

زبان تخصصی بانکداری (۱)

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WHAT ARE BANKS AND WHAT DO THEY DO?

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1.1. Introduction¹

The term “banking” can be applied to a large range of financial institutions, from savings and loans organisations to the large money-centre commercial banks in the USA, or from the smallest mutually owned building society to the “big four” shareholder owned banks in the UK. Many European countries have large regional/cooperative banks in addition to three to five *universal* banks. In Japan, the bank with the largest retail network is Sumitomo Mitsui Banking Corporation,² but its main rival for savings deposits is the Post Office.

The objective of this chapter is to provide an overview of banking and the role played by banks in an increasingly complex financial world. It begins with a review of the meaning of banking, identifying the features of banks that distinguish them from other financial institutions. The most common forms of organisational structure for banks in the developed world are reviewed in section 1.3. Section 1.4 considers the relationship between the central banks and commercial banks, including key debates on the functions and independence of a central bank. The chapter ends with a brief summary of the major theoretical contributions to the banking literature, followed by conclusions.

1.2. The Meaning of Banking

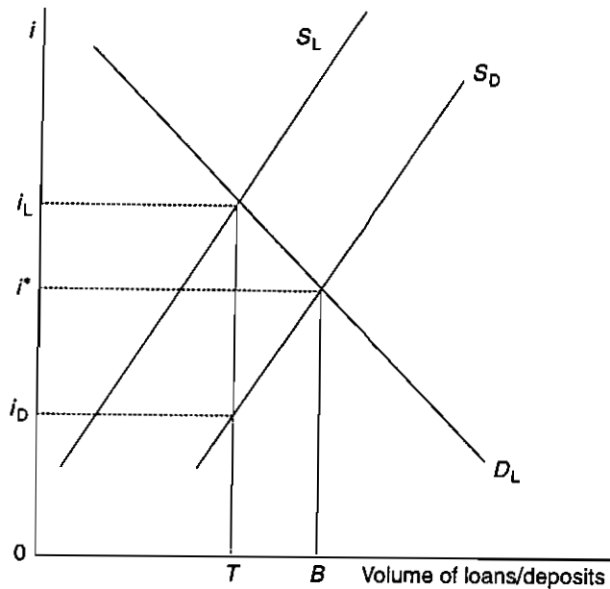
The provision of deposit and loan products normally distinguishes banks from other types of financial firms. Deposit products pay out money on demand or after some notice. Deposits are *liabilities* for banks, which must be managed if the bank is to maximise profit. Likewise, they manage the *assets* created by lending. Thus, the core activity is to act as *intermediaries* between depositors and borrowers. Other financial institutions, such as stockbrokers, are also intermediaries between buyers and sellers of shares, but it is the taking of deposits and the granting of loans that singles out a bank, though many offer other financial services.

To illustrate the traditional intermediary function of a bank, consider Figure 1.1, a simple model of the deposit and credit markets. On the vertical axis is the rate of interest (i);

¹ © No part of this chapter is to be copied or quoted without the author's permission.

² This banking giant is the result of a merger between Sakura and Sumitomo Mitsui Banks in April 2001.

Figure 1.1 The Banking Firm-Intermediary.



$i_L - i_D$: bank interest differential between the loan rate (i_L) and the deposit rate (i_D) which covers the cost of the bank's intermediation

S_D : supply of deposits curve

S_L : supply of loans curve

D_L : demand for loans curve

OT : volume of loans supplied by customers

i^* : market interest rate in the absence of intermediation costs

the volume of deposits/loans appears on the horizontal axis. Assume the interest rate is exogenously given. In this case, the bank faces an upward-sloping supply of deposits curve (S_D). There is also the bank's supply of loans curve (S_L), showing that the bank will offer more loans as interest rates rise.

In Figure 1.1, D_L is the demand for loans, which falls as interest rates increase. In Figure 1.1, i^* is the market clearing interest rate, that is, the interest rate that would prevail in a perfectly competitive market with no intermediation costs associated with bringing borrower and lender together. The volume of business is shown as OB . However, there are intermediation costs, including *search*, *verification*, *monitoring* and *enforcement* costs, incurred by banks looking to establish the creditworthiness of potential borrowers. The lender has to estimate the riskiness of the borrower and charge a premium plus the cost of

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the risk assessment. Thus, in equilibrium, the bank pays a deposit rate of i_D and charges a loan rate of i_L . The volume of deposits is OT and OT loans are supplied. The interest margin is equal to $i_L - i_D$ and covers the institution's intermediation costs, the cost of capital, the risk premium charged on loans, tax payments and the institution's profits. *Market structure* is also important: the greater the competition for loans and deposits, the more narrow the interest margin.

☰mediation costs will also include the cost of administration and other transactions costs related to the savings and loans products offered by the bank. Unlike individual agents, where the cost of finding a potential lender or borrower is very high, a bank may be able to achieve *scale economies* in these transactions costs; that is, given the large number of savings and deposit products offered, the related transactions costs are either constant or falling.

Unlike the individual lender, the bank enjoys *information economies of scope* in lending decisions because of access to privileged information on current and potential borrowers with accounts at the bank. It is normally not possible to bundle up and sell this information, so banks use it internally to increase the size of their loan portfolio. Thus, compared to depositors trying to lend funds directly, banks can pool a portfolio of assets with less risk of default, for a given expected return.

Provided a bank can act as intermediary at the lowest possible cost, there will be a demand for its services. For example, some banks have lost out on lending to highly rated corporations because these firms find they can raise funds more cheaply by issuing bonds. Nonetheless, even the most highly rated corporations use bank loans as part of their external financing, because a loan agreement acts as a *signal* to financial markets and suppliers that the borrower is creditworthy (Stiglitz and Weiss, 1988).

The second core activity of banks is to offer *liquidity* to their customers. Depositors, borrowers and lenders have different liquidity preferences. Customers expect to be able to withdraw deposits from current accounts at any time. Typically, firms in the business sector want to borrow funds and repay them in line with the expected returns of an investment project, which may not be realised for several years after the investment. By lending funds, savers are actually agreeing to forgo present consumption in favour of consumption at some date in the future.

Perhaps more important, the liquidity preferences may change over time because of unexpected events. If customers make term deposits with a fixed term of maturity (e.g., 3 or 6 months), they expect to be able to withdraw them on demand, in exchange for paying an interest penalty. Likewise, borrowers anticipate being allowed to repay a loan early, or subject to a satisfactory credit screen, rolling over a loan. If banks are able to pool a large number of borrowers and savers, the liquidity demands of both parties will be met. *Liquidity* is therefore an important service that a bank offers its customers. Again, it differentiates banks from other financial firms offering near-bank and non-bank financial products, such as unit trusts, insurance and real estate services. It also explains why banks are singled out for prudential regulation; the claims on a bank function as money, hence there is a "public good" element to the services banks offer.

By pooling assets and liabilities, banks are said to be engaging in *asset transformation*, i.e., transforming the value of the assets and liabilities. This activity is not unique to banks. Insurance firms also pool assets. Likewise, mutual funds or unit trusts pool together a large

deposit box facilities to arranging a syndicated loan. The demand and supply curves are like any other product, and the market clearing price, P , is determined by the intersection of the demand and supply curves. Again, market structure will determine how competitive the price is. Banks will operate in other "non-banking" financial markets provided they can create and sustain a competitive advantage in each of them.

Banks do not necessarily charge a direct price for their services, as suggested by Figure 1.2. Many modern banks offer stockbroking services to their customers, and "make markets" in certain equities. In this case, some or all of the "fee" may be reflected in the difference between the *bid* and *offer* price, that is, the price the bank pays to purchase a given stock and the price the customer pays. The difference between the two is the spread, which is normally positive, since the bid price will always be lower than the offer price, so the bank, acting as a market maker, can recoup related administrative costs and make a profit. Again, the amount of competition and volume of business in the market will determine how big the spread is. When the bank acts as a stockbroker, it will charge commission for the service. Suppose a bank sells unit trusts or mutual funds.⁴ Then the price of the fund often consists of an initial charge, an annual fee, and money earned through the difference between the bid and offer price of the unit trust or mutual fund.

This discussion illustrates how complicated the pricing structure of banks' products/services can be. Non-price features can affect the size of the interest margin or the bid-offer differential. Hence, assessing the pricing behaviour of banks is often a more complex task compared to firms in some other sectors of the economy.

1.3. Organisational Structures

The intermediary and payments functions explain why banks exist, but another question to be addressed is why a bank exhibits the organisational structure it does. Profit-maximising banks have the same objective as any other firm; so this question is best answered by drawing on traditional models. Coase (1937), in his classic analysis, argued that the firm acted as an alternative to market transactions, as a way of organising economic activity, because some procedures are more efficiently organised by "command" (e.g., assigning tasks to workers and coordinating the work) rather than depending on a market price. In these situations, it is more profitable to use a firm structure than to rely on market forces.

The existence of the "traditional" bank, which intermediates between borrower and lender, and offers a payments service to its customers, fits in well with the Coase theory. The core functions of a bank are more efficiently carried out by a command organisational structure, because loans and deposits are internal to a bank. Such a structure is also efficient if banks are participating in organised markets. These ideas were developed and extended by Alchian and Demsetz (1972), who emphasised the monitoring role of the firm and its creation of incentive structures. Williamson (1981) argued that under conditions of uncertainty, a firm could economise on the costs of outside contracts.

⁴ Mutual funds (USA) or unit trusts (UK) offer the investor a package of shares, bonds, or a combination of both. The investor purchases units in the fund, as do many other investors. It is managed by the bank or investment firm offering the fund.

1.3.1. Banks and the Principal Agent Problem

The nature of banking is such that it suffers from *agency* problems. The *principal agent* theory can be applied to explain the nature of contracts between:

- the shareholders of a bank (principal) and its management (agent);
- the bank (principal) and its officers (agent);
- the bank (principal) and its debtors (agent); and
- the depositors (principal) and the bank (agent).⁵

Incentive problems arise because the principal cannot observe and/or have perfect information about the agent's actions. For example, bank shareholders cannot oversee every management decision; nor can depositors be expected to monitor the activities of the bank. Bank management can plead bad luck when outcomes are poor.

Asymmetric information, or differences in information held by principal and agent, is the reason why banks face the problem of *adverse selection* because the bank, the principal, normally has less information about the probability of default on a loan than the firm or individual, the agent. Though not shown in Figure 1.1, the presence of adverse selection may mean the supply of loans curve is discontinuous at some point. *Adverse selection* is the reason why the supply curve is discontinuous or even backward-bending (with respect to certain borrowers), and shows that bankers are more reluctant to supply loans at very high rates because as interest rates rise, a greater proportion of riskier borrowers apply for loans. The problem of *adverse incentives* (higher interest rates encouraging borrowers to undertake riskier activities) is another reason why banks will reduce the size of a loan or even refuse loans to some individuals or firms.

Box 1.1 Example of Adverse Selection: Robert Maxwell

In the 1980s, most of the major American and British banks in the City of London had dealings with Robert Maxwell. At the time of his death in 1991, Mr Maxwell owed £2.8 billion to a large group of banks. Little, if any, of it was recovered. The Department of Trade and Industry had censured Robert Maxwell for his business practices in 1954. In 1971, they declared him unfit to run a public company. Despite Maxwell's background, and secrecy about the links of over 400 firms within the publicly owned Maxwell Communication Corporation, banks were attracted to Maxwell because he was prepared to pay high fees and comparatively high rates of interest on his loans, a classic example of *adverse selection*. *Herd Instinct* was also evident. Goldman Sachs, the prestigious investment bank, accepted Mr Maxwell's custom in the late 1980s, originally to buy/sell MCC shares; the loans, options and forex dealings came later. The bank was well known for a high moral tone, which included refusing to take on clients with even a hint of bad reputation, but the New York Committee overruled the misgivings expressed by the London office, possibly because the business was confined to the sale and purchase of MCC shares. For many banks, Goldman Sachs' acceptance of Maxwell as a client was a signal that he was financially sound, and they agreed to lend to him.⁶

Moral hazard is another problem if the principal, a customer, deposits money in the agent, a bank. Moral hazard arises whenever, as a result of entering into a contract, the

⁵ For a more theoretical treatment, see Bhattacharya and Pfleiderer (1985), Diamond (1984) and Rees (1985).

⁶ For more detail, see the Goldman Sachs case (Chapter 10).

incentives of the two parties change, such that the riskiness of the contract is altered. Depositors may not monitor bank activities closely enough for several reasons. First, a depositor's cost of monitoring the bank becomes very small, the larger and more diversified is the portfolio of loans. Though there will always be loan losses, the pooling of loans will mean that the variability of losses approaches zero. Second, deposit insurance schemes⁷ reduce depositors' incentives to monitor the bank. If a bank can be reasonably certain that a depositor either cannot or chooses not to monitor the bank's activities once the deposit is made, then the nature of the contract is altered and the bank may undertake to invest in more risky assets than it would in the presence of close monitoring.

Shareholders do have an incentive to monitor the bank's behaviour, to ensure an acceptable rate of return on the investment. Depositors may benefit from this monitoring. However, even shareholders face agency problems if managers maximise their own utility functions, causing managerial behaviour to be at odds with shareholder interest. There are many cases of bank managers boosting lending to increase bank size (measured by assets) because of the positive correlation between firm size and executive compensation. These actions are not in the interests of shareholders if growth is at the expense of profitability.

1.3.2. Relationship Banking

Relationship banking can help to minimise principal agent and adverse selection problems. Lender and borrower are said to have a *relational contract* if there is an understanding between both parties that it is likely to be some time before certain characteristics related to the contract can be observed. Over an extended period of time, the customer relies on the bank to supply financial services. The bank depends on long-standing borrowers to repay their loans and to purchase related financial services. A relational contract improves information flows between the parties and allows lenders to gain specific knowledge about the borrower. It also allows for flexibility of response should there be any unforeseen events. However, there is more scope for borrower opportunism in a relational contract because of the information advantage the borrower normally has.

The Jürgen Schneider/Deutsche Bank case is a good example of how relationship banking can go wrong. Mr Schneider, a property developer, was a long-standing corporate client of Deutsche Bank. Both parties profited from an excellent relationship over a long period of time. However, when the business empire began to get into trouble, Schneider was able to disguise ever-increasing large debts in his corporation because of the good record and long relationship he had with the bank. Schneider forged loan applications and other documents to dupe Deutsche and other banks into agreeing additional loans. In 1995, he fled Germany just as the bank discovered the large-scale fraud to cover up what was

⁷ Deposit insurance means that in the event of the bank going out of business, the depositor is guaranteed a certain percentage of the deposit back, up to some maximum. Normally banks pay a risk premium to a deposit insurance fund, usually administered by bank supervisors.

essentially a bankrupt corporation. After nearly 3 years in a Florida prison, Mr Schneider gave up the fight against extradition and was returned to Germany to face the biggest corporate fraud trial since the end of the Second World War. In 1998, he was convicted of fraud/forgery and given a prison term of 6 years, 9 months. The judge criticised German banks for reckless lending. Outstanding loans amounted to \$137 million. Deutsche Bank apologised for improper credit assessment, especially its failure to follow proper procedures for loan verification.

1.3.3. Transactional or Contract Banking

An arms-length *transactional* or *classical contract* is at the other extreme and gives rise to *transactional banking* – where many banks compete for the customer's business and the customer shops around between several banks to find the best deal. Little in the way of a relationship exists between the two parties – both sides stick to the terms of the contract. A transactional contract deters opportunistic behaviour and because each contract is negotiated, both parties can bargain over terms. On the other hand, information flows will be significantly curtailed and the detailed nature of the contract reduces the scope for flexibility.

It is important to treat the definitions given above as two extremes, at either end of a spectrum. In reality, most banks will offer a version of relationship banking to some customers or apply it to some products, while contract-like banking is more appropriate for other clients and/or services. For example, virtually all customers who enter into a loan agreement with a bank will sign a legally binding contract, but if the customer has a good relationship with the manager and a good credit history, the manager is likely to allow a certain degree of flexibility when it comes to enforcing the terms of the contract. For new clients, the manager will be more rigid.

