic Bank International	Denmark	1983	4	4
Islamic International Holding Company	Luxembourg	1978	100	26
Islamic Development Bank	Saudi Arabia	1975	1960	1250
Islamic International Bank for Investment & Development	Egypt	1981	12	9
Jordan Islamic Bank	Jordan	1978	10	10
Islamic Investment House	Jordan	1981	10	10
Kuwait Finance House	Kuwait	1977	62	61
Nasser Social Bank	Egypt	1972	29	..
Qatar Islamic Bank	Qatar	1983	55	..

Source: Roy, D. (1991), p. 440.

7. Islamic banking in Egypt:

The process of applying Islamic financial principles took two forms in Egypt: establishment of Islamic banks, both private and public and setting up of Islamic branches of conventional banks; in addition to forming Islamic Investment Companies which belong, according to reasons given below, to the informal sector. In this section we start by examining first the case of formal Islamic banks, as we distinguish between the public and private ones. Second the case of Islamic branches of conventional banks is discussed. Third we discuss the main problems and prospects of Islamic banking in Egypt in the light of their recent experience.

7.1. Public Islamic banks:

7.1.a. Meet Ghamr Bank:

The first experiment in Islamic banking, in the Muslim World, was undertaken in Egypt, in 1963, by the establishment of Local Savings Bank in the semi-rural town of *Meet*

^{۳۶} See Ahmad (1993), pp. 22-23.

^{۳۷} On the circumstances surrounding the establishment of Islamic Banks see Wohlers-Scharf (1983).

Ghamr, in the *Dakahliyah* province, in the Delta. The bank was an adapted model of the German savings banks to comply with Islamic principles^{٣٨}. It was established by a German grant of DM 780,000 and an Egyptian government contribution of £E 60,000 transferred from the Post Office Savings Fund^{٣٩}. During the five years of its operation the Government continued to subsidise the activities of the bank. The subsidies totalled £E 496,000^{٤٠}. Like the rest of the operating financial intermediaries in Egypt during this period the *Meet Ghamr* Bank (MGB) had to be publicly owned. The bank was not subject to direct supervision from the central bank but an especially constituted public authority assumed the supervisory role.

The MGB provided three different accounts. First deposits accounts with a very small deposit minimum and without a maximum. There was no return whatsoever for the holders of such account which can be considered an equivalent of current account in the conventional system. The second type was called "investment with participation accounts" which accepted deposits with a modest minimum and had no maximum. These accounts provided a PLS return to depositors. The third account was the *zakat* and social services account. This account accepted alms taxes from individuals in addition to charities and donations.^{٤١}

As shown in table (2) the number of depositors increased from 17,560 in the first year of its operation to 251,152 by 1966/67, by an impressive average annual rate of 538.3%. Depositors were mainly from the small savers group as the average deposit ranged from £E 2.33 in 1963/64 to £E 7.28 in 1966/67.

Table 2.
Growth of Savings accounts in the *Meet Ghamr* bank.

Year	Number of depositors	Amount (£E)	Deposit Average Size (£E)
1963/64	17560	40944	2.33
1964/65	30404	191235	6.30
1965/66	151998	879570	5.79
1966/67	251152	1828375	7.28

Source: Al-Ashker (1990), p. 61.

Loans were provided by the bank according to PLS principle to small entrepreneurs for periods

ranging from one to five years^{٤٢}. The bank in its second year of operation began to establish small projects of its own. In general, projects financed by the bank were

^{٣٨} The founder of the bank Dr. Ahmad Al Najjar, who became the Secretary-General of the International Association of Islamic Banks, was impressed by the German savings bank while a graduate student in West Germany in the 1950s. When he returned to Egypt he felt that the German model can be modified to conform with the Islamic principles. However, in the socialist period of the 1960s, the Islamic ideas behind the establishment of the *Meet Ghamr* bank had to be hidden and was not advertised in its name. Instead the founder managed to convince the Egyptian authorities by the role of these banks in mobilisation of savings and catering for the poor.

^{٣٩} See Al Najjar (1993), p. 38.

^{٤٠} Mayer (1985), p. 37.

^{٤١} See Al-Najjar (1993), pp. 44-46.

^{٤٢} Al-Ashker (1990), p. 60.

established in the same local area to assure the depositors of the contribution of the bank in the development of their community^{ε٣}. In addition the bank provided interest-free small consumption loans, averaged £E 50 per borrower. Although these loans were provided without collateral, the number of defaulting borrowers was small^{ε٤}.

The favourable experience of the bank convinced several governorates to apply for the establishment of similar banks. The number of applications exceeded seventy but the management of the bank was not able, due to shortages of trained staff, to open more than seven branches located in the Delta and in Cairo.^{ε٥}

Despite the success of the MGB the Government found it necessary to put the bank under immediate control. The call for such control was a response to two main concerns. First, it was realised that the bank was operating under rules which contradicted those applied by the rest of financial intermediaries. The government was suspicious that such a contradiction might bring a dispute amongst the public regarding what should be considered as Islamic and what should not, which may affect the operations of the dominant conventional banks. Second, the government found in the bank a threat to its socialist ideology and its management of the economy which was based on central planning. In the socialist period, a bank being a mixture of a capitalist model and an Islamic character was naturally a target for government intervention.

As a result the MGB lost its operational autonomy and eventually was closed down in 1968. Its operations, which became interest-based, were assumed by the National Bank of Egypt and the central bank.^{ε٦} The Meet Ghamr bank, despite the difficulties it faced, provided an applicable model for other Islamic banks which were established subsequently.

7.1.b. The Nasser Social Bank:

One of the Islamic banks that benefited from the experience of the MGB is the Nasser Social bank (NSB). This bank was formed in 1971 and began its operations in 1972. The bank has been established as a public institution for social welfare and its capital, which reached £E 20 million in 1990, was provided by the government. However the NSB is not registered^{ε٧} with the Central Bank and hence it was exempted from its supervision and regulation.^{ε٨} The NSB has a wider functions, through its 23 branches, than the MGB as it operates at the national level but has applied almost the same rules as its predecessor. The

^{ε٣} The bank managed to establish several projects in the Meet Ghamr area for example: brick factory, semi-mechanised bakery, a dairy, a macaroni factory, a mechanised irrigation project and a private school.

^{ε٤} See Mayer (1985), p.38.

^{ε٥} Al-Najar (1993), p. 58.

^{ε٦} For details of how the bank came to an end see Al-Najar (1993), pp. 59-66.

^{ε٧} Its registration with the CBE has recently been considered.

^{ε٨} Law 66 of 1971 stated that the operations of the Nasser Bank are not regulated by law 163 of 1957 regarding the Central Bank and its authorities.

annual collection of *zakat* constitutes the main source of funding for the bank in addition to an annual subsidy from the government.

In its early years the NSB was free to provide credit without the need to comply with the credit ceilings imposed by the government. Loans provided by the NSB took two forms; productive loans and social loans. It is worth noting that the NSB does not share the profits or losses of its borrowers. It requires them to return the principal in addition to 1% charge. This charge is considered as 'cooperative insurance'.^{٤٩} The NSB subsidise its loans from the *zakat* fund and, to some extent, from the profits it makes from its direct investment.

Nevertheless the NSB has recurrently breached its own regulations. It is reported that the bank undertook several interest-based transactions with other financial intermediaries. Moreover it deposits some funds with conventional banks in return for interest.^{٥٠} As discussed below, this problem can be attributed to the conditions of an Islamic bank which operates in a predominantly conventional system. On the other hand in the case of NSB, its management was not always convinced about the role of an Islamic bank and its distinctive rules.

