

**"Possibility of Cooperation between Islamic Banks
and Conventional Banks"**

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Abstract

Islamic financial institutions have proven their strong capability in mobilizing financial resources, therefore 261 Islamic banks are now operating and managing about \$250 billion. Although there are some constraints that de-accelerating the progress of those types of banks. The target of developing this research is to survey the theoretical assessments through the Islamic banks history, functions and some advantages and disadvantages. Moreover empirical assessment that would show competitions with other banks. Obstacles and challenges through proven statistics. Also this research will take into consideration the effect of Islamic banks on regions it operates in and how it is accepted or abanded from non-Islamic countries. As well as differences between Islamic and conventional banks in regards resource mobilization and financing of economic development in the Arab world would be also mentioned.

Introduction

Since the beginning of the new millennium it has become clear that change is inevitable. The last few years have witnessed tremendous change in the banking arena on regional and international levels. The purpose is to keep up with international economic and political developments to initiate the process of globalizing financial markets after full enforcement of GATT, especially in the field of financial services. This has necessitated a number of developments in the structures, operations and performance levels of local, regional and international financial institutions. It has also marked a tendency towards formulating economic blocs and large banking merges. Such tendency manifests itself in the appearance of a number of large banking entities which aim to prevail over smaller institutions that are still working as isolated individual organizations.

Its expected that they are going to face strong competition. This necessitates are developing a new work strategy that is suitable to challenge this new phase in an attempt to maintain the success they have achieved, and secure a bright future, based on the expertise they have gained over the years.

This is main thing in the fact that there is not a single Islamic bank enlisted among the top 100 banks of the world. In fact, the size of Islamic banks is one of the major obstacles of their ability to interact efficiently in international markets, and keep up with increasing developments in providing modern banking services. It is indeed inevitable for those in charge of the Islamic banking industry to explore future horizons with the aim of having a clearer vision, predicting both obstacles and challenges and dealing with them effectively¹.

It is well-known that most Islamic banks and financial institutions operate within certain environments and communities that encompass both types of conventional and Islamic banking systems. Islamic banking then should deal and coexist with conventional banking as well as benefit from its huge technological, organizational and financial potential without violating the principles of Islamic banking operations. This will be dealt with in detail in the following part.

Islamic banks operate in over 60 countries in the Muslim world, most of them in the Middle East and Asia. Recently, Islamic banks have been opened in Europe and also in the United States. In three countries, Iran, Pakistan, and Sudan, the operations of the entire banking system have been converted to the Islamic mode of finance.

Today, Islamic banking is estimated to be managing funds to the tune of US\$ 250 billion. Its clientele are not confined to Muslim countries but are spread over Europe, United States of America and the Far East.

Islamic banking continues to grow at a rapid pace because of its value orientated ethos that enables it to draw finances from both Muslims and non-Muslims alike.

Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but also ethically motivated.

¹ The institute of Islamic Banking and Insurance. Status of Islamic Banking.<http://www.islamicbanking.com/ibanking/statusib.php>.

Now at these days more than 261 Islamic financial institutions are operating world-wide.

As a response to the success of Islamic banks in attracting depositors in their early years of establishment, many conventional banks formed Islamic branches.

What is Islamic Banking ?

Islamic banking is not a negligible or merely temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

Islamic banking has been defined in a number of ways.

The definition of Islamic bank, as approved by the General Secretariat of the OIC, is stated in the following manner. "An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic *Shariah* and to the banning of the receipt and payment of interest on any of its operations.

The concept from the perspective of an Islamic economy and the prospective role to be played by an Islamic bank therein opines: "It is, therefore, natural and, indeed, imperative for an Islamic bank to incorporate in its functions and practices commercial investment and social activities, as an institution designed to promote the civilized mission of an Islamic economy" (Ibid). ziauddin Ahmed says. "Islamic banking is essentially a normative concept and could be defined as conduct of banking in consonance with the ethos of the value system of Islam"² .

It appears from the above definitions that Islamic banking is a system of financial intermediation that avoids receipt and payment of interest in its transactions and conducts its operations in a way that it helps achieve the objectives of an Islamic economy Alternatively, this is a banking system whose operation is based on Islamic principles of transactions of which profit and loss sharing (PLS) is a major feature, ensuring justice and equity in the economy. That is why Islamic banks are often known as PLS-banks³.

Islamic bankers do not expect to advance money and receive a predetermined sum on a fixed date in the future. Under the *Shariah*, the bedrock of the Islamic faith, they are instead responsible for ensuring that money is invested in viable projects, with reliable borrowers. If the project succeeds the banker shares in the profit. If it fails he suffers the losses⁴.

Just as an "Islamic Bank" is defined with reference to its mandate requiring that it Complies with two sets of law: (1) the "law of the land" and (2) Islamic *Sharia* law.

Islamic bank was "owned by its shareholders, established to conduct banking and investment activities in accordance with the Islamic *Shariah* and its (own) articles of association⁵.

² Shawki Ismail Shehta.

³ Nienhaus, V.: Profitability of islamic PLS banks competing with interest banks : problems and prospects, Journal of research in islamic Economics, 1(1): (1983) : 37-47.

⁴ The institute of Islamic Banking and Insurance. Status of Islamic Banking.<http://www.islamicbanking.com/ibanking/statusib.php>.

⁵ Abdel-Magid, M. "The theory of islamic banking : Accounting implications", the international journal of accounting , vol.1 (utbana-Champaign: University of Illiois, Fall 1981, Page 81.

The guiding principles for an Islamic financial system is a set of rules and laws, collectively referred to as *shariah*, guiding economic, social, political, and cultural aspects of Islamic societies. *Shariah* originates from the rules dictated by the Quran and its practices, and explanations rendered (more commonly known as *Sunnah*) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the Q'uran and Sunnah. In a sense, the combination of law and finance in Islam is inevitable.

History of Islamic banking

It is difficult to say with accuracy which was the first such company or bank, that pioneered this concept in practice. Some analysts and experts in the field are of the opinion that, Islamic banking and finance, in the modern context, first emerged in 1963, when Mit-Ghamr Saving Bank began an experimental project offering interest free banking in Egypt. The project was a success and led to the bank opening four new branches by 1967. In the same year, eight new banks mushroomed offering interest free banking. Due to the political climate prevailing in Egypt during that period, the success of these Islamic banks was seen as a threat, and they were forced to close down in 1971. Some observers are of the opinion that the concept of an "Islamic bank" was born at the Islamic Summit of Lahore, Pakistan in 1974 which recommended the creation of an Islamic Development Bank. Since then Islamic banking and financial institutions have grown rapidly.

American Muslim individuals and groups have been running many Islamic financial institutions from over a decade now. The Amana Fund, the LARIBA bank, and a host of smaller organizations dot the North American landscape. (See other items in our section on Islamic Banking, to learn about the attempts to consolidate and strengthen the institution of Islamic Banking and the institutions that practice the concept). The launching of the multi-million dollar Halal investment company in London is another indicator of the growing salience of Islamic banking institutions not just in Muslim countries, but in the West as well. Countries where vibrant Islamic financial institutions are functioning include: Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan.

The first modern Islamic bank, established in Egypt in 1970, was called Nasser's Social Bank. Islamic accounting, an essential tool for the success of Islamic banks, is said to have been developed contemporaneously at the University of Cairo⁶.

The desirability of abolishing fixed interest rates and the Islamization of financial systems were discussed at the first meeting of the Islamic Organization Conference (IOC) in Jeddah in 1973. Subsequently, many Islamic banks were founded under the profit-and-loss sharing system (PLS), which all transactions are based on this principle.

⁶ Crane, R.D. "Islamic Commercial Law in Contemporary Economics", Embassy Handbook, Washington, DC: U.S. Department of state, (1981).

Returns are variable, dependent on bank performance and not guaranteed. But the risks are managed to ensure better returns than deposit accounts.

Consumers can participate in the profit upside i.e. in a more equitable way than receiving a predetermined return.

Several Muslim countries, Indonesia, Iran, Malaysia, Pakistan, Sudan and Turkey, in recent years have been taking systematic steps to establish an Islamic banking and financial sector.

Malaysia and Pakistan first to Institutionalize Islamic Banking For example, Malaysia in 1983 passed an Islamic Banking Act to facilitate the growth of indigenous Islamic banks and finance companies. In conjunction with this Act, it became the first Muslim economy to issue bonds on an Islamic basis. Since then, some 50-60 institutions have been established, and are now in the process of forming an Islamic inter-bank market (i.e. in which banks borrow or lend to each other). Within 10 years of introducing the Islamic Banking Act, the Malaysian government has taken further steps to popularize Islamic banking and finance, by allowing conventional banks to offer Shariah-compliant instruments, Western Banks embrace Islamic Banking Instruments These trends in Malaysia and elsewhere are having a profound effect on the banking and financial world as a whole. For example, America's Citibank was the first major conventional bank to establish an Islamic bank in Bahrain, with an operating capital of \$20 million (The Economist, August, 24, 96). It may be a puny sum, but, it does suggest to some degree that conventional banks have begun to embrace Islamic banking on a moderate scale.