Relationship banking is most evident in countries such as Japan and Germany, where there are cross-shareholdings between banks and non-financial corporations. In other countries, including the USA and the UK, classical contracts are the norm. In Japan and Germany, the close bank–corporate relationships were, in the 1970s and 1980s, praised as one of the key reasons for the success of these economies. However, in the 1990s, relationship banking declined because of global reforms, which increased the methods for raising corporate finance and the number of players in the market.

Furthermore, the serious problems in the Japanese financial sector that began in 1990 have undermined *keiretsu*, the close relationship enjoyed by groups of firms, including a bank. The bank plays a pivotal role in the group because it provides long-term credit to the main firm and its network of suppliers, as well as being a major shareholder. The bank also gives the *keiretsu* advice and assistance in overseas ventures. With the steady rise in the number of key banks facing bankruptcy, primarily as a result of problem loan portfolios, and a drastic reduction in the market value of banks' equity portfolios due to the prolonged decline in the stock market, the relationships between banks and corporations have been seriously undermined.⁸

⁸ See Chapter 8 for more detail.



1.3.4. Payment Systems: A Byproduct of the Intermediary Process

One theme of this chapter is that banks differ from other financial firms because they act as intermediaries and provide liquidity. Banks require a system for processing the debits and credits arising from these banking transactions. The payment system is a byproduct of intermediation, and facilitates the transfer of ownership claims in the financial sector. Credits and debits are transferred between the relevant parties. In the UK alone, there were over 28 billion cash payments in 2001, but they are expected to decline to 24 billion by 2010. £113 billion was withdrawn from the 34 300 Automatic Teller Machines (ATMs) in 2000.⁹ In the same year, there were 3 billion plastic card transactions with UK merchants.

However, there are two key risks associated with any payment. Banks must manage the following.

- *Liquidity risk:* The settlement is not made at the expected time so that assets/liabilities cannot be transferred from one agent to another via the system.
- *Operational risk:* Arising from the threat of operational breakdowns, preventing timely settlement. For example, the hardware or software supporting the system may fail. System breakdowns can create liquidity risk. Given the open-ended nature of the term, it is difficult to provide a precise definition, which makes measurement problematic.

The international payments system is described in the section on international banking in Chapter 2. In the UK, payments are organised through the following.

- **APACS** (Association for Payments Clearing Services): An umbrella organisation formed in late 1984, and made up of BACS, CCCL and CHAPS. It was supposed to allow relatively easy entry of banks into the UK payments system. Membership is offered to all participants with at least 5% of total UK clearing. Financial firms that do not qualify for membership but offer products requiring clearing and payments are made associate members.
- **BACS Limited:** An automated clearing house for non-paper-based bulk clearing, that is, standing orders, direct debits and direct credits. Fourteen direct members sponsor about 60 000 other institutions to use the system. As can be seen from Table 1.1, BACS clearing volumes stood at 3.7 billion in 2002.
- **CCCL** (Cheque and Credit Clearing Company Limited): Responsible for paper-based clearing, i.e., cheques. In 2002, there were 2.4 billion cheque transactions (see Table 1.1), which is forecast to fall to 800 million by 2012.¹⁰
- **CHAPS:** Provides Real Time Gross Settlement (RTGS) for high value payments, and is the second most active in the world. In 1998, the average value of transactions processed was £2.3 million, compared to £552 for BACS. In 2000, there were some 25 million

⁹ Source: APACS (2003).

¹⁰ Source: APACS (2003).

Table 1.1 UK: total transactions by volume (millions)

	1990	1995	2000	2003
Cash payments	28 023	26 270	27 910	25 859
Cheques	3 975	3 203	2 699	2 251
ATM withdrawals	1 045	1 471	2 027	2 373
Number of ATM cards	47	55	73	88
Plastic cards*	1 741	2 413	3 914	5 317
BACs clearing	1 820**	2 476	3 527	4 060
CHAPS clearing	9**	13	25	33
Cheque & credit	2 513**	2 314	1 981	1 660

* Includes debit, credit, charge and store cards.

** 1992 figures.

Source: APACS (2003), "Payments: Facts and Figures", www.apacs.org.uk

transactions worth £49.1 billion; transactions had risen to 31 million by 2002. CHAPS Euro was formally launched in January 2001, to process euro payments between members, with monthly volumes of 280 000, valued at 3600 million euros.¹¹ It also provides the UK link to TARGET (see below). The real time nature of the settlement eliminates settlement/liquidity risk, unlike BACS, which settles payments in bulk.

- **CLS:** Created to reduce risks associated with payments involving another currency. It will gradually replace the standard foreign exchange settlement method, where a correspondent bank is used. In 2002, CLS introduced real time payment for foreign exchange transactions.
- **CREST:** Settlement of Securities. Central bank-related transactions moved to real time in 2001, and the idea is to introduce it for all money market instruments – payments are still made at the end of the day on a net settlement basis. The London Clearing House (LCH) acts as a central counterparty for transactions on the financial exchanges, and for some over the counter markets. At the end of 2003, LCH merged with its Paris counterpart Clearnet, creating Europe's largest central counterparty clearing house. It will go some way to creating a pan-European clearing house, reducing the cost of cross-border trading in Europe.

1.3.5. Use of Cards and ATMs

In the mid to late 1990s, there was a continued rapid growth in the use of cards instead of cheques. This point is illustrated in Table 1.1. This table also illustrates that cash payments over the decade and into the new century are fairly stable, and ATM withdrawals have more than doubled. Cash payments remain the dominant payment method, making up three-quarters of all payments, and their dominance will continue, though there might be a slight decline once social security benefits are paid directly into accounts. The use of cheques as a form of payment has fallen dramatically, as households and businesses switch

¹¹ The source for all figures cited for CCCL and CHAPS is APACS (2003).

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to the use of plastic cards or direct debit/credit. About 3% of card transactions were via the internet in 2002, and by 2012, APACs is forecasting this to grow to 10%.¹² The ATM network in the UK is run by LINK, which is jointly owned by the banks and building societies. Via LINK, customers have access to over 34 000 ATMs. There are two credit card schemes: Mastercard, owned by Europay, and Visa, part of Visa International. There are also two debit card schemes: Switch and VisaDebit.

Cruikshank (2000) reports that the payment schemes (APACS, Visa, etc.) and ATM network are dominated by the "big four" banks¹³ because the size of shareholdings is normally determined by the volume of transactions in a given scheme. Cruikshank criticised the consequences of this control, which was to take advantage of their monopoly position. Other users of the network were being charged excessive amounts, which had to be passed on to their customers or absorbed in their costs. For example, internet banks had to pay twice as much for access to the system as the big four, and retail outlets were charged excessive prices to offer a direct debit/credit card service to their customers. Cruikshank reported that the fee charged bore no relation to the cost of the investment undertaken by the big four. The big four banks paid the lowest prices to use the system, and, for a brief period, account holders faced charges if they used a rival's machine, though a vociferous public campaign forced banks to largely abandon this practice.

Cruikshank recommended the establishment of an independent regulator for the payment systems: Paycom. Access would be via a licence, the price of which would reflect the cost of use by a given bank. It could also ensure entrants were financially sound, to minimise settlement and liquidity risk. For example, with the exception of CHAPS, the systems are not based on real time gross settlement,¹⁴ so any bank that failed while it was still using the payments system could strain the liquidity of the system. The British government accepted the need for reform, and referred the matter to the Office of Fair Trading. It has announced the introduction of PaySys, a rule-based system to regulate the payments industry (the Treasury will draft the relevant details), which does not go as far as the "public utility" approach represented by Paycom. An alternative is the "competing network" model,¹⁵ whereby there are several large networks that compete for banks to join them.

The clearing system in the United States is quite different. The Federal Reserve Bank operates a number of cheque clearing centres, which are responsible for about 35% of US cheque clearing, which amounted to \$13.4 billion in 1998.¹⁶ Private centre arrangements made between banks account for another 35%, and about 30% is cleared by individual banks. In 1998, \$16 billion worth of electronic payments were processed through one of 33

¹² The source of these projections is APAC (2003).

¹³ At the time, National Westminster Bank, Hong Kong and Shanghai Banking Corporation (HSBC), Barclays and LloydsTSB. NatWest was taken over by the Royal Bank of Scotland in 2000, and Lloyds dropped to fifth position after the merger between Halifax and the Bank of Scotland (to form HBOS) in 2001. It is no surprise that the largest banks control the network. Only very large banks are able to finance the associated costly technology.

¹⁴ It normally takes 3 to 5 working days for a transaction to be completed. For example, if a customer withdraws money from an ATM, it may not be debited from the account for 2 days; in the case of debit cards used at retailers, or a transfer of funds from one account to another, it can take up to 5 working days.

¹⁵ These terms are from Anderson and Rivard (1998).

¹⁶ Source: BIS (2000), tables 8 and 9 (pp. 95–96). All 1998 figures for ACHs, CHIPS and Fedwire are from the same tables.

automatic clearing houses (ACHs) run by the Federal Reserve or one of the private ACHs. International interbank transactions are handled by CHIPS, the Clearing House Interbank Payments System. It is run by the privately owned New York Clearing House Association. CHIPS uses *multilateral netting*. Until 2001, all net obligations were cleared at the end of the day, but a new bilateral and multilateral algorithm means most payments will be settled promptly through a given day, thereby reducing settlement risk. In 1998, there were roughly 60 million settlements, with a total value of about \$350 trillion.

Fedwire is operated by the Federal Reserve and allows banks (that keep deposits or have a clearing facility with the Federal Reserve) to send and receive payments. With more than 11 000 users (1998) there were over 98.1 million transactions worth \$328.7 trillion. Fedwire has offered net settlement facilities since 1999, which has reduced members' exposure to settlement risk.

In Europe, TARGET (Trans-European Automated Real Time Gross Settlement Express Transfer System) was set up in response to the European Monetary Union. It means central banks can transfer money within each EU state. It consists of 15 national RTGS systems, the European Central Bank Payment Mechanism (EPM) and SWIFT,¹⁷ which interconnects these systems. Since the settlement is immediate, in real time, it eliminates settlement risk, because the payments are deducted from and credited to the relevant accounts immediately.

TARGET is viewed as a harmonised system, and greater harmonisation is expected in the future. According to BIS (2003f), TARGET processes over 211 000 payments each day, valued at €1.3 trillion. Though TARGET eliminates settlement risk, operational risk is considerable. For example, in 1999, a system error at one of the very large banks meant it was unable to process payment orders for foreign exchange, money market transactions, securities settlement and customer payment. The backup system also broke down because it relied on the same software. Manual systems could not cope, so that many large value payment and securities orders were not settled until the next day – this operational breakdown effectively recreated settlement risk.

Apart from the TARGET arrangement for central banks, the situation in Europe looks bleak. With the introduction of the euro in 2002, there is a need for a payments system that allows for quick settlement within Euroland. Instead, there is a plethora of bilateral agreements between different banks. Eurogiro was set up in 1992 by 14 countries' giro clearing organisations, and a similar system, Eufiserv, operates among the European savings banks. Some moves have been made to link CHAPS with its equivalent in France (SIT), Switzerland (SIS) and Germany (EAF), but no formal agreement has been reached. The large number of independent arrangements (that do not include all banks) will hamper cross-border settlement even if banks are all using one currency, the euro. The cost of cross-state settlement in Europe is estimated to be substantially higher than in the United States.

Increasingly, the responsibility for payments and securities clearing is being unbundled from the traditional bank functions, and given to a third entity, which is not necessarily

¹⁷ SWIFT (Society for World-wide Interbank Financial Telecommunications): Established in Belgium in 1973, it is a cooperative company, owned by over 2000 financial firms, including banks, stockbrokers, securities exchanges and clearing organisations. SWIFT is a messaging system, for banking, foreign exchange and securities transactions, payment orders and securities deliveries. The network is available 24 hours a day, every day of the year.

another bank. These firms are providing a service to banks: processing settlements and securities for a large number of banks, reducing banks' back office operations. In other words, back office functions are becoming the sole activity of certain firms, which the banks pay, rather than having their own back office operations. According to BIS (2001, p. 310), in the USA, the top five non-bank service providers make up 20% of the outsourcing market.

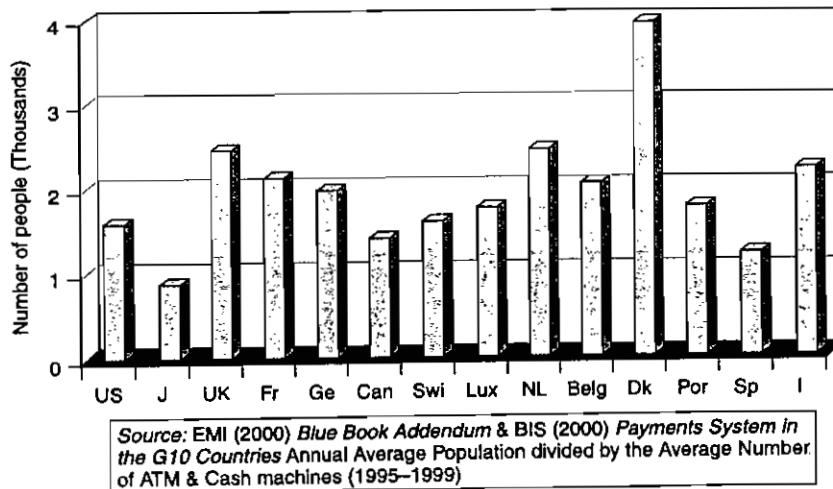
1.3.6. An International Comparison of Payments Technology

Figures 1.3–1.6 illustrate how the pace and form of payments-related technological innovation has varied widely among the different industrialised countries. Figure 1.3 shows that ATMs are more plentiful in Japan and North America than in Western Europe. In Europe, Denmark has the fewest ATMs relative to population, followed by the UK and the Netherlands. The other European countries are roughly the same. The change in the UK is surprising because, in the 1980s, it was one of the leading ATM countries in Europe. It is consistent with the large number of branch closures in the UK, and ATMs have not spread in sufficient numbers to other sites, such as supermarkets, rail and petrol stations.

Turning to Figure 1.4, Germany stands out as having relatively few Electronic Funds Transfer at Point of Sale (EFTPOS) machines, followed by Italy, the USA and Portugal. However, while the ratio of population to EFTPOS is 466 in Germany, it is half that in the USA. Countries with relatively more machines include Spain, Switzerland, Canada and France.

Switzerland, Japan and the USA have relatively high paperless credit transfers (Figure 1.5), while some of the continental European countries rank at the bottom – France, Portugal, Italy and Belgium. Figure 1.6 shows the USA, Canada and the UK have the highest value of payments by credit and debit cards, with some of the continental countries lagging

Figure 1.3 Average population per ATM.



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Figure 1.4 Average population per EFTPOS machine.