7.2. Private Islamic banks:

There are now two private Islamic banks in Egypt. The first is the Faisal Islamic Bank of Egypt (FIBE) which started its operations in 1979. The special act number 48 of 1977 gave the bank independence from all governmental authorities but put it, however, under the supervisory role of the Central Bank. The bank was granted several privileges similar to those granted under the investment law 43 of 1974 and enjoyed more generous tax treatment than that already given by this law^{٥١}. In 1993 the bank had 14 operating branches in the major cities. The authorised capital of the FIBE is \$500 million and the paid-up capital is \$100 million in 1993, with an Egyptian participation of 51% and a Saudi Participation of 49%^{٥٢}.

The second bank is the Islamic International Bank for Investment and Development (IIBID) which was established in 1980 in accordance with the investment law 43 of 1974 and started its operations in 1981. In 1990 the bank had 7 branches located in the biggest cities and 4 branches were under construction. The authorised capital of the IIBID is \$100 million and the paid up capital is \$60 million in 1992^{٥٣}.

Although the FIBE was established as a commercial bank and IIBID as a business and investment bank, in practice the difference between them is not significant as shown in Table (3) below.

^{٤٩} Mayer (1985), p. 41.

^{٥٠} Al-Najar (1993), pp. 117-118.

^{٥١} Note that upon its establishment the FIBE was granted a fifteen years exemption from all taxes and was then reduced to two years.

^{٥٢} Annual report of FIBE (1994).

^{٥٣} Annual report of IIBID (1993).

Table 3.
A comparison between the FIBE and the IIBID

	FIBE	IIBID
Current account	Without overdraft facility	Similar to FIBE
Savings account	Not available	Offers a small return at the discretion of the bank but does not bear any losses incurred by the bank; less risky than investment accounts.
Investment accounts	Funds should be deposited for a specific period from 6 months to 3 years with a PLS return.	Similar to FIBE, but has another account which is a combination of investment and savings accounts as the depositor can withdraw up to 40%
Main Methods of finance	- Short term (<i>Murabaha</i>) - Medium and long term (<i>Mudarabah</i>)	Similar to FIBE
Social services	Wide range of services funded through its <i>zakat</i> account and from the bank in its own capacity.	Similar to FIBE.

7.2.a. Mobilisation of savings:

As shown in Table (4) during the first five years of their business, the two Islamic banks achieved remarkably high rates of growth of deposits. The size of deposits in FIBE increased by 20 times to reach more than £E 2070 million while the IIBID managed to keep £E 535 million. During this period deposits' growth was higher in the two banks than the average growth achieved by the commercial bank as a group and by the National Bank of Egypt (NBE), the biggest commercial bank in Egypt.

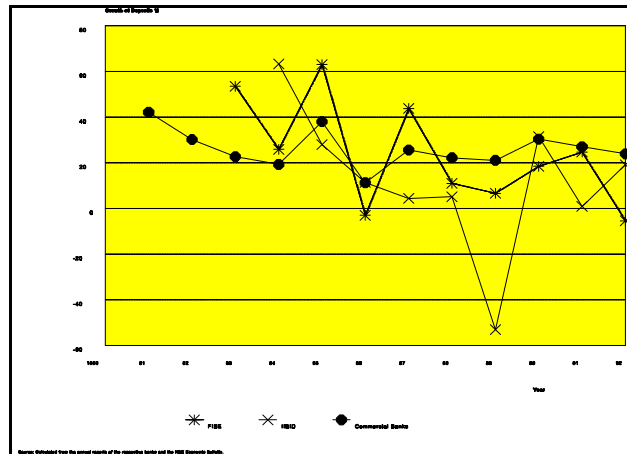
Table 4.
Deposits and their growth in FIBE, IIBID, NBE & all Commercial Banks 1980 -92

Year	FIBE*		IIBID		NBE		All Commercial Banks	
	Deposits	Growth	Deposits	Growth	Deposits	Growth	Deposits	Growth
1980	98.1	-	-	-	1796.1	-	6987.1	-
1981	354.1	261.1	6.0	-	2161.2	20.3	9932.5	42.2
1982	657.8	85.8	61.0	916.7	2364.2	9.4	12928.4	30.2
1983	1009.9	53.5	256.0	319.7	3031.4	28.2	15864.3	22.7
1984	1271.6	25.9	418.0	63.3	3625.2	19.6	18925.9	19.3
1985	2073.5	63.1	535.0	28.0	4824.5	33.1	26124.6	38.0
1986	2011.7	(-3.0)	596.0	11.4	6587.4	36.5	29065.2	11.3
1987	2892.1	43.8	622.0	4.4	7327.0	11.2	36525.1	25.7
1988	3210.3	11.0	654.0	5.1	9681.0	32.1	44637.0	22.2
1989	3424	6.7	306.6	(-53.1)	11763.0	21.5	54053.1	21.1
1990	4057	18.5	403.2	31.5	15004.0	27.6	70482.9	30.4
1991	5059	24.7	406.9	0.9	23683.0	57.8	89558.9	27.1
1992	4785	(-5.4)	484.9	19.2	30684.1	29.6	110999.2	23.9

Source: Annual reports of FIBE, IIBID, NBE and the NBE Economic Bulletin.

) Figures for FIBE are converted from US\$ to £E by using the annual banking sector exchange rate.

However as shown in figure (2), after 1985, average growth rates in the two Islamic banks started to decrease and became lower than that of commercial banks. While the traditional banks continued to have a continued growth of their deposits, the FIBE had negative growth rates in 1986 and 1992. Even more seriously the IIBID suffered a loss of more than half of its deposits in 1989 as a result of difficulties analysed below.



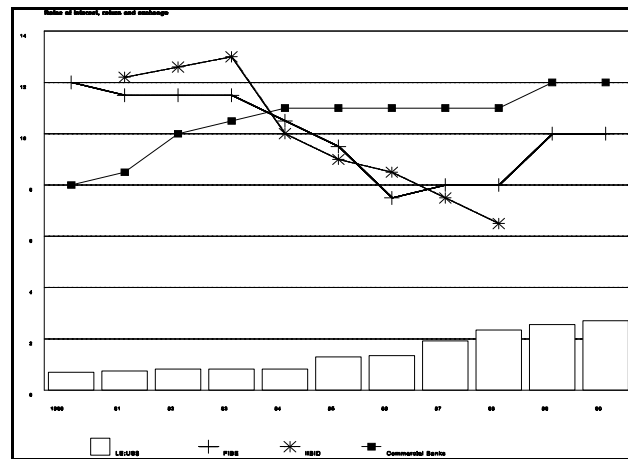
Despite the growth of deposits in the Islamic banks in their early years, the total size of deposits in the two banks combined did not exceed, even in their peak years, 10% of total deposits in the commercial banking sector.

7.2.b. Reasons for the growth of deposits:

The exceptional growth of deposits in the two Islamic banks in their early years can be attributed mainly to the following factors:

١. High rate of return. As shown in figure (3) below, in the first four years of their operation the Islamic banks distributed relatively high rates of return on deposits ranging from 1 to 3 higher than the controlled interest rates offered by conventional banks. We argue that Islamic banks offered such high rate of return to attract depositors.
٢. The religious incentive. The sharp increase of deposits in the early years of the establishment of Islamic banks reflected the need for a significant group of depositors for banks that do not deal with interest in a period marked by religious revival: i.e. it was a one-for-all stock adjustment. The contribution to the welfare of Muslims through the *zakat* fund emphasised the Islamic character of these banks. However it is hard to separate the religious effect from other factors contributed to the growth of deposits, especially the high rate of return mentioned above.
٣. Foreign currencies account. The two banks kept a high proportion of deposits in foreign currency, mainly US dollars. They distributed a return on these deposits quoted in the respective foreign currencies. This attracted more depositors in a time when the local currency interest rate was low and the Egyptian pound was facing gradual devaluation, as shown in figure (3). The massive devaluation of the Egyptian pound during the period 1980 -1990 by approximately 350% contributed to the growth of deposits denominated in foreign currencies when they are

accounted in Egyptian pounds. The Share of foreign currencies accounts in total deposits was 74% in the FIBE in 1990 and 68% in the IIBID in 1988.^{oε}



Source: Kazarian (1993), p. 148 and CBE annual reports. Exchange rates are obtained from the CBE annual reports.

