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ISLAMIC FINANCE IN KUWAIT

by

Daniel A. Casson

A thesis submitted to the University
of Durham in fulfillment of the
requirements for the degree
of Master of Arts.

September 1989.

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14 MAY 1990

To my parents

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ABSTRACT

Islamic banking is an experiment in finding innovative ways to regulate a financial system under Islamic law. In Kuwait the Kuwait Finance House has been operating for ten years as an Islamic financial institution surrounded by other institutions based on the western model.

Kuwait is a particularly interesting centre for Islamic finance, as the Kuwait Finance House (Kuwait's only Islamic bank) has been one of the more profitable Islamic banks in recent years. Kuwait has benefitted greatly from the high oil revenues of the past twenty years, and its tiny size and population mean that most indigenous Kuwaitis now lead affluent lives. The Kuwait Finance House desires to help form a healthy economic climate, by using the acquired wealth wisely according to Islamic law.

This study takes the reader through the principles of Islamic finance and compares its ideals to those of the western venture capitalists, who seek to improve the economic climate in the same way that an Islamic bank does. Chapters 3 and 4 deal with the Kuwaiti economy and financial system, introducing the reader to the country within which the Kuwait Finance House operates. The activities of the House are reviewed in chapters 5,6 and 7, while chapter 8 evaluates how successful the House has been since its inception in 1979. Finally the concluding chapter looks to what lies ahead for the future of Islamic banking in general and the Kuwait Finance House in particular, with special emphasis on the development of a fully-fledged venture capital industry operating within Islamic law.

INTRODUCTION.

In 1977 AD (corresponding to the Muslim date 1397 AH) "Decree Law No. 72...licensing establishment of a Kuwaiti shareholding company named 'Kuwait Finance House (KFH)'" was issued. The decree was signed by the Amir of Kuwait, his Prime Minister, his Minister of Awqaf and Islamic Affairs, his Ministers of Justice and Finance, and finally by his Minister of Commerce and Industry. It marked the dawn of a realisation of the power of Islam in Kuwait, as the new company would engage in "financial, insurance and various forms of investment without practicing usury or charging interest." The Law was promulgated in order to exempt the KFH from any injunctions in the existing laws which were inconsistent with the nature of its activities.

A Memorandum of Agreement was drawn up and the Articles of Association established in order to define the operations to be carried out. These operations could be named with some accuracy because of the experience of the 'Islamic banks' already formed in the Muslim world. However here was a country having become rich from its oil revenues, with per capita income one of the highest in the world, trying to bring some innovation into the financial system. Innovation is a word that will crop up often in this study, because the call to institute Islamic financial principles marked a realisation of the fact that the extant system was not perfect, and that this 'innovative' Islamic system could offer innovative solutions to problems both large and small.

Kuwait is very close to the heartlands of Islam which are situated in present-day Saudi Arabia, Kuwait's most powerful neighbour and ally. On visiting Kuwait the visitor is immediately struck by the impression of a country that has had the opportunity to introduce all the modern day technology in a matter of years, whereas countries such as America, France and Germany had become accustomed to the new technology gradually and sometimes unwillingly. However Kuwait drank up all the trappings of a twentieth century society as fast as they could be introduced. The result was a society very sure of its new-found importance, yet still cognisant of its duty in the 'Umma' (the Islamic community), a duty which necessitated healthy growth in all sections of society.

The KFH is an oasis of Islamic morality in the Kuwaiti financial arena, competing with the interested-based banks for customers, but the view taken in this thesis is that it is working for the time when the whole system will be Islamicised. In three countries of the Muslim world the whole economic order has been Islamicised; Iran, Pakistan and Sudan. In Iran legislation to remove interest was approved in 1983, and in 1984 it came into force: the Central Bank controls all profit sharing, and it is noticeable that credit facilities have been increasingly dedicated to the productive sectors. Sudan has also seen a healthy economic growth in the small business productive sector, but progress is slow because of the frailty of a war-ravaged economy. Finally in Pakistan economic Islamicisation is in the balance after the election victory of Benazir Bhutto, who sees the new Islamic order as a remnant from the time of her predecessor, President Zia Al-Haqq.