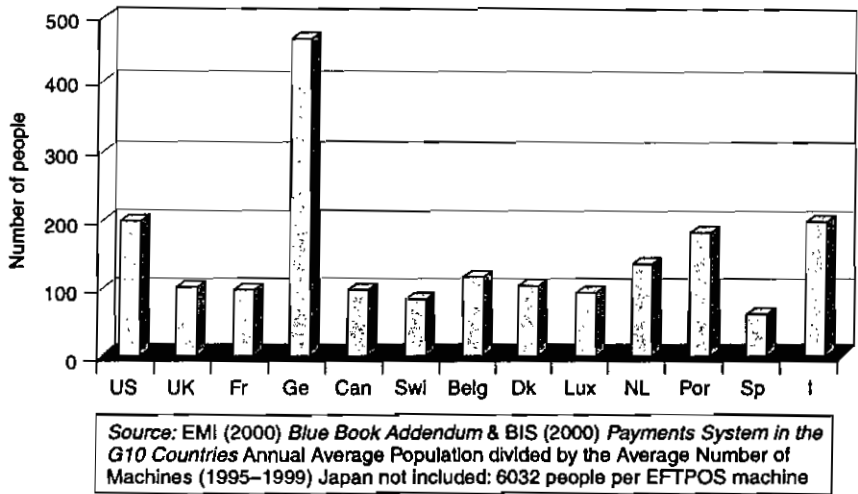
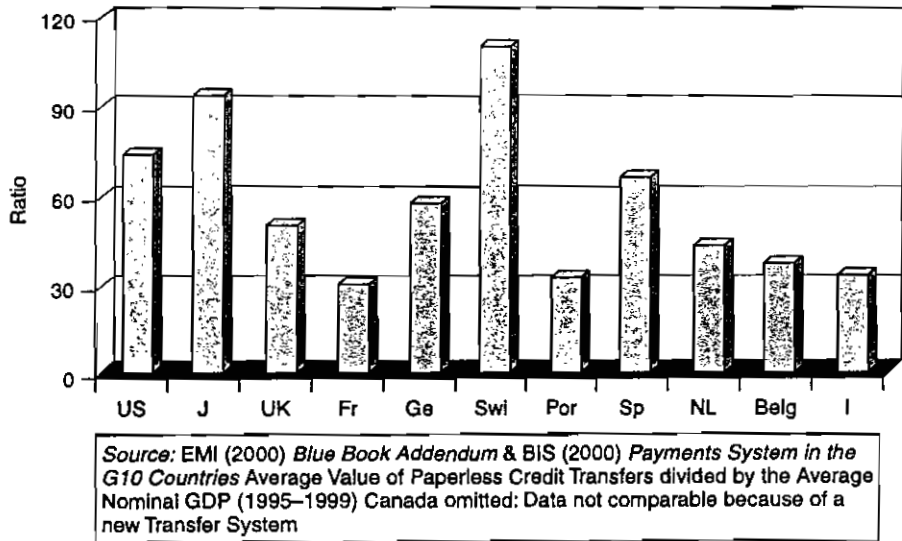


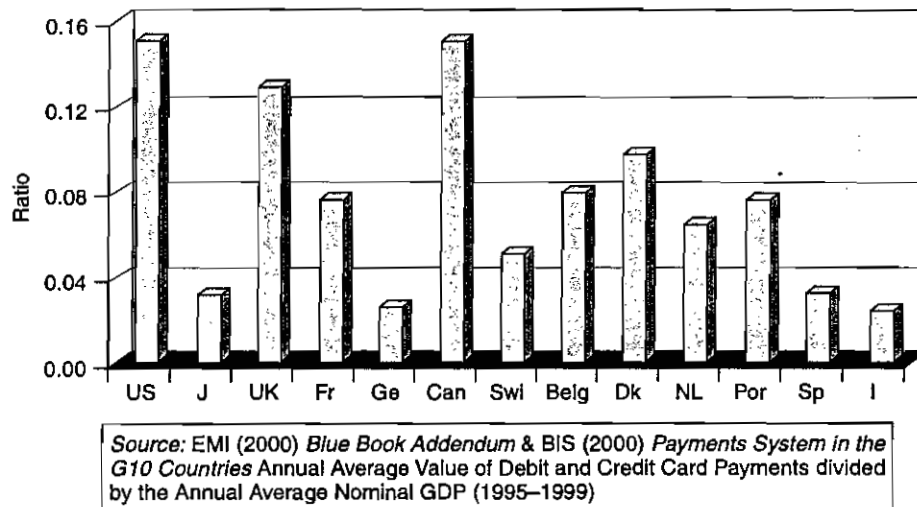
Figure 1.5 Ratio of value of paperless credit transfers to nominal GDP.



behind – especially Germany, Italy and Spain. The use of credit and debit cards in Japan is also low, compared to other countries.

Correspondent banking and custody services are also part of the payments system. Correspondent banking is an arrangement whereby one bank provides payment and other services to another bank. Reciprocal accounts, which normally have a credit line, are used to facilitate

Figure 1.6 Ratio of value of payments by debit and credit cards to nominal GDP.



payments through the correspondent bank. *Custody services* involve the safekeeping and administration of securities and other instruments on behalf of other banks or customers. Globally, the number of banks offering these services has declined, as a small number of large banks dominate an increasingly consolidated market. For example, the Bank of New York has opted to be a niche player, offering global custody services to other banks, managing \$6.3 trillion worth of custody assets in 2000. Banks specialising in these services normally have sound reputations, offer a fairly large range of products and services that are easily obtainable, participate in key payment and settlement systems, and can raise liquidity.

1.4. Banking Structures

1.4.1. Some Comparative Figures

The structure of banking varies widely from country to country. Often, a country's banking structure is a consequence of the regulatory regime to which it is subject, a topic that is covered in some detail in Chapter 5. Below, different types of banking structures are defined. These different banking structures do not alter the *core functions* of banks, the provision of intermediation and liquidity, and, indirectly, a payment service, which are the *defining* features of banks.

Table 1.2 shows the top 10 banks by assets and, in recent years, *tier 1 capital*, defined as equity plus disclosed reserves. The USA leads the way in 1996, when seven of its banks were in the top 10. In the 1990s, US banks were hard hit by global, then domestic, bank debts. By 1997, Japanese banks had replaced US ones, with six leading banks,

Table 1.2 The Top 10 banks, 1969–2003

	1969 (assets)	1994 (assets)	1997 (assets)	1997 (tier 1 capital)	2001 (assets)	2001 (tier 1 capital)	2002 (tier 1 capital)	2002 (assets)	2003 (tier 1 capital)
USA	7	1	0	3	3	3	3	2	3
Japan	0	6	6	3	2	3	3	3	3
UK	1	1	1	1	1	1	1	1	2
France	1	1	1	1	1	1	1	1	2
Germany	0	0	1	1	2	1	1	0	0
Netherlands	0	0	0	1	0	0	0	2	0
Switzerland	1	0	0	0	1	0	0	1	0
China	0	1	1	0	0	1	1	0	0

Source: *The Banker*, various July issues.

measured by assets, though the figures are less dramatic when banks are ranked, for the first time, by tier 1 capital. Note how Japanese banks shrink (by asset size) between 1997 and 2001/2. This partly reflects the serious problems in the Japanese banking sector, a topic to be discussed at greater length in Chapter 8. What is surprising is that Japan's tier 1 capital hardly changes in the period 1997–2000, when the Japanese banks were suffering from serious problems. The reason there is little change in the rankings is because of mergers among the top, but troubled, Japanese banks, especially in 2000/1. Consolidation also took place in the USA during the same period, albeit for different reasons.

Dramatic differences in banking structure can be seen by comparing the UK and USA. Tables 1.3 and 1.4 illustrate this. Table 1.3, which gives figures for the UK, is divided into

Table 1.3 UK Banking Structure, 1997 and 2002
 (a) 2002

Financial institutions	Number	Assets (£bn)
All banks resident in UK, of which:	517	4663
Foreign (branches & subsidiaries)	281	2161
UK incorporated, of which:	236	2472
(1) Commercial	35	1455
(2) BS + mortgage banks	78	683
(3) Other UK owned	53	52
(4) Foreign owned	70	281
Insurance companies, of which:	782	1018
Life	182	942
Non-life	600	76

BS: building societies.

Source: IMF (2003), which claims sources from the Bank of England, BIS, FSA, and their own estimates.

Table 1.3 (continued)
(b) 1997

Financial institutions	Number	Assets (£bn)
All banks in the UK	466	2 643
UK owned banks	112	1 254
EU owned banks	110	608
US owned banks	39	207
Japanese owned banks	19	186.3
Building societies	141	167.7
Building Societies	141	

Sources for assets of banks and building societies: Bank of England (2000), *Statistical Abstract*, tables 3.2.1–3.2.6; 16.2.

Sources for number of institutions: Bank of England website, <http://www.bankofengland.co.uk/mfsd/abst/ab1ukbks.doc> and British Bankers Association (2000), *Abstract of Banking Statistics*.

Table 1.4 US banking structure, 1997 and 2004

Type of bank	US assets (\$bn)		Number		% of total assets	
	1997	2000	1997	2004	1997	2004
Commercial*	4 771	6 239	9 308	7 769	77.6	79
Savings institutions	1 030	1 223	1 852	1 413	16.7	15
Credit unions	349	na	11 328	9 529	5.6	6
Total	6 150	7 462	22 488	18 711	100	100
Securities firms & investment banks	Capital – 30*		7 776*	5 286		

Sources: Table constructed from 1997 figures quoted in Saunders (2000), *Financial Institutions Management*, London: McGraw Hill, chapters 1, 3, which in turn are supplied by the FDIC (second table) and the Federal Reserve Bulletin. 2004 figures obtained from the FDIC website.

*1996 figures.

parts (a) and (b) because the figures are not strictly comparable between 1997 and 2002. Of 420 banks in the UK in 1997, 88 were UK owned,¹⁸ compared to nearly 22 500 US banks. US bank numbers, due to consolidation, are falling – they fell by about a quarter between 1997 and 2000. Even so, compare the 35 commercial banks in the UK in 2002 to over 7700 in the USA.

Table 1.5 shows that in 1996 and 1999, the USA had 10 000 more deposit-taking institutions than the other 10 major western countries combined. At the same time, it does not appear to be over-banked compared to some other countries with much smaller populations. In 1999, the USA had nearly 3500 inhabitants per branch, compared to its

¹⁸ Along with 67 building societies, which are mutually owned.

Table 1.5 Number of Depository Institutions and Population per Branch

	No. of Inhabitants per Branch		No. of Institutions	
	1996	1999	1996	1999
Belgium		1 221		121
Canada	1 857	2 233	2 497	2 108
France		2 350		1 672
Germany	1 169	1 481	3 509	2 995
Italy		1 400		878
Japan	1 634	1 961	4 635	3 169
Netherlands	2 277	2 523	126	123
Sweden	2 291	2 249	125	123
Switzerland	946	1 097	372	336
UK	1 611	1 743	561	506
USA	2 772	3 469	23 123	21 070

Source: BIS (1998, 2001), *Statistics on Payment Systems in the Group of 10 countries*.

neighbour, Canada, with a tenth of the population and 2233 inhabitants per depository institution.

The figures for Canada, France and Germany should be treated with caution. The Canadian banking structure in Canada is similar to that of the UK, with four banks holding a very large percentage of assets and deposits. *Caisses populaires* in Quebec, along with a large number of credit unions, make the numbers look big. In fact, these organisations have a tiny market share, by any measure. The figures also mask the importance of the cooperative movement in certain countries, especially France and Germany. Furthermore, Germany has a large number of regional banks, which somewhat dilute the dominance of the big universal banks such as Deutsche Bank and Dresdner, but again, their respective market shares are quite high. Together with the large number of "thrifts" (savings and loans), the USA has many more deposit-taking institutions, mainly because of the regulatory structure that discourages interstate and intrastate branching, and the Glass Steagall Act (1933) that required banks to be either investment or commercial, but not both. However, reforms in the 1990s should increase consolidation and could lead to nation-wide banking.¹⁹

Japan displays a lower population per bank branch than some countries in Western Europe. In Table 1.5, it ranks seventh – Germany, Italy, Belgium and Switzerland all have fewer inhabitants per branch. However, the figure for Japan may be biased downwards because it excludes the 24 000 Post Office outlets in that country, where on average about 35% of the country's deposits are held. Western European countries differ widely, with extensive branch networks in Switzerland and Belgium, but relatively few in Denmark, the Netherlands and France. The main organisational banking structures are discussed below.

¹⁹ For more detail, see a brief discussion in section 4 and the detailed review of US bank regulation in Chapter 5.

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1.4.2. Definitions of Types of Banking

Universal banking

Universal banks offer the full range of banking services, together with non-banking financial services, under one legal entity. In addition, the banks have direct links between banking and commerce through cross-shareholdings and shared directorships. Financial activities normally include the following.

- Intermediation and liquidity via deposits and loans; a byproduct is the payments system.
- Trading of financial instruments (e.g., bond, equity, currency) and associated derivatives.
- Proprietary trading, that is, trading on behalf of the bank itself, using its own trading book.
- Stockbroking.
- Corporate advisory services, including mergers and acquisitions.
- Investment management.
- Insurance.

Germany is the home of universal banking (the *German hausbank*), with banks such as Deutsche Bank and Dresdner offering virtually all of the services listed above. Though German banks may own commercial concerns, the sum of a bank's equity investments (in excess of 10% of the commercial firm's capital) plus other fixed investments may not exceed the bank's total capital. In addition to a German bank lending to commercial firms, it will also exert influence through the Supervisory Board.²⁰ Seats on a supervisory board are for employees and shareholders. Most of the shareholder seats are held by bank executives because the bank normally has a large shareholding. The influence of the bank is increased because smaller shareholders nominate the bank to represent them when they deposit their shares at the bank for safekeeping. Deutsche Bank has major holdings in Daimler-Benz (automobiles), Allianz (the largest insurance company), Metallgesellschaft (oil industry), Philip Holzman (construction) and Munich Re (a large re-insurance firm), to name a few. The bank also purchased a firm of management consultants (Roland Berger) and is represented on more than 400 Supervisory Boards. In 1986, Deutsche Bank undertook an important strategic expansion outside Germany when it purchased Morgan Grenfell in London. Subsequent purchases have included Banca America d'Italia,²¹ McLean McCarthy, a Canadian stockbroker, and Bankers Trust. It is a truly universal bank, which, together with its subsidiaries, can offer every type of financial service in Germany and, increasingly, in other major countries.

Commercial and Investment banks

These terms originated in the United States, though they are used widely in other countries. The four Glass Steagall (GS) sections of the Banking Act, 1933, became known as the Glass Steagall Act. Under GS, commercial banks were not allowed to underwrite

²⁰ German companies have two boards. The membership of the Executive Board consists of full-time executives of the company. It is where the main decisions are taken. The Supervisory Board must approve the Executive Board's financial decisions.

²¹ A subsidiary of Bank of America in Italy, with 105 branches.

securities with the exception of municipal bonds, US government bonds and private placements. Investment banks were prohibited from offering commercial banking services. The objectives of the Act were twofold, to discourage collusion among firms in the banking sector, and to prevent another financial crisis of the sort witnessed between 1930 and 1933.

The early US investment banks: (a) raised capital for large corporations and government, by acting as underwriters for corporate and government securities and (b) for a fee, arranged mergers and acquisitions (M&As). Modern investment banks engage in an expanded set of activities:

- underwriting
- mergers and acquisitions
- trading – equities, fixed income (bonds), proprietary
- fund management
- consultancy
- global custody

The expansion of activities helps to diversify these firms but has not been problem-free. For example, at Lehman Brothers, Goldman Sachs and others, the growth of the trading side of the bank created tensions between the relatively new traders and the banking (underwriting, M&As) side of the firm. At Lehman's, at one point, 60% of the stock was distributed to the bankers even though banking activities contributed to less than one-third of profits.

Controversy broke out in 2002, beginning with an investigation of Merrill Lynch by the New York Attorney General,²² Eliot Spitzer, and concluding in April 2003 when 10 of the top US investment banks settled with several regulatory bodies for just over \$1.4 billion in penalties and other payments, for alleged conflicts of interest between banks' analysts and their investment bank divisions. The probe began in 2002 when Henry Blodget, considered the top technology analyst at Merrill Lynch, was accused of recommending certain technology companies (thus sending up their share price) who were also clients at Merrill Lynch's investment bank. Mr Spitzer uncovered emails sent by Mr Blodget saying many of the stocks he recommended to investors were "junk" and "crap". Other documentation indicated the practice was widespread. The brokerage head of Citigroup was caught claiming that the research produced by Salomon Smith Barney was "basically worthless". Mr Weill, recent past Chairman of Citigroup, had asked an analyst at Salomon Smith Barney to reconsider the advice given on AT&T.²³ There was a potential conflict of interest because the profits of the investment bank financed banks' research departments. Thus, banks' analysts were under pressure to support a particular company that was also giving underwriting, consulting or other business to the banks' investment banking division.

The \$1.4 billion settlement consists of:

- \$487.5 million in penalties to be distributed between state regulators, the SEC, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD);

²² The New York Attorney General is also the state's securities regulator.