7.2.c. Reasons for the recent deterioration of deposits growth:

- ١). The establishment of other Islamic financial institutions. This took the form of the informal Islamic Investment Companies (IICs)^{oo} and the branches of formal conventional banks. The former claimed their compliance with Islamic law and were active in 1980s. They distributed high rates of return, almost the double of official interest rate. It has been reported that these companies attracted about 22% and 30% of depositors of the FIBE and IIBID respectively.^{o٦} On the other hand Islamic branches of conventional banks were formed as a response to the early success of the Islamic banks. It is argued that they also deprived the Islamic banks from some of their depositors.
- ٢). The decline of rates of return: As shown in figure (3) above since 1984 rates of return distributed by the two banks began to be lower than interest rates offered by conventional banks and consequently rate of growth deposits declined in the former. The recent figures of the FIBE show a negative growth of deposits by 5.4% and 13.3%^{oy} in 1992 and 1993 respectively which can be attributed, inter alia, to the relative low rate of return in comparison with the prevailing nominal interest rates after the 1991 liberalisation programme.

^{oε} See Kazarian (1993), pp. 146-147.

^{oo} See our analysis of these companies below.

^{o٦} Kazarian (1993), p. 149.

^{oy} Annual reports of the FIBE (1993) & (1994).

٣. The impact of the recent controversial *fatwa*^{٥٨}: In 1989 a *fatwa* given by the *Mufti*^{٥٩} of Egypt stated that interest rate is not a form of *riba*. Thus dealings with conventional banks became lawful from an Islamic perspective for those who accept this *fatwa*. Despite strong opposition to this opinion from the majority of Muslim scholars, Islamic banks lost further depositors who followed the opinion of the *Mufti*^{٦٠}.
٤. Irregular distribution of return: One of the major factors which contributed to the heavy withdrawal of deposits from the IIBID in 1989, approximately 53% of total deposits, was the long delay in the distribution of returns in 1988 and 1989. This gave an impression that the bank was facing intense difficulties.
٥. The collapse of Islamic Investment Companies: The IICs affected negatively the Islamic banks twice. First during their rise as discussed further below and second, during their fall. After the collapse of the IICs, 'news'^{٦١} were spread associating Islamic banks with the IICs and that consequently the bank suffered heavy losses because of this relationship. Notwithstanding these news some of the customers were concerned that these banks might have been indulged in the same activities of the IICs, like heavy speculation abroad. These problems combined with the IIBID's irregular distribution of returns led to the heavy withdrawal of deposits, as mentioned in the previous factor.

7.2.d. Growth of assets:

The first four years of operation of the two Islamic banks saw an exceptional growth of total assets with an annual average of 103% for the FIBE and 254% for the IIBID, compared to 24% in the commercial banking sector. The high growth rates of Islamic banks can be partly attributed to the fact that their assets positions started from very modest levels; £E 155 million in the cases of the FIBE and Just £E 12 million in the case of the IIBID. Nevertheless this does not deny that the growth of total assets reflected the achievement of the two banks in the mobilisation of deposits and other liabilities in their early years of establishment.

However since 1986 the growth rates of total assets started to decline and were negative in some years. As shown in figure (4) the growth rates of Islamic banks' assets were generally lower than that of the commercial banking sector after 1985. The financial year 1986 was a bad one for all banks, as the growth rate dropped from its highest level of 38% in 1985 to its lowest level of 11% in 1986. In the beginning of 1986 the economy suffered from an external shock amid the drop of oil prices which affected negatively the main revenues of the economy, namely the Suez Canal, the remittances of workers in the

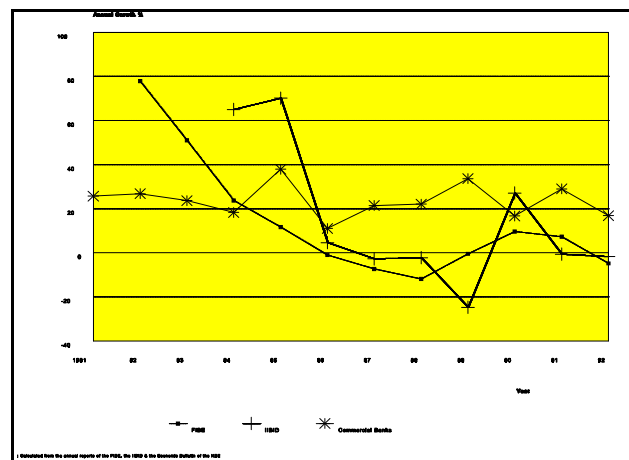
^{٥٨} A *fatwa* is a formal religious opinion declared by an authoritative religious leader.

^{٥٩} A religious leader appointed by the state in most Moslem countries and granted the authority of giving formal religious opinions to the state and the individuals.

^{٦٠} The *fatwa* was given on the 8th of July 1989 regarding the interest rates of Investment Certificates and Post Office Savings Fund. It was extended afterwards to cover some more interest rates-based transactions. It is worth noting that the Imam of Al-Azhar and other distinguished scholars opposed this *fatwa*. The *fatwa* is published in Tantaway (1991) and for an example of opposing arguments see: Al-Salous (1991a) & (1991b) and Al-Qaraddawy (1990).

^{٦١} The IIBID annual report for the financial year 1989 describes them as irresponsible.

Gulf states, tourism and oil exports.^{٦٣} The 1986 external shock was responsible for the poor performance of banks generally, but as shown in the figure below, the Islamic banks were



affected more by it arguably because of their closer links with the Gulf oil states.

The decline of the growth of assets of the Islamic banks after 1986 can be attributed also to the mismanagement problems more than anything else. In the case of the IIBID, the growth of assets suffered from the bank's 1989 problems, which eventually necessitated a Central Bank intervention, with the cooperation of the four public sector commercial banks in order to recapitalise the bank.^{٦٤} On the other hand the FIBE was negatively affected by the collapse of the Bank of Credit and Commerce International (BCCI) which collapsed in 1991.^{٦٥} The FIBE lost an amount of US \$343.7 million, approximately 17.6% of its assets^{٦٥}, deposited with the BCCI under especial arrangements. These deposits did not appear in the BCCI's records and it was difficult to prove their existence to the liquidators. These problems were reflected in the Islamic banks assets as shown in figure (4).

7.2.e. Allocation of funds:

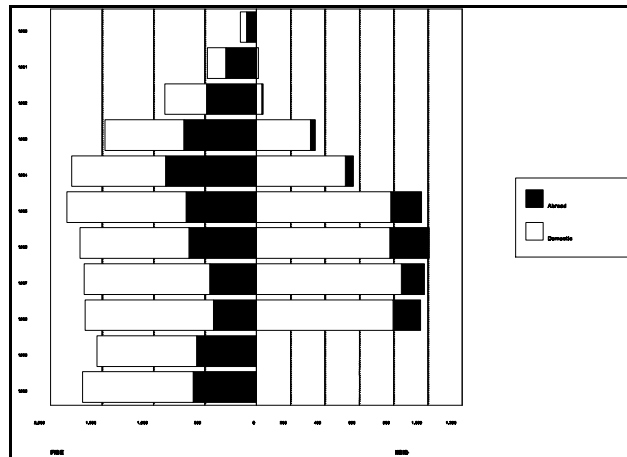
Figure (5) reveals that the FIBE had a significant percentage of its assets, ranging from 33.4% to 60% of total funds, deposited in banks abroad in return for a LIBOR on these

^{٦٣} See the annual reports of the IIBID for 1991 and 1992. It is reported that the four public commercial banks own 79.83% of the capital of the IIBID as a result of their intervention to help the IIBID out from its problems. This, we argue changed the status of the IIBID from being a private and Islamic bank to become a publicly owned conventional bank, despite its Islamic title.

