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This is the third cultural product of ADCB’s public awareness programme, which aims at portraying ethical and practical dimensions of Islamic finance. It comes after two successive introductory booklets: (a) Master Key to Islamic Banking and Finance – 1, which treated preliminary questions – ‘why Islamic finance is needed, and how it fundamentally differs from conventional banking’ and (b) Master Key to Islamic Banking and Finance – 2, which demonstrated alternative Islamic financing modes. The story of Islamic banking has been summed up in the effort to reap the benefits of modern banking in accordance with Shari’ah, which among other things, strictly prohibits usury (riba).

In continuation to the above programme, the present booklet, ADCB Key to Islamic Retail Banking – 3, is an effort to translate the previous conceptual background into the practical setting of Retail Islamic Banking. It goes without saying that retail banking is the publicly known high street banking activity which accepts deposits, issues cheques, finances from individuals and companies and caters a broad range of ancillary services like cash transferences, Credit Cards, Letters of Guarantee, Letters of Credit among many others.

In a similar manner as we did in the previous two booklets, the idea is to start with the basics of retail banking in the present ADCB Key to Islamic Retail Banking – 3 and then proceed to more detailed elaborations in ADCB Key to Islamic Retail Banking – 4. In particular, the present booklet departs from a historical background of banking in the early Islamic civilisation to establish the fact that banking is not at all alien to the Islamic legacy. The booklet then moves to describe the balance sheet functions of an Islamic retail bank, in terms of the core liabilities and assets, leaving it to the next booklet to describe off-balance sheet accounts and services. The six-booklet series will then be concluded by the last two booklets: ADCB Key to Islamic Corporate Banking – 5 and ADCB Key to Islamic Investment Banking – 6.

The purpose of the public awareness programme is to benefit a wide spectrum of potential audience who wish to understand the relevance of Islamic finance to the ever rising challenges of the modern world. Retail Banking Clients, Corporate Banking Network in Basra was rightly called by a Western historian as ‘the Wall-Street of the Middle Ages.’ Few people are aware of the fact that modern banking system owes a good deal of its roots to the banking and financial experience of early Muslim civilisation many centuries ago. The role of usury-free banking in early Muslim states was justified by the rising demand for liquid capital and credit to both governments and private entrepreneurs. The simplest manifestation of banking services within the early Muslim states took the form of money-changers (sayarifa) who were also partially engaged in the holding of deposits and the short-term financing of trade.

Yet a more sophisticated form of banking was represented by the Jahabiza who practiced much of the modern banking activities under the direct supervision of the Islamic state. In the highly developed market economy of the Abbasid State, Jahabiza bankers proliferated throughout the state, even though they were mostly of Ahl al-Kitab origin (People of the Book). The high streets of Basra were so much replete with money-changers and Jahabiza that the banking network in Basra was rightly called by a Western historian as ‘the Wall-Street of the Middle Ages.’
A famous Persian Muslim historian, Nasir Khusraw, estimated the number of Jahabiza bankers in the state of Isfahan alone at 200 banks. It was such a complex network of banking activities that the call for appropriate government supervision and regulation was acknowledged by the Islamic state. To this effect, the Abbasid State established a central banking agency in year 316 H/929 A.D called Diwan al-Jahabiza to foresee the performance and growth of banks within the empire. A similar central bank was established in Egypt by the Fatimid State by the name Dar al-Mal in the commercial capital of al-Fustat to supervise an equally intense Jahabiza banking activity in Fatimid Egypt.

Among the most commonly practiced banking instruments were the sakk (the Arabic root of the word 'cheque') and the suftaja (which combined features of Traveller Cheques and Letters of Credit). The use of cheque (sakk) was particularly known since the time of the Rightly-Guided Caliphs. A renowned historian, Ibn Abdel-Hakam, reported that Umar ibn al-Khattab paid for grains delivered to Bait al-Mal (the State’s warehouse) by cheque, and that he was used to paying workers’ wages by cheques signed by his treasurer, Zaid ibn Thabit.