In these countries government support is total because there is no alternative to Islamic banks, however in Kuwait the government's position as regards the Kuwait Finance House is rather different. The original authorised capital was KD 10 million;

Ministry of Finance	KD 2 million	20%
Ministry of Justice	KD 2 million	20%
Ministry of Awqaf and Islamic Affairs	KD 0.9 million	9%
Private Sector	KD 5.1 million	51%

and in the Decree Law No.72 the three Ministries are named as the instigators of the KFH. The majority shareholding is left to the private sector, but it is the central government that has the largest block voting power. However two of the above ministries must also regulate the interest-based economy by way of the Central Bank. This leads onto an essential theme in this study, that is the power of the central government and therefore the Central Bank over the KFH. The KFH is registered and monitored by the CBK, but it is not ruled by it like the conventional banks because the Shari'a is the KFH's supreme monitor.

This thesis views the KFH as an agent inside the Kuwaiti system and touches only lightly on a comparison with the other Islamic banks. This is because Kuwait is a special case with only one Islamic bank heavily subsidised by the government; its competition does not come from the other Islamic banks, but from the interest-based institutions operating in Kuwait. The in-depth study of Kuwait and its infrastructure in the following pages will give the reader an idea of the ground into which the KFH has been planted as a seed to flower, while the examination of Venture Capital is carried out in order to suggest ways of development for Islamic finance. Muslims can learn from the system in the West even though they can afford to discard most of western dogma as alien to Islam.

The Islamic financier sees the managing of funds as a three-way deal:

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       DEPOSITOR                   BANK

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           /|\      \            /    |
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            |         \        /     \|/
                       \      /
                        \    /
                         \  /
                     USER OF FUNDS
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In the above situation all participants depend on each other and shoulder an equal amount of responsibility. In the case of bankruptcy the distress is shared which lessens the impact; 'a problem shared is a problem halved'.It is this responsibility for the welfare of others that marks Islamic banking practices out from conventional banking practices; that is a point the reader will be convinced of after reading this study.

CHAPTER 1

Islamic Financial Principles.

1.1 Finance as a Part of Islamic Ideology.

Islam is a discipline under whose values life should be directed. In this discipline the life of a Muslim, or "The one who has surrendered unto Allah", is seen as a business whose outcome must be spiritually profitable. The promise of reward on the final day, when God judges everybody's case, can be equated to the profit after a long term of investment. Directing one's life up till this final day is the major incentive in Islam (1).

"And fear the day when you shall be returned to the Lord and every soul shall be paid in full what it has earned, and no-one shall be wronged". [Qur'an 281].

This, and other similar quotations from the Qur'an, begins to show us why finance forms so large a part of Islamic ideology.

In the Jahiliyya period the tribes of Arabia had been involved in extensive trade caravans, and Islam encouraged the aspirations of these tribes by giving honest traders great chance of reward on "Yawm Al-Qiyama" (the day of Resurrection). In the Hadith there are many occasions when Muhammad spoke of the rewards of a businessman:

"A trustworthy and an honest and truthful businessman will rise up with the martyrs on the day of Resurrection" (from Hadith of b. Majah and al-Hakim).

In another Hadith he seems to put them on an even higher level:

"A truthful and trustworthy trader will rise up with the prophets, the righteous and the martyrs" (from Hadith of Al-Hamimand al-Thirmidhi).

Traders are compared to those who fought and gave their lives in "Jihad fi sabil Allah" (striving in the path of Allah), and can thus be described as waging an "Economic Jihad" (2) in this life.

Muhammad was a tradesman and was known to have travelled with several caravans on behalf of his lady Khadijah. Trade is described as a "Fadl Allah" (a God-given glory), and is always to be carried out in an equitable fashion so that neither buyer nor seller is disadvantaged or cheated.

