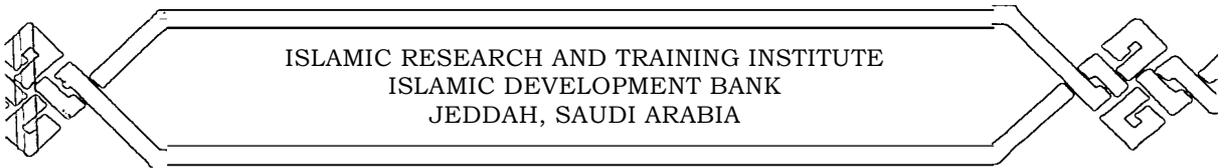




Research Paper No.35

**ASSESSMENT OF THE
PRACTICE OF ISLAMIC
FINANCIAL INSTRUMENTS :
THE CASE OF IDB **UNIT** INVESTMENT
FUND AND ISLAMIC BANKS
PORTFOLIO**



ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

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The Islamic Research and Training Institute was established by the Board of Executive Directors of the Islamic Development Bank (IDB) in 1401H (1981). The Executive Directors thus implemented Resolution No.BG/14-99 which the Board of Governors of IDB adopted at its Third Annual Meeting held on 10 Rabi Thani 1399H (14 March 1979). The Institute became operational in 1403H (1983).

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The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to shari'ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries.

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The functions of the Institute are:

- (A) To organize and coordinate basic and applied research with a view to developing models and methods for the application of *Shari'ah* in the field of economics, finance and banking;
- (B) To provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and shari'ah-observing agencies;
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PORTFOLIO**

BOUALEM BENDJILALI
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ISLAMIC RESEARCH AND TRAINING INSTITUTE
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In the name of Allah, The Beneficent, The Merciful

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FOREWORD

The present paper on *"Assessment of the Practice of Islamic Financial Instruments: The Case of IDB Unit Investment Fund and Islamic Banks' Portfolio"* analysing the Islamic financial instruments used by two important units of IDB is another contribution to the research objective of the Islamic Research and Training Institute (IRTI) which is to undertake studies for enabling the economic, financial and banking activities in the Muslim countries to conform to the Shari'ah. Research on Islamic modes of financing and Islamic financial instruments is a regular feature of the activities of the Islamic Research and Training Institute. This study is a part of this regular feature.

The study analyses the performance of the IDB Unit Investment Fund by investigating the existing patterns in the selection of the projects for funding, and identifying the different factors affecting it. The performance of the Islamic Banks' Portfolio Unit has been analyzed in terms of its income-asset structure. The economic features of the different Islamic financial instruments used simultaneously by the IDB Unit Investment Fund and the Islamic Banks' Portfolio Unit have been examined in detail.

M. Fahim Khan
Officer-in-Charge,IRTI

I. INTRODUCTION

Several theoretical studies have been undertaken by Islamic economists in the different fields of Islamic economics, Islamic banking etc. The theoretical models developed by these economists indicate that the Islamic financial system which depends crucially upon the financial instruments is superior to the conventional financial system in terms of equity stability and efficiency (see for example Mohsin Khan 1987). Hence, the application of the Islamic financial instruments should lead to rapid economic development.

On the other hand, little attention has been paid to the empirical study of the economic performance of the Islamic modes of financing. They are used by many emerging Islamic financial units such as Islamic banks, Islamic Investment Funds etc. It is crucial for the researchers as well as for the practitioners to know how these new units using these new financial instruments are performing.

Two important Islamic financial units, mainly the Islamic Development Bank Unit Investment Fund and the Islamic Banks' Portfolio merit to be studied. The Islamic Development Bank Unit Investment Fund collects resources from the institutional investors of the fund and uses them to finance developmental projects in OIC member countries on commercial basis. The Islamic Banks' Portfolio mobilizes the liquidity available with the Islamic banks, with the Islamic financial institutions, as well as the savings of individual investors and then channels them to finance the trade between Islamic countries. Among the objectives of these two units is the establishment of a secondary market.

The implementation of these policies is supposed to go through a dynamic process of selection of projects and countries using the appropriate and most suitable Islamic modes of financing which permit the optimization of their objective functions. In order to fully understand, the working of the selection process practiced by these two Islamic financial funds, it is important to categorize the various modes of financing into categories that may help interpreting the behavioral choice of the projects and countries. The ratification of a *Mudarabah* contract or a *Musharakah* contract between the provider of funds and a given national enterprise in a Muslim country depends

on certain factors such as the feasibility, the profitability of the project, etc. which themselves depend on the internal as well as the external socioeconomic factors. Hence, the selection process obeys to certain principles which are themselves affected by the various internal and external socioeconomic factors.

The present study on the '*Assessment of the Practice of Islamic Financial Instruments: The case of IDB Unit Investment Fund and The Islamic Banks' Portfolio Unit*' tries to assess the ability of the Islamic financial instruments used by these two units to achieve equity and efficiency. In addition the goal of this research is to identify the main socio-economic factors that affect the selection mechanism used by the two units.

The study is composed of six parts. Part two analyses the performance of the IDB Unit Investment Fund, by first giving a brief description of the Unit in question, then by investigating the existing patterns that may help in understanding the selection process of its projects and identifying the different factors affecting it. Part three studies the performance of the Islamic Banks' Portfolio Unit, by analyzing its income-asset structure. Part four examines the economic features of the different Islamic financial instruments used simultaneously by the IDB Unit Investment Fund and the Islamic Banks' Portfolio Unit. After analyzing the main characteristics of the diverse financial investments, this section investigates the most predominant internal and external socioeconomic factors affecting the project selection decision process of the management of these units. Part five raises some questions related to the problem of negotiability and to the *Shari'ah* that the Unit Investment Fund and the Islamic Banks' Portfolio are facing. Part six concludes the study.

**II. ANALYSIS OF THE PERFORMANCE OF THE IDB
UNIT INVESTMENT FUND**

II. ANALYSIS OF THE PERFORMANCE OF THE IDB UNIT INVESTMENT FUND

2.1. OBJECTIVE AND ROLE OF THE IDB UNIT INVESTMENT FUND

The main objective of the IDB Unit Investment Fund is to raise additional resources for the IDB through Islamic financial instruments. These resources are pooled from the institutional investors of the Fund and are used to finance developmental projects in member countries. The Fund has been established to operate on commercial basis providing investors with adequate returns from a carefully selected range of investments that compare favorably with earnings on Investment opportunities of similar nature.

The IDB manages the Fund as a Mudarib according to the regulations governing the Fund. The present unit holders of the Fund are the Bank and certain institutional and private investors. The IDB Unit Investment Fund contracts investments through Islamic modes of financing, and the payments due for these investments are in general counter guaranteed by the IDB. In addition, the Fund co-finances projects in member countries through leasing, installment sale, etc. At the same time, the Fund invests directly by extending financing to projects in member countries, and maintains an investment account with the IDB where the funds are utilized in the purchase and sale of goods by way of *Murabaha*. The rate of return on the Fund's investment in the investment account equals approximately the rate of return on IDB's liquid deposits with commercial banks for short-term *Murabaha* operations.

2.2. DESCRIPTIVE ANALYSIS OF THE FUND'S OPERATIONS

The Unit Investment Fund started its operations on January 1, 1990 with an initial subscription of US\$100 million. The Fund is divided into units that are sold to investors and are valued periodically. As a Mudarib, and as an underwriter, IDB acquired units of the Fund that remained unsold after the last date of subscription. In the first year of its operations, in 1990, the Fund acquired twelve leasing and installment sale contracts from the IDB Portfolio for a total amount of US\$113.335 million, which equals to 113% of the initial issue of the Fund. This increase was made possible by reinvesting the

installments repaid on the contracts acquired during the same year. The Fund earned during this year an income of US\$16.8 million, where 41% was realized from the appreciation of the Islamic Dinar (ID) against the US Dollar.

During 1991 only three lease and one installment sale contracts were acquired from the IDB portfolio for a total amount of US\$26.158 million. The income earned from assets acquired from the IDB amounted to US\$ 9.593 million. The Fund started in 1991 to make direct investments in projects identified by the Fund as well as to co-finance projects jointly with the IDB. Four projects were planned to be undertaken - one of them in the form of co-financing, and three in the form of direct financing. However, only three projects were realized during 1991, one project in the form of direct financing has been postponed to 1992.

During 1992 only two projects were selected from the IDB Portfolio by the Fund for a value of US\$33.07 million which earned an income of US\$9,835,000, that is, an increase of 26.5% over 1991. The Fund continued to make direct financing as well as co-financing. The IDB Unit investment fund extended financing to four different projects, two in the form of direct financing and two in the form of co-financing, for an amount of US\$22.350 million.