The above historical background sheds light on the pioneering role which Muslim civilisation played in setting fundamental standards of banking many centuries before the recovery of Western Europe from the Dark Ages. Western economic historians have unequivocally acknowledged the leading role of Muslims’ booming merchandise across the Mediterranean with the Italian Cities (Venice, Genoa, Amalfi and others) in lifting Western Europe from its Dark Ages and bringing about the twelfth century economic renaissance to Europe.

At the time when the Islamic state encouraged trade and supported the profit motive subject to injunctions of Shari‘ah, the teachings of the Christian Church in Western Europe cherished a poverty-oriented culture, hence, frustrated entrepreneurial motives and accentuated the impact of the Dark Ages in socio-economic life. In their analysis of Muslims trade with medieval Europe, economic historians acknowledged the groundbreaking role of Mudaraba-financed trade in acquainting Western Europe with a powerful instrument of Corporate Finance, hence opening up immense opportunities of profitable trade across the Mediterranean. Mudaraba came to be known in the Italian cities as commendo, marking thereafter an important historical phase of corporate growth in Western Europe, which culminated through time into the modern corporate structure.

Unfortunately, however, usury came to be approved by the Christian Church around the fifteenth century and the whole process of economic incorporation followed a non-Islamic usury-oriented culture. The contemporary movement of Islamic banking should therefore be viewed as a revival of earlier efforts of usury-free banking which flourished during the brighter years of Muslim civilisation.

The principles and basic mechanism of Islamic banking have already been explained in the first booklet ADCB Master Key to Islamic Banking and Finance – 1, in terms of mobilising relatively small savings, pooling them together and making them accessible to business entrepreneurs who seek to finance their productive activities. While conventional Retail banks perform this operation through interest-bearing loans, Islamic Retail banks perform the same operation through Islamic modes of financing as reviewed in the second booklet ADCB Master Key to Islamic Banking and Finance – 2. Viewed from the Balance Sheet perspective, this basic operation leads to the generation of ‘Liabilities’ which stand for the
Retail bank’s Deposit Accounts, and ‘Assets’ which stand for the financings offered to Retail bank clients.

The Balance Sheet of a Retail bank, like that of most public corporations, consists of a broad range of Liabilities and Assets with varying degrees of liquidity. But the basic balance operation of a Retail bank is to attract Liabilities in the form of ‘Deposits’ and use them to create Assets in the form of ‘Financings’ to bank clients. To the extent that the depositors’ money can remain for a fairly good time with the bank without being drawn, the bank may confidentially utilise such deposits for satisfying the financing demand of his clients. This shows how sensitive Balance Sheet managements is in Retail banking, because the ability to provide finance depends on the nature and stability of deposited money.

Regulatory authorities are particularly keen to protect depositors’ money against undue exposure to Retail banking Balance Sheet risks. Two fundamental precautionary measures are commonly adopted: (1) the allocation of sufficient cash reserves against the deposited funds, and (2) the avoidance of unnecessary risks in the financing activity. Hence, one main reason why Islamic banks tend to avoid the involvement into risky economic enterprises is the very reason for caring for the protection of depositors’ money. This is best reflected in the adoption of low risk modes of finance like Murabaha and Ijara as they were introduced in the second booklet ADCB Master Key to Islamic Banking and Finance – 2.

This booklet is particularly devoted to the description of Deposits (Liabilities) and Balance Sheet Financings (Assets) which underline the basic Balance Sheet operation of Retail Islamic banking.

Deposits of Retail Islamic Banking

Deposit accounts of Islamic Retail banks are broadly classified into two categories: (1) Demand Deposits, also called Current Accounts, and (2) Islamic Investment Deposits or Profit & Loss Sharing (PLS) Investment Accounts, as explained below.