²³ Mr Blodget and Mr Grubman (Salomon Smith Barney) were fined \$4 and \$5 million, respectively and banned for life from working in the securities sector.

1.

- \$387.5 million to be returned to investors;
- \$432.5 million to set up an independent research body – firms must supply their clients with this independent research for the next five years;
- \$92.5 miscellaneous.

Though the banks never admitted to any wrong-doing, they agreed to make the following payments:

- Citigroup–Salomon Smith Barney \$400 million;
- Merrill Lynch \$200 million (including the \$100 million fine it paid in 2002);
- Credit Suisse First Boston \$200 million;
- Morgan Stanley \$125 million;
- Goldman Sachs \$110 million;
- Bear Sterns, JP Morgan, Lehman Brothers, UBS Warburg \$80 million each;
- Piper Jaffray \$32.5 million.

In addition, the investment banks have agreed to a number of new rules.

1. Their research and banking divisions will be supervised separately and issue separate reports.
2. Investment banking divisions are not allowed to rate research analysts.
3. A firewall²⁴ was erected – the compensation of analysts cannot be linked to the performance of the investment banking arm of the bank.
4. Research analysts may not participate in the marketing of the bank, e.g., share sales, deals for institutional investors.
5. No unnecessary communication is allowed between analysts and the investment banking group.
6. Banks must make public any companies that are investment bank clients and are analysed by the bank's research department.
7. "Spinning" or giving favoured clients opportunities to purchase shares in top initial public offerings (in exchange, it is hoped, for consulting or other investment banking business) was banned.

Prior to the payout being made public, Merrill Lynch announced it would insert a Chinese wall between its research and corporate finance divisions. Citigroup revealed that its research and retail broking business would be turned into a separate subsidiary. However, other conflicts of interest issues continue to surface. Banks are accused of fraud²⁵ for inflating prices on stock firms and initial public offerings (IPOs). For example, some banks are cited in a \$30 billion damages issue for ignoring problems at Enron, and there are a number of class action lawsuits. At the time of writing, however, early judgements suggest these may not succeed: they are being dismissed for lack of evidence and because of the views of at

²⁴ See p. 28 for a formal definition.

²⁵ Under the 1934 Securities Act, a bank is liable for fraud if it is negligent and/or ignored problems on a firm's balance sheet that is subsequently promoted.

least one judge (Milton Pollack, who is ruling on 25 class action lawsuits – he has described the plaintiffs as “high risk speculators” and has already dismissed several cases).²⁶

Washington politicians have criticised the settlement as being far too low, which banks will treat as the cost of doing business. For example, Mr Richard Shelby²⁷ noted that Citigroup (parent of Salomon Smith Barney) earned \$10.5 billion in investment banking revenues from 1999–2001, so its share of the fine is under 4% of its revenue for the period. Self-regulation has also come under fire because the NYSE and NASD regulate their own members but failed to spot the problem, nor did the SEC, though they are a powerful government regulatory body.

Merchant banks

Barings, the oldest of the UK merchant banks, was founded in 1762. Originally a general merchant, Francis Baring diversified into financing the import and export of goods produced by small firms. The financing was done through bills of exchange. After confirming firms' credit standings, Barings would charge a fee to guarantee (or “accept”) merchants' bills of exchange. The bills traded at a discount on the market. Small traders were given much-needed liquidity. These banks were also known as “accepting houses” – a term employed until the early 1980s. They expanded into arranging loans for sovereigns and governments, underwriting, and advising on mergers and acquisitions.

Financial reforms,²⁸ including the Financial Services Act (1986), changed merchant banking. The reforms allowed financial firms to trade on the London Stock Exchange, without buying into member firms. Fixed commissions were abolished, and *dual capacity* dealing for all stocks was introduced. This change eliminated the distinction between “brokers” and “jobbers”. Most stock exchange members acted as “market makers”, making markets in a stock *and* brokers, buying and selling shares from the public.

These changes made it attractive for banks to enter the stockbroking business, and most of the major banks (both clearing and merchant) purchased broking and jobbing firms or opted for organic growth in this area. The majority of the UK merchant banks began to offer the same range of services as US investment banks, namely, underwriting, mergers and acquisitions, trading (equities, fixed income, proprietary), asset or fund management, global custody and consultancy. As merchant banks became more like investment banks, the terms were used interchangeably and, in the new century, “merchant bank” has all but disappeared from the vocabulary.

The UK's financial regulator, the Financial Services Authority (FSA), has been more sanguine on the conflict of interest issue, even though many of the US investment banks that are party to the April 2003 agreement have extensive operations in London. In a July 2002 discussion paper, the FSA acknowledged the presence of US banks operating in London. The study also identifies a number of conflicts of interest, the main one being when the remuneration of research analysts is dependent on the corporate finance or equity brokerage parts of an investment bank, which generate revenues from underwriting and

²⁶ Source: “Dismissed”, *The Economist*, 5 July 2003, pp. 81–82.

²⁷ Republican Senator and Chairman of the Senate Banking Committee.

²⁸ Collectively known, along with other reforms, as Big Bang, 1986.

advisory or brokerage fees. There were no specific accusations of bias, and the FSA noted that institutional investors, who are well informed, are more dominant in the UK markets. However, the paper reports the results of a study by the FSA comparing recommendations on FTSE 100 companies made by firms acting as corporate broker/advisor to the subject company to those made by independent brokers with no such relationship. The main finding was that the firms acting as corporate brokers/advisors to the subject company made nearly twice as many buy recommendations as the independent brokers.

Having identified potential conflicts of interest, the FSA noted that many are currently covered under Conduct of Business rules, Code of Market Conduct and insider trading laws. The paper concluded by suggesting four possible options: (1) the status quo; (2) all research reports from investment banks or related firms to be clearly labelled as advertising; (3) following the US route, though this option would require a far more prescriptive approach, which is at odds with the UK's emphasis on principles; or (4) letting market forces do their job, because investors know who the client firms of investment banks are, and discount any reports coming from their research department. These options were put forward for further discussion, and in 2003 the FSA published a consultative paper (CPI171, 2003). It appears the FSA will continue with a principles-based approach, but like the US authorities, recommends analysts should not be involved in any marketing activities undertaken by the investment bank, nor should the investment banking department influence the way analysts are paid. The FSA also suggests that analysts working for a bank underwriting a share issue for a firm should be banned from publishing any research on this firm. There are objections to the last proposal: it is argued that the analyst at the underwriting firm is the best informed about the firm about to go public, so stopping the publication of their reports will mean the market is missing out on a good source of information. Also, what if more than one bank is underwriting a rights issue?

Unlike the USA, the banks will not be required to fund independent research. Nor will analysts be required to certify that any published report reflects their personal opinion. However, the FSA has announced plans to educate the public on the risk associated with stock market investments, which is in line with their statutory duties.

Is an investment bank a bank?

This chapter has stressed that the features which distinguish banks from other financial firms are the combined function of acting as an intermediary between savers and borrowers (either retail or wholesale) and offering liquidity as a service. Payment facilities are a byproduct of these two services.

Investment banks act as intermediaries when offering services such as underwriting, advice on mergers and acquisitions, trading, asset management and global custody. However, it is a different form of intermediation. Nor do investment banks offer liquidity as a service in the same way as a standard bank. They contribute to increased liquidity in the system by arranging new forms of finance for a corporation, but this is quite different from meeting the liquidity demands of depositors. Indeed, the functions of the investment bank differ so much from the traditional bank that the term "bank" may be a misnomer. The US National Association of Securities Dealers (NASD) does not officially recognise the term "investment bank", and uses "broker dealer" to describe investment banks and securities firms. However,

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many investment banks, including Goldman Sachs, do offer the core/traditional deposit, chequing, ATM and loan facilities to very high net worth individuals. Merrill Lynch, in 2000, obtained permission from the Federal Reserve Bank to offer FDIC insured deposits. Though these services form a small part of their business, it does mean they are banks, and in most countries they report to both bank and securities regulators.

1.4.3. Commercial Banking

Commercial banks offer wholesale and retail banking services. In the USA, commercial banking excludes, by the 1933 Glass Steagall Act, investment banking activities. *Wholesale banking* typically involves offering intermediary, liquidity and payment services to large customers such as big corporations and governments. They offer business current accounts, make commercial loans, participate in syndicated lending²⁹ and are active in the *interbank* markets to borrow/lend from/to other banks. Global integration, technological advances and financial reforms have made parts of the wholesale market highly competitive. Most US commercial banks also have retail customers.

Retail banking offers the same services to numerous personal banking customers and small businesses. Retail banking is largely intrabank: the bank itself accepts deposits and makes many small loans. It tends to be domestic, though the information technology revolution has the potential to break down national barriers, an issue discussed in the next section.

1.4.4. Bank Holding Companies

The term "bank holding company" originated in the United States. The Bank Holding Company Act (1956) defined a BHC as any firm which held at least 25% of the voting stock of a bank subsidiary in two or more banks. BHCs are commercial banks, regulated by the Federal Reserve Bank.³⁰ Having been granted legal status, bank deposits under the control of BHCs grew from 15% in the 1960s to over 90% by the 1990s. Each BHC owns banking (and in some countries, non-banking financial) subsidiaries, which are legally separate and individually capitalised.

In the United States, BHCs were used to circumvent laws which placed restrictions on interstate branching, that is, having branches in more than one state. Through the BHC structure, a bank might own several bank subsidiaries in a number of states.

1.4.5. Section 20 Subsidiaries

In 1981, the US Supreme Court ruled that section 20 of the Glass Steagall Act did not extend to subsidiaries of commercial banks. They could offer investment banking activities, provided they were not "engaged principally" in the said activities. Since 1987, BHC

²⁹ Syndicated lending is when a lead bank persuades a number of other banks to contribute to a loan; normally very large loans to finance massive projects such as upgrading a railway network, or sovereign loans to developing/emerging markets.

³⁰ The definition of BHCs under the 1956 Act led to banks forming one bank holding company, with non-banking subsidiaries. A 1970 Amendment stopped BHCs from owning non-bank subsidiaries and gave the Federal Reserve the authority to approve all BHC activities, which had to be closely related to banking. BHCs even had to seek permission from the Fed to expand into credit card operations.

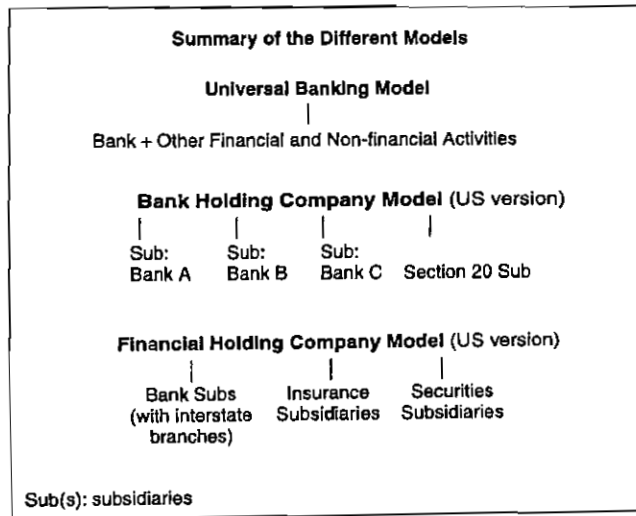
subsidiaries have been authorised by the Federal Reserve Bank to engage in securities activities, and became known as "section 20 subsidiaries". They could underwrite corporate debt and equities provided it was limited to 5% of the bank's total revenue, which was raised to 10% in 1989 and 25% in 1996. With the passage of the Gramm Leach Bliley Act (see below), these subsidiaries are expected to gradually disappear.

1.4.6. Financial Holding Companies

The Gramm Leach Bliley Financial Modernisation (GLB) Act was passed in late 1999 and effectively repeals the Glass Steagall Act. The GLB Act allows US bank holding companies to convert into financial holding companies (FHCs), which can own subsidiary commercial banks, investment banks and insurance firms. Likewise, investment banks and insurance firms may form FHCs, subject to the approval of the Federal Reserve.

The GLB Act means, for the first time, that US banks can become *restricted universal banks*. They can engage in commercial and investment banking and insurance businesses but, unlike the German banks, are *restricted* because, as subsidiaries, they must be separately capitalised, which is more costly than if they are part of a single legal entity. Also, the cross-share ownership of non-financial firms is largely prohibited. In the USA, BHCs are allowed to own up to a 5% interest in a commercial concern.

Different versions of restricted universal banks are found around the world. Canada also has legislation to stop banks from owning commercial firms. In the UK, Italy and Switzerland, there is virtually no integration of banking and commerce. It is discouraged by the regulatory authorities in the respective countries, but not prohibited by law. Under the financial reforms of the late 1990s, Japanese banks may also be part of a FHC, though FHCs may not own insurance subsidiaries. However, cross-shareholdings and shared directorships are an integral part of the Japanese financial and commercial structure.³¹



³¹ See Chapter 5 on bank structure and regulation for more detail.

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1.5. Financial Conglomerates

Briault (2000) defined a financial conglomerate as a firm that undertakes at least two of five financial activities: intermediary/payments, insurance, securities/corporate finance, fund management and advising on or selling investment products to retail customers. He reports that while in 1978 the vast majority of UK banks engaged in just one of these five activities, by 1998, 8 firms were authorised to offer all five functions, 13 were authorised to offer four, and more than 50 were authorised to offer three.

The Briault figures are for the UK, but rapid growth of financial conglomerates is taking place in the world's key financial sectors. Financial reform (e.g., "big bangs") in many countries eliminating (to some degree, depending on the country) segmented financial sectors has encouraged banks to become part of financial conglomerates. Given the nature of most activities listed above, virtually all conglomerates are global.

Briault identified the advantages and disadvantages of financial conglomerates. First, the efficiency of the financial system is improved if these conglomerates can achieve economies of scale and scope. *Economies of scale* is a long-run concept, where all factors of production (e.g., labour, capital, property) are variable. An equiproportional increase in factor inputs leads to a greater than equiproportional increase in output. Firms operate on the falling part of their average cost curves. For example, suppose there are three factor inputs: deposits, labour, property and one output: loans. Then, in the presence of economies of scale, the doubling of deposits, labour and property would result in loans more than doubling.

Economies of scope are said to exist if the joint production of two or more goods or services is cheaper than if they are produced independently, resulting in higher output. Suppose there are two products, $x = \text{loans}$ and $y = \text{deposits}$. Then economies of scope exist if $C(x, y) < C(x) + C(y)$, where C is defined as the cost of production. Put another way, average cost falls with an increased number of outputs produced jointly rather than separately.

However, it has proved difficult to produce definitive evidence for the existence of scale and scope economies.³² Furthermore, any increased efficiency may be offset by the effects of increased monopoly power if the growth of financial conglomerates reduces the number of firms operating in banking and other financial sectors. This will have the effect of raising "prices".³³ The reduced amount of competition in the market could, in turn, increase inefficiency. Hence, it is unclear whether the net effect of financial conglomerates is to raise or lower efficiency.

Second, it is argued that if financial conglomerates locate in countries with emerging financial markets, they can apply their expertise to assist in the development of a country's

³² See Chapter 9 for a more detailed discussion of this issue.

³³ In the case of core banking products, higher prices would be reflected in lower deposit rates; higher loan rates and fees for financial services.

financial markets. Often these economies are short of trained labour in their respective financial sectors. The foreign firm can bring in expertise from other countries, but also train and educate the host country labour force.

A third argument is that financial conglomerates usually diversify their financial functions, with branches/subsidiaries around the world, making them less vulnerable to downturns in one economy or region. Likewise, a decline in securities activity may be accompanied by a rise in banking activity. However, as Staikourous and Wood (2001) have shown, diversification may actually increase the financial institutions' income volatility.

Others have argued that large, diversified financial firms encountering difficulties may "go for broke", adopting high risk/return strategies. If the gamble pays off, the conglomerates survive. If not, their size makes it likely a government might attempt to rescue them should they get into trouble. If, in the absence of a government bailout, they fail, it can trigger the collapse of financial institutions world-wide. Hence, the systemic threat to the global financial system is increased.