Since its inception, the IDB Unit Investment Fund has maintained an investment account with the Islamic Development Bank (IDB) and has participated continuously in investing with other Islamic Banks. The amount invested with the IDB investment account increased from US\$8.307 million as at the end of 1990, to US\$20.347 as at the end of 1991 and then decreased to US\$18.036 million as at the end of 1992. The income generated by these operations which are generally short-term *Murabaha* operations during the successive three years are respectively US\$458,000 in 1990, US\$2,247,000 in 1991 and US\$393,000 in 1992. A sharp decrease is observed in the year 1992. In addition, the Fund participated in leasing and *Murabaha* operation with Al-Baraka Turkish Finance House and Kuwait Finance House in 1991 and 1992. The Fund earned successively an income of US\$1.530 million in 1991 and US\$1.549 million in 1992.

The number of projects acquired and approved, during 1990-1992 by the Unit Investment Fund for each type of financing are shown in Chart 1 given below. From this chart we can easily detect that the total number of projects undertaken by the Unit Investment Fund has decreased over time from 12 projects in 1990, to 7 projects in 1991 and then to 6 projects in 1992. At the same time the number of projects acquired by the Fund from TDB portfolio has also decreased respectively from 12 in 1990 to 4 in 1991 and then to 2 in 1992. We notice also that the Fund has diversified the type of financing over the years, which may mean that either the Fund was obliged to look for some other type of financing given that the number of projects in the hand of the TDB portfolio are not sufficient or are not all of market profitability; or the policy of the Fund was to take more risk in investing in direct financing and co-financing projects in OIC member countries or both. This is one explanation that could be given of the evolution over time of the number of projects in terms of type of financing undertaken by the Unit Investment Fund, and shown below by Table 1 and Chart 1.

TABLE 1

PATTERN OF YEARLY APPROVAL OF PROFILE OF CONTRACTS ACQUIRED BY 'THE IDB UNIT INVESTMENT FUND FROM THE IDB PORTFOLIO

in million US\$

Year	Number of Approvals				Amount Allocated	
	L	IS	Total	Cumulative	Leasing	Installment Sales
1990	9	3	12	12	74.472	18.818
1991	3	1		16	16.704	9.454
1992	1	1	2	18	20.311	12.761
Total						

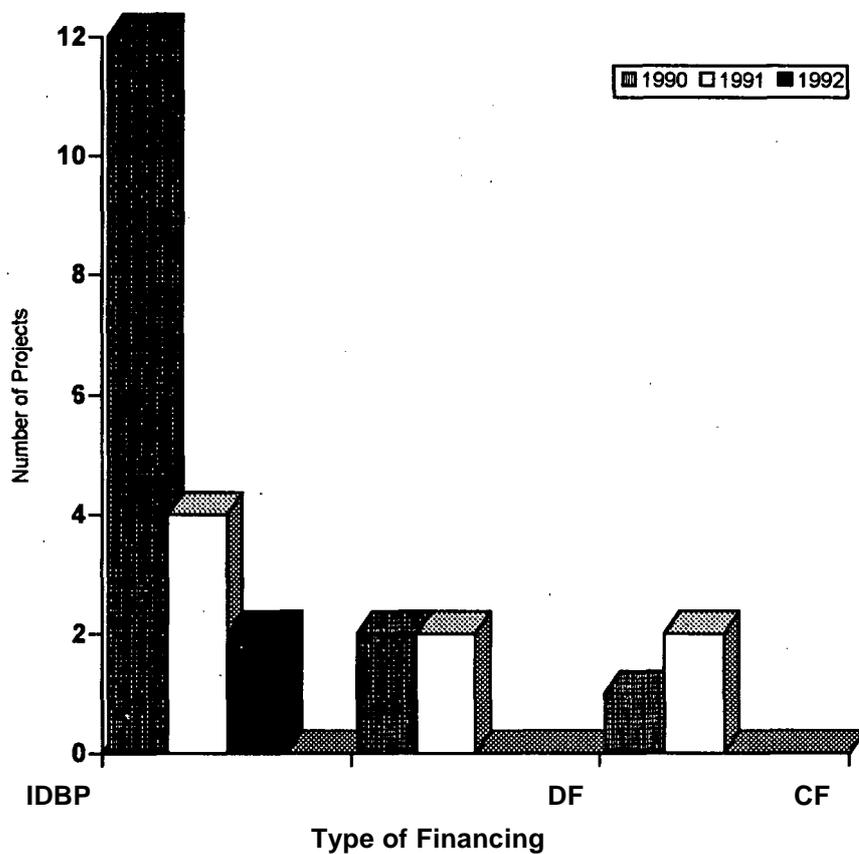
Source: IDB Unit Investment Fund Annual Reports.

Where L: Leasing

IS: Installment Sale

CHART 1

COMPOSITION OF IDB UNIT INVESTMENT .
FUND FINANCING .



Where IDBP stands for the total number of projects acquired by the Unit Investment Fund from the IDB Portfolio. DF and CF respectively for direct financing and co-financing.

Over the three year period (1990-1992), 18 projects were selected and approved by the Fund from the IDB Portfolio through only two modes, leasing and installment sale. Thirteen out of eighteen were financed via leasing, which corresponds in terms of percentage to 72%, thus the investment policy of the Fund preferred leasing and installment sale over the other available Islamic modes of financing such as *Mudarabah*, *Musharaka* etc. In addition, the Fund preferred the leasing mode over the installment sale mode. The total amount approved by the Fund for these projects amounted to US\$ 152.54 million. A net decrease is observed over time. In terms of percentage, 61% of the total amount was invested in the first year, 17% in the second year and 22% in the third year.

The highest number of projects (12) were financed in the first year of the operation of the Fund. The smallest number of projects selected from the IDB Portfolio equals only to 2 projects, one in the form of leasing and the other in the form of installment sale. This decrease in the number of projects chosen from the IDB Portfolio by the IDB Unit Investment Fund might be interpreted in two ways. First, the Fund has obtained enough experience from the past and is now able to compete, therefore, can select its projects from various sources including the IDB Portfolio without the advice and help of others. Second, the projects in the hand of the IDB Portfolio are not enough in terms of numbers as well as in terms of profitability and, hence, the Fund has to look for other sources from where it can select profitable investment projects. It seems that the second explanation is the more likely one because it is too difficult to get that high experience in a one year period.

Viewed in terms of risk, the policy of the Fund seems to be a precautionary one since leasing and installment sale are the most used ones. Moreover, it is well known that the risk attached to these two modes is among the lowest ones compared to the risk attached to the other Islamic modes of financing, such as *Mudharabah*, *Musharakah*, etc.

TABLE 2

**PATTERN OF YEARLY APPROVAL OF PROFILE OF
CONTRACTS ACQUIRED BY THE IDB UNIT INVESTMENT FUND
IN THE FORM OF CO-FINANCING AND
DIRECT FINANCING**

in million US \$

Year	Number			Amount			
	L	IS	Total	Cumulative	Allocated to L	Allocated to IS	Total
1990	-	-	-	-	-	-	-
1991	1	2	3	3	8.56	3.8	12.36
1992	1	3	4	7	8.0	14.35	22.35
Total	2	5	7	14	16.56	18.15	34.71

Source: IDB Unit Investment Fund Annual Reports

Table 2 shows the pattern of yearly approval of contracts acquired by the IDB Unit Investment Fund in the form of co-financing and direct financing. The Fund started to directly finance and co-finance projects in OIC member countries in 1991 with a total of three projects; one in the form of leasing the two others in the form of installment sale. In 1991, the total amount allocated for these three projects amounted to US\$12.36 million, i.e., US\$8.56 million (i.e., 69%) for leasing and US\$ 3.8 million (i.e. 31%) for installment sale.

In 1992, the total number of projects contracted by the Fund in the form of co-financing and direct financed amounted to four (4). Three of these projects were contracted in the form of installment sale and only one in the form of leasing. The Fund has focused more on installment sale until now when dealing with direct financing and co-financing. The total amount allocated to these four projects equals to US\$22.35 millions. Out of this amount, US\$14.35 millions i.e. 64% were allocated to Projects financed in the form of installment sale. Over the two years period, a total amount of US\$34.71 million was dedicated to direct financing and co-financing. The total number of projects undertaken in this respect amounted to 7 projects, with 5 projects financed via installment sale and two (2) only via leasing. That is, 71% of the projects were financed in the form of installment sale. The

amount of money allocated to installment sale equals to US\$18.15 million corresponding to 52% of the total amount. From the number of projects point of view, it appears that the installment sale surpassed leasing. The same holds true from the money allocation point of view as shown by the figures given in Table 2. This results purely from the availability of investment opportunities since the Fund, as a matter of policy prefers leasing assets to the other forms of investment. It is also clear from Table 2, that the Fund is seeking more diversification for its investment policy using different channels of financing (direct financing and co-financing).

