

# ISLAMIC FINANCE TO AID WATER UTILITIES

by

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### **Introduction**

The purpose of this study is to examine whether or not Islamic finance might contribute to financing water projects in the economies of the less developed world. Only those aspects of Islamic finance that may be considered as relevant to this purpose will be discussed; namely, **1)** the circumstances which led to the recent emergence and development of this type of financing. **2)** The salient differences between Islamic finance and western banking concepts and procedures. **3)** The suitability of Islamic finance to the funding requirements of water projects.

In this study water projects are those that provide clean water for drinking and household use and plants for sewage treatment. It does not include water for agriculture or industrial use. Islamic finance covers actions by individual Muslim investors as well as by private sector organizations; namely, Islamic banks, Islamic windows at Western style banks, Islamic mutual funds and the Islamic Development Bank, a multinational financial aid bank based in Jeddah, Saudi Arabia.

### **Conclusions**

**A.** The development of Islamic finance in a developing Islamic country has a positive impact on the indigenous economy of the specific country in two ways:

**A.1. It Activates financial resources** that would have remained outside interest-based finance altogether. **Islamic banks attract** religiously committed savers to maintain bank accounts in the form of demand deposits. **Islamic mutual funds attract** religiously committed savers to participate in profit and loss sharing arrangements for the **long-term**. It is difficult, **however**, to quantify the magnitude of this factor. Account balances with

Islamic financial organizations at present might have been **transferred from conventional banks** instead being provided from of out-of-circulation dormant saving.

**A.2. It provides fixed-rate long-term** facilities that are critical to infrastructure projects like water utilities. Typically, this type of funds is only available from bond markets. Islamic mutual funds **fulfil the role of bond markets** in this respect. As such, Islamic mutual funds become an effective **substitute to bond markets** in those Islamic developing countries that have no domestic capital markets to benefit from.

**B.** The development of private sector Islamic financial organizations in one rich Islamic country **does not necessarily lead to helping** the financing needs of poor Islamic developing countries. Islamic financial organizations **could not finance foreign water utilities** any more than their conventional Western style counterparts could. This is because exposure by Islamic financial organizations to **business risk** is governed by **standard professional credit prudence**. Since the country risk of most developing countries, especially the poorest ones, is high, Islamic financial organizations, except IDB, **could not be expected to risk investing** the saving of their customers in water projects in those countries.

## **1. The Environment that Led to Islamic Financial Organizations**

**1.1 Islamic finance emerged some 25 years ago.** It grew in order to meet the demand for Islamic investment products from mainly Middle Eastern customers in an organized and professional business manner. Some **rich Muslim** men and women investors, however, had followed what they regarded as Islamic investment opportunities for centuries. On the other hand some **small Muslim savers**, lacking the necessary means, refrained from dealing with Western style banks altogether. They **hoarded** their saving in jewellery, real estate, gold coins, works of art and cash at home under mattresses.

**1.2.** Impetus behind this rather sudden surge in demand for such services was due to the equally sudden and substantial increase in **wealth created in the aftermath of the October 1973 war** between Israel and Egypt and Syria. At that time Middle Eastern oil exporters led other OPEC members to take advantage of the war situation. They quadrupled the price of crude oil to over US\$ 10 per barrel. Within a few years hundreds of billions of US\$ were spent by oil exporting governments on modern infrastructure such as roads, airports, harbours, schools, hospitals, telecommunications, water, sewage, electricity and defence. The unprecedented **magnitude and speed of government spending** during this period brought bottlenecks in many areas of the development process. During the later part of the 1970s inadequate seaport facilities in Jeddah, Saudi Arabia, for example, caused huge unloading delays to hundreds of cargo ships at any one time of up to 18 months. Coupled with huge demurrage charges to local importers this situation led the Port Authority to contract a Philadelphia firm in 1979 for one year to unload bulk cargo ships by a fleet of the largest available helicopters.

**Profits and commissions to local beneficiaries** from this unprecedented surge in government spending were considerable. They were primarily **shared among a relatively small number** of politically connected brokers, powerful royals and government officials, privileged local contractors, influential foreign construction companies with well connected local partners, importers and franchisees of every consumer product imaginable. The fortunate beneficiaries of this process included a proportion of the religious observant. While it is difficult to estimate with accuracy the percentage of Islamic investments to total private investments by the new wealthy, it is clear that the depth in the **demand for Islamic investments** was sufficient to ensure the profitability necessary for the emergence and **sustained growth of Islamic financial organizations** such as Islamic banks and Islamic mutual funds ever since.