Functional supervision normally means independent regulators oversee different functions of the conglomerate – meaning different parts of the conglomerate may be answerable to different regulators. The problem with functional supervision is that damage to the reputation of one part of the firm could cause a loss of confidence in other parts of the firm, including its banking arm. The problem is illustrated by the collapse of British Commonwealth Holdings (BCH), a financial services group, in 1990. After news of serious financial problems in the computer leasing subsidiary of BCH (Atlantic Computers) in April 1990, there was a run on the British and Commonwealth Merchant Bank. Two months later, the Securities and Investment Board³⁴ removed the merchant bank from its approved list, and to prevent a further run, depositors' funds were frozen by the courts and an administrator appointed. The subsequent report by the administrators found the merchant bank to be financially sound.

In the UK, the Financial Services Authority created a Major Financial Groups Division (MFGD), which is responsible for approximately 50 of the most complex financial firms headquartered in the UK, USA, Japan or Europe. It includes the big four/five UK commercial banks, along with major banks and investment banks from the USA, Europe and Japan. They have been chosen according to size, systemic importance and the complexity of the business within the financial group. The MFGD assigns a "micro-regulator" to each financial conglomerate, which is responsible for coordinating communication among supervisors within the FSA, assessing the group's overall management and monitoring capital adequacy. A lead regulator is assigned to any firm engaged in several activities but not deemed to be a major financial conglomerate.

In June 1989, the Federal Reserve Bank (Fed) introduced a unique system for large complex banking organisations (LCBOs). Teams of 2–12 supervisors will be assigned to America's 50 largest LCBOs, most of which operate in global markets. The emphasis is on

³⁴ The Securities and Investment Board was one of the self-regulatory organisations set up after the Financial Services Act was passed in 1986. See Charts 5.1 and 5.2 for more detail.

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daily supervision (replacing periodic examinations) of both the banking *and* trading books. The teams will use an organisation's risk management and information systems, provided the regulator is satisfied with the quality of internal audit, compliance, risk management and top management.

The main concern with the LCBO arrangement is the risk of *regulatory forbearance*, when the supervisor puts the interest of the regulated firm ahead of public/taxpayer interest. To counter this problem, teams will be rotated to new LCBOs every 3 years, and other Fed specialists will double-check particularly vulnerable areas.

Managers of financial conglomerates have expressed concern that compliance costs are too high, because most regulators require them to allocate capital (known as *dedicated capital*) to each of their major operations. For example, if they have businesses in investment banking, stockbroking and intermediary banking, capital must be set aside for each of these divisions. As was noted earlier, in the United States, the FHCs are required to keep insurance, investment and commercial banking activities as separate subsidiaries, which means each subsidiary will have separate capital requirements.

There is also the potential for conflict of interest between the different firms held by the conglomerate. In the UK and elsewhere, the regulatory authorities require firms to erect *Chinese walls* to prevent sensitive information flowing between the departments (or subsidiaries) of firms, which could create problems such as insider trading. For example, if a mergers and acquisitions department knows of an upcoming bid on a target firm and those working in the trading division are informed of the bid before it becomes public information, the traders who act on such information would be accused of insider trading. Investigations by US regulators in 2002 uncovered other serious conflicts of interest among modern investment banks that had expanded into brokerage and sales in addition to their traditional activities of underwriting/mergers and acquisitions. The record \$1.4 million payout by New York investment banks was discussed earlier in the chapter, but it is worth recalling the reason for the fines, etc. There was evidence of spinning and of bank analysts "talking up" the share price of companies that were also clients of the investment banking division. Thus, the expansion of modern investment banks into the broad range of activities listed previously may bring diversification benefits, but it has also created serious conflicts of interest. Financial conglomerates are also required to impose *firewalls* to counter the threat of *contagion* between their different operations. Regulators are especially anxious to keep core bank activities separate from those of other subsidiaries. *Firewalls* are legal restrictions placed on information flows and financial transactions between subsidiaries, branches, departments or other firms. For example, the Federal Reserve imposed 28 firewalls on section 20 subsidiaries. The main purpose of the firewall is to protect one unit of a holding company from funding problems associated with another subsidiary within the holding company. However, as will be seen below in the "NatWest" case, there are problems with firewalls that tend to arise if one of the subsidiaries gets into trouble. To quote Walter Wriston (Chairman of Citicorp in the 1980s) testifying before a Senate Committee in 1981, "It is inconceivable that any major bank would walk away from any subsidiary of its holding company".

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CHAPTER 2

HISTORY AND DEVELOPMENT OF THE ISLAMIC BANKING SYSTEM

This chapter discusses the establishment and development of the Islamic banking system which can be traced back to the birth of Islam in Mecca. The Islamic banking concept failed to expand to become a complete banking system in the early years of Islam. Its development only picked up again in the 1960s, before becoming rapid in the 1970s. The development of Islamic banks in certain countries is also discussed for comparison purposes. This is because not all Islamic banks receive full support from their respective governments. Some have to face numerous obstacles. There are some which initially received special privileges, but later had the privileges taken away from them. There are also others which are given special status and are exempted from a number of regulations and laws.



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INTRODUCTION

The Islamic banking system (IBS) is defined as a banking system whose principles underlying its operations and activities are founded on Islamic or *Syariah* rules. This means that all operations of the Islamic bank, that is, transactions involving either deposits or financing, must be based on *Syariah* principles. Such principles also cover other banking transactions like money order transaction, letter of guarantee, letter of credit and foreign exchange. The main factor that distinguishes Islamic banks from conventional banks is that all transactions are administered without involving elements of interest or *riba*. This is due to the fact that Islam forbids the giving or receiving of *riba*. A financial institution cannot be regarded as an Islamic banking institution if its operations involve elements of *riba*. Besides this, the principal objective of the establishment of Islamic banks is to cater to the needs of Muslims in banking transactions. The business management of the banks is based on the concepts of justice and fairness in the interests of society as a whole. The banks are also founded on rulings set in the Quran and *Hadith*.

The establishment of Islamic financial institutions whose operations are based on true *Syariah* principles is a fairly recent phenomena compared to conventional banking. Modern conventional banking system came into existence nearly 420 years ago with the establishment of Banco Della Pizza at Rialto in Venice in 1587 (Homoud, 1985). Nevertheless, in England, modern conventional banks were regarded as non-existent before 1640; the Bank of England was only established in 1694 (Sumner, 1971). The establishment of Mit Ghamr Savings Bank in Egypt in 1963 which operated based on *Syariah* principles marked the early history of Islamic banking and became an eye opener for Islamic thinkers and economists around the world. The success of the Islamic bank in catering to deposit and credit needs of clients proved that *Syariah* principles were still applicable and could be adopted by modern-day businesses. From that time onwards,

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many Islamic banks were established worldwide, particularly in Islamic countries. According to figures released by the International Monetary Fund, there were more than 300 financial institutions with operations based on *Syariah* rules in 75 countries as at end of 2007. The increase in asset value of Islamic banks exceeded 15% per annum, and it was estimated that the asset value of Islamic financial institutions worldwide at the end of 2007 was US\$250 billion (www.imf.org). Activities carried out included all transactions of conventional banks, activities of merchant banks, investment activities, insurance services, mortgage, hire purchase, advisory services and other banking transactions. The establishment of Islamic banks has not been limited to Muslim countries. Islamic banking has gained a footing in non-Muslim countries as well. For example, the Islamic Banking System International Holdings established in Luxembourg in 1978 was the first Islamic financial institution set up in a non-Muslim country. This was followed by the establishment of Dar al-Mal al-Islami in Switzerland in 1981. Apart from this, some banks operating in London and other financial centres in Europe have started using Islamic banking techniques and instruments to cater to the needs of their Muslim clients as well as the needs of Islamic banks which have business relationships with them. Most of the joint-venture banks between European and Arabic parties offer international trade transactions based on the principle of *murabahah*.

Banking products based on *Syariah* principles are also offered by foreign conventional banks. Most of the products or services offered are in the form of investment certificates based on *Syariah* principles. As an example, Kleinworth Benson offered Islamic Unit Trust in 1986. The Union Bank of Switzerland also offered Islamic Investment Fund (Wilson, 1990). The existence of Islamic banks in Western countries is nothing out of the ordinary. In fact, various financial institutions that offer Islamic banking products have been set up in many Western countries such as the United States, the United Kingdom and Australia.

In the United States, Islamic banking was introduced not only in financial institutions but in educational institutions as well. There are more than 20 Islamic financial institutions in the United States which offer deposit facilities, financing and fund management. Meanwhile, there are several educational institutions that are offering courses and seminars on Islamic finance. For instance, Harvard University holds annual forums on Islamic finance. The American Finance House - LARIBA, which was established in 1987, has become the most advanced Islamic financial institution and currently operates in 35 states in the United States. It offers housing financing services, small businesses financing and trade financing (www.lariba.com). In the United Kingdom, the first Islamic bank there, Islamic Bank of Britain Plc began operations on 6 August 2004. It is envisaged that the 1.8 million Muslims in the United Kingdom will have the opportunity to do their banking businesses with the bank (www.banking-business-review.com).

Meanwhile, the Muslim Community Co-operative Australia (MCCA) established in 1989, was the first Islamic financial institution in Australia. With an initial capital of A\$22,300 and only ten members, its total assets have grown to A\$26 million with a membership of 5,619, which represents an increase of about 50 members on average every month (www.mcca.com.au). This institution offers savings and financing facilities using the principles of *murabahah*, *mudharabah*, *musyarakah* and *qard hassan*. Besides these facilities, MCCA also offers facilities for the collection and distribution of *zakat*.

The fall of the Soviet Union also opened up opportunities for Islamic banks to operate in regions which were once under Soviet rule. The Albaraka Group began its operations by setting up a bank in Kazakhstan, named Albaraka Kazakhstan Bank as well as establishing joint ventures in Uzbekistan. Moreover, Islamic banking had gained its footing in Albania (Rudnick, 1992). Besides these regions, financial institutions based on *Syariah* are also found in Russia (BADR Bank) and in China (Ningxia Islamic International Trust and Investment).

While there are Islamic banks which have developed rapidly in both Muslim and non-Muslim countries, there are also those which have experienced failure. For example, the Muslim Community Credit Union (MCCU), an Islamic financial institution established in Australia in the year 2000 in the form of a co-operative offering banking products, was closed and suspended in the year 2002. The closure was due to losses as a result of carelessness and unwise financing (Shaban, 2002; www.mcca.com.au/mcca_the_mccu_story.pdf).

HISTORY OF ISLAMIC BANKING

Although the establishment of Islamic banks only became a reality in the 1960s, this does not mean that banking activities did not exist in Islamic history. Activities which are regarded as practices of modern banking, such as receipt of deposits, loans issuance, money exchange and bills of exchange, existed since the early years of Islam and during the spread of Islam.

Before the birth of Islam, Mecca was the centre of trade and was used as a transit point by traders passing through the city from the north and south borders. Hence, deposit and loan activities developed rapidly and transactions involving money exchange became one of the main activities. These activities continued even after Islam became rooted in Mecca and Medina. From the historical point of view, Islamic banking can be divided into three eras. The first era began from the early years of Islam when it was first born in the city of Mecca up until the period of Caliph ar-Rashidin. The second era stretches from the era of the caliphates until the fall of the Uthmaniyah Empire. This is followed by the third era, which is the era of modern Islamic banking.

Early Era of Islamic Banking System

Islam was born in Mecca when the Prophet Muhammad (p.b.u.h.) first received divine revelations of Islam in the year 610 at Mount Hira', and Islam was consequently preached openly in the year 613 at Mount Sara. Before that time, Mecca was a city of trade, and its business activities continued even after Islam became rooted there. Among the banking activities that remained in operation was the safe-keeping of money and valuables. These savings transactions were made by those with wealth, and savings were entrusted to reputedly highly trustworthy persons. The depositors would choose only persons of proven honesty and sincerity in keeping and returning their valuables. Prophet Muhammad (p.b.u.h.) was one person renowned for his honesty and trusted by the people. He remained custodian of other people's deposits until his migration from Mecca to Medina. Before his departure, the Prophet (p.b.u.h.) appointed Sayidina Ali to return all the deposits to their rightful owners (Homoud, 1985).

Both before and after the arrival of Islam in Mecca, deposits were made for safe-keeping. The person entrusted to keep the deposit would pledge to return the amount deposited. However, during the time of the Prophet (p.b.u.h.), one of his Companions, Az-Zubair al-Awwam would refuse money from depositors if it was in the form of savings. Instead, he preferred it to be in the form of a loan or *qard*. Abdullah az-Zubair explained that when people came to his father with money for him to help keep, his father would maintain that the money was a loan and not a deposit, because he feared that if it was in the form of a deposit, it could go missing. Az-Zubair's action was a wise one; it covered two objectives. First, by treating the deposit as a loan, he had the right to use it. Secondly, if the deposit was not used, it would actually be a loss to its owner. On the other hand, as a loan, the deposit was safer, because it represented a secure guarantee to the owners since the borrower was liable to return the deposit to the depositors.



THE HISTORY OF EARLY ISLAMIC BANKING THROUGH THE STORY OF AZ-ZUBAIR

The history of early Islamic banking through the story of Az-Zubair depicts the change in the concept of deposit, which was originally in the form of trust, to that of loan. Moreover, the deposit facility was not for a particular person or group of persons, but instead it was a public facility. The number of depositors was evidently big; because on the death of Az-Zubair, his son, Abdullah Az-Zubair was hesitant about distributing his father's assets among his siblings even after paying back all of his father's dues. Instead, for the duration of four *hajj* seasons Abdullah made announcements urging those who had deposited with Az-Zubair to come forward and reclaim their money from him. Only after the four *hajj* seasons did he distribute his father's assets. The community of Mecca at that time only knew two uses of money: first, to entrust money to someone else for it to be used in business based on the *qirad* or *mudharabah* principle and then to share the profits of the transaction; and secondly, to loan out money in order to obtain interest or *riba*. The practice of *riba* was widespread before the emergence of Islam, both among Arabs and between Arabs and Jews who were then living in the Arabic peninsula.

With the arrival of Islam, the practice of *riba* was no longer permitted. Nevertheless, this prohibition did not pose a hindrance to the conduct of daily life as well as trade development. Besides this, the practice of exchange of items or money also existed during the early years of Islam. The Prophet (p.b.u.h.) on many occasions had to resolve problems pertaining to money exchange. This is evident from one *Hadith* narrated by Abu al-Minhal: "I asked al-Bara bin Azib and Zaid bin Arqam about practicing money exchange. They replied, 'We are traders in the time of Allah's Apostle (p.b.u.h.) and I asked Allah's Apostle about money exchange. He replied, "If it is from hand to hand, there is no harm in it; otherwise it is not permissible."' (Khan, 1989, p. 157).

In addition, transactions involving money exchange during the early days of Islam did not only entail the exchange of one currency for another; there were activities similar to what is known in today's

banking system as money order. It has been said that Ibn al-Abbas received the *warik* (a type of currency that originated from silver and melted down to become dirham, which is a 3.0 gram coin of pure silver) and sent an acknowledgement to Kufah, a mediaeval city of Iraq. Similarly, Abdullah Az-Zubair received money from the Mecca community and subsequently wrote a receivable acknowledgement to his brother, Mis'ab bin Az-Zubair in Iraq who repaid the depositors when they arrived in Iraq.

Middle Era of Islamic Banking System

The middle era of Islam began with the end of the reign of Caliph Uthman in the year 661 AC. What followed was the reign of Caliph Umayyiah (661-750) with Damsyik as the centre, followed by the reign of Caliph Abbasiyyah (750-1258) which was centred in Baghdad, the reign of Caliph Umayyiah in Spain (756-1031) and the period of the Uthmaniyyah Empire (1350-1918).

