Islamic Banking Reputation Suffers In Wake Of Sept. 11

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ZURICH -- International efforts to uncover the money trail of terrorists who carried out the Sept. 11 attacks on the U.S. have cast a pall over Islamic banking.

The heightened scrutiny come as Islamic banking is already suffering from its investments in sagging technology and media shares and threatens to severely cripple the sector. Islamic bankers and supporters say the suspicions are unjustified and are unfairly sullying the reputation of a legitimate business area.

U.S. and European authorities have said repeatedly since Sept. 11 they believe Muslim banks based in the Middle East and North Africa moved money to fund the terrorist actions around the world - allegations the industry strenuously denies.

It's worth noting that - to date - no major Islamic bank has been conclusively linked to terrorists or terrorist activities. Several suspected of terrorist links are on lists issued by the U.S. government along with demands to bank regulators around the world to cease dealings with those banks.

Just the accusations leveled by high-profile politicians and government officials at Islamic banks since Sept. 11 could cripple an industry already on the rocks, the chairman of Saudi Arabia-based Dallah al Baraka said recently. Dallah al Baraka is a leading Islamic bank with $7 billion in assets under its control.

"This will affect Islamic banking and institutions in a bad way. If everyone talks about it they way they do in the media than it will scare investors away," said bank Chairman Saleh Abdullah Kamel.
The Misunderstandings Are Many

Islamic banking isn't any more prone to attract funds from terrorists than Western institutions, supporters say. It's just misunderstood, and for a number of reasons, misperceptions and suspicions are often reinforced.

Most Islamic banks are headquartered in the Middle East and North Africa, in places tied in recent years to Muslim militant activity or terrorism. As well, countries with all-Islamic banking systems, like Pakistan, Sudan and Iran, are known for banking regulations not up to international standards.

Also experts on money laundering say staff at Islamic banks may be tempted to ask fewer questions when an organization presents itself as a charity wants to open an account, thus bolstering a stereotype of lax customer screening.

"In every banking system there are ways on how to best override security mechanisms," said Mark Pieth, a Swiss expert on money-laundering and Professor of Criminal Law and Criminology at the University of Basel. "At a Swiss bank, you'd say the purpose of opening an account is tax evasion and you'll find sympathetic bankers, at an Islamic bank, saying you're representing a charity might work."

Still, Pieth considers it far from clear the al Qaeda terrorist network run by Osama bin Laden really channeled its funds through Islamic banks, saying funds would be better hidden using less obvious institutions. "It all depends on how professionally they are managing their finances."

In the wake of Sept. 11, banks and individuals quickly moved to distance themselves from bin Laden as the search commenced for him and his funds.

Sudan-based Al Shamal Islamic Bank took center stage in the investigations into the terrorist money trail, but the institution has denied allegations it's connected to the Saudi-born fundamentalist. Western banks scurried to sever their correspondent ties with Al Shamal.

U.S. authorities have also said they have information implicating Dallah Al-Baraka Group to transactions conducted by al Qaeda and other extremist groups. Dallah is a shareholder in Al-Shamal bank.

Kamel said no such links have been made about his bank.

"No allegations have been made by the U.S. authorities about Dallah and no government authority in the U.S. or here (Saudi Arabia) has called me with such allegations. All these allegations are blackening the name of banks and institutions that have no involvement," said Kamel.

Demystifying Islamic Banking
The essential feature of Islamic banking is that it is interest-free.

Islam prohibits Muslims from taking or giving interest, known as riba, regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged.

Still, the Islamic ban on interest doesn't mean that capital is costless in an Islamic system.

It recognizes capital as a factor of production, but it doesn't allow the factor to make a prior or predetermined claim on the productive surplus in the form of interest.

Instead of interest, Islamic banks tend to use profit-sharing products, known as Mudaraba. Here the money provider entrusts money to the managing trustee to spend in a manner that accords with Islamic law, known as shari'ah.

The money will later be returned at a pre-agreed profit. Islamic investment is mainly done through stocks, which don't issue dividends and are considered lawful, or halal.

If dividends from stocks are paid, they are often distributed by Islamic fund managers to charitable institutions.

Islamic investing can be riskier than conventional one because choices are limited. Certain types of stocks and commodities are excluded.

Investments in alcohol, pork, gambling and pornography are banned. But most Muslims would also object to investments in the financial services sector, because banks and insurers derive much of their income from interest. Law-abiding Muslims are also advised to stay away from food companies because there is often a pork component to their products.

Hence, the telecommunications and technology sectors have become popular with Islamic funds. But talk about bad timing: Many of those Islamic funds have been sustaining heavy losses since the telecoms and IT stock collapse.

The Arab Bank PLC says it closed its Islamic fund in May because it deemed it too risky in light of the deteriorating global economic condition.

Still, like many banks in the Middle East that aren't exclusively Islamic, the Arab Bank still provides other Islamic financial instruments like Murabaha, or cost-plus financing. Under this finance system, the bank buys goods that an importer or buyer wants and then sells it to him at an agreed mark up price.

Loyal Client Base Dating Back To 1970s

Against the religious background, clients tend to be loyal, which makes short-term financing of business activities a core strength of the
Islamic banking system.

In contrast, liquidity management is a challenge because the ban on interest rates prohibits securities repurchase agreements with central banks.

The boom in Islamic banking started with petrodollars in the 1970's. The growth in Islamic banking since, can be attributed in part to a reluctance on the part of Muslims to invest in companies whose activities are considered unethical or socially harmful.

"Islamic banking has gone through a meteoric rise in the past couple of years. I would expect that to continue growing as more Muslims are drawn by its principle," said a banking analyst at Japanese brokerage Nomura International. "There is a demand from Muslims who want to go back to Islamic principles. Some of these banks have been quite profitable."

There are over 250 Islamic institutions in some 50 countries that are managing funds worth over $200 billion, according to the London-based Institute of Islamic Banking and Insurance.

"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," the institution says.

Banking group HSBC is one of the largest international financial institutions with an Islamic banking division. It says demand for Islamic products has grown consistently over the past ten years. "Dollars were amassed, creating institutions in the Middle East to bring the money back in the community. Islamic banking offered an alternative that wasn't there before," said an HSBC official who works at the bank's Islamic division, Amanah Finance.

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