Every human being should live his life as if in the presence of Allah, therefore it can be assumed that Allah presides over all matters of finance and property exchange. Property is only a trust from Him, so that when an exchange occurs He would not endure unlawful pressure or fraud on behalf of the one party. The Hadith: "Let no-one harm others or be harmed by others" (the Hadith of the five fundamental ones) shows how trade has to conform to the life discipline which has been set out for mankind. It is worthwhile noting the verse in the Qur'an from Surat al-Baqara which reads:

"And do not eat up each other's property by wrong means, nor use it as bait for judges, with intent that you may eat up wrongfully and knowingly a little of other people's property". [Qur'an 2:188].

This quotation can be applied to cases arising out of contractual agreements, and so reaffirms the need for honesty in life dealings.

There is a Hadith (3) which states that as a man gets older two things become younger in him; the desire to collect more wealth and to live longer. A Muslim should be content with what he can attain by fair means, and he is commanded by Allah not to cheat in the amounts he trades in.

"So establish weight with justice and fall not short in balance." [Qur'an 55:9].

This injunction led to the formation of a very important office in early Muslim times, that of the Muhtasib, who would actually go round the market place checking that weighing scales were not falsely weighted and that all dealings were fair. Any property gained in an unlawful manner is Haram (4) and detracts from the worth of the Zakat (5) a man gives to the poor and needy. His progeny will be burdened by the false dealings of their ancestor for many generations: however property acquired by lawful means will be a blessing on future generations for ever.

"When a servant of Allah earns property in an unlawful manner, and then gives it in charity, it will not be accepted of him. There will be no blessing in that he spends and that he leaves behind but it becomes a provision for the fire of hell. In reality, Allah does not wipe out evil with evil, but erases evil with good. Undoubtedly dirt does not clean dirt." (Hadith).

The aims of the Qur'an are equity, justice, mutual co-operation and self-sacrifice. All these can be seen as the natural way to form a welfare state, where this state is directed, by God's laws, to distribute the wealth equitably. For this reason hoarding is condemned, extravagance denounced and moderation enjoined. However the asectic way of life is very hard to justify in a Islamic view, as nowhere does Islam condone deprivation in any way. The seceding from life is seen by mainstream Islam as an avoidance of responsibility, a negative choice, an unworldly choice. The exchange of property should contribute to the overall economic goals of an Islamic regime, and we should strive for economic growth at all times.

This growth is desirable, because it means using our resources to the full, and it should reserve a good future without creating a gulf between the rich and the poor(6). In this point the Islamic system sees itself opposed to western capitalism, which has perpetuated the wealth of a few at the expense of the majority. However Islam does not back the Marxist ideology (7), that labour is the only thing of value in life: it encourages entrepeneurship, risk-taking and use of venture capital. It seeks to outdo both these extremes by imposing on its followers a stricter sense of their responsibility towards others while realising the need for individual striving. In this system the state plays the role of supporter and upkeeper of justice: it does not intervene but acts as a guide.

Islamic banking is formed out of the necessity that a Muslim society strives for socio-economic justice. Its actions are an extension of the trading to which Muhammad attaches so much importance, and therefore it is ruled by the injunctions Muhammad made on such trade. Islamic banks must ensure the economic well-being of the community, which means helping towards full employment and economic growth. They must help to create stability in the value of money, so that it remains a stable store of value. While carrying out all these jobs it is necessary that an Islamic bank provides the services available in western banks.

The aim (8) of an Islamic bank is to make its customers realize their social responsibilities towards the poor and needy. By encouraging full use of resources as directed by the religious sources, the bank can lead to a superior standard of life for all

Muslims and can therefore be seen as a potential leader of the community. The importance attached to trade by Muhammad is translated into modern terms in the banking experiments now flourishing in many Muslim countries. Backed by a return to Islamic values they have begun to re-evaluate the life discipline imposed by Allah, so that all his wishes can be fullfilled whilst having a thoroughly modern outlook. These banks are part of a progressive stage in Islam, not a regressive one, because they are working towards a more equitable society in a positive way. The spirit they aim to promote is engendered in one story from Muhammad's time. When the Muhajirun fled to Medina due to the unbearable persecution of the Meccan pagans, the "Ansar" (residents of Medina) gave them shelter and split their belongings into half, and gave them to the Muhajirun so that they could again prosper. This marriage of economics and spiritual well-being is very strong in Islam, because Islam is a power that promotes accountability in all areas of life.