The middle era of Islam witnessed the continuation of banking activities which were practised in the early era of Islam. For instance, the transfer of money as practised by the sons of Az-Zubair became the norm among money changers. Apart from this, during the middle of the fourth *Hijrah* century a new development emerged in the history of Islamic banking. Homoud (1985) extracted a story from the first part of the book *Zulir al-Islam* written by Ahmad Amin. According to the book, Saif Dawala al-Hamadani, who was Amir of Aleppo, issued cheques during his visit to Baghdad. While in Baghdad, Saif visited a local shop Bani Khaqan for a drink and upon leaving the shop he asked the owner for a piece of paper on which he wrote the name of the money changer together with the amount that he owed, 1,000 dinar. The paper was then exchanged by the shop owner for the stated amount of money as written by Saif. When asked by the shopkeeper who it was who



wrote on the paper, the money changer replied that the person was the Amir of Aleppo, Saif Dawala al-Hamadani.

The usage of cheques for trade purposes was also a norm in the city of Basrah for which regulations had been formulated for matters related to seals and witnesses. Around 400 H or 1010 AC, Basrah flourished with the activities of money changers. During that period, ships and Muslim traders were travelling to and fro between countries to trade. In his book titled *Safarnameh*, Naser Khasro, a Persian traveller, recounted his travel experiences between 437 H and 444 H. During his visit to Basrah, he described that markets were set up in three different venues every day. In the morning, trading took place in Khaza, while activities moved to the Uthman market at midday and at nightfall trading shifted to Qaddahin. Trading and business activities carried out in each market were conducted using cheques issued by money changers. These cheques were then used to purchase whatever the buyers needed. Nonetheless, buyers could only use such cheques as long as they resided in the city of Basrah.

The fall of the Roman Empire at the end of AD 400's and the occurrence of the Dark Ages which swept Europe (from the 5th to the 10th century) had a significant adverse impact on the economic activities of Muslim countries. It was not until the revival of the economies of the European countries in the 12th century and the resurrection of the conventional banking system that the conventional banking system expanded beyond the shores of the European continent to make its debut in the Muslim countries. Although Islamic banking failed to expand during this era, development took place in terms of *fatwa* (legal opinions) by Muslim jurists pertaining to issues of *muamalat*, particularly those involving *riba*. This was the era of many renowned jurists or *ulama* such as Imam al-Azam Abu Hanifah (60 H/698-150 H/767), Imam Malik ibn Anas (93 H/712-179 H/795), Imam Ahmad ibn Hanbal (164 H/778-241 H/855) and al-Shafii (150 H/767-204 H/820), who were the founders of the Hanafi, Maliki, Hanbali and Shafii

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schools of thought. The views of these *ulama*, particularly on the subject of *muamalat*, have become the reference point for *ulama* in the modern era of Islamic banking in giving their opinions and judgements related to Islamic banking activities such as whether the conduct is lawful and in accordance with *Syariah* principles or otherwise.

Era of Modern Islamic Banking

The development of the Islamic banking system may have started with the establishment of Mit Ghamr Savings Bank, but this does not mean that no earlier attempts were made to establish Islamic financial institutions. Some parties believed that the first attempt to establish an interest-free bank was made in Malaysia in the mid-1940s (Erol and El-Bdour, 1989). However, this organization which was founded on *Syariah* principles was unsuccessful. Another such attempt took place in a rural area of Pakistan in the late 1950s. This local institution did not charge interest on its lending (Wilson, 1983).

The establishment of Mit Ghamr Savings Bank in one of the rural regions in the Nile Valley in Egypt marked the dawn of the modern era of the Islamic banking system and paved the way for the establishment of other Islamic banks. This bank provided basic banking services such as deposit accounts, loan accounts, equity participation, direct investment and social services. The services founded on *Syariah* principles provided by the bank were very well received by the local community and the farmers. The number of depositors increased tremendously from 17,560 depositors in its first year of operation (1963/1964) to 251,152 depositors at the end of the 1966/1967 financial year. Similarly, the amount of deposit increased from £E40,944 (Egyptian pound) at the end of its first year of operation to £E1,828,375 at the end of the 1966/1967 financial year. The bank was successful in preventing customers from going to

CHAPTER 7

ISLAMIC FINANCIAL MARKETS

This chapter discusses the development of the Islamic financial markets, the financial instruments which have been created and how they are transacted. The discussion also covers the Islamic financial markets in Malaysia and the authorities involved because the Malaysian Islamic financial markets are at the forefront in terms of growth as well as breadth and depth.

INTRODUCTION

In the early stages of their establishment, the focus of Islamic banks was on providing various deposit and financing facilities which were *riba-free*. The overwhelming support from Muslim depositors resulted in an extraordinary liquidity problem for Islamic banks. In many cases, the banks' funds could not be mobilized and remained idle because of limited investment opportunities since they are restricted from channelling these funds into interest-based financial instruments. Consequently, Islamic banks were unable to invest the excess funds and reap returns from their investment. In the

conventional system, however, a mechanism that allows surplus banks to loan out their excess funds to deficit banks exist. Various financial instruments are also available to the surplus banks to invest any excess funds they have.

In light of the problems facing Islamic banks, the global Islamic banking system viewed that having its own financial markets was essential for further growth. In principle, the financial market is the meeting place of two parties with mutual needs – one party requires funds to support its financial needs, and the other has unused surplus funds which it intends to invest for the purpose of attaining returns or income. Realizing the existing problems, intellectuals directly involved in Islamic banking system began to put their thoughts into how an Islamic financial market could be created and the form of mechanism required. Islamic financial instruments also needed to be developed as alternatives to the conventional ones. These financial instruments must, however, possess the following features of conventional financial instruments:

- (i) They must be negotiable, that is, it must be easy to transfer the ownership of the instruments from one holder to another.
- (ii) They must be liquid, that is, they may be easily sold when cash is required.
- (iii) They must carry minimum risk.
- (iv) They must be easily valued and priced.

Due to the fact that Islamic financial markets are at a developing stage, these new concepts have raised many theoretical and practical questions. The issue of religious rules (*hukum*) also sometimes causes confusion and continuous debate not only among the local intellectuals but also between countries.

TYPES OF FINANCIAL MARKET

Conventional financial market is made up of four components, namely capital market, money market, futures market and mortgage market. The capital market trades in instruments with an original maturity of more than one year. Money market deals in short-term financial instruments whose maturity period is one year or less. The forward and future market involves a contract between two parties for future delivery of currencies, securities or commodities. Mortgage market covers real estate financing (e.g. financing of homes, buildings and other properties). Although these are the common financial market components frequently discussed in text books, another financial instrument with a unique transaction mechanism is becoming increasingly popular in wealth mobilization. This mechanism is referred to as unit trust. Unit trusts are open-ended investments and they offer access to a wide range of securities.

The four components of the financial market need not necessarily exist in all countries of the world. With the exception of developed countries, the existence of these components depends to a large extent on a country's level of economic development.

Capital Market

Capital market is the place where long-term financial instruments with maturity exceeding one year are issued and traded. The principal goal of establishing this market is to channel savings into long-term productive investments. Participants in this market comprise those from the government and private sectors. In the conventional market, the financial instruments issued and traded are those issued by the government as well as by the private sectors. The government is defined as the authorities comprising the federal

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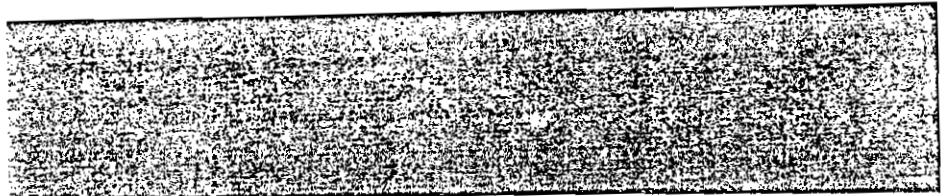
government, state governments, local authorities and government agencies. These authorities would in certain instances use the capital market either to obtain funds to finance administration and development expenses, or to invest any surplus funds. The private sector comprises giant companies, medium and small companies, as well as individuals.

The financial instruments in the capital market may be categorized into equity instruments and debt instruments. Equity instruments are in the form of share certificates, either common or preferred stocks. Debt instruments are made up of bonds which may be classed into common bonds and convertible bonds. The main difference between stocks and bonds lies in their payment of returns (either in the form of dividend or interest) to the owner or holder. For a person who holds shares of a company, there is no guarantee that he shall receive annual dividends since the company has no legal obligation to pay dividends to shareholders. Payment of dividends depends only on profits and it is the Board of Directors who determines whether or not to pay dividends to stockholders. On the other hand, when bonds are issued, the company is bound by law to pay annual interest in accordance with the terms made at the time of the issuance. If the company fails to pay interest as promised, it may face legal actions from the bondholders. Furthermore, this clearly suggests that the company is facing financial problems.

In Malaysia, any company doing business or wishing to do business in the country must be registered with the Companies Commission of Malaysia under the *Companies Act 1965*. The owner and the company are two separate entities. The relationship between the owner of the company and the company itself depends on the amount and types of shares held. Although shareholders are legally the rightful owners of the company, it does not mean that they are responsible for all actions undertaken by the company. Shareholders are also not responsible for the company's debts. However, in case of liability claim on the company, the amount is limited to the value and total shares owned.

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The difference between common stock and preferred stock rests on dividend payment. Unlike common stock, the payment of dividends for preferred stock is usually in the form of a fixed percentage and it takes priority over common stock dividends. For common stock, dividends paid depend entirely on the discretion of the Board of Directors. In addition, preferred stockholders have a claim prior to common stockholders on the company's assets. Preferred stock is of two types, namely cumulative and non-cumulative. Cumulative stock accords the holders a continuous claim on the dividends. Hence, any unpaid dividends will be accumulated until the company resumes paying them. As such, cumulative stockholders are entitled to all past and present dividends. On the contrary, non-cumulative preferred stockholders only receive dividend in the current year. Non-cumulative preferred stock does not confer any claims on missed dividends.

The central point in the issuance and transaction of stock is the concept of limited liability, whereby the stockholder's financial liability is limited to the amount he has invested in the event that the business incurs a loss. He is not personally liable for the company's debt other than the value of his investment. This concept of limited liability is actually related to the *mudharabah* principle in Islam, whereby the entrepreneur is neither held responsible for the loss incurred by the business nor is he required to replace the owner's capital should such a loss incurred under the condition that the loss is not due to his carelessness or negligence. However, issues of relevance between the owner and the company such as in the context of conventional company legislation are not mentioned anywhere in the original source of Islamic *fiqh* (jurisprudence) and were never discussed by Muslim scholars and *ulama* (Usmani, 1992). Nevertheless, Muslim scholars believe that the concept of limited liability is closely related to the concept of "juridical person" or separate entity. Given that *Syariah* accepts the concept of juridical person, it is thus permissible for Islamic banks to deal with stocks and shares.

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Since stocks represent a financial claim or is a title of ownership, these certificates do not constitute money. Hence, the negotiation and transfer of ownership pertain only to the object of the certificate and not the certificate itself which is regarded from the legal point of view as a proof of the claim. Under *Syariah*, common ownership is permissible and therefore it is legal to undertake sales, pawning or donation. During the process of buying and selling stocks, what changes is only the ownership right, and it is this exchange of value that is paid using cash or other modes of payment.

In contrast to common stock, preferred stock cannot be bought by Muslims and Islamic banks. This is because preferred stock is associated with a pre-determined fixed rate of return which is prohibited by *Syariah*. However, as an alternative, Muslim scholars suggested that preferred stocks may be issued by using the concept of a preference dividend based on a pre-determined profit ratio. Since what is specified is only the profit ratio and not a fixed payment, the preferred stocks based on this concept do not contradict *Syariah* (Mannan, 1990). This simply means that preferred stockholders do not know the amount of annual dividends to be received and dividends are based on the profits made by the company. Hence, large profits are translated into high dividends for stockholders.

This view was researched and reviewed by the *Syariah* Advisory Council of the Securities Commission of Malaysia. The Council, in its 20th meeting on 14 July 1999, put forward a resolution that non-cumulative preferred shares be allowed by *Syariah* by applying the concept of *tanazul* (to drop claims to rights). The application of this concept is based on the agreement of the common stockholders during the general meeting to commit *tanazul* for the issuance of preferred stocks. Subsequently at every general meeting, the common stockholders would also commit *tanazul* in order to grant dividends to preferred stockholders based on the percentage of net profit obtained by the company. This means that the percentage of return to preferred stockholders is based on profit and not the face value of the preferred stocks. The amount of returns received by

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individual investor is in turn based on the amount of stocks held. Due to the fact that the issuance and distribution mode of returns are based on profit, the *mudharabah* principle is the most appropriate *Syariah* principle to be used as the basis for stock issuance. Besides the requirement to comply with positive laws and other regulations as determined by monetary authorities, there are other matters that must be adhered to for the issuance of stocks to be *Syariah*-compliant. Similar to any ordinary public offering, a prospectus describing the financial and non-financial aspects of the company will have to be provided to potential investors. Among the important information that should be stated are:

- (i) Investors must be aware that the contract is governed by the principle of *mudharabah*.
- (ii) The method of distributing returns to investors must be clearly stated in the contract. Aspects such as profit ratio, when dividends will be paid and mode of payment must be stated.
- (iii) The purpose of the stock issuance must be clear. One aspect that is still constraining the application of stocks in the Islamic capital market is the issue of reselling stocks bought. Before the money invested by the stockholder can be utilized by the issuing company, the purpose of the proceeds must be clearly stated in the contract.

The *ulama* are of the view that for as long as no investment has been undertaken, a stock cannot be resold at a higher price during the period after it is issued and bought. The transactions within this period is subject to the *Syariah* rules of disposition of money and thus it should be sold at its face value. Thus, the prospectus should specify as to when the stocks are permissible for transactions. Under current practice, the permissible date is usually concurrent with the date the stock is listed on the stock market.

Another issue that has stirred much debate among Muslim scholars is stock market speculation. Islam forbids speculation

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because it involves gambling or *maisir*. But the issue of speculation in the stock market has not met with any resolution due to the difficulty in determining its position. Stockholders' returns from their investment in stocks are of two types, capital gains and dividends. Capital gain is profit made as a result of selling stocks for more than the original purchase price. Dividends, on the other hand, are the cash distribution of earnings to the stockholder. Naturally, several questions pertaining to the Islamic capital market and the trading of stocks arise: Is it allowable by *Syariah* for investors participating in the Islamic capital market to sell today the stocks bought yesterday? Is the buying and selling of stocks considered gambling? Or is one really buying or selling a certain right over the company?

Although scholars associate speculation with gambling, this view is not reciprocated by the *Syariah* Advisory Council of the Securities Commission of Malaysia. At its 10th general meeting on 16-17 October 1997, this Council ruled that speculation may be allowed. Although speculation was never discussed by Muslim jurists, the *bai muzayadah* principle may be associated with this practice. However, *Syariah* does not allow cheating and manipulation in the stock market. In addition, there are *fatwa* which have listed stocks that are either deemed as permissible or prohibited for Muslim investors. In Malaysia, the *Syariah* Advisory Council of the Securities Commission publishes a list of *Syariah*-compliant stocks. As at end of November 2008, a total of 855 *Syariah*-compliant securities listed on the main board, second board and MESDAQ market were approved by the *Syariah* Advisory Council of the Securities Commission of Malaysia. This represents 85% of the total securities listed. *Syariah*-compliant securities as defined by the Council include ordinary shares, warrants as well as transferable subscription rights.