TABLE 3

PATTERN OF YEARLY CONTRACTS ACQUIRED BY THE IDB UNIT INVESTMENT FUND WITH ISLAMIC BANKS

(in million US \$)

Year	Number of Contracts	Cumulative No.	Total Amount Allocated	Cumulative
1990	3	3	19.107	19.107
1991	4	7	27.847	46.944
1992	4	11	26.036	72.980

Source: Calculated from IDB Unit Investment Fund Annual Reports.

Table 3 shows the contracts that have been contracted between the IDB Unit Investment Fund and the other Islamic Banks including IDB. Eleven contracts have been realized over the three years period with a total of US\$72.98 million. A net increase of 46% is observed from 1990 to 1991.

Table 4 below gives the details in terms of names of institutions and the exact amount deposited by the Fund with every institution in question. It is worth noticing that the Investment Account with IDB has taken the largest amount over the three years with respectively, US\$8.307 million US\$20.347 million and US\$18.036 million. The amount invested in Al-Baraka International Bank has decreased tremendously over the three years from US\$8.8 million in 1990 to US\$3.2 million in 1991 to US\$1.9 million in 1992.

TABLE 4

**. PROFILE OF YEARLY PARTICIPATION OF THE
FUND WITH THE ISLAMIC BANKS**

(in million US\$)		
Year	Name of the Islamic Banks	Amount Invested
1990	Al Baraka International Bank	8.8
	Investment Acct with IDB	8.307
	Kuwait Finance House	2.0
1991	Al Baraka International Bank	3.2
	Al Baraka Turkish Finance House	2.0
	Kuwait Finance House Investment	2.3
	Acct with IDB	20.347
1992	Al Baraka International Bank	1.9
	Al Baraka Turkish Finance House	2.2
	Kuwait Finance House Investment	3.9
	Acct with IDB	18.036
Total:		72.29

Source: IDB Unit Investment Fund Annual Reports

TABLE 5

**PROFILE OF CONTRACTS ACQUIRED BY THE IDB UNIT
INVESTMENT FUND IN 1990 FROM THE IDB PORTFOLIO**

(in thousand US\$)					
No.	Country	Name of the Company	Duration (Year)	Type of Contract	Amount Allocate
	Bangladesh	Bangladesh Shipping Corpn.	7	L	3600
2	Bangladesh	Bangladesh Shipping Corpn.	7	L	3566
3	Bangladesh	Chittagong Urea Fertr. Ltd.	10	L	18808
4	Jordan	Arab Potash Company	8.5	IS	7137
5	Oman	Sohar Buraimi Power Development Project	8	L	5236
6	Oman	Gas System Project	8	L	5689
7	Pakistan	National Refinery Ltd.	9	L	7617
8	Pakistan	General Tyre & Rubber Co.	8	L	15169
9	Turkey	Turk Motor Sanagi Vie Ticaret	8.5	L	5500
10		Petlas Tyre Company	8	L	9307
11		Izmir Demir Celik Samay	6.5	IS	6954
12	Tunisia	Compagnie Tunisienne de Forage	6	IS	4727

Source: IDB Unit Investment Fund Annual Reports

TABLE 6

**PROFILE OF IDB CONTRACTS ACQUIRED BY THE
FUND FROM THE IDB PORTFOLIO IN 1991**

No.	Country	Name of the Company	Duration in years	Type of Contract	Amount Allocated
1	Algeria	ENIEM		IS	1800
2	Jordan	Ministry of Planning	10	L	9879
3	Morocco	Compagnie Marocaine de Navigation	8	IS	9454
4	Pakistan	National Fibers Ltd.		L	8560
5	Tunisia	Societe de Fonderie et de Mecanique	5.5	L	2391
6.	Tunisia	SITER (Societe des Industries Textiles)		L	4464
7	Tunisia	STIP		IS	2000

Source: IDB Unit Investment Fund Annual Reports

Table 5 above shows the profile of contracts acquired by the IDB Unit Investment Fund during the year 1990. All contracts have been selected from the IDB Portfolio. No co-financing and no direct financing were undertaken during this year. Out of 12 contracts, 9 are in the form of leasing and three in the form of installment sale. The average duration of these contracts is 7 years and 10 months. 6 countries out of 46 OIC member countries have benefited from these contracts. Bangladesh and Turkey have obtained three contracts each with respectively a total amount of US\$25.974 million and US\$21.761 million. Pakistan and Oman came after in terms of number of projects with two projects each and respectively with a total amount of US\$10.925 million and US\$22.786 million. Lastly, Jordan and Tunisia obtained one project each with respectively an amount of US\$7.137 million and US\$4.727 million.

Table 6 above gives the profile of contracts acquired by the IDB Unit Investment Fund during the second year 1991. Seven projects were acquired during this year which are distributed as follows: Three out of seven in the form of installment sale and the remaining four in the form of leasing. The number of projects in the form of leasing has decreased in terms of percentage, from 75% (9/12) to 57% (4/7) in one year. In its second year 5 countries have benefited from the Fund. Tunisia has obtained three contracts for a total

amount of US\$8.855 million. The rest of the contracts has been distributed among the 4 other countries as shown by Table 6. However, even though Tunisia comes first in terms of number of projects, it is classified second in terms of money after Jordan and Morocco which obtained respectively US\$9.879 million and US\$9.454 million.

TABLE 7

**PROFILE OF PROJECTS FINANCED BY THE
FUND IN 1992**

NO.	Country	Name of the Company	Duration in Years	in thousand US\$	
				Type of Contract	Amount Allocated
1	Algeria	CNAN (Compagnie Nationale Algerienne de Navigation)	10	IS	12761
2.	Algeria	Sonelgaz		IS ,	6000
3.	Bahrain	Electricity Authority	10	L	20311
4.	Iran	Saveh White Cement Company		IS (DF)	6350
5	Pakistan	Al-Noor Fertilizer Company		L (CF)	8000
6	Tunisia	STIP (Societe Tunisienne des Industries Pneumatiques)		IS (DF)	2000

Source: IDB Unit Investment Fund Annual Reports where DF and CF mean respectively direct financing and co-financing.

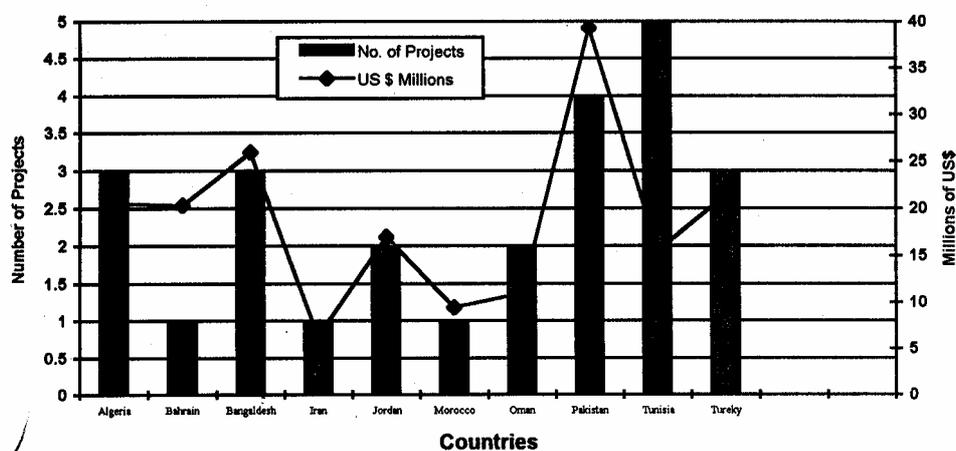
Table 7 above shows the profile of projects contracted by the IDB Unit Investment Fund during the year 1992. Six projects were undertaken by the Fund either in direct financing or co-financing using one of the following two modes, leasing or installment sale. Five countries have benefited from these six investment projects with the following distribution, 2 projects for Algeria and one project each, for the remaining 4 countries as described in Table 6. In terms of amount of capital allocated per country we found that Bahrain comes first with US\$20.311 million, then Algeria with US\$18.761 million then Pakistan with US\$8 million. It is clear that even though, Algeria comes first in terms of number of projects financed in 1992, it is classified second in terms of capital allocated per country.

Over the three years period, a total number of 25 projects have been financed by the IDB Unit Investment Fund. However, only 10 countries out of 48 OIC member countries have benefited from the investment of the IDB Unit Investment Fund. Chart 2 below shows the distribution of projects undertaken by the IDB Unit Investment Fund in the different OIC member countries. From this chart Tunisia comes first in terms of number of projects with 5 projects, then Pakistan with 4 projects then Turkey, Algeria and Bangladesh with 3 projects each, then come Jordan and Oman with 2 projects and lastly Bahrain, Iran and Morocco with one project each. In terms of money allocated, Pakistan comes first with US\$39.346, then Bangladesh and Turkey with US\$25.974 and US\$21.361 respectively then Algeria and Bahrain with US\$20,561 and US\$20.311 respectively then the rest of the countries as shown in Table 7.1 and Chart No. 2.