1.2 The Prohibition of Riba.

One of the most important injunctions in Islamic finance is the prohibition of "riba". This is a word overflowing with interpretation (9), even though its literal translation of "expansion" or "growth" sounds quite simple. It comes to mean "usury", "interest" and "unjust profiteering"; but to really understand it we must look back to the origins of its prohibition in Islam.

In the Qur'an riba is mentioned in different Suras, of which Sura II contains the most information:

"Those who devour usury (riba) will not stand except as stands one, whom the devil, by his touch, has driven to madness. That is because they say, trade is like usury but Allah has permitted trade and forbidden usury ..... Allah will deprive usury of all blessing, but will give increase for deeds of charity, for he loves not creatures ungrateful and wicked... Oh you who believe, fear Allah and give up what remains of your demand for usury, if you are indeed believers." [Qur'an 2: 275-278].

This lengthy quotation is necessary to show how wicked riba (10) is regarded: it deprives man of any blessing and any hope of a profitable reward in the next world. The next mention is in Sura III (Surat al-Imran):

"Oh you who believe, devour not usury, doubled and multiplied, but fear Allah so that you may really prosper." [Qur'an 3:130].

The word translated into English as "prosper" is from the Arabic root "Falaha" which gives rise to the word "Falah", which is the "success" that we must aim for in life. By practising usury a man's wealth will actually decrease:

"That which you lay out for increase, through the property of (other) people, you will have no increase with Allah: but that which you lay out for charity, seeking the countenance of Allah, will increase: it is those who will get a recompense many times over". [Qur"an 4:61].

A usurer is seen to have rejected his own faith, and for those who "devour men's property wrongfully" a grievous punishment has been prepared.

In the Hadith we find more mentions of usury, the taking of which is compared to committing adultery thirty-six times (narrated by Abd Allah b. Hanzala). The most famous Hadith on the subject is narrated by Abu Sa'id al-Khudri of the messenger of Allah (Muhammad), and it explains usurious transactions:

"Gold is to be paid by gold, silver by silver, wheat by wheat, barley by barley, dates by dates and salt by salt, like by like payment being made on the spot."

If a man practises riba, it will lead to the ultimate downfall of mankind, when poverty will become widespread:

"Narrated b. Mas'ud that the Messenger of Allah said 'Even though usury leads to growth, it eventually leads to poverty.'" (Bahaqi and b. Majah).

With the coming of the revelation to Muhammad, the usury of the inhabitants of the Arabian peninsula was seen as one of the ills of the former way of life. The usury was not simply restricted to individual dealings, but was at the very core of the economic system of the Jahiliyya Arabs (11). All commercial activity was based on the system of usury, and it is claimed by some writers that this economy was dominated by the Jews, which was another reason to see corruption (fasad) in it. Islam came, denying this unjust system, and calling for a new basis, where goodwill, cooperation and mutual solidarity ruled. The words of Allah in the Qur'an, and of Muhammad in the Hadith, leave no room for doubt that the new "Umma" (Community) should be set on an equitable and just economic base. This point fits in with the first section because it shows that the economic system of Islam is at the very core of its teaching.

After these early remarks based on the words of Muhammad,

it is necessary to define more clearly the meaning of Riba.
The Prophet forbade as Riba:

a) Selling of commodities without letting the buyer touch them or examine them;

b) Selling of commodities whose defects have been disguised;

c) Selling the cow which has not been milked for a long time, to make the buyer think falsely, that the cow always has abundant milk;

d) Selling of animals still unborn;

e) Selling of birds not yet hunted and fish not yet caught;

f) Selling of agricultural produce not yet ripened;

g) Prearranging with a man to bid a high price for a commodity so that others will have to do the same.(12)

These are just some of the practices which Muhammad saw as unjust. From the above there are a few basic tenets that seem to hold. Firstly it is not lawful to sell an unknown commodity: secondly every sale which involves uncertainty in any area is not allowed and finally, that any profit which is stipulated at the time of the contract is unjust profit.