A number of other Western financial institutions have followed suit by offering Islamic mutual funds and other investment products in an attempt to attract liquidity from this growing market. Far example, non- Islamic banks such as Goldman Sachs, Kleinwort Benson and ANZ Grindlays are now offering financial products that meet an Islamic criteria. Germany's fourth largest bank, Commerzbank, started offering Islamic mutual funds from December 1999.

In February 1999, Dow Jones introduced the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with the *Shariah* laws.

PRINCIPLES OF ISLAMIC BANKING

An Islamic bank is based on the Islamic faith and must stay within the limits of Islamic Law or the sharia in all of its actions and deeds. The original meaning of the Arabic word sharia was 'the way to the source of life' and it is now used to refer to legal system in keeping with the code of behaviour called for by the Holy Qur'an (Koran). Four rules govern investment behaviour:

- a. the absence of interest-based (riba) transactions;
- b. the avoidance of economic activities involving speculation (ghirar).
- c. the introduction of an Islamic tax, Zakat.
- d. the discouragement of the production of goods and services which contradict the value pattern of Islamic (Haram)

In the following part we will explain these four elements give Islamic banking its distinctive religious identity.

a. Riba

Perhaps the most far reaching of these is the prohibition of interest (riba). The payment of riba and the taking as occurs in a conventional banking system is explicitly prohibited by the Holy Qur'an, and thus investors must be compensated by other means. Technically, riba refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. While earlier there was a debate as to whether riba relates to interest or usury, there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest⁷.

In banning riba, Islamic seeks to establish a society based upon fairness and justice⁸. A loan provides the lender with a fixed return irrespective of the outcome of the borrower's venture. It is much fairer to have a sharing of the profits and losses. Fairness in this context has two dimensions: the supplier of capital possesses a right to reward, but this reward should be commensurate with the risk and effort involved and thus be governed by the return on the individual project for which funds are supplied.

Hence, what is forbidden in Islamic is a predetermined return. The sharing of profit is legitimate and that practice has provided the foundation for Islamic banking⁹.

⁷ The Islamic Banking Forum, What is Riba . <http://karbigac.org/>

⁸ (Qur'an 2.239).

Table(8): Difference Between Riba and Profit.

Riba	Profit
1- When money is "charged" its imposed positive and define result is Riba.	1- When money is used in trading (for e.g.) its uncertain result is profit.
2- By definition, Riba is the premium paid by the borrower to the lender along with principle amount as a condition for the loan.	2- By definition , profit is the difference between the value of production and the cost of production.
3- Riba is prefixed, and hence there is no uncertainty on the part of either the givers or the takers of loans.	3- Profits is post-determined, and hence its amount is not known until the activity is done.
4- Riba can not be negative, it can at best be very low or zero.	4- Profit can be positive, zero or even negative.
5. From Islamic Shariah point of view, it is Haram.	5- From Islamic Shariah point of view, it is Halal.

b. Ghirar

Another feature condemned by Islamic is economic transactions involving elements of speculation, ghirar. Buying goods or shares at low and selling them for higher price in the future is considered to be illicit. Similarly an immediate sale in order to a void a loss in the future is condemned. The reason is that speculators generate their private gains at the expense of society at large.

c. Zakat

A mechanism for the redistribution of income and wealth is inherent in Islam, so that every Muslim is guaranteed a fair standard of living, nisab. An Islamic tax, Zakat (a term derived from the Arabic zaka, meaning "pure") is the most important instrument for the redistribution of wealth. This tax is a compulsory levy, one of the five basic tenets of Islam and the generally accepted amount of the zakat is one fortieth (2.5 per cent) of Muslim's annual income in cash or kind from all forms of assessed wealth exceeding nisab.

Every Islamic bank has to establish a zakat fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions. This tax is imposed on the initial capital of the bank, on the reserves, and on the profits as described in the Handbook of Islamic Banking.

d. Haram

A strict code of ethical investment' operates. Hence it is forbidden for Islamic banks to finance activities or items forbidden in Islam, haram, such as trade of alcoholic beverage and pork meat.

Furthermore, as the fulfillment of materials needs assures a religious freedom for Muslims, Islamic banks are required to give priority to the production of essential goods which satisfy the needs of the majority of the Muslim community, while the

production and marketing of luxury activities, Israf wa Traf is considered as unacceptable from a religious viewpoint.

In order to ensure that the practices and activities of Islamic banks do not contradict the Islamic ethical standards, Islamic banks are expected to establish a Sharia Supervisory Board, consisting of Muslim jurisprudence, who act as advisers to the banks.

Activities of Islamic Banks

Individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. In the following , we will describe the salient features common to all banks.

All the Islamic banks have three kinds of deposit accounts: current, savings and investment

- 1. Current accounts:** - Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.
- 2. Savings accounts:** - Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands¹⁰.
- 3. Investment account:** - Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed.

Banks adopt several modes of acquiring assets or financing projects. But they can be broadly categorized into three areas: investment, trade and lending.

I-Investment financing: - This is done in different ways:

1st) Musharaka where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent legal entity and the bank may withdraw gradually after an initial period.

Musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution. In this case, the bank enters into a partnership with a client in which both share the equity capital and may be even the management-of a project or deal, and both share in the profits or losses according to their equity shareholding.

¹⁰ Abdel-Magib, M.F. ;” Theory of Islamic banks : accounting implications “, International Journal of Accounting, Fall (1981) : 78-102.

b) Mudarabha where the bank contributes the finance and the client provides the expertise, management and labor. Profits are shared by both the partners in a pre- Arranged proportion, but when a loss occurs the total loss is borne by the bank.

The following rules must govern all Mudaraba transactions:

The division of profits between the two parties must necessarily be on a proportional basis and can not be a lump sum or guaranteed return.

The investor is not liable for losses beyond the capital he has contributed.

The mudarib does not share the losses except for the loss of his time and efforts.

c) Murabaha Murabaha was originally an exchange transaction in which a trader purchases items required by an end user. The trader then sells those items to the end-user at a price that is calculated using an agreed profit margin over the costs incurred by the trader. To be in consonance with the principles of Islamic finance governing exchange transactions every Murabaha transaction must meet the following conditions:

Murabaha transactions may be undertaken only where the client of a bank, or financial institution, wants to purchase a commodity. This type of transaction can not be effected in cases where the client wants to get funds for a purpose other than purchasing a commodity, like payment of salaries, settlement of bills or other liabilities.

To make it a valid transaction it is necessary that the commodity is really purchased by the bank and it comes into the ownership and possession (physical or constructive) of the bank so that it may assume the risk of the commodity so far as it remains under its ownership and possession.

After acquiring the ownership and possession of the commodity it should be sold to the client through a valid sale.

D) Ijarah In the context of Islamic banking Ijarah can be defined as a process by which " usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her ".

In many respects, Ijarah resembles leasing as it is practiced in today's commercial world.

The distinguishing feature of this mode is that the assets remain the property of the Islamic bank to put them up for rent every time the lease period terminates so as not to remain unutilized for long periods of time under Ijarah the bank or the leasing company assumes the risk of recession or diminishing demand for these assets.

Literally, Ijarah means to give something on rent. As a term of Islamic Fiqh, Ijarah can also refer to wages paid to a person in consideration of the services rendered by him/her. In the above discussion, the term

Ijarah is used to represent the usufructs of assets and properties, and not to the services of human being.

E) Istisna is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him, the transaction of (Istisna comes into existence, but it is necessary for the validity of Istisna that that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of Istisna creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving notice to the other. But after the manufacturer has started the work, the contract can not be cancelled Unilaterally.

However, the party placing the order has the right to retract if the commodity does not conform to the specifications demanded.

F) Salam or Bay-Salaam as it is also called, is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advanced price fully paid on the spot.

Here the price is paid in cash, but the supply of the purchased goods is deferred, The buyer is called " Rabb-US-Salam ", the seller is " Muslam ilaih ", the cash price is " ra'sul-mal ", and the purchased commodity is termed as " Moslem fih ".

Salam sale is suitable for the finance of agriculture operation, where the bank can transact with farmers who are expected to have the commodity in plenty during harvest either from their own crops or crops of others, which they can buy and deliver incase their crops fail. Thus the bank renders great services to the farmers in their way to achieve their production targets.

Salam sale is also used to finance commercial and industrial activities, especially phases prior to production and export of commodities and that is by purchasing them on Salam and marketing them for lucrative prices.

II- Trade financing: - This is also done in several ways. The main ones are:

One) Mark-up where the bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on.

b) Leasing where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning and becomes the owner of the item.

c) Hire -purchase where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item.

d) *Sell-and-buy-back* where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price.

e) *Letters of credit* where the bank guarantees the import of an item using its own funds for a client on the basis of sharing the profit from the sale of this item or on for mark-up basis.

III-Lending: - Main forms of Lending are:

One) *Loans with a service charge* where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities.

b) *No-cost loans* where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers.

c) *Overdrafts* also are to be provided, subject to a certain maximum, free of charge.