TABLE 7:1
ALLOCATION OF FUNDS AND PROJECTS

Country	No. of Projects	(in million US\$)
		Amount
Algeria	3	20.561
Bahrain	1	20.311
Bangladesh	3	25.974
Iran	1	6.350
Jordan	2	17.016
Morocco	1	9.454
Oman	2	10.925
Pakistan	4	39.346
Tunisia	5	15.582
Turkey	3	21.361

CHART 2
**ALLOCATION OF FUNDS AND PROJECTS FROM IDB
UNIT INVESTMENT FUND**



It is clear from these figures that the amount of capital invested in each country is not proportionately related to the number of projects acquired in that same country. Furthermore, the Unit Investment Fund has financed three projects in Bangladesh classified by IDB among the poorest countries, with an amount equivalent approximately to US\$26 million.

2.3. ON THE INCOME STRUCTURE OF THE IDB UNIT INVESTMENT FUND: THE DIVIDEND POLICY APPROACH

In this section, we shall look at the income structure of the IDB Unit Investment Fund over its first three years of existence. A number of variables are considered such as total income, distributed income to unit holders, proposed dividends, Mudarib share, total asset, dividend payout ratio etc. The analysis of the evolution over time of these variables and their interrelationships might indicate the necessary measures to be taken by the policy makers to optimize their objective function. For instance, it is well known that one of the main concerns of the management is the maximization of the shareholders' wealth which can be increased through either dividends or

capital gains. Thus, the management needs to know how to evaluate the effect of its dividends policy on shareholders' wealth. In case the Fund pays an extra cash dividend to its shareholder, it must raise new capital if it still wants to take on investments. But, since borrowing is precluded, the Fund sells new shares after paying the extra dividend to its existing shareholders to finance its increased dividends. But the value of the Fund will not change since it depends on the return provided by the Fund's assets, the investments have already been chosen and no more borrowing can be done. If the total value of the Fund is not changing and the new shareholders buy shares the old shareholders must suffer a loss of wealth equal to the part of the Fund's value that belongs to the new shareholders since the total value remained the same. But if the new shareholders paid a fair price for their shares, the value of their equity must equal the extra dividends paid to the old owners. Thus the old shareholders suffer a capital loss exactly equal to the dividends they have received and their total wealth remains unchanged. After the extra dividends have been paid, the old shareholders own the same number of shares, each worth less than before. In the case the Fund plans to reduce dividends, the reduction in dividends must be matched by a reduction in the number of shares to be issued or by a repurchase of existing shares. By repurchasing shares, the Fund decreases the number of shares outstanding, and since the total value of the Fund is unchanged, each share is worth more. As far as the shareholder is concerned, the reduction in dividends is matched by an increase in the value of his share, and therefore, the repurchase has no impact on his wealth.

We have argued that an increase or a decrease in dividends has no effect on the shareholder wealth. This conclusion has been drawn on the assumption of perfect and efficient markets. However, the real world has several imperfections. In this regard, floatation costs - the costs associated with issuing a new security - make retained earnings more attractive to the Fund than a new share issue. If dividends and new equity are essentially the same, it does not make economic sense to pay out dividends and then to replace the lost funds with more costly new equity. Hence, floatation costs tend in general to favor lower dividend payments. On the other hand, whenever an investor sells or buys a financial asset, he incurs transactions costs. If this investor would like to invest in another stock issued by another institution, he will prefer higher dividends on his current share to meet the transactions costs. With higher dividends, the sale of the share may become unnecessary and the investor may avoid the transactions costs entirely. This

shareholder will, therefore, prefer that the Fund pay higher dividends. However, this in no means favor higher dividend policy. There may be, another shareholder who may want to increase his capital gains instead. For such an investor, the Fund's dividend payment may not be attractive to him since the dividends paid to him have to be reinvested in buying other financial assets. Because of transaction costs, such a shareholder is forced to incur additional expenses. On the other hand, if the Fund retained the dividend and invests it on behalf of the shareholder this latter may receive an eventual capital gain without incurring additional transaction costs. Thus, given the different preferences among the shareholders of the Fund for dividends and capital gains, investors with preferences for current income will favor a high dividend payout ratios, while the shareholders who prefer capital gains will favor a low dividend payout ratios. It is then in the interest of the Fund to maintain a stable and predictable dividend policy, because a sudden change in the policy will cause some rearrangement in the Fund's ownership.

In addition to some factors, such as inflation can also affect the Fund's dividend policy. For instance, during periods of inflation, the funds generated from depreciation may be insufficient to replace outdated equipments. The cost of replacement may be so high that the acquisition of new equipments may require a high influx of capital. Therefore, during inflation, the management of the Unit Investment Fund may plan to reduce its dividend payout ratios to ensure that it has sufficient amount of internally generated funds to finance the new equipments or even an expansion of the project.

Unfortunately, there is no clear cut formula for setting such a dividend policy. Part of the problem is of course related to the link between dividends and the Fund's value which is not clear and depend on many internal and external favors. Moreover, even if dividends affect the Fund's value, the management needs to know exactly how dividends affect the total value in order to increase the shareholder's wealth:

Looking at Table 8 below, which represents the general income structure of the IDB Unit Investment Fund, we notice a net decrease in the proposed dividends given in column seven over the three years. Consequently, retained earning has increased as indicated by column 8 of Table 8. On the other hand, even though, the total assets of the IDB Unit Investment Fund has almost doubled in this period, total income ,as indicated in column 2 has decreased over that same period. From this first observation, we can deduce

the existence of an inverse relationship between the two internal variables, namely the total asset and the net or total income.

The last column of Table 8 shows the evolution over time of the dividend payout ratios. It is clear from the figures given in that column that the trend is increasing which may indicate for the present time a stable dividend policy. However, given the short time series in question, it is difficult and too early to draw any predictable conclusion for the dividend policy of the IDB Unit Investment Fund. But, as a temporary rule of thumb, this might indicate a high dividend payout ratios which will attract new shareholders with preferences for current income.

Column 9 of Table 8 represents the Mudarib share. The figures given in this column show a net decrease over the three years. Its share decreased by almost half in two years. The trends of the Mudarib share and of the shareholders are both decreasing as shown by the figures given in Table 8. This is expected since the interests of the Mudarib and of the shareholders are positively linked through *Mudaraba*.

TABLE 8
ASSET - INCOME STRUCTURE (1990-1992)

In million US\$

Year	TI	Income From L+IS	D.I.	T.E.	N.L	P.D.	R.E.	Mud Share	T.P. A.	T.A.	N.A.	D.P. R. (%)
1990	16925	9168	15021	152	16773	10000	-	1677	755	115126	105096	60
1991	13429	9523	15727	112	13317	8000	4341	1332	599	117107	109081	60
1992	9710	9835	14942	1042	8668	7000	7727	867	586	201190	109882	80

Source: Computed from IDB Unit Investment Fund Annual Reports

Where the variables are defined as follows:

$$\text{D.P. R.} = \text{Dividend pay out ratio} = \frac{\text{Dividend paid}}{\text{Net income NI}} = \frac{\text{PD}}{\text{NI}}$$

T. I.	= Total income
D. I.	= Distributed income to unit holder (without the Mudarib share and without the amount transferred to the preservation account $= NI+RE -MS - TPA$)
L	= Leasing
I.S.	= Installment sale
NA.	= Net assets
T. E.	= Total expenditure
N. I.	= Net income which equals T. I. minus T.E.
P. D.	= Proposed dividends
R. E.	= Retained earnings at end of the year
M. S.	= Mudarib share of net income
T.P.A.	= Transfer to capital preservation account
T. A.	= Total asset

Source: IDB Unit Investment Fund Annual Reports.

In this second part of the study, a thorough descriptive analysis of the IDB Unit Investment Fund has been done using elementary statistics, with some' graphs, in. addition to the definition of the objective and role of the Fund. Moreover, the income structure of the IDB Unit Investment Fund has been investigated from the dividend policy approach point of view. In the next part, the same analysis on the performance of the Islamic Banks' Portfolio will be undertaken.

III. ANALYSIS OF THE PERFORMANCE OF THE ISLAMIC BANKS' PORTFOLIO

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3.1. OBJECTIVE AND ROLE OF THE ISLAMIC BANKS' PORTFOLIO

It has been experienced during the recent years a drop in the trade earnings of many OIC member countries. The arguments advanced are of two natures. The first argument advanced is the application of protectionist policies and measures by the developed countries against exports of developing countries and in particular the OIC member countries. The second one is the net decrease in the availability of credit facilities to meet the growing needs of the exporters of OIC member countries.