**1.3. Neighbouring countries** benefited from the crude oil bounty as well. **Millions of Muslim expatriate workers** from Bangladesh, Egypt, Jordan, Indonesia, India, Lebanon, Pakistan, Philippines, Sudan, Syria and Yemen were needed in the thinly populated and skill short states of the Arabian Peninsula to help construct and manage the new educational, medical and other welfare facilities. **Some of the expatriate saving was expressed in the growing demand for Islamic investment products already underway.** Today it is estimated that about six million workers from these countries continue to reside in Saudi Arabia alone. The majority, however, earn an average annual income of around US\$ 2,000, barely enough for a family's subsistence back home. These are the construction and sanitation workers, domestic helpers and drivers to the millions of Saudi household women who are not permitted to drive. But, a minority of expatriate communities represents professionals such as teachers, doctors, nurses and engineers. The high earning capacity of this category of expatriates allows at least some of them to save and invest in a manner compatible with their belief in the Islamic prohibition on interest. The spread of Islamic financial organizations in their countries of origin helped to activate productive business saving, a portion of which would have otherwise remained dormant.

**1.4.** Notwithstanding the substantial growth of Islamic finance during the recent past it is still in infancy. **The banking system in Islamic countries is still dominated by interest-based** banking. Even in Saudi Arabia, the home of Islam's two holy cities of Macca and Madinah, according to the annual reports of publicly held commercial banks the ratio of the balance sheet total of the one banking organization that conducts its operations in an Islamic manner, Al Rajhi Banking and Investment Corporation, as at the end of 2000 to the aggregate balance sheets of all ten private sector commercial banks in the country is slightly below 14% (US\$13 billion/ US\$ 95 billion). If government owned banks are included the ratio becomes smaller. Al Rajhi was formed as a money changing business more than fifty years ago. It was reorganized as a publicly owned bank supervised by the Saudi Arabian Monetary Agency in 1988. Its strong market position at present goes back well before October 1973. By that time it had already had assets of about \$ 3 billions. **In Egypt the ratio is estimated at around 1% and in Jordan, even less.** Islamic banks in other countries in the Middle East have similar small market share while other countries have no Islamic banks altogether. These figures do not include Islamic mutual funds.

Not all Islamic finance resources represent an activation of previously dormant assets. A portion had undoubtedly been deployed in the conventional Western style banking system. As the new Islamic financial organizations were formed savers **transferred those assets from the old to the new**. It is difficult to quantify the amount of this shift. Islamic finance future growth prospects will be discussed in (5.3) below.

## **2. Usury or Interest**

**2.1. Islamic scholars differ on the legitimacy of dealing with interest-based commercial banks.** In 1986, the Academy of the Islamic Conference condemned all forms of dealing in interest as void and forbidden. They believe that profit and loss sharing is the only **humane basis** upon which financial relationships in society should be built. On the other hand, Sheikh Tantawi, the **Sheikh of Al Azhar University** in Cairo, Islam's 1,000-year old and most respected religious learning institution by Muslims worldwide declared that **bank interest is permissible** because it is considered as a sharing of the bank's profit. Some scholars **distinguish between interest and usury** and argue that bank interest is acceptable because it is moderate and convenient to the borrower in rate and conditions. What they regard as **prohibited is usury** because of its exploitative rates and conditions of those in need. They argue that during the formative years of Islam some **1,500 years ago there were no banks** in today's sense of public ownership and active government supervision to protect consumers from the greed of usurers. Nor was the economy as complex and internationally interdependent as it is today. **Bank lending** is viewed by some as a useful **supplement to equity participation**, especially in the case of those entrepreneurs who believe strongly in the prospects for high profitability from their businesses that they would prefer to pay a predetermined rate of interest for a loan than share in those profits with new shareholders or partners. Bank lending, therefore, provides financial markets with a choice.

**2.2. Religious interpretations differ** from one scholar to another in one country or another and from time to time. Islamic laws that govern the daily lives of Muslims as well as the interpretations of scholars in orthodox Saudi Arabia often differ from those pronounced on the same subject by scholars in moderate Sunni regimes, let alone Shia Iran or other factions elsewhere.

Notwithstanding the influence of scholarship, however, it is **customer demand** that ultimately shapes **entrepreneurial supply**. It is the expected return on Islamic investments that in the final analysis dictate the religious parameters that financial managers provide.

## **3. Islamic Liabilities**

**3.1. Islamic banks** do not pay interest on customer deposits. **All deposits are kept on an interest free current account demand basis.** Depositors could withdraw those deposits without notice at any time or write checks against their balances. This contrasts with conventional Western style banks which offer a range of interest bearing deposit products to individuals and institutions such as customer time-deposits, inter-

bank deposits and certificates of deposit in addition to current accounts and demand deposits that are generally interest free but sometimes pay a small rate of interest especially when these balances exceed a certain minimum average amount. Interest bearing time deposits may not be withdrawn prior to maturity unless the depositor forfeits a financial penalty. As such, the difference between an Islamic bank and a Western bank is to be found not only in the manner in which Islamic banks assets are deployed, as will be discussed in (4) below, but also on the liabilities side.