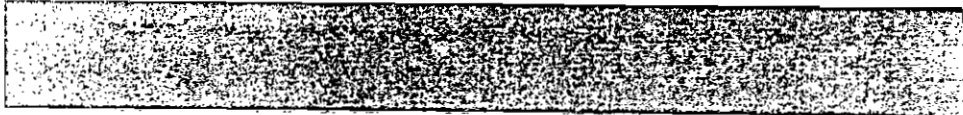
The three main elements that make stocks non-permissible are *riba*, gambling and prohibited products or related products. But even so, investment is permitted in activities that have tolerable

level of mixed contributions from permissible and non-permissible activities where the non-permissible activities represent only a small percentage of the activities and do not exceed the benchmarks established by the Council. For example, the Council has established four benchmarks for determining the tolerable level of mixed contributions from permissible and non-permissible activities as follows (www.sc.com.my):

- (i) The 5% benchmark is used to assess the level of mixed contributions from activities that are clearly prohibited such as *riba*, gambling, liquor and pork.
- (ii) The 10% benchmark is employed to assess the level of mixed contributions from the activities that involve the element of *umma balaca* (common plight and difficult to avoid) such as interest income from fixed deposits in conventional banks. This benchmark is also used for tobacco-related activities.
- (iii) The 20% benchmark is applied to assess the level of contribution from mixed rental payment from non-compliant *Syariah* activities including rental payment from premises that are involved in gambling, sale of liquor, etc.
- (iv) The 25% benchmark is used to assess the level of mixed contributions from the activities that are generally permissible according to *Syariah* and have an element of *mashlahah* (public interest), but there are other elements that may affect the *Syariah* status of these activities. Examples of such activities include hotel and resort operations, share trading, stockbroking and others; these activities may also involve other activities that are deemed as non-permissible according to *Syariah*.

In contrast to stocks, conventional bonds are prohibited as they represent interest-based funding. There are various types of bonds in the conventional capital market which are normally issued by the corporate sectors to obtain funds, namely mortgage bonds,

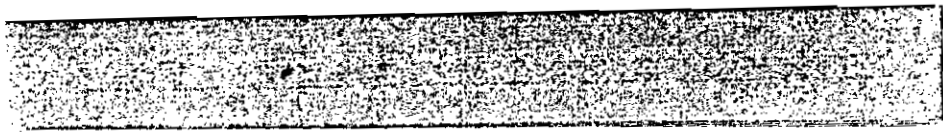
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debenture bonds and subordinate debentures. Mortgage bonds are normally issued with maturities of between 20 and 40 years. They give the bondholders first claim on some or all of the issuing company's assets in the event of default. The maturity period of debenture bonds is typically up to 25 years. Unlike mortgage bonds, these bonds are secured by assets and in terms of priority they are ranked after mortgage bonds. Subordinate debentures are also known as convertible bonds because they are issued as loans and the issuing company pays a fixed annual interest rate to the bondholders. Upon maturity, the holders have the choice to convert them into common stocks. Therefore, until such conversion they are considered long-term debts and the issuing company is contractually obligated to pay interest and principal payments.

In the early stages of Islamic banking in Malaysia, there were not many financial instruments in the form of debt certificates issued by the authorities or the government and corporate bodies which could be subscribed to by Islamic banks. However, the government of Malaysia through its central bank, Bank Negara Malaysia, issued debt certificates that may be subscribed or bought by Islamic banks under the *qard hassan* principle. The certificate, known as Government Investment Certificate, was issued to provide an opportunity to Bank Islam Malaysia to invest its surplus funds. The bondholder was given gift or *hibah* every year-end at a pre-determined rate. This commitment of the government in issuing bonds which are *Syariah*-compliant continues to this day. As at end of September 2008, the size of Islamic bonds issued in Malaysia was RM37.66 billion which represented 44.9% of total bonds issued in the country. Meanwhile, the amount of *sukuk* outstanding for the same period was RM146 billion.

One suggestion made by Muslim scholars which has yet to be widely practised by Islamic banks is the issuance of an "asset-based *mudharabah*" instrument in place of debenture bonds. This instrument represents monetary claim against funds under the management of the Islamic bank on a fiduciary basis. The operations



and arrangements of this instrument are similar to mutual funds or unit trust. There are two types of *mudharabah* instruments suggested, namely unrestricted *mudharabah* and restricted *mudharabah*. Under unrestricted *mudharabah*, the Islamic bank acts as the *mudarib* and is authorized to use full discretion in managing the affairs of the funds. The restricted *mudharabah*, on the other hand, has specifications as to the period, place, purpose and type of business allowed. The bank is only allowed to perform functions that are prescribed in the prospectus or *mudharabah* agreement. The following are the suggested features of a *mudharabah* bond (Pervez, 1996):

- (i) Asset valuation is undertaken at the end of each prescribed year. A positive price movement over the previous asset-valuation date reflects return on investment which is declared on each asset valuation date. Net profit after payment of all *mudharabah* costs is distributed between the instrument holders and the bank. The bank's management fee is a fixed percentage of the profit as agreed in the contract. The bank may, however, on its sole discretion reduce but not enhance its fee by voluntarily forgoing part thereof.
- (ii) In the event of a net loss, the net asset value is reduced and the bank cannot impose management fee for the period. If the loss is as a result of gross negligence or violation of the terms of the contract, then the bank has the responsibility to compensate for the loss.
- (iii) The creditors do not have any recourse to other assets of the instruments holders should their claims exceed the total assets of the *mudharabah*.
- (iv) Although the bank's management fee based on a fixed percentage of net profit is permitted, imposing a fixed amount of payment is not.
- (v) In line with the contract, reserves, as a percentage of net profits, can be built to meet future contingencies and unforeseen losses.

At maturity of the contract, the amount held in reserves after meeting all costs and claims is distributed to holders of the bond.

Jordan is among the earliest countries to introduce asset-based *mudharabah* bonds. As stipulated in *Law No. 13 of 1978*, Jordan Islamic Bank is allowed to issue financial instruments called *muqaradah* bond. This Law defines the bond as follows:

Documents having a uniform value, issued by the bank in the names of the persons who subscribe thereof by paying their face value on the basis of participation by the holders of these bonds in the annual profits realized, in accordance with the terms of each separate issue of such bonds.

Based on the above interpretation, the most important element of the *muqaradah* bond is that its issuance and returns to the holders are based on the profit-sharing principle. Although Jordan Islamic Bank was allowed to issue such bonds, the instruments were issued by the bank only in 1997. Instead, it was first undertaken by the Jordanian government, though on a limited scale. The enactment of the *Muqaradah Bond Act 1981* by the Jordanian government paved the way for the Ministry of Awqaf to develop *wakaf* assets. Among the authorities which have been allowed to issue bonds under this Act are the Ministry of Awqaf, public institutions with financial independence and municipalities. One important aspect related to the issuance of *muqaradah* bonds provided by law is that the Jordanian government guarantees the settlement of the face value of the bonds. This guarantee is in line with the *fatwa* issued by the Jordanian Fatwa Committee that government's guarantee (the government as the third party) is permissible and does not contradict *Syariah*. At the end of 2007, the *muqaradah* bonds were valued at JOD218.5 million whilst at the end of 2006 it was JOD166.7 million (Jordan Islamic Bank, 2007). The issuance process depends mainly on which projects the bank regards as economically potential. After identifying the financial needs of a project which it intends

to venture into, Jordan Islamic Bank would offer the bonds to the public by allowing them to purchase the bonds based on a fixed face value. Annual profit would only be distributed based on the profit obtained from the project and the principal money would be returned upon its completion.

Apart from Jordan, Pakistan was also interested in issuing *Syariah*-based bonds when it converted its whole economic system to an Islamic system in 1977. For that purpose, two new laws were formulated, called *Modaraba Companies and Modaraba (Flotation and Control) 1980* and *Modaraba Companies and Modaraba Rules 1981*. The aim of these laws is to provide the necessary framework for the flotation of *mudaraba* instruments and permit management companies, banks and other financial institutions to register themselves as *mudaraba* companies and to enable them to issue financial instruments of this type in Pakistan. This financial instrument bears similarities to *muqaradah* bonds issued in Jordan, that is, bonds with restrictions and without restrictions. An additional feature of the bonds in Pakistan is that they can either be for a limited period or for perpetuity. These Islamic bonds are traded on the Karachi Stock Market. Besides *mudharabah* bonds, another type of Islamic financial instrument recommended by the Council of Islamic Ideology, Pakistan, is the Participation Term Certificates (PTCs). The following are the salient features of PTCs (Qureshi, 1990):

1. PTCs are for a specified period not exceeding ten years excluding the grace period.
2. The broad principles governing the legal aspects of PTCs are laid down by the government by making suitable amendments in the prevailing *Company Act*.
3. As the PTC finance is provided for a specific period, it is secured by a legal mortgage on fixed assets of the company and a floating charge on the current assets owned by the company.



4. For the purpose of profit allocation to PTC holders, the investment ranks pari-passu with equity. Profit sharing is based on mutual agreement.
5. Pre-tax profits before appropriations are used in determining return to the PTC holders.
6. Profits payable to the PTC holders are income tax-deductible expenses.
7. The share of profits paid to PTC holders is deducted prior to shareholders' claim on the company's profits.
8. In the event of a loss, the first recourse shall be to free the reserves including the credit balance in the profit and loss accounts of the issuer and the balance of the loss will be shared between the PTC holders and other providers of funds in proportion to their funds.
9. Proceeds of the PTC must be used exclusively for implementing the project as stated when the PTC was issued to potential investors. PTC issuers must conduct the business with diligence and efficiency and to use all expertise and wisdom when operating the business ventured into.
10. For purpose of providing protection to the PTC holders, a trustee must be appointed and given the authority to obtain information from the company, to visit the plant and to inspect machinery of the company as well as to have access to all their business records.
11. Options may be given to PTC holders to convert a certain portion of their outstanding certificates to ordinary shares.
12. A rights option may also be given to ordinary shareholders to subscribe to any new issuance of PTCs.

From the above features, one can see many similarities between PTCs and conventional bonds. For instance, PTCs are secured by mortgage

and floating charges and this feature is similar to mortgage bonds. Furthermore, the option for the holders to convert their certificates to common or ordinary shares is a feature of subordinate debentures. Although this instrument is acceptable in Pakistan, some Muslim scholars are doubtful as to the permissibility of it (Ariff and Mannan, 1990). This is because its legality from the *Syariah* viewpoint has yet to be established. Nevertheless, PTCs and *mudharabah* bonds have been issued in Pakistan although they have not been well received. For example, the face value (nominal) of investments in securities undertaken by banks in Pakistan at the end of 2008 was PKR1,000,357.2 million and of this amount, investment in PTCs was only PKR35,175.1 million or 3.5% of the overall investment. Meanwhile, investment in *mudharabah* bonds was PKR30,265.8 million or 3% of total investment. Islamic bonds or more commonly known as *sukuk*, which are based on the *mudharabah* concept have not been fully developed by other Islamic countries and banks alike throughout the world. Islamic Development Bank, despite being the pillar of financial management based on *Syariah*, has not been in the forefront in issuing *sukuk mudharabah*. The bank, however, has introduced two asset-based *mudharabah* instrument schemes known as Islamic Banks' Portfolio (IBP) and Unit Investment Fund (UIF). IBP is a pool of funds contributed by institutions and individual investors for the purpose of financing trade, undertaking leasing and for equity participation in corporations of Islamic countries. UIF, on the other hand, is largely used to finance leasing assets and for instalment sales. Since their establishment and until 2006, IBP valued at US\$4.4 billion and UIF at US\$1.8 billion were managed by Islamic Development Bank.

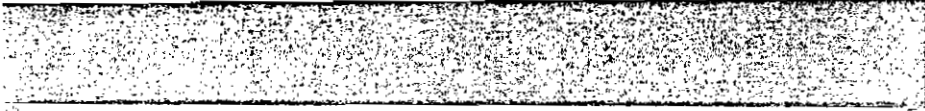
This situation does not mean that no other efforts have been taken to develop Islamic bonds. Malaysia, for instance, is quite advanced in developing Islamic bonds. Islamic bonds are issued by both the government and private sector. Since the issuance of Islamic bonds based on *musyarakah* by Shell MDS Sdn Bhd in 1990, their popularity has been on the rise from year to year. In

2001, the issuance of Islamic bonds in Malaysia surpassed that of conventional bonds. As at end of June 2008, the Malaysian bond market reached a size of more than RM500 billion with corporate bonds representing 51% or RM258 billion of total outstanding bonds. Throughout 2008, a total of 44 Islamic bonds or *sukuk* with an issuance value of RM3,234 million were approved by Securities Commission of Malaysia (www.sc.com.my).

Besides Malaysia, Bahrain also plays an important role in the issuance of Islamic bonds. Islamic bonds issued in Bahrain are based on the principles of *salam* and *ijarah*. The history of Islamic bonds in Bahrain started in 2001 when *salam sukuk* was first issued. This monthly issuance valued at US\$25 million each was offered for sale by Bahrain Monetary Agency (BMA). As at end of November 2008, BMA had administered new issuance of *salam sukuk* worth BD6 billion. Apart from *salam sukuk*, BMA also issues *ijarah sukuk*. The first *ijarah sukuk* was issued in September 2001 with a value of US\$100 million and a maturity of five years. In addition, on 20 July 2004, BMA issued *ijarah sukuk* in Bahraini currency (dinar or BD) totalling BD40 million (US\$106 million) with a maturity of ten years. Up until November 2008, new issuances of *ijarah sukuk* totalling BD5 billion were issued and traded on the Bahrain Stock Market.

The presence of the Islamic International Finance Market (IIFM) is also expected to act as impetus for the issuance of Islamic bonds worldwide. As an international body which among its major tasks is to endorse the issuance of Islamic bonds and ensure they are indeed *Syariah*-compliant, the service of IIFM is highly required by companies intending to issue Islamic bonds and would like their bonds to be subscribed by the international community. As at the end of July 2008, IIFM had endorsed six issuances of Islamic bonds as follows (<http://www.iifm.net>):

- (i) US\$600 million – Malaysia Global *Sukuk*
- (ii) US\$400 million – Solidarity Trust Services Limited Trust Certificates


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- (iii) US\$700 million – Qatar Global *Sukuk*
 - (iv) US\$250 million – Bahrain Monetary Agency International *Sukuk*
 - (v) US\$100 million – Tabreed Finance Corporation Trust Certificates
 - (vi) US\$120 million – Durrat Al-Bahrain *Sukuk* Company B.S.C.

Currently, principles such as *ijarah*, *istisna*, *salam*, *murabahah* and *bai bithaman ajil* are used widely in structuring Islamic bonds. However, there is a lack of consensus among the *ulama* as to the fact that the discounting method implemented in transactions in the bond secondary market is *Syariah*-compliant. For instance, the principle of *bai al-dayn* which is widely used in Malaysia is strongly opposed by the *ulama* in the Middle East on the basis that only debt certificates of the same value may be transacted.

Money Market

The most important function of the money market is to provide an efficient means for economic units in the economy to adjust their liquidity positions. Financial instruments in this market have three crucial features, namely low default risk, short term to maturity and high marketability. In the conventional money market, the most widely traded financial instruments are treasury bills, negotiable certificates of deposits, banker's acceptance and repurchase agreements.

Treasury bills are bills issued by the treasury department of a country. The proceeds of these bills are used to finance government operating expenditures. The bills are sold to investors on a discounted basis (lower than face value). The income obtained by investors is the difference between the face value and the purchase price of the bills. Treasury bills are issued with maturities of three months.



six months, nine months and one year. Negotiable certificates of deposits are another type of time deposit facilities offered by financial institutions, particularly commercial banks, with a minimum amount of savings for each certificate (e.g. RM150,000). The certificate usually has a maturity period of not more than one year, and the interest rate offered by the bank is pre-determined at the initial stage of the savings period. The certificate is then resold at any time, whether at the issuing bank or at the secondary market.

Banker's acceptance arises most often in connection with international trade and is commonly issued to facilitate import-export transactions. It is known as a bill of exchange drawn on and accepted by banks. Upon acceptance, that is, when the banker's acceptance is endorsed by the bank, the bank assumes responsibility for ultimate payment to the holder of the draft. With this, the financial instrument becomes negotiable and can be traded on the secondary market. Banker's acceptance transactions are implemented based on the discounting method, where purchase is made at a value which is lower than the value of the certificate on maturity. On the maturity date, the bank pays the holder of the banker's acceptance the face value of the certificate. A repurchase agreement is normally issued by the banks and other financial institutions such as discount houses and merchant banks. This agreement consists of the sale of a short-term security by the bank to investors in return for cash, and pledges to repurchase the instrument from the investor at some later date at a pre-determined price which constitutes the face value plus interest payment. The agreement gives the buyer the right to retain interest earnings based on the period of execution of the repurchase.