In addition to this, many opportunities exist for intra-trade between the OIC member countries which can be exploited to enhance trade flows between them. Given the right incentives and access to the appropriate facilities, the Islamic Banks' Portfolio for investment and development (IBP), which has the participation of a number of Islamic banks and Islamic financial institutions was launched in May 1986, to finance the foreign trade on the basis of Islamic modes of financing such as *Murabaha*, leasing etc. provided that at least one of the financing parties, the exporter or the importer must be an OIC member country and to establish a secondary market for its certificates. The currency .. used in the financing *of trade transactions is the US dollar with an IBP financing period not exceeding 18 months depending on the nature of the commodity traded. The Islamic Development Bank (IDB) manages the operations of the portfolio as *a Mudarib* according to the regulations of the portfolio and the decision of the "participants committee". The portfolio uses its own material and human facilities as well as the outside assistance of experts in Islamic *Shari 'ah* in securities .market and in other relevant technical and financial fields in the management. The resources of the portfolio are mainly oriented to exporters and importers within the private sector in OIC member Countries as defined in the Memorandum of Understanding signed by the "participant committee" which states:

*"The objective of the portfolio is to mobilize the liquidity available with the Islamic banks and financial institutions and the savings of individual investors and to channel them for financing trade of Islamic countries. The IBP shall also contribute to the development of Islamic financial instruments in the form of **negotiable certificates** which would provide their owners with a liquidity element and enable participating Islamic banks and financial institutions to exchange liquidity so as to set up the nucleus of the Islamic financial market".*

Having defined the objective, the role and the mechanism in a very brief manner we shall concentrate next on the performance of the portfolio for the period 1409H-1413H.

3.2. ON THE PERFORMANCE OF 'THE IBP

The number of operations implemented and the actual amount financed over the year might be taken as figures indicating the development of real performance of the IBP and its role in the economic development of the Islamic countries. Other parameters such as profitability, ability to arrange and manage syndications ability to mobilize resources, progress towards satisfying the *Shari'ah* requirements might also be considered to evaluate the IBP's performance. Table 3.1 below shows that there does not exist a given pattern of the number of operations approved by the management of the Islamic Banks' Portfolio over the first 5 years of its existence. The number of operations approved decreased from 19 to 6 in the first two years then, increased to 13 then to 22 and finally decreased to 9 over the three following years. The number of operations implemented is far distant from the number of operations approved in the first three years. However, a net improvement is noticed in the two last years. The trend of the actual amount financed allocated for these operations has been increasing as shown by column 5 of Table 3.1.

TABLE 3.1

Year	No. of Operations approved	Amount approved (million in US\$)	No. of Operations implemented	Actual Amount financed in US\$ millions	Amount (US\$ in million) left unused by the projects	Aprx of the unutilized balance of the approved	Ratio of unutilized balance over approved amount
1408H	19	61.8	5	27	34.8	82650	0.13
1409H	6	10.5	4	8.5	2	127000	1.2
1410H	13	55.9	6	34.5	21.48	255992	0.46
1411H	22	126.9	18	116.4	10.5	'47396	0.037
1412H	9	226.86	8	222.75	4.11	94788	0.04

Source: IBP Annual Reports.

The actual amount financed in \$ US millions passed from 27 millions in 1408H to 116.4 millions in 1411H to 222.75 \$ US millions in 1412H. In other words, the initial amount (amount corresponding to year 1408H) has been multiplied by 431% in 1411H and by 825% in 1412H. The actual amount financed in 1411H has increased by 191.4% in 1412H. Consequently, Column 7 of Table 3.1 shows a net decrease over the years in the amount left unused even though, the actual amount financed has tremendously increased. Column 8 shows the trend of ratios of the estimated unutilized balance of amount approved over the approved amount in each year. In the first year of its operation this ratio equals to 0.13%; which means that for each 100 dollars approved approximately 13 cents were unutilized. This ratio passed to 1.2% in 1409H and then decreased over the subsequent years to reach an average of 4 cents for each 100 dollars approved (see Tables 3.2, 3.3, 3.4 and 3.5 in the appendix for more detail).

The increasing actual amount financed over the years of the various operations is one of the signs of success. Column 5 of Table 3.1 below shows this tremendous increase. The IBP started with an actual amount of US\$27 millions in 1408H to reach an actual amount financed of US\$222.75 million in 1412H. In other words, the initial amount has been multiplied by 825% in 5 years.

TABLE 12
INCOME STRUCTURE

No....		1 4 0 8 H	1 4 0 9 H1410H....	1 4 1 1 H.	1 4 1 2 H
1.	Income from Investment in short term trade operations	3009635	5017628	3100574	2764252	1704385
2.	Income from <i>Murabaha</i> operations	515438	704332	2592835	2554027	3443839
3.	Expenses	46740	18745	29393	22841	43052
4.	Net Return before allocating the Mudarib share	3478333	5703215	5664016	5295436	5105172
5.	The Mudarib share	173918	247926	202588	311254	236944
6.	Net Profit (Return)	3304416	5455289	5461428	4984182	4868228
7.	Retained Income at the beginning of the Period	-	3130499	5170128	2381751	1498567
8.	Reserve	173917	285161	283201	264772	255259
9.	Dividend (Distributed Profits)	-	3130499	4425425 (+3683825)	5602594	-
10.	Retained Income at the end of the Period	3130499	51701218	2381751	1498567	6111536
11.	Total capital employed in \$ US Million	50	65	65	70	74
12.	Net return - capital employed ratio	6.96%	8.77%	8.7%	7.55%	6.89%
13.	Dividend payment ratio	0	55%	78%	106%	0

Source: Calculated from IBP Annual reports.

Looking at Table 3.2 which represents the Income Structure of the IBP over the first five years, we see that the net profit or net return increases over the three first years reaches its peak in 1410H, and decreases over the rest of the period. The net return - capital employed ratio shown in line number 12 of Table 3.6 increases over the two first years and then decreases over the rest of the period. This can be explained by the negative trend in the income generated from *Murabaha* operations as well as the income generated from investment in short term trade' operations. This decrease in the net profits might also be due to the decrease in LIBOR which is used as a bench mark. This is also illustrated by the decrease in the net return over the last three years as shown in Row 4 of the Income-Structure in Table 3.6. Row 13 of Table 3.6 gives the dividend payout ratio which is defined as the ratio of

dividends over net return. It is clear from the figures that there is no particular pattern to the dividend payout ratio time series. Particularly, the time series representing the dividend payout ratios given by column 13 in Table 3.1 increased over the first four years and then decreased drastically in the last year. This series as shown by Table 3.1 is far of being stable. This difference in dividends is also due to the policy change in accounting from an accrual base to a cash base. The instability of the series of the dividend payout ratios of the Islamic Banks' Portfolio will be a disadvantage for the management, since as we have argued in section 2.3 a high dividend payout ratio will attract investors with preference for current income while a low dividend payout ratio will attract investors with preference for capital gain. Consequently, such an instable dividend policy will cause some rearrangement in the decision of the shareholders which may cause an outflow of investors towards financial institutions which possess a more stable dividend policy. Thus, maintaining a stable and predictable dividend policy will attract either clientele with preference for current income or a clientele which prefers capital gain. It is therefore, in the interest of the management of the Islamic Banks' Portfolio to publicize a stable and predictable dividend policy.

In this third part, the study has first defined the objective and role of the Islamic Banks' Portfolio, then an analysis has been done on the performance of the IBP through its five first years of its existence.

**IV. CATEGORIZATION OF THE MAIN
ISLAMIC FINANCIAL INSTRUMENTS
USED BY THE UIF AND IBP**

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4.1. THE MAIN MODES AND THEIR CHARACTERISTICS

The empirical analysis of the UIF and IBP in the previous section resulted in the following:

1. Among the set of Islamic financial modes only *Murabaha*, Leasing and Installment sale have been used intensively.
2. A number of OIC member countries have benefited from the investment policy of the two units in the few years of their existence. Bangladesh classified among the poorest countries has benefited approximately 12% of the total number of projects approved.

It is therefore natural to study the economic motives that are behind the choice of this particular category of modes as well as their interrelationship with the objective function of the two units in question. In other words, this section will attempt at studying the economic advantages and disadvantages of this group of financial modes in comparison with the other group which comprises *Musharaka*, *Mudaraba* etc. among others.

In addition, this section will determine the different economic variables that have an influence on the choice of the country in which the UIF and IBP invest. Before developing these two points, we shall give a brief description of the main Islamic modes used by the 1DB Unit Investment Fund and the Islamic Banks' Portfolio.