**3.1.a.** Since all deposits of **Islamic banks** are demand deposits, their loan or leasing assets should correspondingly remain short-term in order to **avoid liquidity problems**. On the other hand, since Islamic banks demand deposits are free, a maturity mismatch between liabilities and assets would not cause actual financial loss. Only an opportunity loss should interest rates rise before maturity above the price uplift of the deferred settlement transaction. Accordingly, while the overall average maturity of an Islamic bank's loan book should remain short-term for liquidity reasons, say six months, **a small portion** could be slightly longer provided that the overall average remains around six months. Such could benefit the Islamic from the usually higher return on the longer periods of a normal yield curve. The average maturity of loan assets may differ from one bank to another. The determining factors are the **structure of a bank's deposits and its leverage ratio** (deposits to net worth). The greater the balance of bank net worth (capital and reserves) compared with deposits the longer the average loan maturity could become. Also, the greater the number of depositors and the smaller their average deposit size the less is the likelihood and impact of a sudden and significant deposit withdrawal.

**3.1.b.** Since Islamic bank depositors earn no return, it would be reasonable to expect that Muslim wealth holders would be attracted instead to **invest the bulk of their assets with Islamic mutual funds**. As will be explained in (3.2) below this is because investors share in the profits and losses of mutual funds operations. It is not to say, however, that Islamic banks will have no role to play in Islamic finance. On the contrary, they continue to be the only organizations that **guarantee the repayment of all deposits**. Also, they are the only providers of **letter of credit services** which every importer and exporter must have if the routine conduct of trade is to continue.

**3.2.** **Mutual funds** are independent legal entities. They **have their own board of directors and staff**. **Islamic mutual funds** participants or unit-holders, just like their counter parts in non-Islamic conventional Western mutual funds, **share in the profits and losses of the fund**. As such there is no difference on the liabilities side between Islamic and non-Islamic mutual funds. Participants in both receive no interest. They are **not depositors or creditors** of the mutual fund. **They are owners**.

**3.2.a.** Mutual funds are **not permitted to solicit or accept customer deposits**. Only banks can do so under the close supervision of central banks. While a bank, whether Islamic or Western, is obligated, under risk of bankruptcy, to return all deposits to their owners in full upon demand or at maturity, mutual fund **unit-holders share in the profits or losses** of the fund. They may lose their entire investment. **The difference between an Islamic and non-Islamic mutual fund** is to be found in the type of return and method of asset deployment. While assets of the former must return a profit, rent

dividend or capital gains, as will be discussed in (4) below, they may additionally produce interest income in the case of the latter.

**3.2.b.** When Islamic mutual funds assets are deployed in long-term leasing or trading transactions they could provide Islamic investors the corresponding opportunity to earn **fixed annual returns for long periods**. As such, Islamic mutual funds become a **substitute for bond markets** as far as mobilizing the fixed-rate long-term resources of a community. This type of funding is critical for the development of infrastructure projects, water and others. Islamic mutual funds, therefore, are useful to those developing economies that have no capital markets for bond issuance.

**3.2.c.** In view of Islamic banks' inability to offer depositors a reward for their current accounts and demand deposits (though some pay an equivalent return in the form of a motor vehicle, a chandelier or any object of value to the customer) Islamic banks usually offer Islamic fund management services. This is in order to: **A)** Retain those customers who wish to receive a return on their liquidity and not keep it all in non-interest bearing current accounts. **B)** Attract customers away from competing fund managers. **C)** Earn risk free fee income from fund management. The financial statements of bank-managed mutual funds are not reflected in the balance sheets of the managing banks. They are prepared, audited and published independently. The most important difference between owning a bank deposit in an Islamic or conventional bank and a bank-managed mutual fund unit is in liability of the bank or the mutual fund to the investor. Unlike depositors in Islamic and conventional banks who enjoy a legal recourse against the banks for the timely repayment of principal plus interest **unit-holders of bank-managed mutual funds have no recourse** against the managing banks for repayment in the event of loss of principal or return.

**3.d.** Some **international banks** and local Western style banks in Muslim countries met customer demand for Islamic investment products by establishing **Islamic windows** that offer Islamic banking services by managing their own Islamic mutual funds. But some Islamic banks and men of religion charge that such coexistence between the pure and the impure is unacceptable. Defenders counter that self-interest is behind such a charge.

## **4. Islamic Assets**

The availability of **Islamic loan assets is as important** to the growth of Islamic banks and mutual funds as the availability of **Islamic investors' liquidity**. Both sides of the balance sheet must grow simultaneously and harmoniously if disequilibria between the supply and demand for Islamic funds are to be avoided. It is estimated that on the eve of the birth of Islamic investment organizations in the mid 1970s there was in Saudi Arabia alone more than US\$ 5 billion awaiting the development of secure outlets for Islamic investments.

**4.1. What type of return may** Islamic financial organizations earn from their assets? **Instead of interest** they must earn any one of the following four types:

**4.1.a. Trading profit** through the buying of commodities and finished goods, excluding alcoholic and pig products, by an Islamic financial organization for sale in the future at hopefully a higher price, but sometimes at a lower price. Here the exchange of goods for money between the Islamic organization and the buyer occur simultaneously at sale time. This is purely a **trading transaction** where the Islamic bank assumes the full market risk of commodity price fluctuations. It does not provide the buyer with any financing.

A **variation** that changes the transaction from trading to financing would be for the Islamic bank (lender) to sell the goods to a buyer (borrower) with immediate delivery of the goods but on a deferred settlement of the sale price for a certain period in the future, in full or on instalments. An explanation of this type of transaction will be made in (4.2.b) below.