1 Current Accounts

Current accounts satisfy two main conditions: (1) they promise no return to the depositor apart from the bank’s guarantee of the principal amount, and (2) they can totally be drawn at any time without notice – that is, ‘on demand’. From an Islamic perspective, the taking of Demand Deposits is equivalent to borrowing funds from depositors while withdrawal is equivalent to repayment of borrowed funds. The borrowing of funds is permitted in Shari’ah so long as it is an interest-free loan in the sense of promising no reward to the lender.

Yet to utilise the interest-free loan in any profitable activity it is important that the Islamic bank, as borrower, guarantees repayment of the loan to the lender. This is a very important jurist criterion for distinguishing between the concept of qard (repayable loan) and that of amana (trustable fund). The former creates what jurists call “hand of guarantee” (yad daman) on the borrowed funds, while the latter creates a “hand of trust” (yad amana). In other words, the borrower is obliged to repay the qard under all circumstances unless the lender relieves him of this obligation, but no such obligation arises in the case of amana. Repayment of amana is done on a best effort basis and may only be guaranteed in case of gross negligence.

Hence, Current Accounts in Islamic banks follow the rules of qard in Islamic jurisprudence, which promises no return to the depositor while holding the...
bank accountable to repay the deposited funds at any time. The provision of
checking facilities does not affect the legitimacy of Current Accounts so long
as it is a generally accepted practice for banks to provide depositors with
check books to control inflows and outflows of their accounts.

Conventional banks do provide the same service of Current Accounts but in
many cases, tend to violate the Islamic rules of qard. On one hand, it is not
unusual for Conventional banks to promise certain gifts or alternative forms
of incentive as it might be necessitated by competition among rival banks to
attract Current Account depositors. On the other hand, it is a usual practice
of Conventional banks to offer Overdraft facilities whereby Current Account
depositors may draw larger amounts than what they have deposited.

The problem in this case arises from the switching of lender/borrower positions
between bank and client whereby bank becomes lender and client becomes
borrower. Hence, the violation relates to the charging of a positive interest
rate by bank as lender, which as we have repeatedly emphasised is strictly
prohibited in Islamic jurisprudence.

2 Investment Accounts

Investment Accounts are the Islamic alternative to the interest-bearing
Term Deposit Accounts in Conventional banks. Like Term Deposits, Islamic
Investment Accounts are held for specific periods of time by banks and hence
cannot be drawn on demand (i.e. without prior notice). But unlike Conventional
Term Deposits, Islamic Investment Accounts keep away from using the interest
rate both in the compensation of account holders and in the utilisation of
funds.

Two primary issues are hence raised by Islamic Investment Accounts. On one
hand, holders of Islamic Investment Accounts can only be compensated from
profits as actually realised by the Islamic bank and therefore depositors are
not promised any positive returns on their funds, whether prefixed or floating,
On the other hand, utilisation of funds for the generation of profit can only
be carried out through Islamic modes of financing as they have already been
reviewed in the second booklet ADCB Master Key to Islamic Banking and
Finance – 2.

As regards to the legitimate means of compensating depositors, this depends
upon how Islamic banks accept investor’s deposits. Basically, there are two
alternative options of accepting investors deposits:

(1) Either through Unrestricted Mudaraba with the investors (who act as the
Rabb al-Mals), such that the bank (acting as Mudarib) is authorised to invest
the fund proceeds in any line of economic activity of its own choosing, and to
mix the bank’s own resources with those of the investors. This can also be
done through Musharaka in which case the bank acts as ‘Partner’ (Musharik)
coupled by the authorisation of all the other partners to act as the sole
manager of the investment activity.

(2) Or through Restricted Mudaraba where the choice of the investment
activity and the mixing of funds have to be done with the client’s consent.
As an alternative to Restricted Mudaraba, it is possible to adopt an Agency
Agreement where the bank simply offers its services to investors against a
management fee.