Other banking services such as money transfers, bill collections, trade in foreign currencies at spot rate etc. where the bank's own money is not involved are provided on a commission or charges basis.

Islamic banks financing is granted on the basis of either of three modes:- sharing, sale and leasing.

1-Sharing Modes

There are two forms of applications of this principle: full equity sharing and non-voting equity financing. In full equity sharing, the bank sits on the board of directors and participates in formulating policies and managerial decisions, while in non-voting financing, the bank fully entrusts managerial decision-making to the fund user. Both forms of sharing modes may be formulated to share net income or gross output. They may also be permanent, declining or timed.

2-Sale Modes

In this group of modes, the bank is asked to buy goods and sell them to users (producers/ consumers) against future payment.

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

3-Leasing Modes

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

Contribution of Islamic banking

The actual practice of Islamic banking over the past three decades and the rise of Islamic banks as a new species of banks reveal three innovations in banking traditions:

- (1) a new kind of relationship between banks and depositors.
- (2) integration of financial and real market in financing.
- (3) incorporation of ethics and moral values in investment decisions.

1-Relations with Depositors: Returns paid to depositors as well as the bank's own income from financing represent distribution of net profit at the closing of a financial period.

The early practices of the money exchangers in the 15th century and over the past five centuries, the relationship between depositors and bankers was based on a lending contract.

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

2- Closing the financing Gap: The second contribution of Islamic banks, as witnessed over the last part of the 20th century, is the bridging of gap between financial and real markets. Since Islamic banks limit their financing to the three aforementioned modes or principles as: (1) the establishment of new productive projects, (2) purchase of producer/consumer goods, or, (3) lease of productive machinery and equipment and consumer durable. Two main categories of traditional financing are totally excluded from the arena of Islamic banking practices: (a) general purpose financing that aims at simply supplementing government and corporate budgets, whether for seasonal or non-seasonal purposes. (b) increase in indebtedness as a result of debts rescheduling¹¹.

3- incorporation of ethics and moral values in investment decision.

Table (1) : The Development of Islamic Banking in Egypt, 1990-2002

	Growth of Deposits		Growth of Finance & Investment		Ratio of Finance & Investment to		Ratio of Finance &	
	CBs	FIBE	CBs	FIBE	CBs	FIBE	CBs	FIBE
1990					48.7	62.5	67.7	75.7
1991	27.1	3.8	22.5	2.5	44.7	75.0	65.3	93.7
1992	23.9	3.0	17.2	4.9	44.8	75.1	61.7	95.4
1993	8.5	2.5	10.1	0.7	45.4	74.4	62.6	93.8
1994	9.6	4.2	13.7	5.6	46.7	76.4	65.0	95.1
1995	9.8	9.4	24.3	13.1	52.9	77.9	73.6	98.4

¹¹ file:///C:/My Documents/Islamic Banks at the Threshold of the Third Millenium.htm

1996	12.4	3.4	22.3	8.7	57.2	82.1	80.0	103.4
1997	10.2	1.3	11.5	6.7	57.3	89.9	80.9	108.8
1998	8.4	8.6	19.3	8.7	63.8	89.3	89.0	108.9
1999	6.9	9.6	17.1	6.2	69.7	86.6	97.5	105.6
2000	11.4	23.6	5.9	21.1	67.0	86.2	92.6	103.5
2001	14.3	12.1	10.6	10.6	63.3	87.3	89.6	102.2
2002	12.0	11.9	3.5	11.8	60.1	87.7	82.8	102.0

Source: Faisal Islamic Bank, Research Department, Cairo-Egypt, 2004.

Table: (1) exposes the growth rates of the main financial items of Islamic banks compared to conventional banks :

The first column shows Deposits Growth Rate in both systems during the period (91-2002) , where we notice the following :

- The first seven years witnessed an increase in the Deposits Growth rates of conventional banks ; an average of 14.5% during the year (91-1997) against only 4% in Islamic banks. This is because, many conventional banks issued saving pools at an extra-ordinary interest rates reached at 19% P.a. in a manner aiming at attracting savings to confront the Dollarization phenomenon.
- Unfortunately , this step did not only work out but rather caused problems to these banks under the obligation of paying high interests to customers, the thing which affected their profitability negatively. This led to huge disorder in the interest rates structure of the conventional banks.
- On the contrary, Islamic Banks kept on adopting its policy and strategy based on the real investment and distributing actual return to depositors.
- During the next period (98-2002) and following the return to normal stance, the growth rates of both systems were compatible with more progress for Islamic banks in many years; an average growth rate of 13.2% in Islamic banks against 11.2% in conventional banks.
- This emphasizes the increasing trust of customers to deal through Islamic banking system. In this regard, it is worth mentioning that the gross number of Islamic banks customers amounts to about one million customer out of a total of 6 millions representing the banking system customers, at a rate of 17% . AN un-negligible rate reflecting the sound presence and credibility of Islamic banks in the banking arena.
- The same may be noticed for Finance and investment Growth rates.
- Average ratio of finance and investment to Assets in Islamic banks amounted to 88% , as against 60% in conventional banks during the period (90-2002).
- Average ratio of finance and investment to deposits amounted to 98% in Islamic banks, against 77.5% for conventional banks during the same period.

Table (2) : The financing operations of Islamic and Conventional banks in Egypt , 1991-2002.

	Conventional banks		Islamic Banks	
	Commercial Banks	Investment Banks	FIBE	IBID
Productive sectors	35%	19%	16%	12%
Intermediary Sectors	65%	81%	84%	88%

Long term Financing	27%	24%	7%	12%
Secured Loans	56%	73%	96%	87%

Source: Faisal Islamic Bank, Research Department, 2004.

Percentage of finance operations directed towards productive sectors in the conventional banks - Commercial and investment-amounted to 35% and 19% respectively of its total resources; an average of 27% , against only 14% in Islamic banks. This percentage is relatively close between Islamic Banks and other investment Conventional banks, while it's clearly high in commercial conventional banks.

This is mainly attributed to the national responsibility and commitment of the four commercial public banks towards financing the productive activities of the companies of the public enterprises sector. And due to the problems confronting these companies, the provided financial facilities changed into long- term operations. This is manifested by the rates mentioned in the third column, as they reflect the long-term financing percentage in these banks; an average of 25.5% in the conventional banks, against 9.5% in Islamic Banks. In addition to this, the Murabaha in Islamic Banks represents a major part of the investment, most of which directed to goods and commodities and classified as commercial operations despite the fact that they are related to purchasing intermediary commodities, equipment's and investment commodities.

These results provide- without any doubt- a chance to search for joint financing channels between conventional and Islamic banks by way of concluding joint financing agreement where conventional banks share in providing the investment financing of these projects, and Islamic banks share in financing the commercial activity represented in the working capital and the investment commodities and their spare parts.

Such step is significant to realize the targeted integration and cooperation. The table also indicates that although Islamic banks mainly provide the in-kind financing directed to purchasing goods and tangible equipment's and machinery, yet they face no problem in obtaining collateral's .

Hence, it is natural that secured operations occupy a high rate averaging to 92% ; as against 65% in Conventional banks that mainly provide cash financing.

Table (3) : The Market share of Faisal Islamic Bank of Egypt in the Deposits & investment of Egypt's Banking System, 1991-2002.

	% of total Deposits	% of private Deposits	% of total Finance & investment	% of private finance & investment

1991	4.6	5.0	6.6	11.19
1992	3.8	4.3	5.9	10.0
1993	3.6	3.9	5.4	8.47
1994	3.4	3.7	5.0	7.84
1995	3.4	3.7	4.6	7.8
1996	3.1	3.5	4.0	6.27
1997	2.9	3.2	3.9	6.6
1998	2.9	3.2	3.5	5.9
1999	3.0	3.3	3.2	5.4
2000	3.3	3.7	3.7	6.3
2001	3.2	3.6	3.7	5.8
2002	3.2	3.7	4.0	6.7

Source: Faisal Islamic Bank, Research Department, 2004.

The table shows the market share of the bank in the deposits and investments of Egypt's Banking system during the period (91-2002) ; as indicated in the following :

- 1- Average banks share to total deposits (Governmental + family) during the period under review amounted to 3.4% , while share average to family and private sector deposits amounted to 3.8% during the same period.
- 2- Average banks share of total finance and investment of the banking sector amounted to 4.5% and an average of 7.5% of private finance and investment during the same period.

The growth of the ratios over these years proves the stability of the deposits or finance items; with tendency to rise during the recent period. This highlights the sound presence of FIBE in the banking market; taking the following into consideration :

- The increasing competition from domestic banks or joint or foreign investment banks.
- The share of the four public banks of deposits and investment stands for 65% of total banking market the remaining amount is distributed over all the other banks.
- The remarkable presence of FIBE is really sound when considering the various saving pools and diversified finance methods provided by other conventional banks; many of which can not be provided by FIBE due to religious restrictions.
- FIBE is among 61 Banks representing total operating banks in the Egyptian banking market; Nevertheless, it ranges among the first five large banks; with public banks excluded.
- The average rates of return distributed to the banks customers is considered relatively below average of other similar banks; yet they enjoy credibility because these rates are calculated according to the actual activity results.