A **further variation** would involve the Islamic bank (lender) in acquiring the final product upon completion, such as a building, from a contractor/supplier (this time as a borrower) and pay for the construction cost on contract date, or on instalments as progress payments. Meanwhile, the Islamic bank would have already agreed to either sell or lease the building to a third party at an agreed price, typically before the construction had started.

**4.1.b. Rent** from fixed-rate leasing transactions with acceptable lessees. Here the financial organization (lender/lessor) acquires a fixed asset from a supplier and rents it for a certain tenor at fixed periodic amounts of rent to a lessee (borrower). A floating-rate lease could be made acceptable if the lessee is given the right in the contract to abrogate the lease agreement on any rent review date without any penalty.

**4.1.c. Dividend** from partnerships and equities in publicly held companies. Partnerships could be entered into by the Islamic bank for a specific transaction, a certain business activity or may cover the entire business operations of the other partners. A separate accounting is kept for transactional partnerships.

**4.1.d. Capital gains** on the value of fixed assets or equities over time. Well before the recent advent of Islamic financial organizations, this type of return has always been a favourite with Muslim investors. It still is an important to invest in areas such as real estate and household valuables.

**4.2. What are the characteristics which make financial transactions Islamic?**  
The following two conditions are central to defining an Islamic transaction:

**4.2.a.** In order **to avoid generating interest** an Islamic transaction **must not involve the exchange of like-with-like goods**, such as exchanging gold today for gold in the future, or salt today for salt in the future. Otherwise, the difference between the amount of gold or salt exchanged at the beginning and the end of the period involved would be purely interest. Actually, Islamic Sharia **prohibits the exchange of six items against themselves**; namely, gold, silver, wheat, barley, dates and salt, presumably

because these are capable of being **used as money** that measures value, be a medium of exchange as well as a store of value, all be it for a relatively short period of time in the case of the latter four eatable commodities. Islamic transactions must involve the **exchange of different goods** such as money for finished goods or commodities.

How about exchanging **two different currencies** such as the US Dollar today for Egyptian Pound at a future date? Are these two currencies considered as two different commodities or one? As will be discussed in (5.1.b) some Islamic scholars and bankers consider them to be one and the same commodity, thus their exchange is prohibited, while others consider them to be two different commodities, thus they are exchangeable.

**4.2.b.** Islamic transactions must **involve three independent parties**; namely, a supplier of goods, an Islamic bank (lender/financier) and a buyer (borrower/lessee) of goods. To illustrate, using an Islamic lending transaction as an example, while a Western bank would lend, say, US\$ 100,000 for one year at a rate of interest of 7% for a total repayment of US\$ 107,000 in order that a borrower may purchase a tractor, the Islamic bank would acquire the tractor from the tractor's supplier and immediately sell and deliver it to the borrower (now a buyer from the bank) on a deferred settlement of one year for a sale price of US\$ 107,000, or less if the Islamic bank wishes to be competitive. While the US\$ 7,000 difference in the former case represents the interest amount on the loan for 1 year, the US\$ 7,000 in the latter represents the difference between the sale and purchase prices of the tractor or the profit of the bank. That the US\$ 7,000 represents in the two cases the **time value of money** is irrelevant to the thinking of an individual Islamic investor, bank or mutual fund. The fact that profit and interest are each expressed as a percentage of the amount of the loan principal or the purchase price should not collapse the essence of the two into one. The important **issue here is the structure** of the transaction that gives rise to the US\$ 7,000. As long as the transaction is **officially and documentarily a trade**, not a loan, the uplift is profit not interest, notwithstanding its representation in a percentage form.

## **5. Lack of Uniformity in Islamic transactions**

In this section, first the diversity of interpretations of Islamic banking principles will be outlined, secondly the reasons behind such divergence of opinion is examined, thirdly the growth trajectory of Islamic financial sources is predicted and finally the political context is mentioned.

**5.1. Adherence** to the two conditions discussed in (4.2) above **varies among Islamic financial organizations**. The demarcation line between the structure that is considered Islamic and that which is not may be blurred. It differs from one Islamic organization to another. Three examples will illustrate the issue.

**5.1.a.** While an Islamic investor, individual or an organization, might consider it **acceptable** to purchase, say, a table or a bushel of rice from a supplier and sell back immediately to the same supplier at a higher price on a deferred settlement basis, another investor might **reject** such a structure because it violates the requirement discussed in (2) above that an Islamic trade transaction must involve three independent parties; a bank

(lender), a buyer (borrower) and a supplier. Otherwise, the transaction becomes one of a straight loan from the bank to the supplier of the goods.

The same transaction might become **acceptable** to one Islamic bank or mutual fund if modified to make the buyer (borrower) of the goods a **branch entity of the supplier**, but still remains **unacceptable** to another Islamic bank or mutual fund on the grounds that a branch office is not different or sufficiently independent from the supplier. Even if the transaction were to be modified by distancing the supplier even further from the buyer (borrower) through making the buyer (borrower) a **wholly owned subsidiary of the supplier**, with its own board of directors and management, one Islamic bank might **agree** to do the transaction while another might still **reject** any structure that is less than three genuinely independent and unrelated parties, notwithstanding the appearance of independence among the three parties in the subsidiary arrangement.