4.1.1. *Murabaha*

This technique is now very standard in Islamic financial transactions. It is a sale and purchase contract which satisfies the requirements of several types of financing, such as the financing of consumer durable, short term trade financing etc. In *Murabaha* also called cost plus sale on mark-up based financing, the seller informs the buyer of his cost of acquiring a product and

and the seller. The seller who is the finance provider in this type of contract has the full control over the use of his funds. The profit margin or mark-up can be justified by the risk that the finance provider is bearing; even though it is minimum, (See Khan 1991). On the other hand, the buyer should give the specifications of the goods to the seller. He must have access to the information about the price, the nature and the availability of the product in the market. In *Murabaha* (mark-up) the finance provider takes advantage from the difference of prices (immediate and deferred price) of the product. It should, however, be made clear that the final return to the seller is random and inferior to the mark-up price because of the element of risk borne by the finance provider while the product is in his possession. Thus, the risk is present and is positively related (proportional) to the possession time of the merchandise in the hands of the seller. The *fiqhi* legitimacy is based on the fact that the financier has owned the merchandise for at least some period of time and hence bearing risk and uncertainty. Therefore, the return to the seller is justified on two grounds, ownership and risk in accordance with the principle of Al-Kharaj bil al-daman (see: Kalif and Tariqullah 1992).

Murabaha has become a very popular financing technique among Islamic • banks and has many applications such as application of *Murabaha* to letter of credit to the purchase of land, buildings etc. as practiced by the Jordan Islamic Bank. For more details on this point (See: Ahmad 1993).

4.1.2. Deferred - Payment Sale (*Bai-Muajal*)

This mode allows the sale of a certain commodity on the basis of deferred payment in installments or in a lump-sum payments. The seller agrees to sell the product at a specific price to be paid at a specific date. The price of the good is subject to negotiation between the two parties, the buyer and the seller and is fixed at the time of the sale. The price charged by, the seller comprises two components:

1. the actual cost of the commodity to the seller; and
2. the , seller's margin of profit which varies according to the value and type of the commodity.

This type of contract makes provisions for the immediate delivery of the goods while permitting the postponing of the payment. The payment

becomes a debt to be paid at a later date as agreed by both parties. In this kind of situation, it is permitted for the seller (financier) to charge a higher price, than the prevailing market price. In addition, the deferred sale technique is relatively simple and allows the seller to make positive profit without bearing the risk of having to share in the possible losses, except in the case of bankruptcy or default on the part of the client. Islamic banks and other Islamic financial institutions are using this technique to provide finance to trade etc. (See: Ahmad 1993 for more details).

4.1.3. *Ijarah (Leasing)*

In this transaction, a person or an institution leases a particular product for a specific sum and for a fixed period of time. The lessee will take advantage from the benefits of the asset against the payment of a known rent. The lessee can also negotiate for a lease-purchase of the product, where each payment includes a portion that goes toward the final purchase and transfer of ownership of the asset. In this type of contract, the capital owner is responsible for all the risks attached to the life of the asset. These risks might result from at least two sources the uncertainty attached to the total life of the asset (uncertainty attached with the maintenance cost. as well as the risk resulting from price fluctuations at the disposing time of the asset) and the uncertainty attached to the extent to which the asset will remain on lease during its productive life. For a more detailed discussion on the subject (See: Khan 1991). Leasing is becoming a popular technique of financing among Islamic banks and Islamic Financial Institutions (See: Ahmad 1993).

Particularly, the 1DB Unit Investment Fund which is involved --in developmental projects in the OIC member countries is using this type of contract frequently as the statistics of the last chapter have shown.

The three above mentioned modes form one group and can be classified under the sale based principle because all these three techniques create deferred obligations (see Kahf and Tariqullah 1992). *Murabaha* and deferred sale can be classified as debt based modes of financing because the financing in these two modes is in the nature of a debt and the user of funds has to pay back the entire financing. However, *Ijara* to some extent can be considered as a non-debt financing technique. We now present briefly the two other modes, *Mudarabah* and *Musharakah*.

4.1.4. Mudarabah

Mudarabah refers to a contract between two parties *rab al-mal* (the finance provider) who supplies the *mudarib* with capital and *mudarib* who does the management for a given percentage of the net profit. The capital provider participates with his capital while the *mudarib* participates with his effort and skills. The finance provider will not be involved in the management of the business. The resulting profits are distributed in a mutually agreed proportion while the loss is borne by the provider of capital alone. The *mudarib* will lose his effort and time in the later case. Hence, the profit and the capital invested are not guaranteed because of the risk element (business risk) which makes *rab al-mal* (finance provider) entitled to a share of profit. In case, the *mudarib* violates any of the stipulated conditions of the contract or causes loss in business because of negligence or poor management, he will have to bear the entire loss. In practice, *Mudarabah* constitutes one of the most widespread financial technique of commercial activity, because it fulfills an important economic function through encouraging investment and trade (*Mudarabah* certificates can be floated by a given Islamic financial institution to mobilize resources to finance different business such as building houses, industrial plants etc.). Some principles such as the profit sharing principle (PSP) and the profit and loss sharing principle (PLSP) are based on the *Mudarabah* principle. A detailed discussion on these principles are given in Kahf and Tariqullah (1992). *Mudarabah* is classified as a non-debt creating mode of financing because the capital is not given to the Mudarib as a debt but to manage it in counterpart of a determined percentage of the net profit. In the framework of a *Mudarabah* the capital (provided by the financier) and the rate of return on capital are at stake and remain uncertain during the whole period of the project. Hence *Mudarabah* generates risk on the side of *rab almal* (finance provider) (see F. Khan 1991) for a more detailed discussion on this particular point. In addition, this Islamic financial technique has been used. by Islamic financial institutions and Islamic banks for more than two decades (see Ahmed 1993).

4.1.5. Musharakah

Musharakah is an Islamic financial technique which denotes a joint venture undertaken by more than one provider of funds. In this type of

transaction all parties provide funds and are entitled to participate in the management, but not obliged to do so. At an Islamic financial institution, a *Musharakah* transaction can be described as follows: One, two or more investors approach the Islamic financial institution to finance a project. The financial institution along with the other partners (investors) provide the entire financing. Every one of them has the right to participate in the management. Profits are shared according to an agreed ratio which does not need to be equal to the capital proportion. However, losses are borne by each partner exactly in proportion to their respective capital contribution. *Musharakah* has been practiced by many Islamic banks to finance domestic trade, importation of goods, development of the agricultural sector, etc. Al-Barakah Islamic Bank of Sudan and the Bank Islam Malaysia are involved in such *Musharakah* transactions (see Ahmed 1993 for more applications and details).

In *Musharakah*, each partner puts at stake his entire amount of capital as well as the opportunity cost of capital for the entire period of the project. Moreover, the moral hazard and the problem of informational asymmetry is reduced since each partner would be involved in the investment decision of the joint venture. *Musharakah* is a technique which is mainly used to finance production and hence should not generate demand pull inflation. For more discussion on these later points (see Khan 1991).

4.2. COOPERATIVE VERSUS NON-COOPERATIVE MODES

In this section we study the classification of the main Islamic financial techniques which are used by the IDB Unit Investment Fund and the Islamic Banks' Portfolio into cooperative and non-cooperative modes. Let us imagine an economic environment in which two types of economic agents, say the *mudarib* and *rab al-mal* in the case of a *Mudarbah* contract, are constrained for one reason or another to conduct their business under bilateral contracts. If i and j denote, respectively, the *Mudarib* and *rab al-mal* and m_{ij} the value of the potential profit of the result of their partnership, we define a cooperative mode by a mode that creates partnership between at least two economic agents i and j so that there is associated real (non-negative) number (m_{ij}) denoting the (monetary) value of the potential profit of that partnership. M_{ij} denotes the outcome of the mixing of effort, management and capital via the mode. The contract between the two economic agents must of course specify

how the profit (loss) is to be divided between them. The outcome *mij* in a cooperative mode is indivisible during the entire period of the contract. Its maximization (minimization) is equivalent to the simultaneous maximization (minimization) of the interests of all partners.

On the other hand, in a non-cooperative mode every economic agent maximizes his own objective function. Hence, the objective functions of the economic agents tied by a non-cooperative contract (such as *Murabaha*) do not have to move in the same direction. That is, the optimization of the objective function (profit) of one of the agent does not force the maximization of the other objective functions of the other economic agents involved in the contract. Their interests might be conflicting.

Following this discussion, it is now clear that *Mudarabah* and *Musharaka*, which are equity financing instruments can be classified as cooperative contracts. The three other modes, *Murabaha*, installment sale and leasing which may be identified as exchange contracts are classified according to our previous discussion as non-cooperative modes. One of the main common distinctive features of all these five modes is their link to the real market. The outcome *mij* cannot reach its final destination neither in the case of a *Mudarabah* contract nor in the case of a *Murabaha* contract. without going through a real transaction. In the first case the final destination is either the Mudarib or *rab al-mal*. However, in the second case the final destination is either the seller or buyer. The financial instruments derived or based on the non-cooperative modes may find difficulty to be marketable because these non-cooperative contracts change easily to *dayn* (debt). Therefore, their exchangeability or marketability above their face value will be difficult because if the price exceeds the face value then the difference is *riba* which of course is against *Shari'ah*. Hence, markets may not exist for financial instruments based on these exchange modes whenever the price exceeds their face value. However, financial instruments derived on the basis of cooperative modes which are contracts related to equity financing have the property of not changing easily to *dayn*. That is, they will still have that property of *malkiya* (ownership) representation and hence can be sold and bought according to the market price of that commodity that they represent.