Table (4) : The structure of financing Operations of Faisal Islamic Bank of Egypt, 1991-2002

	Stock of financing						Flows of financing*			
	Murabha	Musharaka	Mudaraba		Leasing	Other				
1991	25	15	50	7	--	3				
1992	40	22	28	8	--	2				
1993	42	21	27	6	--	4				
1994	46	19	25	9	--	1				
1995	43	22	23	10	--	2				
1996	44	20	17	15	--	4				
1997	43	21	7	17	--	12				
1998	25	20	8	12	--	15				
1999	42	20	11	9	--	18				
2000	43	21	10	10	6	10				
2001	42	21	8	12	5	12				
2002	40	25	7	18	5	5				
Mean	39.58	20.58	18.14	11.08	1.33	7.33				
SD	6.999	2.314	12.9	3.84	2.424	5.774				

(*) N.A.

source: Faisal Islamic Bank, Research Department, 2004.

The development of the bank's structure of financing operations shows the changes occurred during the period under review. The central Bank of Egypt held an average of 46% of total investments during the year 1980/1990; later retarded to an average of only 18.4% during the years 1991/2002. Contrary to this, Murabah and Musharaka Operations stood for the major share with ascending tendency during the period under review.

Besides, the standard Deviation during the first period 1980/1990 was higher than the second period 1991/2002 for most of the investment fields. The things which proves the stable shares and different quotas of all types of investment without any major changes whether increase or decrease.

Table (5) : The financial operation of the Faisal Islamic Bank of Egypt , US \$ million , 1991-2002. (1000.000 S)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total Assets	1950	1869	1634	1658	1824	1891	1847	2012	2100
Foreign Activities						671	560	572	520
Domestic Activities						1220	1287	1440	1600
Of Which (%) :	25	40	42	46	43	44	43	45	42
Murabaha									
Musharaka	15	22	21	19	22	20	21	20	20
Mudaraba:									
- Central Bank	50	28	27	25	13	17	7	8	11
- other	7	8	6	9	10	15	17	12	9
Leasing	--	--	--	--	--	--	--	--	--
Other	3	2	4	1	2	4	12	15	18

Source: Faisal Islamic Bank, Research Department, 2004.

The statement indicate a continuous growth of the bank's Assets and also the investment balances. In this regard, growth rate of the total assets during the period 1991/2002 amounted to 22.92% despite the depreciation of the Egyptian Pound against US Dollar.

As for investment in local Currency, it increased by 69.3% during the period 1996/2002.

It is worth noting that the decrease in Foreign Currency investments, assesses the investment policy of the bank to focus domestically .

Also, Although Murabaha represents the major investment in the domestic market, yet Mudarbah and Musharka hold an important position among the banks modes of finance. In addition to this, the bank started to focus on leasing operations during the recent years, also on other modes such as Salam, Istisnaa, and Direct , trading contracts.

Table(6): The Structure of Egyptian Islamic Banking according to its working in the Market (till 2004)

	No. of branches	%
<u>First: Islamic Banking</u>		
- Faisal Islamic Bank of Egypt	14	15.6
- International Islamic Bank	8	8.9
<u>Finance Bank</u>	4	4.5
<u>Nasser Bank</u>	1	1.1
<u>Second : Conventional Banks</u>		
<u>Bank Misr</u>	29	23.6
<u>For development</u>	19	21.1
<u>Dakhaliah for development</u>	4	4.5
<u>Nile Bank</u>	2	2.2
<u>Investment Arab Bank</u>	2	2.2
<u>Tegareeoon</u>	2	2.2
<u>Suez Canal Bank</u>	1	1.1
<u>Egyptian Bank</u>	1	1.1
<u>Cairo Bank</u>	1	1.1
<u>Mohanness Bank</u>	1	1.1
<u>Gulf Egyptian Bank</u>	1	1.1
<u>Total</u>	90	100

Source: Faisal Islamic Bank, Research Department, 2004.

Table(7): The Characteristics between Islamic & Conventional banking

Characteristics	Islamic Banking System	Conventional Banking System (interest based system)
Business Framework	Based on Sharia laws Sharia scholars ensure adherence to Islamic laws and provide guidance.	Not based on religious laws or guidelines-only secular banking laws
Balance between moral and material requirement	The requirement to finance physical assets which banks usually take ownership of before resale reduced over extension of credit.	Excessive use of credit and debt financing can lead to financial problems.
Equity financing with risk to capital	Available. Enables several parties, including the Islamic bank to provide equity capital to a project or venture. Losses are shared venture. Losses are shared on the basis of equity participation while profits are shared on a pre-agreed ratio. Management of the enterprise can be in one of several forms depending on whether the financing is through Mudarabah, Musharaks , etc.	Not generally through commercial banks , but through venture capital companies and investment banks which typically take equity stakes and take equity stakes and management control of an enterprise for providing start-up finance.
Prohibition of Gharar	Transactions deemed Gharar are prohibited. Gharar demotes varying degrees of deception pertaining to the price and quality of goods received by a party at the expense of the other. Derivatives trading e.g. options are considered as having elements of Gharar.	Trading and dealing in derivatives of various forms is allowed.
Profit and Loss Sharing	All transactions are based on this principle. Returns are variable, dependent on bank performance and not guaranteed. But the risks are managed to ensure better returns than deposit accounts. Consumers can participate in the profit upside i.e. in a more equitable way than receiving a predetermined return.	This principle is not applied. Returns to depositors are irrespective of bank performance and profitability. The customer as depositor is like a lender and does not share in the success of the enterprise beyond receiving a fixed rate of predetermined interest. Unlike the Islamic system the depositor can not theoretically gain subject to improved bank performance.

Difference between Islamic Banks and Conventional Banks

The conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state.

Some of the differences between the Islamic Banks and the Conventional Banks

The following is a brief discussion in which we list the fundamental differences in the nature of work between the Islamic and conventional or commercial banks:

First, traditional or commercial banks are intermediate financial institutions which stand between the savers and the investors¹². On the other hand, Islamic banks are a mixture of internationally known traditional financial institutions for they not only operate like saving banks but are also similar to finance companies in so far as they can offer financial support to high risk projects. Furthermore, they can operate as open or closed investment funds [or banks].

Second, the form of the Islamic bank and the form of the conventional bank: The Islamic bank is more than the conventional bank for it works like any other specialized bank, (such as industrial banks, agricultural banks or building societies). It finances projects in all the above mentioned fields in addition to the fact that it can work like any investment bank because it is interested in the establishment of long-term projects.

Third, conventional banks do not get involved in the buying and selling or even the keeping of commodities, only within certain conditions. Also these banks, in accordance with their charters, can not buy capital assets or fixed assets unless they are used by the bank itself¹³. As for Islamic banks, they can trade with all types of commodities and can keep capital assets and establish limited companies or other types of companies.

Fourth, the conventional bank promises to pay fixed rates on its deposits, regardless of whether it makes profits or losses. The Islamic bank however, does not promise profits; if it made any profits during the financial year it would give the depositors the agreed rates; conversely, if the bank made losses, the depositors would share the burden together with the bank.

¹² (Al-Hawari, 1996).

¹³ (Al-Hawari, 1996)

Fifth, any conventional or commercial bank can issue excellence share, which has fixed rate from the profits, but the Islamic bank can not do that because they are of limited interests¹⁴ .

Sixth, all reserves in the commercial or conventional banks are deducted from the net profit, but in the Islamic bank they are deducted only from the net profit ear-marked for the share-holders¹⁵.

Seventh, a considerable part of the conventional or commercial bank's funds are directed towards commercial (business) loans , but the majority of the funds in the Islamic bank are directed toward Al-Musharaka finance (shared finance or partnership companies), Mudarabah finance (speculative finance) or resale with specification of gain or other .

Eighth, regardless of their rate of profits, the Islamic banks prohibit the production of trading with certain prohibited goods and services in Islam ¹⁶such as:

- The finance of breweries or meat processing companies dealing with pigs.
- The finance of gambling casinos.

Ninth, one of the characteristic features of the Islamic banks is the existence of what is called `Al-zakat fund'. This seeks to establish social equality. Such funds are found in the Kuwaiti Finance House (KFH), the Islamic Bank of Jordan (IBJ) and various other Islamic banks. This fund is financed by taking 2.5% of the bank's capital every year, with the bank's customers are given the option of paying their Zakat to the bank.

Finally, the importance of the 5Cs (capital, capacity, collateral, character, and condition): The Islamic banks attach varying degrees of importance to the elements of the 5Cs from that of the conventional or commercial banks. The commercial bank may give priory to the collateral, whereas the Islamic bank gives priority to character of customer. The commercial bank is perhaps more interested in the capital and capacity, but the Islamic bank is found to be more interested in capacity than in capital. On the other hand, there may be some similarity between the commercial bank and the Islamic bank on the issue of priority attached to the security and soundness of any project submitted to the bank for the purpose of financing ¹⁷.