Would a wholly owned **subsidiary in a different jurisdiction** altogether that has its own independent board and management satisfy the requirement of independence between a supplier and a buyer (borrower)? To some Islamic banks the answer might be **yes**. To others the answer might be **no**. How about a **partially owned subsidiary of the supplier**? Some Islamic banks might insist that before such a relationship becomes acceptable the shareholding must be limited to a **minority** position only, but others might be satisfied with a **majority**.

**5.1.b.** While one Islamic financial organization might refrain from entering into a **forward foreign exchange contract** on the grounds that the difference between the spot and forward prices of the subject currency is pure interest, another might find such a transaction acceptable. **Expediency and ease of operation**, charge adherents of the first camp, is behind such an unacceptable dealing. How about the exchange of one currency at the present against another currency in the future? While some regard different currencies as one and the same commodity, thus their forward exchange is prohibited, others view them as two different commodities thus their exchange is permitted.

**5.1.c.** The receipt or payment of interest in monetary form is not directly involved here. Some Islamic organizations find it acceptable to recognize the interest income or interest expense that arise from their **deposit accounts balances** with Western banks in the form of **points**, black for credit balances, red for debit or overdraft balances, instead of money. Other organizations find such an arrangement to be synonymous with the giving and taking of interest and therefore refuse to follow it.

**5.2. Why these differing treatments?** There are two reasons:

**5.2.a.** The first reason is the lack of uniform rules and guidelines of generally accepted Islamic business principles and the enforcement of those principles. **25 years is a rather short time** in the life of financial markets to develop a recognized set of rules for a new type of financial service. The financial services community has been accustomed to different methods of banking for centuries. Religious advisors, individuals or committees that advise and sometimes audit the religious validity of Islamic financial transactions at Islamic banks provide different rulings on the same issue. Opinions can

**differ over time from one scholar or committee to another** and in one country or another. The ultimate judge is the customer who may choose whoever he or she considers to be agreeable. But to do so they often need the guidance of religious specialists on the theological purity of various banks and mutual funds, a condition that takes the issue back to the lack of consensus among the scholars.

**5.2.b.** Like any other business an Islamic financial organization that enjoys more **income opportunities** than it can handle is more likely to be selective in choosing the transaction it wishes to undertake. It is also more likely to insist on its own terms, whether credit standards or the purity of Islamic structure, than another Islamic bank under earnings pressure that leaves it little choice but to be expedient and compromise on both.

**5.3. Future growth of Islamic financial organizations** is dependent on the ability of Islamic banks and mutual funds to establish and maintain **credibility** within the Islamic community among both borrowers and investors. In what follows the role of four factors in influencing the growth of Islamic finance will be addressed:

**5.3.a. First, adhering to unified investment standards.** This is rather unlikely to be achieved anytime soon. It depends on consensus among the differing political and doctrinal affiliations of Islamic scholars and bankers on a unified set of principles for Islamic banking. Meanwhile, Islamic customers of like persuasion are likely to continue to gravitate towards those Islamic financial organizations that meet their own religious criteria to the exclusion of others.

**5.3.b. Second, generating a competitive level of return** on assets with Western style investments. Islamic financial organizations could at best be competitive in their return on assets with conventional banks. A **higher return inevitably means a higher degree of risk**. The effect of rates of return on Islamic customer investment decisions depends on the value that an investor attaches to his or her religious peace of mind. While some would choose the Islamic method regardless of how much smaller the Islamic return than the alternative might be, others would not be attracted unless the Islamic return is equal or greater than the financial return of alternative investments. To some investors **return could be financial as well as spiritual**.

**5.3.c. Third, applying prudent credit and investment policies,** procedures and documentation that would ensure a low record of losses due to bad loans or failed equity investments. This factor relates closely to the above factor in (5.3.b) in so far as it determines the rate of return of the Islamic financial organization. Prudence requires that investors and lenders analyse future earning potential of business opportunities, their cash flow prospects and strength of balance sheet. An Islamic investor is just as protective of his or her capital, loan or lease as any other investor. They all expect to be **repaid their principal in full on time** along with the agreed upon return, whether in the form of trading profit, rent, dividend capital gain or interest. Business risk considerations usually transcend religious boundaries. The primary responsibility of a banker or a mutual fund manager, Islamic or not, is to their shareholders and unit-participants not to borrowers regardless of religion. Accordingly, **due diligence in credit matters exercised by**

**Islamic banks can be expected to be as vigorous** as that exercised by their Western style counterparts. Indeed, central banks enforce the implementation of credit regulations on Islamic banks as energetically as they do on all banks under their supervision.