^{٦٤} The Bank of England stopped the BCCI's operations on 5/7/1991 and was liquidated by a court order issued on 14/1/1992.

^{٦٥} See the Annual reports of the FIBE of 1991 and 1994.

deposits, despite its claimed compliance with Islamic law^{٦٦}. Recently the FIBE reduced the size of funds deposited abroad and allocated them domestically. However this shift towards the domestic market was in the form of deposits with the Central Bank and commercial banks. As shown in figure (6) from 1980 to 1990 deposits with the banking sector averaged 46.1% of the domestic allocation of funds, while the average of deposits with other banks for all commercial banks was just 39% during the same period. Again the FIBE received interest as a return on such deposits.



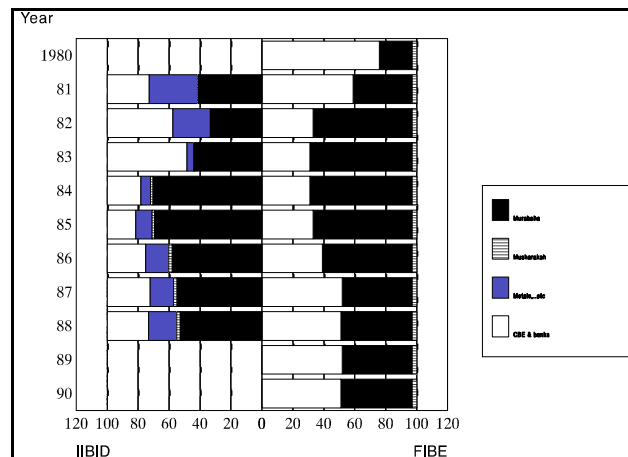
Source: Annual reports of the FIBE and the IIBID.

The IIBID differed from the FIBE in terms of the share of funds deposited with foreign banks as this share did not exceed 32% in any year from 1981 to 1988. As shown in figure (6), the IIBID had a lower share of its funds deposited with the CBE and other banks as its annual average was 30.1% during the studied period, but, like the FIBE it did receive interest on these deposits. The IIBID differed from the FIBE in another aspect as it allocated a share of its fund, ranging from 4.3% to 31.3% to speculative operations in foreign currencies, precious metals and other goods in the domestic and foreign markets.^{٦٧} Due to heavy losses, the bank has recently stopped its speculation in precious metals and reduced the size of the other operations.^{٦٨}

^{٦٦} Kazarian (1993), p. 162. The problem of Islamic banks' indulgence in interest-based transactions was highlighted by Al-Najar, the former Secretary General of the International Association of Islamic Banks in his (1993) lecture in Asseala (Morocco).

^{٦٧} Kazarian (1993), p. 164.

^{٦٨} Speculation activities are forbidden in Islam and the bank was advised to stop such activities. It is worth noting that the word *mudarabah* has two meanings in the Arabic language, the first is trust finance which is adopted in this paper, the other means speculation. While the first is religiously allowed the second is not. Thus it is often to find that the first is described by the *shar'iah* (legitimate) to distinguish between the two of them. Some banks however do not distinguish between them in their reports, possibly to grant their speculation activities with legitimacy.



Source: Author's own calculations from the annual reports of the FIBE and the IIBID.

Beside depositing its funds with domestic and foreign banks, the FIBE's main activity was providing *murabaha* (markup) and *ijarah wa iqtina* (lease-purchase) finance. These two forms of finance comprised, on average, 51% of the bank's domestic funding from 1981 to 1990. In the case of the IIBID, lease purchase and markup financing comprised 53% of the bank's domestic funding from 1981 to 1988. These two forms of finance were for short term purposes with a period ranging from three months to one year. Costs of funds were determined by the bank in advance according to the size and duration of funding. Funds were secured by collateral which was the asset, usually a durable good or a real estate, purchased by the bank for the client.

While *mudarabah* (trust finance) was completely absent from the portfolios of the IIBID and the FIBE, there was very limited use of *musharakah* (equity participation) by the two banks, as shown in figure (6). *Musharakah* comprised a constant share of 3% of the FIBE's domestic allocation of funds. The IIBID made as well a very limited use of *musharakah* as its share in its portfolio ranged from 0.7% in 1981 to 2.2% in 1988. *Musharakah* as a risky long term form of finance was mainly used by the two Islamic banks in their own direct investments. In the case of the FIBE 73% of *musharakah* funding was used in the bank's own projects, e.g. food processing, household products, investment and consultancy firms, private schools and hospitals, housing, pharmaceutical production, ... etc⁷⁹. The rest of this type of funding, 27%, was allocated in joint projects similar in their activities to the ones owned entirely by the bank.

Generally the share of agricultural and industrial sector financing in Islamic banks funding was small. As shown in table (5) trade and services were favoured for their higher returns and shorter gestation periods.

⁷⁹ Annual reports of the FIBE (1994), pp. 16-17 and (1991), pp. 43-47.

Table 5.
Sectoral allocation of funding (%)

Sector	FIBE (1983-88)	IIBID (1985-88)
Trade and Services	56.5	25.8
Foreign currency dealings	18.7	4.6
Construction and housing	17.3	11.1
Industry	6.7	-
Agriculture	1	-
Unidentified markup finance	-	58.5

Source: Compiled from Kazarian (1993), p. 171.

The table shows the dominance of trade and services sector in the case of the FIBE where it comprise 56.5% of total domestic funding during 1983 -88, while the industrial and agricultural sectors did not receive more than a share of 7.7%. Although it seems that the IIBID had less of its investments in these activities, in fact it was not too different from the FIBE. Given the characteristics of the unidentified markup finance of the IIBID that mainly relates to household durable goods and real estate, as discussed above, then most of the 58.5% markup finance during 1985 -88 can be classified under trade and services.

7.3. Islamic branches of conventional banks:

As a response to the success of Islamic banks in attracting depositors, in their early years of establishment, many conventional banks formed Islamic branches. Bank Misr was the first conventional bank to set up an Islamic branch which started its operations in 1980.^{Y*} Apparently the bank was concerned that the newly established FIBE would attract away some of its potential business as well as existing depositors.

At the end of 1990 there were 62 Islamic branches of 23 conventional banks. Just 12 of these branches were of private while 26 of them belong to public banks and 24 to joint venture banks, i.e. owned partly by public banks. Total assets of Islamic branches reached £E 2.2 billion and the total of deposits was £E 1.82 billion. The size of these branches was small compared with the assets and deposits of the three major operating Islamic banks, including Nasser Bank, which reached £E 6.1 billion and 5.1 billion respectively.^{Y¹}

Most of Islamic branches' depositors were individuals who used to have deposit accounts with the same bank^{Y²}. They simply transferred their accounts to the Islamic branch of their bank for three reasons: first it offered the same return as the main bank, and in some cases even more. Second it had an Islamic image which fulfilled, according to the perception of these depositors, the religious aspect of the dealing. Third these branches were fully supported by their well established main branches, some of them, like

^{Y*} See Mayer (1985), p. 47.

^{Y¹} Kazarian (1993), p. 135.

^{Y²} In an interview with Mrs Madeaha Gaber, the manager of the foreign department, at the Nile Bank which has two Islamic branches and fourteen other branches, on 1/5/1993 she confirmed this point. Also Kazarian (1993), p. 184, points out that 97% of Islamic branches' depositors interviewed by him transferred their accounts from a traditional branch to an Islamic one for the same reasons given above.