Table(8): Difference between Islamic & Conventional banking

Conventional Banks	Islamic Banks
1- The functions and operating modes of	1- The functions and operating modes of Islamic

¹⁴ (Al-Hawari, 1996).

¹⁵ (Idris, 1996).

¹⁶ (Al-herran, 1996),

¹⁷ (Al-Hawari, 1996).

conventional banks are based on manmade principles.	banks are based on the principles of Islamic Shariah.
2- The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the use of funds (entrepreneur).
3- It aims at maximizing profit without any restriction.	3. it also aims at maximizing profit but subject to Shariah restrictions.
4. It does not deal with Zakat.	4. In the modern Islamic banking it has become one of the service-oriented functions of the Islamic banks to collect and distribute Zakat.
5. Leading money and getting it back with interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the Islamic banks.
6. Its scope of activities is narrower when compared with an Islamic bank.	6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.
7. It can charge additional money (compound rate of interest) in case of defaulters.	7. the Islamic banks have no provision to charge any extra money from the defaulters.
8. In it very often, banks own interest becomes prominent, it makes no effort to ensure growth with equity.	8. it gives due importance to the public interest. Its ultimate aim is to ensure growth with Equity.
9. For interest based commercial banks, borrowings from the money market is relatively easier.	9. For the Islamic banks, it is comparatively difficult to borrow money from the money market.
10. since income from the advance is fixed, it gives little importance to developing expertise in project appraisal and evaluation.	10. Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.
11. The conventional banks give greater emphasis on credit-worthiness of the clients.	11. the Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
12. The status of a conventional bank, in relation to its clients, is that of creditor and debtor.	12. The status of Islamic bank in relation to its clients, is that of partners, investors and trader.
13. A conventional bank has to guarantee all its deposits.	13. Strictly speaking, and Islamic bank cannot do that.

Table (9): Theoretical Comparison

Islamic Banking	Conventional Banking
<ul style="list-style-type: none"> - Is based on profit or rent - Deals in assets. - Is based on profit sharing on deposits side, and on profit on assets side. - Actively participates in trade, production and valid services through valid contracts. 	<ul style="list-style-type: none"> - Is based on interest. - Deals in money or papers. - Is based on fixed return on both Sides of the balance sheet. - Does not involve itself in trade and business

The Relationship Between Central Banks And Islamic Banks

Central Banks plays the major role in supervisory activities applied on banks in different parts of the world. Central bank activities in that respect include supervisory operations which are administered on banking units operating within the boundaries of their governing states. They cover checking registers and books for the purpose of validating sound assets and operations. They are also involved in developing rules and principles related to bank operations in general, and establishing the range of dealing with specific activities and clients. The role of central banks is not merely limited to such activities; they are also authorized to determine credit and debit interest rates, set tariffs for banking services which would apply to all banks that are subject to their authority.

The relationship between Central Banks and Islamic Banks

Since Islamic Banks have been initiated in the mid 1970s they have always adhered to the rules, regulations and decisions issued by central banks.

It has been observed recently that the nature of the relationship between Islamic banks and central banks differs from one country to another. This depends on the legal framework which regulates the status of Islamic banks within these countries. Based on this, there are three types which represent such relationship:

1- This type is found in Pakistan and Iran. Within this type the relationship between Islamic banks and central banks is determined by specific rules and regulations. In that case the central Islamic bank undertakes the supervision of Islamic banking units, and makes sure that they follow such rules and regulations properly without any contradiction in objectives or policies.

2- It is manifest in the states which have authorized the foundation of Islamic banks, and issued laws which regulate their operations as separate from conventional banks. They have set limitations and regulations for such banks, and have dedicated specific government structures to supervise their activities, and verify their practices. Such type can be found in Turkey, Malaysia, Jordan, and the United Arab Emirates. Within this type the relationship between central banks and Islamic banks is highly regulated. No conflicts or problems arise between both parties .

3- This type can be found in countries which have established Islamic banks in accordance with special laws, unlike conventional banks which are established in terms of a contract similar to that of corporations. Within this type Islamic banks

are not exempt from the laws which regulate the activity of other banks. They operate as small units within a large group of conventional banks which are regulated by the state law, and supervised by the central bank. Such Islamic banks can be found in Egypt, the Sudan, Kuwait, Bahrain, and other countries. Islamic banks of this type have specific nature and qualities which make them distinctive from other conventional banks. There is also a specific relation between such banks and those dealing with them, and they have achieved certain success on economic and social levels.

Future Perception of the Relationship between Islamic Banks and Central Banks

It should be recognized that Islamic banks do not avoid central bank supervision; rather, they welcome such supervision, and hope it would be processed within a framework which complies with their specific nature, and understands their role. It has become evident that Islamic banking units, after a long period of Islamic banking operations, have managed to produce a distinguished type of banking activities, and have been met with success and appreciation on the part of large numbers of bank clients. The position of such banks necessitates that central banks facilitate the work of such units, and support them in performing their positive role in sustainable development in the countries in which they operate¹⁸.

It is our conviction that in order to develop a positive relationship between monetary authorities (represented by central banks) and Islamic banks as well as cause such supervision on Islamic banks to be of benefit to the national economy and bank clients, future perception of the relationship between both parties within the current dual system could include two major steps:

1. Central banks should now begin to make some modifications on conventional supervisory methods which are suitable to the position of Islamic banks, and based on putting the recommendations of the expert sub-committee of the Islamic Conference Organization into effect. The following points include the most important procedures which could be taken into consideration in that respect:
 - a) Designing patterns and forms of regular data required from Islamic banks to be developed and approved by central bank officials and Islamic bank representatives. Such new forms should meet supervision objectives, and comply with the nature of Islamic bank operations.
 - b) Human resources within central bank supervisory systems are usually divided into groups, each of which undertakes supervisory tasks on a specific number of banks.
 - c) Reconsidering cash reserve policy in so far as investment accounts in Islamic banks and credit ceiling policy are concerned, especially that there are current legislations within the dual system which have

¹⁸ Al- Omar, Fouad A., " The future of islamic Banks under globaliziation of Economies" , Unpublished paper, IDB, Jeddah.

exempted investment and business banks from these two tools taking into consideration the nature and importance of their work.

- d) Conducting research studies on the availability of a method approved by Islamic Sharia which aims at causing Islamic banks to benefit from Central banks in their capacity as the last sanctuary of banking units operating under their supervision; or more accurately, it is indeed the optimal lender in cases of liquidity deficit which could pose as a setback in Islamic bank operations.

2. Banking regulations, laws and legislation for Islamic banks should be developed and enforced.

Aspects of Developing Cooperation between Islamic Banks and Conventional Banks on Islamic Basis

The growing size and quality performance of Islamic banking operations is due to the increase and variety of Islamic financial tools and instruments which represent an important part of international banking operations. Another aspect of such positive presence is manifest in the tendency on the part of capable conventional banks and banking institutions - whether within the Islamic world or outside it - to introduce some of the Islamic banking activities within their own operations. In addition, there are further initiatives adopted by research centers and universities in Europe and the U.S. - especially at Harvard, La Sorbonne and Birmingham universities - to establish departments to conduct research studies on Islamic economy and the principles of Islamic banking¹⁹.

Forms of such cooperation could be divided into three major perspectives:

A) Cooperation on the level of institutions concerned with supervision, planning, developing, and enacting legislations, laws and regulations in both systems (that is central banks, monetary institutions and authorities as well as institutions and authorities which control Islamic banking operations); relation between central bank and Islamic Banks was previously discussed in details.

B) Cooperation on the level of banking units within both conventional and Islamic systems, and

C) Cooperation on the level of Islamic banking system units and supervisory bodies within their hosting countries.

The following part will deal with such perspectives in detail.

A. cooperation on the level of institutions concerned with supervision, planning, developing and enacting legislations, laws and regulations in both systems (central banks, monetary institutions and authorities / institutions and authorities which control Islamic banking operations)

¹⁹ Mirakhor , Abbas, 1986 , " Some theoretical aspects of an islamic financial system , paper presented at a Conference on Banking sponspred by the Central Bank of the Islamic Republic of Iran, Tehran, 11-14 June.

It has been observed that the rising number of Islamic banks and financial institutions as well as the increasing size of their operations have now become an effective factor which offers the international authorities, concerned with Islamic banking.

B) cooperation on the level of banking units within both conventional and Islamic systems

Cooperating and dealing with the conventional banking system in an effective way is indeed an important matter for Islamic banks and financial institutions. The most important thing in that matter is that such operations should never adopt what is prohibited by Islamic Sharia (Islamic law).

The Islamic banking system - which is part of such more comprehensive structure - has been created in an attempt to spread banking awareness among more than one billion Muslim people, and attracting clients and investments that did not use to feel secure with conventional banking operations. Such clients and investments abstained from involving into banking operations in general.

Current cooperation is manifest in the following:

1- Islamic banks participate with conventional banks - on local and international levels - in offering various mutual banking services such as collecting checks, processing trade bills, clearing operations, local and international transfers, accepting and issuing banking collaterals, letters of guarantee, bank checks, and opening mutual documentary credit in addition to various electronic banking transactions and all correspondent operations in a manner that does not violate Islamic Sharia.