**5.3.d. Fourth**, Islamic banks, like their conventional counterparts, need to have a **lender of last resort** to aid them in the event of encountering liquidity problems. Without such a safety net the credibility of the Islamic banking sector would suffer. This should be preceded by central banks actions to license Islamic financial organizations, establish Islamic procedural rules for them and enforce prudent credit standards. Such is the most effective way to establish credibility and produce uniformity of principles and practices, at least in a particular country. However, forced uniformity by Islamic central banks is not likely to be achieved universally any time soon. Being government institutions, central banks conform to prevailing domestic laws and to the interpretation of religious dogma by local scholars who are influenced, if not dictated to, by the differing agendas of the ruling political establishments of different countries.

**5.4** The growth of Islamic finance is not strictly a function of business considerations. It depends on **political realities as well**. Opposition by some political authorities in Islamic countries to Islamic banking might emanate from the fear that such a development could have **undesirable political consequences for the ruling establishment**. Labelling banks as Islamic and non-Islamic in the same country might accentuate the divide among people on religious grounds and **lead to extremism**. Activists in a particular country might interpret a rapid growth in Islamic banking organizations as evidence of the growing political strength of the Islamic opposition. Islamic financial organizations could become a **political tool** in the hands of some religious political leaders. **Resistance by the conventional banking system in Islamic countries** could be vigorous if for no reason other than business consideration.

Accordingly, the Prospects for future growth of Islamic finance depend primarily on the expansion of Islamic religious fervour among Muslim savers that in turn would increase their demand for Islamic investment products. Furthermore, it depends on the professional record and the calibre, reputation and standing of Islamic financial organizations.

## **6. The Search for High Quality Islamic Assets**

**6.1.** Developing secure **Islamic assets** outlets of a reasonable return, domestic or international, is as formidable a challenge to emerging Islamic banks or mutual funds as attracting **Islamic investors' liquidity**. This is because of the inherent resistance within traditional organizations to new borrowing procedures that require abandoning **familiar age-old business practices**, routines, traditional banking relations and documentation. Of course higher risk borrowers would welcome the opportunity to accommodate any new source of funds that would increase their borrowing limits. But, Islamic banks needed to adhere to high quality earnings if they were to **gain credibility**, especially during the formative years of their careers. This may explain their reluctance to engaging in the

actual trading of commodities as true traders do in preference to engage in financial transactions that intermediate goods but avoid market gyrations of commodity prices.

**6.2. What could entice a traditional customer to borrow from an Islamic financial organization** particularly if the borrower enjoys high credit quality that allows it to choose from among the many sources of funding in the domestic and international markets? There are three inducements:

**6.2.a. First, a lower cost for Islamic funds** compared with the cost of conventional alternatives. Devout Muslim borrowers, however, would be expected to place less emphasis on pricing than other borrowers would. Such borrowers may even be willing to pay a higher price in return for the peace of mind which Islamic finance brings them.

Non-Muslim borrowers played an important role in the early growth of Islamic lending. They were attracted to this new form of financing mainly by their lower costs. By the early 1980s, lines of credit facilities in excess of US\$ 5 billion were agreed with dozens of prime corporations in Western Europe, Japan and Asia. Utilization by these companies averaged some US\$ 3 billion in the mid 1980s. The choice of country was a function of fiscal considerations; namely, whether or not an Islamic financial transaction would be construed by the specific Western jurisdiction as a trade, in which case income tax and custom duties implications needed to be examined, or a financing, in which case it was withholding tax on interest that needed to be addressed.

To illustrate, the **pricing rational** behind Islamic banks' short-term deferred settlement facilities to prime borrowers is pertinent. The same reasoning applies to longer tenor trading and leasing transactions. This discussion does not relate to equity investments in partnerships or publicly held companies because the investment decision in such a case is not different from other equity investment decisions so long as the subject investment does not include companies that deal in prohibited products.

Prime corporate borrowers, domestic and foreign, are able to select the **least expensive funding** source at any given time from among a variety of sources such as commercial paper, bankers' acceptances and Western bank borrowing. Islamic financing is a new source. It will tend to be tapped **only if its price is competitive** with the rates of interest of other sources of funds at the specific moment of borrowing. How competitive? By that amount which is sufficient **to compensate the borrower for the additional expense** incurred in implementing the different procedures required by Islamic lending to intermediate commodities trading in financial transactions. Generally, prime international corporations pay for their short-term US\$ borrowing a small spread of around 1/4 of 1% over the London Inter-bank Offered Rate (Libor), for a total cost of Libor plus 1/4 of 1%. Rates for banker acceptances or commercial paper for similar tenors could be at certain moments lower than Libor. If so, Islamic pricing must become competitive with the lower rates of these instruments.

Is such pricing reasonable for Islamic organizations and investors? The answer is yes. The **alternative is to deposit their liquidity with conventional commercial banks**

and earn the going deposit rate. At best this is equal, if the amount is sufficiently large (around US\$ 1 million), to the London Inter-bank Bid Rate (Libid), which is typically  $1/8^{\text{th}}$  of 1% lower than Libor. If Islamic funding priced as if it were kept as a bank deposit at Libid then a prime corporate borrower would save  $3/8^{\text{th}}$  ( $1/4 + 1/8$ ) of 1%. Many borrowers find such saving attractive. Should a borrower pay a wider spread on conventional loans, its Islamic loans would carry a correspondingly higher rate of profit to the bank than Libid.