Bank Misr, had had a good banking profile for more than seventy years, in contrast with the newly established Islamic banks or Islamic Investment Companies.

It is difficult to analyse the performance of Islamic branches as they do not have separate balance sheets or accounts as the outcome of their operations are integrated with the rest the activities of their parent banks^{٧٣}. This problem however reflects the fact that the resources of these branches are mixed with the rest of the banks' funds and directed towards financing the banks' activities^{٧٤}. Even in the few cases where some of the Islamic branches were granted some autonomy in the allocation of their funds, in practice the branches found it difficult to utilise fully their resources. Not more than 20% of their deposits were allocated directly in the form of *murabaha*, the rest was deposited with main branches. Thus they did not comply well with the Islamic principles.

Moreover Islamic branches did not share the features of Islamic banks in two important aspects from the religious viewpoint: first they did not have a board of religious scholars to verify the banks' operations and assure their compliance with Islamic law in all transactions, second they did not have a *zakat* account which emphasised the Islamic character of the intermediary.

We argue that the establishment of Islamic branches of conventional banks is a form of product diversification.^{٧٥} They were established to benefit from the Islamic resurgence and avoid loss of customers to the growing Islamic financial institutions. The establishment of a limited number of Islamic branches of big conventional banks which had large network of branches and outlets, like Bank Misr, was not a part of a gradual Islamisation of the banks concerned, but rather it was meant from the beginning to keep the number of Islamic branches as small and symbolic as possible. In practice the Islamic branch was not more than a branch without any significant difference from any conventional branches other than in name.

We consider the very existence of these branches an evidence of the general confusion concerning what is Islamic and what is not, as far as financial transactions are concerned. The contradicting *fatwas* regarding interest and whether it is a form of usury, as discussed above, was responsible, *inter alia*, for this bewilderment.

7.4. Problems of Islamic banking in Egypt:

1- The dominance of short term *murabaha* finance:

As pointed out above *murabaha*, markup, finance dominated the portfolios of Islamic banks. We argue that this is a reflection of an inefficient allocation of funds, mainly because funds under this scheme are directed towards the purchase of, usually imported, durable consumption goods. This type of finance was favoured by Islamic banks along with

^{٧٣} The Nile Bank, for example, in its annual report of 1992 did not mention anything regarding its two Islamic branches apart from their names and locations.

^{٧٤} In the Interview with Mrs Gaber she mentioned that her bank does not distinguish between its branches and all of them including the Islamic ones direct their funds to the bank's activities.

^{٧٥} In interviews with Mr Ali Nigm the former Governor of the CBE and Chairman of the Delta Bank and Mr Motaz Mansour, Managing Director of Misr Iran Development Bank, they supported this argument.

ijarah wa iqtina, purchase-lease, contracts which do not differ in principle to *musharakah* and applied mainly in the purchase of real estate. The very dominance of such contracts makes one sceptical about the development role, usually stressed by Islamic banks in their bylaws and annual reports.

Moreover *musharakah* finance,^{∇¹} in the way it is applied by Islamic banks, is considered as controversial from the Islamic perspective. It is often described by Islamic economists as a device by which some 'Islamic' banks bypass the restriction on usury.^{∇²} Interest rates are charged implicitly in the form of the predetermined cost of providing the funds by the banks. Moreover it does not differ from the same practice applied by conventional banks when they provide loans under lease or lease purchase schemes^{∇³}.

2- The limited practical role of PLS contracts:

Despite the emphasis given in Islamic financial literature regarding the importance of the *mudarabah* (trust finance) and *musharakah* (equity participation), in practice our enquiry within the banks found that the former was completely absent and the latter had a very limited presence in the portfolio of Islamic banks in Egypt. Similar problem was realised in other countries.^{∇⁴}

This problem can be attributed to the fact that these two forms of PLS finance require an extensive bank effort to ensure that the outcome of the projects are accurately reported. For example the prevalence of tax evasion in LDCs and the associated problem of double bookkeeping for firms make it difficult by the participating bank to find out the actual outcome of the project concerned. Even in the absence of the double bookkeeping problem the PLS contracts may be subject to a principal-agent problem arising from asymmetric information. Thus while profit sharing may increase bank efficiency as it separates administrative control from institutional interest rates, it generates more difficulties, at the same time, on its monitoring activities^{∇⁵}.

Nevertheless conventional banks are not themselves immune from such problems. If the profit outcome of a project is stochastic, this gives project managers an informational long

^{∇¹} It seems that Islamic banks are not interested in revealing their *murabaha* bias. They used to aggregate all their funding operations under one item in the assets sides of their balance sheets called *musharakah*, *mudarabah*, commercial and productive *murabaha* and real estate investments, so it is difficult to know the relative importance of these different forms of funding from reading the balance sheets. Acquiring such information is difficult as it has to be obtained directly from the concerned banks or the Control Department of the CBE with a especial permission. Reasonable itemisation of the data is required for any careful analysis of the operations of Islamic Banks.

^{∇²} See Al-Najar (1993), pp. 589- 591.

^{∇³} The Economist magazine (6/8/1994) made a comparison between explicit borrowing from conventional banks and obtaining funds under *murabaha*. The Economist mentions that " The Koran says you cannot borrow \$100m from the bank for a year at 5% interest, to buy the new machinery your factory needs? Fine. You get the bank to buy the machinery for you- cost \$100m- and then you buy the stuff from the bank, paying it \$105m from now. The difference is that the extra \$5m is not interest on loan, [...]but your thanks to the bank for the risk it takes of losing money while it is owner for the machinery [...] Since with modern communications the bank's ownership may last about half a second, its risk is not great." Thus there should not be a surprise that Muslim scholars reject this form of finance, alas, widely adopted by Islamic banks.

^{∇⁴} See for example Khan and Mirakhor (1990), Iqbal and Mirakhor (1987) and Anwar (1992) for a discussion of this problem in the two cases of Iran and Pakistan.

^{∇⁵} See Fry (1988), 266 and Goodhart (1992), p. 53.

term relationship through equities in projects financed by the bank according to *mudarabah* or *musharakah*, they would then have "insider's information" about the operations and outcomes of such projects.

As has been established recently, the *Mudarabah* contract between managers and the bank might act as an efficient revelation device, giving the bank more information about the project^{^1}. Further if the contract is designed to make the share of the entrepreneur in the outcome of the project, i.e. $(1 - \alpha)$ in equation (4) above, became a variable one depending on the level of effort instead of being a predetermined fixed share, this would reduce the incentive issue associated with the principal-agent problem. Indeed the practical solution for the problem lies in the hands of Islamic banks which had to abandon, or at least reduce, their concentration on short term financing under *murabaha* or markup contracts and enhance the role of PLS.

3- Limited developmental role of Islamic banks:

Our analysis of Islamic banks implies that their role in economic and financial development was limited. The reasons behind this can be summarised in the following factors:

- First, their heavy concentration on short term credit in trade and services sector which had high and rapid return. Short-termism would result in an inimical effect on investment and growth.
- Second, and mainly because of the previous problem, Islamic bank investments are biased against the Agricultural and Industrial sectors whose projects tend to have longer gestation periods than trade and services.
- Third, the share of small and medium size projects was modest as most of the banks' projects were characterised by being big and capital intensive^{^2}.
- Fourth, the considerable share of foreign allocation of funds which were mobilised from the domestic economy.
- Fifth, There is a problem of extensive financing of imported durable consumption goods through *murabaha*.
- Sixth, the concentration of their activities and branching policies^{^3} in urban areas, already congested with bank branches, excluded a significant number of potential depositors by geographic filtering income filtering. On the other hand the determination of a deposit minimum excluded further number of depositors by income filtering.