4.3. DETERMINANTS OF THE EXTERNAL FACTORS OF SUPPLY OF FUNDS

In seeking to understand the choice of the investment decision of the Islamic Financial Institution in the OIC member countries, there are two standard reference points. The first is the effect of the internal economic factors which play a crucial role in the determination of the profitability of the project to be chosen. The second reference point is the external factors deemed important in determining the decision making-process of the financial institution. The Islamic Financial Institutions and in particular the IDB Unit Investment Fund and the Islamic Banks' Portfolio have a double objective.

The first objective is to optimize the shareholders wealth according to the *Shari'ah*. The second is to enhance the development of the OIC member countries. Therefore, investment and trade in member countries and among member countries is given priority in both private and public sectors.

However, as we have mentioned, the Islamic financial institutions will not choose a non-profitable project in any country. In addition, it will not invest in a country that has a high probability of not reimbursing its debt. This is why it is important to determine the internal and external factors affecting the decision making process.

When the IDB Unit Investment Fund, or the Islamic Banks' Portfolio, choose to invest in a given OIC member country, in a private or in a public project, it has to bear the risk of not being paid on time or not being paid at all, because of the bad economic conditions of that country. Hence, since the Islamic financial institution is an expected-profit maximizer, the decision problem facing the management of the institution is the size of the funds that it will extend to the project in this country either through *Mudarabah*, as *rab al-ma!*, or through *Musharakah*, as a partner or through any other exchange contract such as *Murabaha* or installment sale. Most of the OIC member countries are less developed countries and the legal and institutional framework do not allow an easy transfer of hard currency from the country to outside the country. The outflow of the hard currency depends in general on the portion of foreign exchange assigned to the total external debt service of the country where the Islamic financial institution will be investing which of course depends on the economic health of the country. Therefore, if the total

contract amount payable by the other partner is greater than the portion of foreign exchange assigned to that specific external debt related to the project in question, the Islamic financial institution will only receive that last portion (portion of foreign exchange assigned to that specific external debt). Hence the financial institution will incur a loss equal to the difference between the total contract amount payable by the other partner and the portion of foreign exchange assigned to the project which is a portion of the foreign exchange assigned to external debt. The loss depends on the value of this latter random variable (portion of foreign exchange assigned to external debt). The management of the Islamic financial institution should then study the chances of the company or the governmental agency, or even the country in which it is investing, to be rescued by either the central bank in case of a private company or governmental company or international, such as the Islamic Development Bank, or the International Monetary Fund, or a more economic powerful country in the case of a country. The Islamic financial institution might consider to invest in a given country because the risk of not being paid is small because the probability of that country of being rescued in case of difficulty by another rich country is high. This is so, because of more than one factor. One of these factors is the geopolitical weight of that country in the Muslim world and in the international arena, which can be considered by the richer country as important. The strategic raw materials, the size of the country and its proximity to the richer country are also factors that might also play a positive role in determining the chances of being rescued. In brief, consideration of these non-economic factors with the conventional economic variables might provide an explanation to the choice of the country in which the Islamic financial institution invests.

The payment capacity of the private or governmental company, as it is in most of the cases in the contracts with the IDB Investment Fund or the Islamic Banks' Portfolio, depends as we have argued before, on the country's payment capacity which itself depends on the foreign exchange it can generate and allocate for the external payment. The liquidity position of the country and the export sector, play an important role in the generation of foreign exchange. The other main economic variables which are commonly used and that have potential impact on the payment capacity of the company or country are the following: The per-capita gross national product used to indicate the relative level of the economic development of a country and expected to have

a positive sign with the payment capacity of the country. The ratio of exports to gross national product which is also positively related to the payment capacity since the higher the ratio the larger the amount of foreign exchange available for servicing the payment. Export growth rate is another variable which also plays a positive role since a country with high growth rate in export has a low probability of default. Hence, its impact on the availability of foreign exchange is expected to be positive. Another variable which can be used is the ratio of investments to GDP. The allocation of a greater share of GDP into capital formation increases the likelihood of future economic growth, thus improving the chances of payment which increases its credit worthiness. The impact of this variable is also expected to be positively related with capacity payment. The ratio of total debt to GNP indicates the degree of a country's solvency and is expected to be negatively related to the capacity payment. Another variable which might also be useful for payment capacity is oil. This variable can be used as a dummy variable by the oil producers. The probability of default for an oil exporting country is expected to be inferior to a non-oil exporting country. Hence, this dummy variable is also expected to have a positive relationship with the foreign exchange availability, and hence, with the capacity payment.

The list of these economic and non-economic variables can be used to construct an econometric model to investigate the capacity payment of the partner. These economic and non-economic variables listed above will be considered as explanatory variables and the capacity payment as one of the explained variables. The construction of such a model is important and needs a more detailed and elaborated database. It constitutes by itself another important study to be undertaken.

V. DIGRESSION

This section raises some of the problems that may be encountered by the units established in the IDB, such as the Unit Investment Fund, and the Islamic Banks Portfolio. From the analysis carried out in the previous chapters of this study on their performance, the following problems emerged:

5.1. ON 'THE PROBLEM OF SOCIO-ECONOMIC LOSS

It has been noticed that a number of approved projects have been canceled at later dates. The amounts allocated for these specific projects through specific Islamic financial instruments have been unutilized for a given period of time. This phenomenon affects negatively the performance of the financier, particularly the *mudarib* as in the case of the IDB Unit Investment Fund and the Islamic Banks' Portfolio. The *mudarib* might very easily lose his providers of funds if the actual return is too small with respect to the expected return because the shareholders, who consist of Islamic banks and private Islamic financial instruments are not utilizing optimally their financial resources due to the non-execution of the contracts as scheduled. The difference between the "Optimal" returns on these investments and the "Second best" return on these same amounts allocated for the projects might be considered by the shareholders as an incurred estimated loss. The optimal return is that return , which corresponds to the contract executed as approved. When the approved contract is not executed, then delayed and finally canceled the return on the amount allocated for that specific project is a second best return during the period between the approved date and the date of the cancellation of the contract. The period has exceeded sometimes six months according to the figures given by the data.

On the other hand, a cancellation of a given contract eliminates the implementation of a given real transaction. This canceled real transaction is now transformed into another second best transaction since as argued above the first transaction was supposed to be optimal given the economic environment at that time. Therefore, the economy as a whole is not also benefiting optimally from the amount of capital allocated to these real transactions, since these optimal transactions were expected to realize an optimal economic growth that enhances the economic development of the

Islamic Ummah. This will result in a loss which will be born by the society as a whole due to this non-respect of these contracts. Moreover, the loss which has refrained the economic growth of the country has deeper impacts on the macro economic variables of that same country. The expected level of employment will not be attained since it was based on the expected optimal economic growth which has not been reached, because of the loss incurred by the economy. Therefore unemployment rises, production decreases and consequently prices increase due to a decrease in supply. In summary, whenever a contract is not executed as approved a loss may be incurred by the following parties:

1. The shareholders might later on, look for moving to more efficient Islamic financial institutions and hence, emerges the problem of instability.
2. The society as a whole will lose in terms of economic growth since the contracts have not been implemented according to the optimal way.
3. The IDB Unit Investment Fund and the Islamic Banks' Portfolio will lose their reputation since the shareholders will move towards a more stable and more promising manager.
4. In the conventional setting, the financier, as in our case, the IDB Unit Investment Funds might ask for an indemnity to be paid for the delay in the execution of the project or for its cancellation after being approved if the non-execution or delay of execution of the project behooves upon the other partner. However, in the Islamic context and to our knowledge the problem has not been solved yet, from the *Shari'ah* point of view. If the contract between the two parties is an *Ijara* contract or *Murabaha* or *Bai Muajjal* and if the other parties did not honor the contract then he will be forced to pay an indemnity for the loss. However, if the contract is in the form of *Musharaka* or *Mudaraba*, there exists a divergence of opinion among the *fouqaha*. The problem is still open and needs more research.

5.2. ON THE: PROBLEM OF NEGOTIABILITY

It has been noticed from the analysis of the activities of the IDB Unit Investment Fund and the Islamic Banks' Portfolio that the more frequent

modes used in their transactions are the non-cooperative modes, which are *Murabaha*, Installment Sale and *Ijara*. Beside the *Ijara* which may be classified as a non-debt mode, the two others are debt based modes. The financial certificates based on the debt modes can only be negotiable at a price equal to the face value of the asset it represents. It cannot be marketed at a price higher or less than its face value. However one point merits some attention. If the face value is in terms of the currency of the country where the certificate has been issued, and particularly in the less developed countries where inflation is- galloping, the person who buys this certificate loses.