3 ‘Unrestricted’ Investment: Balance Sheet Accounts

The first option gives rise to the PLS (Profit & Loss Sharing) concept as it has
already been explained in the second booklet ADCB Master Key to Islamic
Banking and Finance – 2. In short, the PLS Investment Account underlines
an Unrestricted Mudaraba contract between the bank and the depositors
allowing for the mixing of the bank’s funds. Alternatively, it can be based
upon Musharaka contract whereby the bank acts a Partner (Sharik) as well as
manager of the funds, subject to the provision that all the other partners (the
Investors) have given up their right of management to the bank. In both cases
the parties may share between themselves whatever profit or loss happens to be generated from the utilisation of such deposited funds subject to an agreed PLS ratio.

The process of profit generation in the Unrestricted Investment Accounts gives rise to the creation of Assets, in the sense of extending financing facilities to other client activities. Islamic banks are legitimately entitled to generate profit from the utilisation of Current Account deposits so long as Islamic banks guarantee repayment of these deposits on demand. Hence, to the extent that the PLS Investment Accounts are also utilised by the bank in the process of profit generation, the holders of such accounts are entitled to a share in such profits. This explains why PLS accounts are Balance Sheet accounts.

The Unrestricted PLS Accounts are accessible to all potential depositors who wish to share in the overall profitability of the Islamic bank, subject to terms and conditions, which impose no restrictions on the Islamic banks utilisation of funds apart from Shari'ah compliance.

4 ‘Restricted’ Investment: Off-Balance Sheet Accounts

The last two options of accepting investors deposits – Restricted Mudaraba and Agency Contracts – have one thing in common. They both give rise to ‘Restricted Investment Accounts’ where the investor wishes to generate profit from a specific field of economic activity rather than share in the overall profitability of the bank. It is therefore an Off-Balance Sheet Investment Account as the bank does not mix such funds with the pool of funds invested on unrestricted basis (such as Current Accounts, Investment Accounts and Shareholders’ own funds). It simply reduces the bank’s role to that of a manager of funds.

As it is the case in Unrestricted Investments, the depositor cannot be guaranteed any returns. Mudaraba is adopted for the management of Restricted Investments, where the depositor assumes the position of Rabb al-Mal while the Islamic bank assumes the position of Mudarib. In this case the bank’s income is defined as a share in the profit that can be realised from the management of the investment. However, if loss is realised, it will be borne by the holder of Restricted Account alone and the bank will only lose its administrative effort.

Alternatively, the bank may act as ‘Agent’ for its client in the management of Restricted Investment Accounts (working for an agency fee that can be a fixed amount or defined as a percentage of the project’s net asset value, provided it is denominated in a fixed amount at the outset of the agency). The Agent is bound to work to its best effort but cannot guarantee any return to the investor. This is an important point to recall as it is against the conventional practice where Agent is held to indemnify the principal against all damages.

The only means for Retail Islamic banks to generate profit is through the creation of Assets in terms of financing of individuals or the productive activities of clients. In the second booklet ADCB Master Key to Islamic Banking and Finance – 2, a brief demonstration has been provided about various Islamic modes that can be adopted in the process of meeting clients demands for funds. In general, the creation of financial assets invokes common procedural features regardless of the mode of financing being adopted (Mudaraba, Musharakah, Investment Agency, Murabaha, Ijara, Istisnaa or Salam) but it is important to note that the Assets generated by different financing mode possess different contractual features. This will be described below in terms of the broad classification of Islamic modes into variable return modes (PLS Assets) and structured fixed return modes as shown on the following pages.
1 Assets generated by Variable Return Modes

Assets generated through Mudaraba and Musharaka contracts would usually reflect the following properties:

- The Islamic bank’s return from financing can only be generated from the operations of the projects being financed. Accordingly, the financing decision requires a careful economic feasibility study of the prospective projects to assess their potential profitability.

- Due to considerable risk in Mudaraba and Musharaka, Islamic banks would normally approach them through well-structured transactions in an effort to limit the range of expected return volatility as much as possible.