4- Violation of Islamic law:

We have shown that the two banks dealt with interest as they deposited funds with other banks in the country and abroad. This clearly is a violation of shari'ah and a contradiction with the very reasons supposedly behind the establishment of such banks. In the case of an Islamic branch of a conventional bank without separate accounting or operational identity,

^{^1} See Presley and Sessions (1994), pp. 587-595.

^{^2} See the list of the FIBE's companies in its 1991 report. The capital size of industrial and agricultural projects ranged from \$ 0.6 to 23 million.

^{^3} See the branches lists of the two banks in their annual reports. In the case of the FIBE five out of its fourteen branches were established in Cairo, the rest were located in the capitals of few governorates.

the violation is a general situation not merely an exception. The carrying out of speculative activities was another breach of Islamic law, and further it resulted in heavy losses.

7.5. Reasons behind the problems of Islamic banks:

The experience of Islamic banking in Egypt presents an aberration from the theoretical framework of Islamic finance and a clear deviation from its objectives.

The gap between the theoretical foundations and practice can be explained mainly by two factors: lack of qualified management and limited application of Islamic banking; both, to a great extent, are of transitional nature.

1- Lack of qualified management: Given the fact that the Islamic experiment was new in Egypt, it was hard to find skilful bankers who believe, at the same time, in the role of an Islamic bank. As indicated by several Islamic economists,^{^ε} Islamic banks in their early years had to compromise. Thus most of the management can be divided in two groups; 'believers' in Islamic banking with limited banking skills, and professional bankers with lack of interest in Islamic banking. Very few had the skill and the conviction. Consequently mismanagement problems and violation of Islamic law occurred.

2- Limited application of Islamic banking: Despite the growth of Islamic banks and 'branches' during the 1980s, the banking system in Egypt was still dominated by conventional banks. In 1990 the number of branches formed by Islamic and conventional banks was 104 while the total branches of banks was 1034. The totals of deposits and assets of Islamic intermediaries were merely 10% and 8% of the deposits and assets of the whole banking sector respectively. Being governed by the same rules of the CBE like the rest of operating banks and considered as part of it, the Islamic banks found it difficult not to deal with the rest of financial system. Such dealings were not necessarily undertaken according to the rules of Islamic banks as a minority.

An understanding of this problem can be obtained from the experience of labour-managed firms in the capitalist economies^{^ο}. Many capitalist economies, including the British, had a version or more of labour-managed firms, e.g. cooperatives. These firms had different character and objectives from the capitalist firms.^{^τ} However in economies dominated by profit-maximising firms, the labour managed firms ended up acting like the dominating ones or at least they tended to degenerate into quasi-capitalist firms.^{^ν} Similarly, under the prevailing circumstances, Islamic banks could end up behaving like conventional banks, or at least degenerate into quasi-conventional banks.

It is worth arguing however that even if such adequate support can be provided within the economy, it is difficult to maintain at the international level, as can be learned from the

^{^ε} An interview with Prof Fathy Sakr on the 17th of April 1993; and see Al-Najar (1993).

^{^ο} For an analysis of labour-managed firms see Vanek (1970) and Ireland and Law (1982).

^{^τ} While the capitalist firm is described as a profit maximiser, the labour-managed firm maximises income per worker over a planning period.

^{^ν} For a coverage of this point see Ireland and Law (1982), op. cit., 173-174.

experiences of Iran and Pakistan. Despite these countries Islamisation of the whole banking system which minimised the violation of Islamic law, the two countries could not achieve the same with their international financial transactions which normally involved interest. Under a so-called financial globalisation, we argue that the maintenance of pure interest-free financial transaction would be more difficult even at the national level. ^{^^}

8. Informal Islamic Finance:[^]

The Case of the Islamic Investment Companies (IICs):

The IICs are considered informal due to the fact that they escaped any form of regulation and did not come under the monetary authority's supervision or even company laws. Most of IICs' practices can be easily classified under the parallel and black markets activities of the informal sector; for example, tax evasion, bribery, theft of state land, violation of import restrictions, illegal foreign exchange dealings. Further, they adopted a pyramid scheme[^] to pay outstanding dividends out of late comers' deposits.

8.1. The rise of IICs:

The IICs grew in a spectacular manner during the 1980s. [^] The estimated number of these companies was 105 at the end of 1988. As discussed further below, the exact number of these institutions, like the size of their deposits and the number of their depositors, has never agreed upon. However if we consider the latest official number of depositors of 502,826 and given that the dependency ratio in Egypt is 5.6, this means that almost 3 million people was affected directly by the activities of the IICs. Total deposits held with the IICs was estimated at £E 3.8 billion in 1988, i.e. 7.8% of GDP, the equivalent of 17% of public commercial banks deposits and approximately 10% of total deposits of the banking sector. [^] Most of these deposits were collected in less than three years; from 1985 to 1988.

The flourishing of the activities of IICs, mainly collection of households' savings, is ascribed to several factors.

- As in the case of Islamic banks these institutions managed to capitalise on the Islamic resurgence and its impact on public opinion regarding specific financial transactions that involve usury. They launched a massive advertising campaign assuring that they work in accordance with Islamic principles. Company names [^]

^{^^} On the issue of financial globalisation see for example O'Brien (1992).

[^] This section is based on Mohieldin (1994).

[^] Also known as Ponzi schemes, named after Charles Ponzi's financial ploy in 1919-20 in the USA. See Train (1985), pp. 11-16 for a historical background.

[^] The first Islamic Investment Company was *Al-Sharif*. It was established in 1958 but did not go public until 1978, when it announced that it would open the door for the public to invest in the enlargement of the company's operations with promises of high returns in the form of dividends according to Islamic principles.

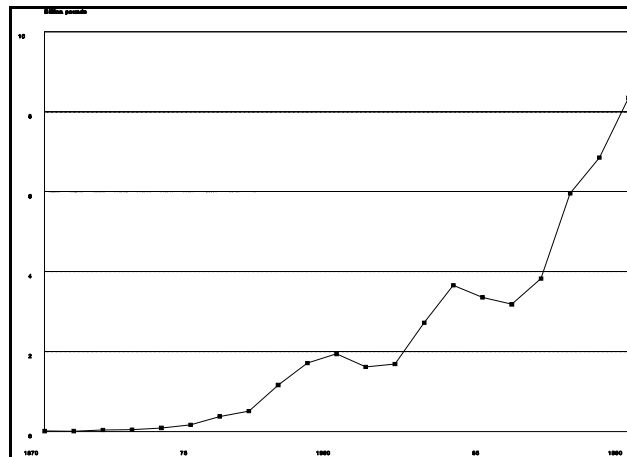
[^] The figures of deposits and depositors are those published by the offices of the Attorney General and the Socialist Attorney after the collapse of the IICs in June 1988.

[^] If we look at the names of some of the big companies, we would find that they meant to have an Islamic indication like Al-Rayan, the name of one of the doors of paradise, Al Huda: the right path, Badr: the first battle in the history of Islam.

- were carefully chosen, with Islamic terminologies like *mudarabah*, trust financing, and *musharakah*, joint-venture, being employed to emphasize the claimed identity.
- These institutions had a wide network of low operating cost branches, open almost 24 hours a day, reaching areas neglected by the traditional banks. Bureaucratic procedures were kept to a minimum and the process of depositing funds was simple and short for the convenience of uneducated depositors.
- Depositors, particularly small savers, flocked to them, attracted not only by Islamic slogans but by the fact that the dividends distributed by the IICs were more than double the 12 percent rate of interest then offered by the conventional banks. These banks also seemed to provide a hedge against inflation, as it was 4 percentage points higher than the official figure of inflation in 1988.
- These companies innovated a new method for distributing dividends. They offered the depositors an average of 1.5 to 2 percent monthly return, on credit, until the accounts are settled at the end of the year. The idea was an appealing one to a lot of depositors who want to receive a specific monthly flow of money without any worries about fluctuations in expected return on funds invested according to profit and loss sharing à la Islamic principles. The method attracted a range of depositors; pensioners, widows, persons on low income, ex-emigrants in the gulf states, .. etc.
- Catering for small depositors was one of the factors leading to the success of these companies in attracting savings. This group of people has never been put seriously on the agenda of the formal banking system. Some of the banks set a minimum to open a deposit account which disqualified a large number of potential depositors. Other banks did not deal in domestic currency which disqualified a further number of potential depositors. Maltreatment of customers in some branches of public banks and insolent staff in some branches of foreign and joint -venture ones discouraged a significant number of potential depositors.