2- The units of both systems participate in establishing a number of mutual projects of economic activities in addition to investment funds in stocks and securities on regional and international levels.

3- There is accelerating cooperation between Islamic banks and Islamic branches of conventional banks in terms of introducing work systems, consultations, training, preparing required cadres, and undertaking other mutual banking operations, especially correspondent operations (as branches are given second priority in Islamic bank dealings whereas the first priority is naturally given to other Islamic banks).

C- Cooperation on the level of Islamic banking system units and supervisory bodies

It is noteworthy that when some countries have adopted procedures of unifying supervisory systems on Islamic banks and other banks, some central banks exercise their supervisory activities with relative understanding and flexibility. This reflects sufficient consideration on the part of such bank officials for the different nature of the activities and practices of Islamic units. This is manifest in the following:

1- Some states have issued special legislation for Islamic banks besides the legislation for conventional banking system. Other states have had the initiative to develop and enforce legislations which would allow establishing Islamic banks in accordance with specific laws and regulations.

2- Most of the central banks within these countries - whether before or after adopting the policy of liberating interest rates in some countries - have not interfered in stating returns rates distributed on investment account holders in Islamic banks as well as profit margins in various investment operations of Murabaha operations (resale of goods) or Musharaka operations (partnerships) ... etc.

3- Despite the ban imposed on conventional banks in most countries to practice operations of direct sale and dealings in real estates and movables, central banks in some of these countries, in consideration of the nature of Islamic bank operations in the fields of trading and Murabaha (resale of goods), allow such banks to have custody of movables, real estates, and goods as well as own them for the purpose of reselling them.

4- Within the framework of cash reserve and liquidity ratios, which are considered among the most important monetary policy tools in most countries of the world, some central banks calculate the reserve ratios for deposits in foreign currencies rather than local ones. Considering the nature of Islamic banks, such deposits generated from calculating the ratio are processed within legal Mudaraba (speculation) contracts with central banks. As for liquidity ratios, some central banks have set a lower level for the liquidity ratios within Islamic banks in comparison with their counterparts in other banks, taking into account the specific nature of their dealings. In addition, some countries have limited the calculation of the reserve and liquidity ratios only on deposits at demand.

5- Based on the fact that central banks in some Muslim countries understand the nature of investment account balances in Islamic banks and adapting them from a legal perspective, central banks have modified some of the concepts related to the significance of such accounts when calculating capital adequacy ratios, included in the criteria stipulated by Basel Committee, considering the different nature of such accounts, based on participating in profits and losses, and subject to the rules of legal Mudaraba (speculation) contracts. Accounting and Auditing Authority for Islamic Financial Institutions (Bahrain) plays an effective part in clarifying this matter through studies and activities undertaken by its sub-committees which have reached the conclusion that the total ratio of investment accounts is 50%.

6- Central banks in some Islamic states - as the optimal financier - offer facilities in the form of subordinating cash subjects to the provisions of Mudaraba (speculation) contracts in the case of confronting a deficit problem or temporary lack of liquidity within Islamic banks in these states.

This can be achieved through the following procedures:

- Developing and enforcing banking laws and legislation for Islamic banks in order to create an independent supervisory system to be formulated by a legal structure with clear, comprehensive and detailed stipulation of the different perspectives of the rights, duties and nature of Islamic bank dealings besides organizing the operations of Islamic branches of conventional banks, or at least

stipulating a full part of that matter within bank and credit laws and regulations in different countries.

- For a start there should be an independent department within central banks and monetary institutions, specialized in supervisory tasks on Islamic bank operations. Such department should be provided with qualified and well-trained staff that is fully aware of integrated practical and theoretical concepts of the Islamic banking system. The required human resources should participate in training programs and courses of study specifically prepared for that purpose.
- Reconsidering the policy of calculating the cash reserve ratio and credit ceilings policies - if any - especially that, as already mentioned, some legislation's have exempted some banks from being subject to such instruments, or, at least, reducing them to the lowest possible level.
- Reconsidering the rules of calculating cash flow ratios and capital adequacy - in accordance with the nature of Islamic banks, and keeping up with the tendency in some countries to give careful consideration for that matter - on the level of all Islamic banks whether in the Arab World or in foreign countries in which there are Islamic banks.
- Designing patterns and forms of regular data required from Islamic banks. These should be developed and approved by Islamic and central bank officials for the purpose that such patterns and forms meet the requirements of supervisory objectives on the one hand and adapt to the nature of Islamic banking operations on the other.

Advantages & Disadvantages of Islamic banking

Advantages of Islamic Banks:-

First of all, Islamic finance forges a closer link between real economic activity that creates value, and financial activity that facilitates it. Islamic finance is global and cosmopolitan. Committing itself to a text accessible to all and prophetic precedence, easily available. Islamic finance is open to any innovations that are in congruence with its fundamentals. Moreover, It is not a closed system as it has no regional, ethnic or class affiliations. Islamic finance will foster greater stability as it synchronizes payment obligations of the entrepreneur with his or her revenues. Also it is a more efficient as it allocates invest able funds on the basis of expected value productivity of projects rather than on the criterion of creditworthiness of those who own the projects, as is the case in debt-based finance. Finally, Islamic finance will be less prone to inflation and less vulnerable to gambling like speculation, both of these being currently fueled by the presence of huge quantities of debt instruments in the market. Debt instruments function as money

substitutes while equity-based financial instruments do not. And speculators find it much easier to manipulate debt instruments than those based on profit-sharing.

As Islamic banking has its disadvantages, it also has its advantages. It has been reported by many scholars that the system of Islamic Banking has different advantages.

Murabaha is considered to be better than debt financing. We claim that it serves to keep the financial market in sync with the market for real goods and services, therefore making it less capable of betting like speculation. Representing these and possibly other qualities require *Murabaha* to be practiced in real earnest. For example as a means of financing the acquisition of production means and needed goods by people who are expected to be able to pay for them, but after sometime. It is only the practitioner who can ensure that *Murabaha* does not degenerate to that level.

Since financial intermediation does not involve selling goods and services directly, it would be more appropriate to get financial intermediaries involved in *Murabaha* business indirectly. The same applies to other forms of business like *Salam*, *Istisna*, lending. A financial institution is not really qualified to handle these businesses directly. It is often unwilling to expose its capital to the risks involved in direct businesses. As a result it tries to make the transactions as risk free as possible. It does not matter if these means, on the average and in the long run, settling down for a lower rate of return.

They would also be able to branch out their activities as a means of decreasing the risk. Perhaps they are already specializing in handling different market segments in terms of the commodities involved. These businesses would need financing. This way there would be a buffer between the changing circumstances of real businesses and those handling only finance. The fact that their stake will be not in individual deals based on one of the contracts mentioned above but in a large basket of deals will make a crucial difference. In its own interest, the business being financed will have reduced the risk of loss by diversification and other methods.

What would be the basis for the Islamic financial institutions' financing of *Murabaha* companies, in this case of Lending companies? In my opinion, the basis for Islamic financial insinuations will be more appropriate in the form of *Mudaraba* or profit sharing. This conforms to the earliest form of financial intermediation discussed in Islamic jurisprudence, *al Mudarib yudarib*.

Whether it is the building and construction area or agriculture, manufacturing industries or the transport and communication sector, foreign trade or domestic commerce or the government's infrastructure building activities, ways can be found to meet their financial needs through these companies, without recourse to interest based lending and borrowing.

However, with this change they could rightfully demonstrate how their activities avoid contributing to the unsteadiness of the system, something we accuse interest based institutions of doing. By doing this the system will enjoy the unique feature of sharing based intermediation: synchronization between revenues and payment

obligations, and still keep the flexibility which the presence of very low risk modes of financing impart to a system.

Disadvantages Of Islamic Banks:

Everything has its advantages and its disadvantages; so do Islamic Banks.

The Islamic system is not well known in the world therefore some countries might fight the system itself and some countries fight the interest-free rate system.

It has been said that the concept of the Profit Loss Sharing used in Islamic Banks a better system than the one used in Conventional banks. But that has been proven wrong, as there are four main problems where Islamic Banks found the profit loss sharing a problem while financing.

The first problem is that long-term projects have been proven to be a problem using the profit loss-sharing concept. Twenty Islamic Banks have figured out in the year 1998, that less than only about ten percent of the capital is used in long term projects. That's because long term projects take a long time and so the bank cannot give the customer back his money except after a period of time, while on the other hand conventional banks pay the customer back his money right from the beginning. Also Islamic Banks have to wait until the end of the project to give the customer his profit, unlike conventional banks pay the profit quicker. Second, another reason is that a project with the basis of the profit loss sharing concept would take a long time because it needs expertise and experience.

Third, most of the banks customer work with the bank in small business, but it is difficult to give these investors money even if there is a lot of money in the bank because it is difficult to finance small business under the Profit Loss concept

Forth, as Islamic Banks operate differently than conventional banks, the new staff have to learn many new skills that they will need to work with which takes time. Also new principles have to be taught, which would also be time consuming.