- The financed client is committed to a best effort policy that is translatable into clear contractual terms, but otherwise the client cannot guarantee return or principal to the Islamic bank.

- The bank’s readiness to offer such financings is often based on an expected rate of return of a relevant project to be financed. This expected rate of return proves useful in assessing the expected performance of the project even though it cannot be guaranteed.

- To guard against the possibility of loss that might arise from the client’s negligence or misconduct, it is permissible to take collaterals from the financed clients. This is the only situation in which the client would be held liable to guarantee principal in Mudaraba and Musharaka financings.

2 Assets generated from Fixed Return Modes

A fairly detailed review of Fixed Return Modes (Murabaha, Ijara, Istimnaa and Salam) has been given in the second booklet Master Key to Islamic Banking & Finance – 2. With this background, it is now possible to appreciate the features of the financial assets generated by Fixed Return Modes:

- Assets generated from Fixed Return Modes share the common property of having a well-structured and reasonably predictable future cash flow. This property draws from the fixity of price in sale transactions which embed the class of Fixed Return Modes.

- Unlike the case of Mudaraba and Musharaka Assets, it is now obligatory on the client to pay out the scheduled installments, and hence the Islamic bank can take securities or collaterals from clients to ensure timely payment of the agreed installments.

- Unlike floating interest rates, which permit Conventional banks to update the structure of future cash flows in response to some external indicators (rate of inflation), this is not open to Islamic banking rates of return. Again, it is due to the fixity of contractual price in deferred sales of goods and services and the inability to adjust the price due to future disturbances.

- This principle reflects the use of historical costs rather than current market prices in the valuation of Islamic banking assets. It is a generally accepted accounting principle in Islamic banking as worked out in AAOIFI standards.

- In particular, cash flows generated from Murabaha contracts are special forms of pure receivable debt arising from the sale of real goods against agreed deferred payments (installments). Having sold the goods, the bank will have no recourse to revise the agreed installments or to penalize defaulted clients in the way that Conventional banks can do through charging additional interest.

- Basically, it is due to the above feature that Murabaha is most suited for short term financing in international commodity markets or medium term local financing of cars purchases or consumer durables.
• However, Ijara provides a particular flexibility since the bank’s continued ownership of the physical Asset (real property or equipment) gives it a special recourse to revise the terms of the Ijara contract in response to any external economic shocks.

• The above property makes Ijara particularly suitable not only for long term financing, but also for the structuring of open-ended mutual funds where investment fund units can be bought and sold among potential investors.

• Istisnaa and Salam Assets are the Islamic counterparts of Conventional Futures. But unlike Conventional Futures, which are extensively used in pure speculative trade, the Islamic counterparts are addressed to the financing needs of clients at particular periods of time and therefore may be mistakenly perceived as subject matter of speculative trade.

It has been shown that modern banking owes much of its roots to the early Islamic civilization. This booklet moved forward from the background of Islamic Financing Modes given in the second booklet ADCB Master Key of Islamic Banking & Finance – 2, to describe the basic Retail banking operation of deposit-taking and asset-creation through the Balance Sheet perspective of a Retail Islamic bank. The booklet provides a snap shot at Asset/Liability structure of an Islamic Retail bank. The next booklet ADCB Key to Retail Islamic Banking – 2, will focus mainly on Retail financing and ancillary banking services.

Conclusion

It has been shown that modern banking owes much of its roots to the early Islamic civilization. This booklet moved forward from the background of Islamic Financing Modes given in the second booklet ADCB Master Key of Islamic Banking & Finance – 2, to describe the basic Retail banking operation of deposit-taking and asset-creation through the Balance Sheet perspective of a Retail Islamic bank. The booklet provides a snap shot at Asset/Liability structure of an Islamic Retail bank. The next booklet ADCB Key to Retail Islamic Banking – 2, will focus mainly on Retail financing and ancillary banking services.