Under these conditions and with the prevalence of negative real interest rates at the time, different kinds of inflation hedges would be a plausible alternative. IICs seemed to take account of these problems and managed to appear as a good substitute for other inflation hedges for small depositors.

The increasing role of the IICs in the Egyptian economy in general and the financial sector in particular can be equally attributed to some other factors for which they were not responsible but managed to exploit. As shown in figure (7), Egypt at that time was witnessing a remarkable increase in the remittances of Egyptian workers abroad, primarily in the Gulf states.



Source: World Bank, World Tables, 1991 and 1992.

Moreover, various restrictions in the official foreign exchange market, the overvalued exchange rate of the pound, and the incapability of the formal financial sector, with its limited instruments, to cope with the requirements of those emigrants. Hence many of the emigrants preferred to deal in the foreign exchange black market. Many of the founders of the IICs started as foreign exchange black marketeers⁹⁴. They had plenty of cash in hand and found themselves surrounded by businessmen who could not finance imports through the formal channels. Furthermore, the government itself sought the help of black market traders in order to finance the imports of some essential goods.

However, as a way of reducing risk involved in illegal transactions, setting up a 'legal' façade appeared then as a plausible idea. Hence, the first companies were established like *Al-Rayan* and *Al-Saad*.⁹⁵ The founders of both companies were at the top of the list of the 55 main foreign exchange black market traders.

The IICs emerged in a financially repressed environment with, effectively, a non functioning capital market and a malfunctioning banking sector. Potential investors faced several bureaucratic, legislative, and regulation difficulties when dealing with conventional institutions. In such circumstances, a significant number of potential savers and investors preferred to deal with the se new companies for higher rates of return in a seemingly placid way.

The experience of the IICs can be related to the two main arguments⁹⁶ that are usually adopted regarding the reasons behind financial dualism and the very existence of the informal financial sector. The first argument considers the informal financial sector a

⁹⁴ See Sadowski (1991) pp. 229-231.

⁹⁵ Two of Al-Rayan brothers and the chairman of Al-Saad were number 2,3 and 4 respectively on the interior ministry's list of the biggest foreign exchange black marketeers.

⁹⁶ See Germidis (1990) and Kitchen (1986).

response to the imperfections and weaknesses of the repressed formal sector. The tight regulation of financial intermediaries and various restrictions imposed on their activities push potential savers and investors to find other instruments of savings and sources of credit outside the formal sector.

The second line of argument states that the existence of the informal financial sector can be explained by inherent dualism in the economic and social structure of the whole society. In other words the informal sector would flourish when a significant part of the population is still attached to traditional values regardless of the condition of the formal sector.

The case of IICs suggests a combination of the two arguments for an explanation of their existence. On the first hand, they support Goodhart's law⁹⁷ by being the unregulated substitute for a heavily regulated formal financial sector. On the other hand they appeared as institutions working according to the dominating religious and traditional values. This clearly supports the second argument; an argument completely neglected by the western style financial intermediaries and not utilised effectively enough by the formal Islamic banks.

8.2. The size of IICs:

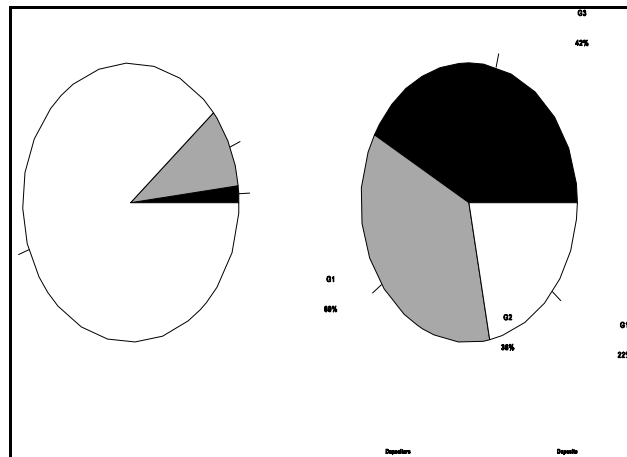
Deposits held by IICs reached a figure estimated to be between £E 3.4 billion and £E 4.6 billion in 1988. The number of depositors in the biggest 5 companies was 391,000 according to one of the estimates, and 525,000 according to another. The total number of IICs' depositors was estimated to range between 406,000 and 648,000⁹⁸. The deviation in figures is quite compatible with the nature of informal sector establishments. Organized book-keeping, clear records and a reasonable degree of disclosure of information were never considered by the IICs. There was no need for that when there was no supervising authority to monitor their activities.

These companies accepted almost any amount of money as deposits; from as small as £E 100 to £E 2 million.⁹⁹ As shown in figure (8), in one of the biggest IICs, *Al Huda Misr*, we can distinguish between three main groups according to the average size of deposits. First 15,000 small depositors (G1) with an average size of deposits of £E 2700, who made up 89% of the total number of depositors and had a share of 22% of the whole volume of deposits. Second a group of 1600 depositors (G2) who had an average size of deposits of £E 40,825 constructed 9% of total depositors and 36% of total deposits. The company also managed to attract in addition 400 big depositors (G3) with an average deposit size of £E 188,000 who formed 2% of the total number of 17,000 depositors, and held 42% of the total size of deposits.

⁹⁷ See Goodhart (1984), p. 96.

⁹⁸ See Abdel Fadel, op. cit., pp. 15-17 for an estimate of the size of deposits and number of depositors.

⁹⁹ See Al Jumhooryah newspaper 3/8/1993 p. 11.



Thus the IICs appealed to different groups regardless of income. The occupations of depositors proves that they also managed to break through class barriers. The means for that were mainly religion and the high returns promised on funds deposited.

8.3. The IICs' adoption of pyramid scheme:

The question that arises here is what sort of activities enable the companies to pay their depositors 24% per annum on deposits in local and foreign currencies?

We argue that a pyramid scheme is the plausible explanation for the high rate of distributed profits of IICs.¹⁰⁰ O'Connell and Zeldes (1988), define a 'rational' pyramid scheme as 'a sequence of loan market transactions with positive net present value to the borrower'.¹⁰¹ Generally according to the pyramid scheme cash payments on debts, deposits, are met mainly by increasing the amount of debt outstanding by fresh borrowing and debts are backed not by real assets but rather by future debts¹⁰².

Unquestionably, speculation and pyramid schemes, to a certain extent, might be a recognised feature of the operations of many formal financial institutions as argued by Minsky (1986). But speculation, in the words of Keynes (1949), may cause no damage as bubbles on a steady stream of enterprise. But in the case of IICs the case was serious as they became 'the bubble on a whirlpool of speculations'¹⁰³.

¹⁰⁰ And indeed it is the explanation for the current high interest rate paid by the government on treasury bills in Egypt.

¹⁰¹ See O'Connell and Zeldes (1988), p. 434.

¹⁰² See Minsky (1986) p. 206-14 and Kindleberger (1978) p. 79.

¹⁰³ See Shafik (1989) p. 303.