**6.2.b. The second inducement is the longer fixed-rate tenor** of Islamic funds compared with the fixed-rate tenor of Western commercial banks facilities. While Islamic banks are basically short-term providers of funds, a small portion of their deposits and net worth may extend slightly beyond one year, on a fixed-rate basis, of course. **Islamic mutual funds can** provide longer fixed-rate facilities. A mutual fund may be specifically established to invest in **long-term loans or leasing** arrangements. Its shareholders may not withdraw their participations before an agreed upon period of years, a commitment that could then be mirrored on the assets side of the fund's balance sheet. By providing fixed-rate medium-term facilities for around five years, may be even longer, Islamic finance bridges the gap that traditionally existed between conventional capital market instruments such as bonds (some 10 years plus) and the short-term tenors of commercial paper (1-12 months) on one the hand and Western style banks on the other. Such is a useful complement to traditional financial markets tenors.

**6.2.c. The third inducement is the favourable accounting treatment on borrowers' books** compared with conventional loans. Since a borrowing from an Islamic financial organization involves the purchase of goods by the borrower from the bank or mutual fund on a deferred settlement basis the borrower may consider the transaction as a supply of goods on credit terms rather than a loan. As such it may be booked as account payable to goods suppliers (not as a bank loan) on the liabilities side of the balance sheet. On the assets side, it may be recorded as inventory (not as cash). Such trading entries, in contrast with financing entries, would have the effect of reducing the overall bank borrowing of the borrower, which would in turn improve its ratio of net worth to bank borrowing.

## **7. Suitability of Islamic Finance to Water Utility Projects**

### **7.1. Water projects, like other project, require three types of funds:**

**First. Equity.** This represents the first line of defence for lenders against loss in the event of bankruptcy of a business entity. While shareholders prefer to keep equity to a minimum, lenders, as well as rating agencies, prefer a maximum. The division between the two is due to cost considerations. Equity is the most expensive form of financing. Generally, however, about a 50/50 division of total project cost between equity and long-term debt would be reasonable.

**Second. Long-term debt.** Because of long payback periods, the majority of water utility project borrowing should correspondingly be long-term. Furthermore, In order to avert exposing the project over its long life to changes in the cost of borrowing, annual

interest charges should remain as stable as possible. Accordingly, the majority of water utilities debt should be: **a)** long in duration (10 years plus). **b)** Fixed in annual cost.

**Third. Short-term debt** for working capital needs.

**Islamic funding sources meet these requirements** adequately. They welcome equity participation. Their trading profit and rent are effectively equivalent to lending at fixed-rates. Finally, their tenor ranges between the short and long term.

**7.2.** Project equity and borrowing should be **denominated in local currency**. Except for the crude oil exporting countries that continue to enjoy surpluses in their balance of payments, equity and borrowing in US\$ in other developing countries invariably lead to **foreign exchange losses** to both shareholders and business ventures, respectively. This is due to the almost certain depreciation in the US\$ value of the currencies of developing economies arising from their need for foreign goods and services for development that most likely exceed their foreign exchange export proceeds for the foreseeable future.

The likely use of **Islamic funds to support** the development of water utility projects in the **home market** of the fund as well as in **foreign countries** will be addressed here.

**7.3.** The availability and terms of **indigenous Islamic financial facilities to domestic water projects** depend on whether the water project is owned by the **government** or by the **private sector**.

**7.3.a. Government owned water facilities.**

In developing countries water works are almost always government owned. Only if the government provides the project its **explicit guarantee** would the **credit risk** of a government owned business venture become synonymous with that of the government itself, thus commanding the lowest cost for domestic risk. Otherwise, lenders need to be satisfied that the commercial risk of the project is acceptable and priced accordingly.

**Islamic banks** are capable of meeting the demand by government owned water projects for short-term working capital loans of 6 months. Also, as discussed in section (3.1.b) they may offer a certain small portion of their deposits and net worth on a fixed-rate basis for slightly longer. **Islamic mutual funds**, on the other hand, can provide fixed-rate medium/long-term facilities in a manner similar to a bond issue. As such, Islamic mutual funds are particularly important for local project development in those developing countries with no capital markets for bond issuance. **Pricing** should be competitive with bond interest rates for similar periods before investors and borrowers could be expected to take part. Needless to repeat that lending by Islamic banks and mutual funds must **comply with the requirements of Islamic financial transactions**; namely, intermediating goods in transactions and including three independent parties in each.

### **7.3.b. Private sector owned water facilities.**

It is assumed that private sector **ownership of major water operations is allowed** and that government regulatory agencies are in place to protect consumers from potential price and quality exploitation by the private sector. Islamic banks basically provide short-term working capital facilities to water utilities. Islamic mutual funds may **participate in equity holding** in water works jointly with other shareholders or alone, as well as provide **fixed-rate medium and long-term loans**. In fact, equity ownership of water works provide a good opportunity to Islamic investors to invest in acceptable business that is relatively secure, provided that the return on investment is allowed by the government to be competitive with alternative investments. Since the creditworthiness of the water utility is the investor's sole protection from future loss, a full **analysis of the risk** involved should find the project acceptable before a loan, lease or equity transaction is concluded.