Financial instruments for the Islamic money market have not really expanded to Muslim countries. Nevertheless, Malaysia, followed suit by Indonesia, have started to pave the way by providing *Syariah*-based financial instruments for negotiation in the money market. In 1994, Malaysia established an Islamic inter-bank money market which consisted of three chief components, namely



inter-bank trading in Islamic financial instruments, Islamic inter-bank investments and inter-bank cheque clearance system. However, in 1999 when consolidation occurred in the cheque clearance system, RENTAS (Real Time Electronic Transfer of Funds and Securities), the Islamic inter-bank cheque clearance system ceased to be regarded as a component of the Islamic inter-bank money market. Currently, the Islamic inter-bank money market is made up of two components only, namely inter-bank trading of Islamic financial instruments and *mudharabah* inter-bank investments.

Inter-bank trading is a market where banks would trade among one another all the *Syariah*-based financial instruments. These financial instruments comprise Government Investment Issue (GII), Bank Negara Negotiable Notes (BNNN), Islamic Accepted Bills (IAB) and Islamic Negotiable Instruments (INI). Financial instruments of this type were introduced as a mechanism whereby the deficit bank (investee) obtains investment from a surplus bank (investor bank) based on *mudharabah*. The period of investment is normally from overnight to 12 months. The rate of return is usually based on the rate of gross profit before distribution for investments of one year. At the time of the negotiation, the investor bank will not know the amount of return it will receive; it will only know at the end of the investment period. On 2 February 1996, Bank Negara introduced a minimum benchmark rate for these investment certificates which is based on the prevailing rate of the Government Investment Issues plus a spread of 0.5%. The purpose of imposing this benchmark rate is to ensure that only banks with reasonable rates of return may participate in the Islamic money market.

Besides the financial instruments mentioned above, Bank Negara also provides Islamic inter-bank deposit facilities based on the *wadiah* principle. This facility is intended to serve as a method to absorb any surplus liquidity in the Islamic banking system. Apart from Malaysia, Indonesia has also taken similar steps in providing financial instruments for the Islamic money market system and

making available inter-bank deposit based on the *wadiah* principle and inter-bank investment certificates based on the *mudharabah* principle.

Forward and Future Markets

The goal of the forward market and future market is to enable participants in the markets to offset their price risk in future transactions which involve money, security or commodity. The seller and buyer in both markets are allowed to establish their terms of the exchange prior to future delivery date. Unlike forward market in which contracts between seller and buyer are not standardized, contracts in the future market are. Additionally, future contracts are made between parties involved in the transactions and the futures exchange, and not with each other.

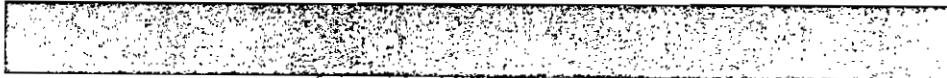
Forward market is allowed by *Syariah*, as supported by the fact that there are a number of *Syariah* principles which are of relevance to forward transactions, namely *salam*, *istijrar* and *istisna* (also known as *bai salam*, *bai istijrar* and *bai istisna*, respectively). However, there is divergence of opinion regarding the types of goods that may be transacted in the forward market. For instance, Islamic banks in Jordan, Egypt and Sudan are prohibited from engaging in forward currency trading. Currency trading can only be executed at spot rate (sometimes called immediate rate or other rates), whereas both spot and forward transactions are available at Islamic banks in other countries. Futures market, meanwhile, is the least developed component of the Islamic capital market because it is very much at a controversial stage. The legitimacy of future market is inconclusive among Muslim scholars. Some scholars have asserted that futures market is not permissible because it involves the sale of goods not in possession of the goods. Others have strong opposite opinions on the matter. Kamali (1997), a modern scholar, was of the opinion that futures contracts may be allowable because



it does not involve gambling, *riba* and uncertainties. In fact, there is no clear prohibition in the Quran and *Hadith* against futures sales. However, ElGari (1998) questioned the usability of this financial instrument. He believed that if the *salam* principle was applied on future sale transactions, then payment should be made at the time the contract was signed and not in the future. Nevertheless, the Syariah Advisory Council of the Securities Commission of Malaysia, at its 11th meeting on 26 November 1997, resolved that the futures contract involving crude palm oil was allowable and in accordance with *Syariah*.

With forward markets for commodities allowed by *Syariah*, there is a high possibility for the securitization of debts that emerge from these transactions. In fact some Muslim countries have already created bills to be traded in the capital market and money market based on forward trading. For example, banker's acceptance is a financial instrument created based on forward trading. However, there is divergence of opinion pertaining to the legitimacy of debt securitization that derives from such instrument. In Malaysia, transactions based on the *bai ad-dayn* concept is widely enforced, but this concept is rejected by scholars in the Middle East. Consequently, this has limited the use of this instrument and questioned its applicability in the market.

The most widely traded financial derivatives in the forward and future markets as well as the capital market of the conventional system are warrants and options. Warrants are a type of security which gives its holder the right to buy common stocks directly from a company at a potentially advantageous price. This right is usually issued in combination with long-term debts such as bonds or debentures. Options, on the other hand, allow the holder to enter into contracts to buy or sell shares, commodities or currencies at a pre-determined price called the strike price until some future date. There are two types of options, namely call option and put option. In a call option, the holder is given the right to buy, while a put option gives the holder the right to sell a security or a futures



contract at a strike price. The company, on the other hand, has the responsibility to sell or buy the options at the pre-determined price. However, the holder of the warrants and options may at any time sell his right on the stock exchange or any secondary market at a market determined price.

There is considerable debate among Muslim scholars about the legality of warrants and options which has yet to be resolved by *Syariah*. *Syariah* permits the use of options. For instance, in the case of *murabahah* and *ijarah*, options are sometimes given to the buyer or tenant in the event that the goods contract defaults. ElGari (2004) was of the opinion that call option is lawful and is called *arboon*. This view is supported by Kamali (2002). In Malaysia, warrants and options are permitted so long as they originate from shares which are allowed by *Syariah*. The legitimacy of warrants and options lies in the fact that the holder is entitled to exercise his right just as the owner of a property has the right to dispose of his property in the open market. In this case, warrants and options are regarded as *mal* and the owner of the *mal* may resell it.

Mortgage Market

Mortgage market refers to the market that provides finance for real estate. Real estate loans are normally issued by various types of financial institutions. Commercial banks, savings and loan institutions and cooperatives are institutions in the forefront in providing this type of property loan. Interest-based loans impose various terms and conditions including matters related to interest rate and method of repayment. Repayment varies and depends to a large extent on the lending institution. Some institutions charge fixed monthly instalments until maturity, while others charge either a small initial instalment with progressive payment until full repayment is made or repayment based on the amount of interest incurred. There are also loans which require the borrower to settle

all interest incurred but pay instalment on the principal and interest at some future date.

As with conventional banks, Islamic banks adopt various methods with respect to matters related to real estate financing. Repayment depends on the *Syariah* principle applied by each bank. For instance, an Islamic bank buys a property at the original price and sells it to its customer at a higher price. The customer is required to pay a certain portion of the profit the bank earned from the higher sale price before paying the original purchase price of the property. Some banks require that the customer pay the profit together with the original cost of the real estate during the initial stage of financing. Others adopt a repayment method whereby the customer makes small initial payments followed subsequently by higher repayments towards the end of the financing period. The amount of instalment depends largely on the agreement between the bank and its clients. Although Islamic banks do not face any real issues or problems in providing such real estate financing, the securitization concept must be in place or established so that it does not become immobilized.

In the conventional system, there are two types of mortgage-backed securities instruments, namely pass-through mortgage securities and mortgage-backed bonds. Pass-through mortgage securities refer to securities that "pass through" all payments of principal and interest on pools of mortgages to holders of security in the pool. For example, let us assume a financial institution has a real estate loan of RM100 million (inclusive of principal and interest) for which a RM100 million bond is issued against this property. Thus, when the borrower pays for the loan plus interest, the financial institution would immediately channel that payment to the bondholder based on the value of the bond held. For instance, if a person holds 1% of the bond value, he is entitled to receive 1% of the total principal and interest payment. Mortgage-backed bonds are similar to corporate bonds which have a fixed maturity date and interest payment except that these bonds have specific

mortgages as collateral. The bondholders would receive interest payment on the due date and principal payment upon maturity. Collaterals on these bonds are the real estate loans issued by the financial institution to the real estate owners.

Islamic mortgage market is still undeveloped. Currently, no Islamic financial institution has used real estate financing in *sukuk* issuance. However, Malaysia has taken precedence over the development of Islamic mortgage market. The use of Islamic mortgage bonds is administered through the National Mortgage Corporation or Syarikat Cagamas Berhad (Cagamas), a subsidiary company of Bank Negara Malaysia. Cagamas was established in 1986 with the objective of financing the purchase of housing loans and other consumer receivables from financial institutions and issuing bonds to purchase the loans. These Cagamas bonds would then become the main driver of growth and catalyst for the development of a secondary mortgage market. There are four types of bonds issued by Cagamas: (i) Fixed Rate Bonds which have tenures of one and a half years to seven years with semi-annual interest payments; (ii) Floating Rate Bonds which have tenures of up to seven years and an adjustable interest rate pegged to the Kuala Lumpur Inter-bank Offer Rates (KLIBOR); (iii) Short-term Notes which have maturities between 1 month to 12 months and only pay the face value at maturity; and (iv) *Sanadat Mudharabah Cagamas* which are Islamic bonds based on the profit-sharing principle. Bondholders receive dividends semi-annually based on a pre-determined profit-loss ratio.


Funds collected through the issuance of conventional financial instruments are used to purchase housing loans. The *Sanadat Mudharabah Cagamas* are used to purchase Islamic home financing debts. Since 2001, Cagamas has also started to acquire Islamic hire purchase debts. Although Cagamas purchases Islamic home financing debts and Islamic hire purchase debts from financial institutions, the acquisition made is purchase with recourse. This means that when the bank sells the debts to Cagamas, it agrees to

reimburse Cagamas for losses resulting from the purchased loans such as replacing any bad debts. Cagamas has also set several conditions in its debt purchase transactions. As at the end of 2007, total Islamic home financing debts purchased by Cagamas was RM12.6 million, while Islamic leasing debts purchased amounted to RM3,408.6 million (www.cagamas.com.my).

Although Cagamas, in principle, has paved the way for the implementation of the securitization process for Islamic home financing debt and Islamic hire purchase debt, this process could be developed further by allowing Islamic financial institutions to issue their own bonds. Apart from financial institutions, other organizations could also be authorized to manage the issuance and trading process of these Islamic mortgage bonds. *Syariah* principles such as *wakalah* could possibly be used to implement and develop the Islamic mortgage market.

Unit Trust Market


The unit trust market is another branch of the financial market which can be explored and operated more actively in accordance with *Syariah*. Unit trust funds are essentially collective investment schemes structured to allow investors with similar investment objectives and risk tolerance to pool their savings in a common fund. The pool will then be managed by an investment company and invested in a diversified portfolio of authorized investment on behalf of the investors in accordance with the investment objectives of the trust funds. The investment scheme of the unit trust fund involves a tripartite relationship between the fund manager, trustee and investor who are legally bound by the terms and conditions specified in the Trust Deed. The fund managers are professionals who are highly skilled in investment and are responsible for the management and operations of the unit trust funds. The pooled funds are invested in any or a combination of investments such as



shares, money market instruments, futures contracts, commodities, bonds, private debt securities and others. If the accumulated funds are invested mainly in shares traded on the stock exchange, then the funds are known as equity funds. Assets of the trust funds are owned by the trustee, not the fund manager. Investors normally do not have any rights on the assets purchased by the managers; instead their investment returns are in proportion to the numbers of units owned.

The method of fund mobilization based on the unit trust scheme first started in the United Kingdom in 1931. In Malaysia, a unit trust was first established by a company called Malayan Unit Trusts Limited in August 1959. In 1963, this company was bought over by the South-East Asia Development Corporation which had two subsidiaries, namely Singapore Unit Trusts Limited which operated in Singapore and Asia Unit Trusts Berhad which had operations in Malaysia (Bank Negara Malaysia, 1984). The industry was initially regulated by Bank Negara Malaysia but since 1993, the principle legislative body governing the establishment, operation and administration of unit trust is the Securities Commission of Malaysia. The governing legislatures for the unit trust industry are the *Trusts Act 1949* and the *Companies Act 1965*.

There are two types of unit trusts, open-ended and closed-ended unit trusts. With an open-ended fund, there is no fixed pool of money. The total amount of money available for investment and the number of units in existence increase or decrease depending on the subscription and redemption of units in the fund. Investors of the unit trust may at any time redeem on demand their units at market price, either directly from the manager or through appointed agents. Closed-ended fund, on the other hand, has a fixed size and are incorporated companies whose businesses are to buy and sell shares on the stock exchange. No new shares are issued after the subscription period ends. Closed-ended fund shares are listed and traded through the stock exchange and prices of these shares are determined by market forces. Investors normally receive two



types of returns, namely capital profit from the price increase of the unit trust, and annual dividends, if any, obtained at the end of the financial term.

The development of the unit trust industry in Malaysia gained momentum and unit trusts became a household product with the establishment of Perbadanan Nasional Berhad which manages the Amanah Saham Nasional scheme in April 1981. A variety of unit trust schemes were launched by this corporation and subsequently by other finance corporations. As at 31 December 2008, there were 39 corporations managing unit trust schemes. The total funds approved were 521 and the approved fund size was 473.939 billion units, while units in circulation were 208.342 billion. The total account for the trust units was 12,274,908, with the asset value of funds totalling RM169,414 billion (www.sc.com.my).

Since managing unit trust does not involve any elements of *riba*, it is therefore relatively easy to put into operation a trust scheme that complies with *Syariah* principles. Currently, a great number of fund management companies are involved in managing trust funds. These companies are not only operating actively in Muslim countries but also in Western countries such as the United States and the United Kingdom. In Malaysia, the successful launch of two unit trust funds in 1993 by Arab Malaysia Unit Trust Berhad created the impetus for other fund management companies to follow suit. This is evidence by the increasing number of *Syariah*-compliant unit trust funds available today. For instance, all the unit trusts managed by Perbadanan Nasional Berhad conform to *Syariah*.

When a *Syariah*-compliant unit trust scheme is launched, a number of conditions must be complied with. Among them, the investment undertaken must be in companies that are not involved in activities which encompass the elements of *riba*, *maisir* and *gharar*. The companies must not also be involved in the supply, manufacture or service of things prohibited by Islam such as alcohol, gambling and non-*halal* food products. A *Syariah* Monitoring Board must be established to monitor and endorse that the investment undertaken

does not involve Islamic prohibitions. A process of cleansing or purification shall be carried out on the returns of the Islamic unit trust should any part of it raises doubts.

As at 31 December 2008, there were not less than 149 *Syariah*-compliant funds in Malaysia which represented more than 25% of the total unit trust funds. Two models which may be applied in managing Islamic unit trust funds are *mudharabah* and *wakalah*. If the *mudharabah* model is applied, the fund manager would act as the *mudharib* and profits obtained from the investment would be shared with the investor. On the other hand, if the *wakalah* principle is used, the manager would only act as a representative and would receive administrative fees for his efforts. The type of principle used is normally stated in the prospectus. Under normal conditions, the contents of the *Syariah*-compliant fund prospectus are not much different from that of the conventional fund prospectus. This is because conditions imposed by the Securities Commission of Malaysia for both Islamic and conventional trust funds are fairly analogous except for statements with respect to managing of the funds, appointment of the *Syariah* Monitoring Board members and profit distribution method.

ISLAMIC FINANCIAL MARKET PRACTICES IN MALAYSIA

The practices of Islamic financial market largely depend on the financial instruments available. However, the scope of discussion in this section is limited to the practices of the issuance and trading of the main financial instruments in the Malaysian financial market. One important aspect of the financial market that needs a great deal of attention is the supervision and regulation of each component of the financial market. For instance, in Malaysia, the entire financial market was initially under the supervision of Bank Negara