The recent history of financial fiascos is full of examples of wide -scale pyramid schemes, from the Ponzi scandal in the early 1920s¹⁰⁴ in the USA, to the MMM crash in Russia in 1994.¹⁰⁵ In the two incidents, as in the case of the IICs, there was misrepresentation and violation of implicit and explicit trust, if one uses the expression of Kindleberger.¹⁰⁶ Moreover in the three cases of Ponzi, MMM and IICs there was a heavy reliance on slick advertising campaigns, in which a seemingly genuine activity appeared as a façade. In the case of Ponzi it was arbitrage opportunities in international postal coupons, in the MMM case it was the trade in privatisation vouchers, and in case of the IICs, it was the establishment of holding companies involved in a variety of production and services activities as a smoke screen.

8.4. The fall:

The IICs enjoyed no supervision or regulation until the symptoms of problems appeared on the surface after immense losses of some IICs in speculating on gold and foreign currencies in the international markets in November 1986. This was followed by a series of similar problems and concluded with the international financial crisis on black Monday in October 1987, marking the beginning of the fall of these companies.

These problems along with others forced the government to intervene to regulate these companies. There were some cases of security problems when crowds of depositors marched on *Al Rayan's* branches to withdraw their deposits after the news of their losses in November 1986 and 1987. *Al Rayan* was rescued by an immediate liquidity transfer from a financial company in the Gulf¹⁰⁷ and managed to cover all withdrawal requests, estimated at £E 25 million a day. But this drew attention to the importance of formal monitoring of these companies.

These companies were accused of financing the Islamic candidates campaign in the 1987 general elections, which made the government more interested in regulating them. However the government did not intervene quickly enough. The delay in intervention was due partly to the fear of accusation of being anti-Islamic and believing that a major run on the IICs would endanger banks and government agencies that had dealings with them. Further, at that time the government did not have even an approximate figure of the number of these companies or their depositors. In order to enhance their bargaining power with the government, IICs' managers claimed that there were around 575 operating companies with 15 million depositors.¹⁰⁸

¹⁰⁴ See Train (1985), pp. 11-16.

¹⁰⁵ On the MMM crisis see the two issues of *The Economist*, of 30/7/1994 and 10/9/1994.

¹⁰⁶ See the contribution of O'Connell and Zeldes (1992), in the *New Palgrave Dictionary of Money and Finance*.

¹⁰⁷ Shohaib (1989) and several newspapers.

¹⁰⁸ *Al Shaab* newspaper 21/6/1988.

Moreover IICs established a complex network of loyal journalists, government officials, former ministers and governors, police and army officers, and religious personalities. Many of them served the objectives of IICs by exploiting information they gained while they were in their powerful positions and abusing the confidence of the public in their views. This network delayed the government action against the IICs. In return for their services members of the network were allocated consultancy jobs in IICs with high salaries or paid higher returns on their deposited funds with the companies or both.¹⁰⁹

It was clear that these companies escaped any direct control of any of these authorities by exploiting the two compliant Laws of 159/1981 and 43/1974 concerning joint stock companies and investment and other laws concerning limited liability companies and limited partnership companies.¹¹⁰ Effectively, there was no law to regulate the IICs and hence there was no authority governing them.

Meanwhile, some companies were unable to sustain their high dividends and faced a liquidity and solvency crises. An attempt was made by *Al Rayan* and *Al Saad*, two of the biggest IICs, to solve their problems by merger in what was known then as the merger of the giants¹¹¹. However, this merger was a violation of commercial law. The government capitalised on that and passed a feeble law no 89/1986 which was enforced and augmented after 2 years by law no 146/1988. According to the latter law investment fund business is restricted to joint-stock companies, a minimum capital standard was imposed and regulatory oversight was vested with the Capital Market Authority.

However this movement of the government was too late and did too little to reform the companies and help them adapt to the new rules. At the same time the government action might have contributed to their early collapse as they were heavily regulated and effectively denied access to fresh capital.

After more than 5 years of regulation, and hence the collapse, of IICs in 1988, depositors in some companies received just 10% of their funds valued as at June 1988 according to a slow timetable managed by 2 legal authorities the Attorney General and the Socialist Attorney. Other depositors did not receive even the 10% as their companies' assets were difficult to liquidate or not adequate to cover any deposits. Those who had banked with big IICs learned that it would take years to recover their deposits, while those who had their deposits in the small IICs discovered that their funds not only had decreased in real terms, like those of big firms, but evaporated in nominal terms. Moreover the adverse experience of IICs has undermined the confidence of potential savers in collective investment institutions and has been hampering attempts to develop mutual funds in the Egyptian formal financial system ever since.

¹⁰⁹ A group of these consultants and advisors were known after the collapse of the IICs and revealing of some files as the group of the 'lists of blessings', *kushouf al-Barakah*, as they were paid special rates of returns on funds deposited for them with the IICs. To the knowledge of the author the case was closed without adequate investigation.

¹¹⁰ For a legal discussion of the activities of IICs see Ahmad (1990) pp 77-79 and 91-95.

¹¹¹ Al-Ahram Newspaper 17/4/1988 p. 18.

9. Concluding remarks:

The theoretical framework of Islamic finance challenges some of the main fundamentals of mainstream thinking regarding the mechanisms of financial transactions. The rejection of a predetermined interest rate, as a form of the disallowed *riba*, implies a change to profit and loss sharing principle (PLS) in conducting financial intermediation. In this paper we have provided a simple model to illustrate the difference between an Islamic bank and a traditional one.

The analytic conceptualisation which has developed since the 1980s, has established that the Islamic financial system has several advantages over the conventional one, mainly:

- It is more equitable as it establishes a direct relationship between lenders and borrowers through which they share the outcome of the 'partnership' be it profit or loss.
- There is a close and direct relationship between the return on savings and investment.
- The Islamic system offers a flexible adjustment mechanism in the case of unanticipated shocks.
- It ensures that the real values of assets and liabilities will be equal at all points in time.
- The rate of return is determined by the real sector, and not by the financial sector.
- It protects the exchange/transaction role of a banking system by limiting the risk on deposit balances

However, further impartial analysis of the Islamic financial model is needed for a better understanding of its concepts, mechanisms and objectives. We argue that such analysis will not only develop the Islamic model to a more fully fledged one, but may offer as well some different insights to the field of economics.

In principle the framework provides Islamic banks with a variety of savings instruments and funding schemes. In practice Islamic banks in Egypt, as in other Muslim countries, performed relatively better in the mobilisation of funds than in their allocation. They suffered from a bias towards the controversial short-term *murabaha* finance concentrated in trade and services sectors, whereas the *mudarabah* and *musharakah* schemes were virtually neglected.

The future of Islamic financial institutions in Egypt relies on their ability to learn from the problems of recent years and find answers for intricate questions mainly:

- How to innovate instruments to attract risk averse depositors? Under the current practice Islamic banks avoided this problem by distributing rates of return close to the prevailing interest rate and not declaring explicitly that depositors may lose part of their nominal principals in the case of loss. With more transparency required, under the financial reform programme currently adopted, can Islamic banks keep their risk averse depositors and attract potential ones?
- How to overcome the dominance of short-termism and *murabaha* contracts in their portfolios?
- What kind of training is required for their current and future personnel to ensure an efficient functioning of Islamic banks in accordance with their distinctive rules and constraints?

- The case of the IICs emphasises the need for a prudential regulator and adequate supervision and rejects the calls for complete deregulation of the financial system or lenient monitoring. The question however is how to establish a suitable regulatory framework for Islamic financial institutions in a predominantly 'conventional' financial system?
- Further to the previous point is what sort of relationship Islamic banks will have with the Central Bank, including the issue of 100 percent reserve requirements?
- Should they be part of a deposit insurance scheme or is that another breach of Islamic law?
- Finally, how to conduct their transactions with conventional banks and the international markets without violating their Islamic principles?

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