Obstacles

There are several crucial factors which are absent from Islamic finance or are present only in part and spread diversely.

Current problems of Islamic banks may be summarized as follows':

1. Shortage of experts in Islamic banking: The supply of trained or experienced bankers has lagged behind expansion of Islamic banking. The training needs affect not only Arab, both Islamic and non-Islamic are domestic banks. But also foreign banks. Academic institutions. international organizations, and transnational firms must respond to the need by organizing training materials, lectures. and workshops,

2. Absence of accounting (and auditing) standards affectsto Islamic banks: Uncertainty in accounting principles involves revenue realization, disclosures of accounting information, accounting bases. valuation, revenue and expense matching, etc. Thus. the results of Islamic banking schemes may not be adequately defined. particularly profit and loss shares attributed to depositors.

3. Lack of uniform standard of credit analysis, especially for PLS schemes. Similarly, there is a widespread training involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation.

4. Potential conflicts with central banks: Islamic banks have been established as separate legal entities; therefore, their relationships with central banks and other commercial banks are uncertain. Problems may be complicated, Islamic bank is established in a non-Muslim nation, and is subject to that nation's rules and requirements.

5. Potential conflict between domestic banks. foreign banks, and Islamic banks : It appears that domestic banks and Foreign banks will experience continuing difficulty in adopting Islamic banking practices, including the PLS scheme, until they can become more confident of the results of investing ventures.

6. Lack of a deposit insurance system: The lack of such a system becomes more grave, because Islamic banks generally don't have standard measures of reserve requirements or liquidity ratios

7- PLS-financing is unpopular with both Islamic banks and clients. For the banks, there are too few attractive projects with an acceptable level of risk. Clients, on the other hand, are unwilling to share too much information and profit with the banks. As a result , PLS-financing attracts many high-risk / low reward projects, and uncooperative, or even fraudulent, entrepreneurs.

8- PLS is not suitable for short term financing or for the non- profit sector. Companies often need finance for short term liquidity. The administrative procedure of PLS is too lengthy to answer such urgent needs. Furthermore, is difficult to determine the return on financing liquidity. The same applies to financing the non profit sector : what is the return of an investment in schools, or in a new highway?

9- There is a lack of developed Islamic, financial products, *institutions* and markets. Owing to a lack of suitable financial instruments, Islamic banks still experience difficulties in optimizing their risk, return and liquidity. furthermore, he network of Islamic banks is still underdeveloped and too mall. Finally, there are no developed Islamic money and capital markets. In cases of liquidity shortages, Islamic banks cannot call upon central banks, because they provide interest-based financing. Recently, Malaysia opened an Islamic inter-bank money market. Initiatives of this kind, more research, and new Islamic financial instruments may cure the 'childhood diseases of the system.

10. Islamic banking in non-Islamic countries is still difficult. Western banking legislation requires banks to guarantee the capital of depositors, and ensure them a fixed return. This is directly opposed to the PLS-principle. Furthermore, the valuation of Islamic banks' investment is a difficult and cumbersome task, for which no adequate procedures have yet been developed. As a result, Islamic banks fail to satisfy central banks' strict liquidity and capital adequacy requirements, and have great difficulty in obtaining full banking permission in the West.

11- No universally Accepted Methods of regulation or Auditing, In Islamic finance, there are no universally accepted methods of regulation or auditing and the declaration of a financial product of transaction as Halal is the responsibility the individual *shariah* committees concerned without commonly accepted financial instruments or clear understanding of the accounts of a transaction counter party, no efficient and sizeable financial market can develop .

12- The problem of communication outside the region Conventional bankers and, indeed most individuals in non-Islamic societies are spectacularly ignorant of the realities of islam, Islamic societies, and Islamic finance.

13- Lack of knowledge of Islamic Financial Products Although most Muslims are aware of Islamic financing possibilities, and some use the services provided by Islamic banks and the Islamic facilities offered by conventional banks, there is a lack of knowledge concerning the terms of the financial products, *and* how to use the instruments available.

14. Informative advertising : Because of the innovative nature and complexity of Islamic financial products, informative advertising is needed that goes beyond mere financial reporting or the promotion of awareness of a particular bank.

15- Production of leaflets One of the most effective means of providing educative promotion at the retail level is through the production of leaflets on the particular Islamic services being offered.

It is clear that the problems are mainly concentrated in the field of financing. With respect to deposits, Islamization has succeeded. If the problem of financing could be overcome. Islamic banking should be able to make a decisive breakthrough.

How to overcome the obstacles ?

We suggest the solution to be able to overcome these obstacles:-

To avoid Shortage of Experts in Islamic Banking we can establish a training institution to qualify Islamic Banking staff or other students interested to acquire knowledge about it. The proposed center may take the form of a university or an academy to teach Islamic Banking sciences²⁰. The purpose of such academy is to prepare, train, and graduate Banking Cadres that are practically and scientifically qualified for working in Islamic Banks. This would lead to achieving required integrity of Islamic banking. In addition to this, some Islamic banks with big expertise can be used . Also, training missions can be exchanged between Islamic banks to fulfill said target.

- And for the absence of accounting and auditing standards pertinent to Islamic Banks and no universally accepted methods of regulation or auditing

²⁰ Such academy may be established in collaboration with the Islamic Development Bank (for its organizational and financial capabilities), the General Council of Islamic Banks and institutions (for their informational activities), Arab Academy for financial and Banking sciences (for their educational and banking training capabilities), and the Al-Azhar University (Saleh Abdullah Kamel Center for Islamic Studies).

Islamic Banks have universally accepted standards laid down by the Accounting and Auditing Association of Islamic Financial Institutions.

The sound efforts of the Association can not be neglected in the field of developing the accounting and auditing aspects of the Islamic Financial Institution, introducing these aspects and their applications by way providing training opportunities. Actually regulations and standards are currently used and led to introducing a number of investment and financing moods based on Islamic principles such as profit and loss sharing (Pls.).

These efforts led to unifying the adopted regulations and standards, and the Association needs to acquire some sort of professionalism to enforce the application of the said regulations and standards. Also to financial statements, the contracts used to eliminate differences and paradoxes currently observed among Islamic Banks.

No doubt, this will provide a huge momentum towards achieving integration of the Islamic Banking system, and leading it to cope with the International accounting standards.

And about lack of uniform standard of credit analysis (for Pls.), Pls.-financing is unpopular with both Islamic Banks and clients and Pls. Is not suitable for short term financing or non-profit sector :

The Islamic Pls. Moods of finance provided by Islamic banks such as Mudarabah and Musharakah with their various types do not create any accounting or auditing problem, as they are executed on basis of fair rules and published distribution Rates agreed upon.

Nevertheless, due to the nature of these moods and the bank's classification as partner and not debtor, the decision to enter into such operations entitles the bank to be cautious in order to avoid probable risks.

As for financing terms, there is no any problem in determining the financing terms of Pls. Operations; can be on short term or long term bases in regard to the nature and purpose of each operation.

The bank uses short term financing when financing part of the working capital for one operation or one financial year, or when financing a specific operations such as contracting, supply or operations of self-liquidation nature.

While using long term financing can be used for decreasing Musharakah (partnership) operations.

Also we have potential conflicts with Central Banks : It is acknowledged that the general outline of the targets sought by Central banks and Monetary institutions when supervising traditional banks, does not differ from that needed for Islamic banks. Some Central Banks in a number of countries - conducted their supervisory activity with due understanding and flexibility, the thing which means the full comprehension of responsibility to these banks of the different nature and practices as well as activities of the Islamic Units.

However, the matter needs more understanding and support from the side of the supervisory bodies such as Central banks and Monetary Agencies in the Islamic Countries or other countries in which Islamic bank operate through the following measures :

- Drawing special laws and legislations to Islamic banks to shift into an independent supervisory system with legal outline laying in detail and accurately the rights, duties, and the nature of the Islamic banks dealings; and also adjusting the works of the Islamic units of the traditional banks.

To start; there should be a special department in the Central banks and Monetary Agencies to inspect, audit, and supervise Islamic banks dealings.

- The policy of the monetary reserve and the credit ceilings should be reconsidered; as some legislations exempted some banks of these tools or at least have been minimized as low as possible.

- Designing models and periodical data sheet required from Islamic banks in agreement with responsible of Central banks to satisfy both the supervisory objectives and the nature of Islamic banking system.

- The exerted efforts in this concern shall prove successful once they are put in clear outline specifying the nature and characteristics that differentiate Islamic banks from any other banks, and the nature of the risks they are exposed to.

Also there are potential conflict between domestic banks, foreign banks and Islamic banks :

There are many aspects of cooperation now between the two systems. This cooperation can be strengthened and deepened through :

- Increasing and expanding joint investments between both systems whether on the governmental level or the mutual one subject to the regulations and rulings of Islamic *Sharia*.

- Completing and increasing the automation between the two systems, so that Islamic banks can move forward.

- Establishing an advanced base and network for financial banking, and domestic and international markets conditions to support the objectives of the two systems.