### **7.4. Islamic funds to support foreign water utility projects.**

Countries rich in US\$ reserves with a state of equilibrium in their balance of payments on foreign transactions allow their financial institutions to export capital in US\$. The Islamic financial organizations that are capable of investing and lending abroad are those of the Islamic crude oil exporting countries of the Arabian Peninsula. Their resources are denominated in either their own national currencies, which are in turn closely linked in value to the US\$, or in freely convertible foreign currencies to the US\$. The availability and terms of Islamic finance to water projects in foreign countries differs from the case of government owned projects to private sector owned projects.

**7.4.a. Islamic financing of foreign government owned projects.** Before committing to lend to a foreign government or a business entity owned by a foreign government Islamic financial organizations, like any other, would want to be satisfied that the **credit rating**, or alternatively their own credit analysis of the country to which the project belongs, is such that the central bank will **have the necessary US\$** to repay its obligations on the due date. Otherwise, private sector Islamic organizations would decline participation. IDB, on the other hand, being a development aid bank, would most likely be willing to help because its purpose and lending criteria are different from those of private sector organizations.

**7.4.b. Islamic financing of foreign private sector owned projects.** It is assumed that the **private sector is permitted** to own water utilities. Since the risk of a private sector business entity is born by the strength of its balance sheet, cash flow, profitability and management skills, all must be satisfactorily assessed before a transaction to provide equity or Islamic debt is concluded with a foreign Islamic organization. Additionally, cross border financing should expect that the value of the currency of the developing host country **would depreciate during the life of the transaction against the US\$**. This risk applies to both foreign equity and debt. Islamic banks provide basically short-term working capital facilities. Islamic mutual funds provide equity as well as medium/long-term loan and leasing facilities.

In developing countries, except the crude oil exporters, **foreign exchange control** laws require that foreign equity investors and lenders denominate their shareholdings and

loans to the private sector in the local currency. Foreign investors must purchase the local currency from the central bank at the exchange rate prevailing at the time of the transaction. As the value of the **local currency depreciates** against the US\$ between the time of making the investment and the time of repaying the loan or repatriating the equity the value of the local currency in terms of the US\$ would contract, thus **causing a US\$ loss** to the foreign Islamic financial organization. In order to avert such a loss, the Islamic entity would have to reach an agreement with the water utility to **indemnify it against any foreign exchange loss**, or alternatively from the host country's central to hold the value of the local currency against the US\$ constant for the duration of the investment.

## **8. Summary**

Islamic financial organizations **emerged some 25 years ago** in the aftermath of the October 1973 war between Israel and Egypt and Syria.

Islamic **scholars differ** on the legitimacy of dealing with interest-based commercial banks. Sheikh Tantawi, the Sheikh of Al Azhar University in Cairo, declared that bank interest is permissible. Others condemn all forms of dealing in interest as forbidden.

Islamic banks **do not pay interest on customer deposits**. Therefore, all Islamic deposits are kept on demand. Unit-holders of Islamic **mutual funds share in the profits and losses** of the fund. Islamic mutual funds are effectively a **substitute for bond markets**. Such facilities are important to those Islamic developing countries that have no bond markets. International banks and local Western style banks in Muslim countries have established **Islamic windows** to offer Islamic financial services.

Islamic return on assets should take the form of **trading profit, rent, dividend or capital gain** instead of interest. Islamic financial transactions must **intermediate commodities** or finished goods. They must involve **three independent parties**; namely, a supplier of goods, an Islamic bank (lender/financier) and a buyer (borrower/lessee) of goods.

**Adherence to these conditions varies** among Islamic financial organizations. There are four requirements for Islamic organizations to **establish credibility** in the Islamic community: **a)** Adhering to consistent and verifiable Islamic investment standards. **b)** Generating a competitive level of return. **c)** Applying prudent credit and investment policies and procedures. **d)** Central banks licensing, supervision and support as a lender of last resort.

What could **entice a traditional customer to deal with Islamic** financial organizations? Three inducements: **a)** Lower cost for Islamic funds. **b)** Longer fixed-rate tenor. **c)** Favourable accounting treatment.

Water projects, like any other project, require three types of funds: **Equity, long-term debt and short-term debt**. Islamic money sources meet these requirements adequately. Project equity and borrowing should be **denominated in the local currency** of the water project in order to **avert foreign exchange losses** to both shareholders and business ventures that usually result from the almost certain depreciation of the local currency against the US\$ during the life of the investment.

Islamic funds could support the development of water utility projects in the domestic market of the fund after satisfying the necessary conditions of credit analysis. However, on the other hand, Islamic finance could not be expected to reach high-risk developing countries in general, let alone the poorest ones, any more than conventional financial institutions could be expected to.

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