However, if the face value of the asset is in terms of a more stable currency or in terms of a strong currency (a currency tied to a strong economy) or in terms of a basket of stable currencies, the person who buys this certificate will be protected against such negative effects. Hence, if the certificates are devised on the debt-based modes much as on *Murabaha* etc., and if the face value is in terms of a stable currency, then these certificates might be marketable based on the exchange rate expectancy. For instance, assume that the face value is 1000 Dinars which is equivalent say to US\$100 at the time of purchase and suppose that after a given period there is a devaluation of 50% in the national currency because of the bad economic situation due to internal or external factors, the client of that certificate will lose if the face value is in terms of national currency. However, if the face value was in terms of a stable currency the client would not suffer any loss.

The non-debt modes can be used to device certificates such as *Mudaraba* certificates or *Musharaka* certificates or *Ijara* certificates etc. These certificates may be negotiable at the market price which can be different from the face value. That is, a price which can be lower or higher than the face value and determined by the forces of demand and supply of the market.

The first category of certificates may be called debt-certificates. The second category may be partitioned in two different sets. The set number one is the set whose elements are the certificates which represents only property (*Malkiya*) or usufruct (*manfia*) such as *Ijara* certificates. The second set is the set whose elements represent a mixture of debt (*dayn*); or liquidity (*Naqd*) or usufruct (*manfia*) and property, subject to the condition that debt plus liquidity is less than usufruct plus property. In summary we have three different sets:

1. Set whose elements are based on debt such as *Murabaha* certificates.

Set whose elements are based on usufruct or property such as *Ijara* certificates.

3. Set whose elements are based on a mixture of debt, liquidity, property and usufruct such as *Musharaka* certificates in the case of a Charika.

The certificates belonging to the second or third sets are negotiable and hence can be used to develop a stock market where these certificates can be marketed and hence can be used for financing purposes. That is, they can be used to get liquidity. From the user of funds point of view who needs liquidity to finance his project these certificates which belong to the second and third set are liquid-oriented certificates: However, from the provider of funds point of view, these certificates are on the contrary not liquidity-oriented certificates but they represent a channeling device for his funds and allow the provider of funds_ (financier) to get involved directly or indirectly into the economic process through investment.

The stockmarket will include all these three categories of certificates. The volume of this market will depend on the internal characteristics of each of these three sets. For example, certificates devised on *Mudaraba* which belong to the third category we have mentioned above, can have many forms by only changing some of its characteristics, such as the length of time (short term *Mudaraba* certificates, medium term *Mudaraba* certificates, long term *Mudaraba* certificates) etc. Therefore, the volume of the market depends on the possibility of expansion of the volume of these three categories which depend on the internal characteristics of each of the three sets.

Hence, the question that arises is the following: is it possible to devise financial certificates which are combinations from these three sets, and which are not elements of neither of the certificates belonging to the three sets ? That is, new certificates completely different from the existing other certificates that were generated internally ? This question in our opinion needs more investigation.

VI. CONCLUSION

A great deal of attention has been given to the theoretical aspect of the Islamic financial instruments, especially the study of the economics of the various well-known Islamic modes of financing. Yet, there has been little work focusing on the empirical impact of these modes. The present study has made a modest attempt to analyze the performance of two Islamic financial units namely, the IIB Unit Investment Fund and the Islamic Banks' Portfolio. The results found in the first part of this study show that the principal Islamic financial modes used by the two units in their transactions essentially are the non-profit loss-sharing modes. These modes are in general less risky than the profit-loss-sharing modes. The results of this first part showed also, that a number of projects have been undertaken in the few years of the existence of these two units. The second part of the study focused on the study of the economic characteristics of the modes used by the two Units under investigation, and showed the existence of the theoretical link between the nature of these modes and the objective of the two institutions. The main well-known modes have been classified into two groups, the "cooperative" modes, versus the "non-cooperative" ones. The results indicated that the two Islamic financial institutions are more inclined in using the non-cooperative financial modes. It has also been shown, that the choice of financial instruments of finance are derived on the basis of the "non-cooperative" modes because of their link to debt (dayn).

The selection of the modes of financing is related to the objective function of the finance provider; to the type of investment and where the investment is taking place. The study identified and discussed in its third part the internal and external economic factors and their important role in the decision of the investment selection process of the management of any Islamic financial institution.

Finally, the study investigated the problem of negotiability and transferability of the certificates based on the cooperative versus non-cooperative modes of financing and suggests that the Islamic financial institution should move towards cooperative modes in order to create the proper economic environment of negotiability and of transferability. Second, the problem of financial loss for the society has also been investigated and some questions on the indemnity have been raised from the fiqh point of view.

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APPENDIX I

TABLE 3.2

**LIST OF APPROVED OPERATIONS IN 1408H AND 1409H
AND CANCELED DURING 1409H**

(in million US\$)

No.	Beneficiary Country	Approval Date	Amount	Mark-up	Cancellation Date	Estimated Loss of the Unutilized Balance Incurred	
						1408H	1409H
1	Egypt	I/1408H		7.75	7/1409H	2500	1460
2	Egypt		2	9.5	7/1409H	40000	23300
3			0.234	10.5	"	7020	4095
4			0.3			4500	2625
5			0.732	10.5		21960	12810
6	Algeria		2.5	7.5		0	0
7			1.0	7.5		0	0
8			0.5	7.5		0	0
9			0.5	7.5			0
10			2	7.5		0	0
11		19-8-1408H	2	7.875	7-8-1409H	2500	1460
12	Turkey	1-12-1408H	10	8	27-1-1410H	4170	50000
13	Tunisia	25-5-1409H	1	10	13-8-1409H	0	15625
14		14-6-1409H		10	13-8-1409H	0	15625
Total			24.766			82650	127000

Source: IBP Annual Reports

APPENDIX II

TABLE 3.3

**LIST OF APPROVED OPERATIONS BUT CANCELED
DURING 141011**

(in million US\$)

No.	Beneficiary Country	Approved date	Amount Allocated	Duration in month	Mark up (%)	Estimated loss of the unutilized balance incurred
1.	Nigeria	15-10-1410H (17-5-90)	0.880	18	13	5500
2.	Nigeria	15-10-1410H (17-5-90)	1.120	12	13	7000
3.	Iraq	5-1410H (20-12-89)	5	12	11.49	116667
4.	Iraq	5-1410H (27-12-89)	1.750	6	11.49	35000
5.	Iraq	1-1410H 27-12-89	1.728	6	11.49	34560
6.	Uganda	2-1410H 14-8-89	0.93	12		7265
7.	Saudi Arabia	2-1410H (13-9-89)	10	6	8.49	50000
Total			21.408			255992

Source: IBP Annual Reports.

L=7,49%

APPENDIX III

TABLE 3.4

LIST OF APPROVED OPERATIONS BUT CANCELED DURING 1411H

(in million US\$)

No.	Beneficiary country	Approved date	Amount allocated	Cancellation date	Mark up (%)	Estimated loss of the unutilized balance incurred
1	Saudi Arabia	2/1410H	10	23-6-1412H (30-4-92)	8.49	22222
2	Malaysia	30-1-91	4.4	7/11/1412H	9	4033
3	Egypt	1-1-92	4.112	13-6-92	12	68533
Total						94788

Source: IBP Annual Reports
Where L = 7.49

APPENDIX IV

TABLE 3.5

LIST OF APPROVED OPERATIONS BUT CANCELED DURING 1412H

in million US\$)

No.	Beneficiary date	Approved date	Amount allocated	Cancellation date	Mark-up	Estimated loss of the unutilized balance incurred
1	Pakistan	17-12-90	0.5	16-3-91	8.7	875
2	Algeria	26-12-90	4	30-4-91	10.5	33334
3	Algeria	26-12-90	-3	17-2-91	10.5	12381
4	Atawfic	14-2-91	3	28-2-91	8.645	805
Total						47396

Source: IBP Annual Reports
where L = 5.175%

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ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Dada 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1395H (20 October 1975).

Purpose

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah*.

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel **engaged** in development activities and undertaking research for enabling the economic, financial **and banking** activities in Muslim countries **to conform to the *Shari'ah***.

Membership

The present membership of the Bank consists of 48 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Capital

The authorized capital of the Bank is six billion Islamic Dinars. The value of the Islamic Dinar, which is a unit of account in the Bank, is equivalent to one Special Drawing Right (SDR) of the International **Monetary** Fund. The **subscribed** capital of the Bank is **3,654.78** million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

Head Office

The Bank's head office is located in Jeddah in the Kingdom of Saudi Arabia and the Bank is authorized to establish agencies or branch offices elsewhere.

Financial Year

The Bank's financial year is the Lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.

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