- As many traditional banks have become very much interested in the Islamic investments and financing, and also Islamic banks are very keen to strengthen cooperation with these traditional banks so as to invest the surplus liquidity available at them through legitimate and safe channels.

- Exerting efforts with traditional banks in major countries to better understand the nature of Islamic banks. Such cooperation shall lead to decrease the risks of these investment to meet Basel II requirements, in addition to expanding the circle of Islamic dealings.

- International financial institutions and banks can benefit of having a share in the Islamic banking services market by way of purchasing part of the financial tools and investment portfolios issued by Islamic Banks.

- It is highly important that international traditional banking institutions shall continue opening Islamic units provided their adherence to the rulings and regulations of Islamic Sharia, as well as, Islamic banking standards.

To overcome lack of a deposit insurance system : Islamic banks adhere to the regulations applicable on the banking systems in the countries in which they operate. Hence, the deposit insurance system applied by some countries is applied accurately on the saving and investment accounts of the Islamic banks operating there. As for other countries that do not apply this system; Islamic banks are similar to other banks do not enjoy this system. The same is for the Reserve and Liquidity ratios.

There is a lack of developed Islamic financial products, institutions and markets :

In order to overcome these obstacles, there is a need for integration among the units of the Islamic banking industry. This is concluded through the following measures :

1/1 Islamic Banks and Financial Institution should cope with the universal tendency towards amalgamations and forming giant institutions so as to absorb the modern and high cost techniques to compete in the financial markets specially with the application of the GATT.

1/2 Activating the tasks of the International institutions and organizations hosting the Islamic banking practice such as : Islamic Development Bank (Jeddah), The Accounting and Auditing Association of Islamic Financial Institutions (Bahrain), Financial Liquidity Center (Bahrain), The Islamic Association for Investment Insurance and Export Credit (Jeddah) Islamic financial Services Council (Malaysia) This factor is essential to achieve the targeted objectives..., and indeed the participation of the majority of the Islamic banking units in the membership of these institutions, would support their march and pave the way towards expressing their ideas and view points in order to support and consolidate the system.

1/3 Establishing other institutions with specific tasks to support and consolidate the Islamic banking working techniques; most important of which:

1/3/1 A central institution for the Islamic financial dealings FATWAS. As there is pressing need for this institution to unify the Fatwa sources to eliminate any contradiction for any specific subject. All Islamic banks should participate in this institution to issue neutral and powerful opinions applicable on all Islamic financial Institutions.

1/3/2 It is necessary to work towards establishing Takaful Fund (solidarity fund) for Islamic Banks to provide urgent financial and material (support for any Islamic bank facing the risks of insolvency, bankruptcy, ... etc. Such fund would have a mechanism for management and methods of work.

1/3/3 In addition to this, an educational and training center for Islamic banking sciences to prepare, train, and graduate qualified banking cadres. Also, training and qualifying present staff on various aspects of Islamic banking management and administration.

1/4 Inviting Islamic banks and financial institutions in the Arab and Moslem countries in particular to take necessary procedures towards :

1/4/1 Entering into bilateral and multiple agreements with other units operating in the field of Islamic banking and financial activities in a manner covering all avenues of work and activity as appropriate.

1/4/2 Islamic banks and financial institutions in each country should open a dialogue and serious discussions with the supervisory and monetary authorities to explain how these institutions need and independent supervisory tools different from the used ones.

1/4/3 Providing all possible support and assistance to the Islamic banking units operating within traditional banks, and taking necessary arrangements to achieve appropriate co-ordination to promote the market volume available for Islamic banks.

1/4/4 Offering Islamic financing tools for public projects inside the states in which Islamic banks operate such action would contribute positively the Islamic banks' credibility.

1/4/5 Using the advanced technology to join Islamic banks units with modern information and communication network. There is also a need for data bank to assist these banks. In this concern, praise Islamic banks and financial institutions (Bahrain) for establishing a site in the Internet.

10. Islamic banking in non-Islamic Countries is still difficult :

The situation is not as hard as before. There are many governments and international institutions who sponsor and support the Islamic banking system with appropriate legislation. The following is example of the successes achieved by Islamic banks :

- Some countries such as Pakistan, Sudan and Iran shifted their banking system into entirely an Islamic one. Some other countries issued special laws to organise the work of Islamic banks such as, Kuwait, Malaysia, Emirates, Yemen, Lebanon, and recently Syria.
- International supervisory institutions are more convinced with the Islamic banking industry and started to encourage and support them.

This can be seen in the following:

- Establishing an Islamic financial services council in Malaysia under the supervision of the World Bank and the international Monetary Fund. They are considered with Asian Development Fund as an associate members of the council.

- The support provided by major European responsible for the Islamic banking industry and encouraging it to promote mutual cooperation relations with other international institutions to enhance the role of Islamic banking in the International financial system.

- The American Treasury nominated in last June an Arab economic expert to the post of major council for high officials to better understand the Islamic banking system and the Islamic Financing instruments.

- The Dow Jones stock Exchange launched the first International Islamic market Index "Titans 100", to meet the increasing global demand of Islamic investment indices.

- Due to the continuous efforts of the Islamic banking industry officials, there seems now a new atmosphere of understanding and flexibility from the side of the Central banks in various countries in implementing some measures and supervisory rules on Islamic banking units.... This can be seen in the following :

- Allowing many Islamic banks to conduct direct trade, possession of goods, valuables, and real estates for the purpose of re-sale, in a time when other traditional banks are not allowed to do so.

- Understanding the nature of the Investment Accounts in Islamic banks, and emphasizing them from a Sharia perception as a relationship between the bank as "work owner", and the client as "Money owner"; and hence adjusting some conceptions when calculating the capital adequacy ratio specified by Basel II, as being based on Pls.

- Monetary authorities in some western countries allowed the establishment of Islamic banks within their land, such as "The Islamic Bank of Britain" which started its operations in last September in London to offer its services for more than 2 million Moslems residing in The United Kingdom,

- It is also expected to inaugurate "The American Finance House" in coming October in the City of Chicago, as an Islamic financial Institution providing and offering banking services in accordance with Islamic Sharia principles. Many Islamic financial Institutions and businessmen from the Gulf area and America would share in this institution.

- Many Central Banks and Monetary Authorities adopted some Islamic financing modes and tools such as : Interest free certificates as those issued by the Bahrain Monetary Fund, and also The 100 million Euro Islamic Certificates issued by the German state "Saxoni Einhalt", managed by Citibank group in collaboration with the Kuwait Finance House.

Also we have problems of Communication outside the region ,The lack of knowledge of Islamic financial products, Informative advertising,

And also we have Production of leaflets :

The should be some sort of coordination among all the Islamic banking units operating in the Islamic and non-Islamic countries on how to face the problem of knowledge and informative advertising. Cooperation should focus on organizing joint exhibitions to promote and market Islamic banking products and services and introducing different modes of Finance.

The Islamic banking current infrastructure can be used, such as The General Council for Islamic banks and financial institutions, the Islamic Development Bank, and the Islamic Financial Services Council in Malaysia.

In addition to this,

Beside this, most of the Islamic Banks have the informative and media sites on the Internet, with users expected to reach at about 3 billion population according to the "Financial Times" estimates.

Traditional advertising techniques are also used such as the audio-visual methods, direct contact with bank clients, and also the photographed advertising leaflets and brochures that are sent by mail to clients and placed in the bank halls.

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: Given the fact that the Islamic experiment was new in Egypt, it was hard to find skilful bankers who believe, Consequently mismanagement problems and violation of Islamic law occurred²¹.

²¹ Mahmoud Mohieldin; (Islamic Finance in Egypt), Working Paper No. 17 , The Egyptian Center for Economic Studies, October 97, P. 27 .

Conclusions

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

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

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

This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

Recommendation

This can be achieved through the following procedures:

- Developing and enforcing banking laws and legislation for Islamic banks in order to create an independent supervisory system to be formulated by a legal structure with clear, comprehensive and detailed stipulation of the different perspectives of the rights, duties and nature of Islamic bank dealings besides organizing the operations of Islamic branches of conventional banks, or at least stipulating a full part of that matter within bank and credit laws and regulations in different countries.
- For a start there should be an independent department within central banks and monetary institutions, specialized in supervisory tasks on Islamic bank operations. The required human resources should participate in training programs and courses of study specifically prepared for that purpose.
- Reconsidering the policy of calculating the cash reserve ratio and credit ceilings policies - if any - especially that, as already mentioned, some legislations have exempted some banks from being subject to such instruments, or, at least, reducing them to the lowest possible level.
- Reconsidering the rules of calculating cash flow ratios and capital adequacy - in accordance with the nature of Islamic banks, and keeping up with the tendency in some countries to give careful consideration for that matter - on the level of all Islamic banks whether in the Arab World or in foreign countries in which there are Islamic banks.
- Designing patterns and forms of regular data required from Islamic banks. These should be developed and approved by Islamic and central bank officials for the purpose that such patterns and forms meet the requirements of supervisory objectives on the one hand and adapt to the nature of Islamic banking operations on the other.

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