In the Shari'a we find two senses of the word Riba: "Riba al-Nasi'a" and "Riba al-Fadl". The "Nasi'a", the first kind of Riba, comes from the root "NaSa'a", which means "to postpone" or "defer". This sort is quite obviously the interest that is the underlying basis of all western economies. The point is that there is a pre-determined positive return, which is seen as the reward for waiting. Another way of looking at it, is that the interest is the value of time which man, in this case, sees himself as owning; however in Islam, time is valueless and cannot be treated as a commodity to buy and sell. If the reward for waiting could have been either negative or positive, this sort of transaction would be allowed, but "interest" leads to certain profit.

For Islam to free itself from the unjust shackles of western banking "Riba al-Nasi'a" should be abandoned altogether. Muslim economists argue that loans without interest are the only fair loans, as the U.S.A. bore witness to in helping Europe get back on its feet after World War II. Some have argued that if interest keeps up with inflation the net result of no real appreciation is permissible, but people (such as Chapra in his "Towards a Just Monetary System" (Chapter 2)) reject this theory as a way of trying to justify a corrupt system, whereas one should really be trying to build a totally new system (13).

The injunction on Riba al-Fadl (14) comes from the above quoted Hadith, that like should be exchanged for like, and only on on the spot. In this Hadith six commodities are mentioned, but, on the basis of "Qiyas" (analogy), these are extended to include many other commodities. The final two objects mentioned are silver and gold, which some people take to refer to all commodity money: and the last four objects "wheat, barley, dates and salt" are thought to represent all staple food items. However the phrase "like by like" can be extended to include every commodity, even though some radical thinkers actually believe that only the six commodities mentioned are to be governed by the injunctions on "Riba al-Fadl". Modern interpretation tends to the belief that any storable item is meant in this Hadith, and so the "Fiqh" (Law) is formed around this theme.

Any profit in excess is "Riba al-Fadl": it precludes the cheating of a new entrant to the market, false weighting of scales (discussed above) and generally unfair trading. The Prophet realised that barter transactions were very difficult to judge properly, because a quantity of one product cannot be calculated as the quantity of another product: therefore he encouraged cash transactions, so that the cash gained by the one party could be used to buy the original object of the barter. This use of cash is necessary for the total eviction from the system of "Riba al-Fadl".

It is true to say that "Riba al-Nasi'a" is well defined, whereas "Riba al-Fadl" deals with actions less easy to define. However both these ideals are at the core of an Islamic approach to life, and are seen as necessary for the continued existence of mankind. The lack of definition of "Riba al-Fadl" may be seen as a positive attribute, because it leads to constant review of what is right and what is wrong in Islamic trade circles, and eventually therefore, to the practises adopted by the Islamic banks. These institutions continue to develop as new ideas are put forward, and the system is developing in an innovative and more imaginative way.

The rationale behind striving for a riba-free economy is that this economy would be a totally equitable one, where poverty would not exist. Riba, as well as being corrupted, is a corrupter, as it leads to greed and the concentration of wealth in the hands of a few. Cheating the system brings no honour or good account in the eyes of Allah, who works to rid the world of extortion, greed and hoarding. Abolishing interest would arrest the reckless borrowing of money by entrepreneurs, who continue to squander their loans irresponsibly because they have done no real work to attain them: the system of interest induces laziness in people who are not willing to face up to their responsibilities to build a better economic climate.

In the West many people see the concentration of wealth in the hands of a few as the way to this healthier economic climate, and they seem to excuse their means because the goal they are working for is an equitable system. In Islam the method as well as the means must perpetuate, if not equality, then equity. Wealth is a responsibility to be shared with the rest of mankind in a just system.

Many questions still remain about riba, and Islamic law is open to many different interpretations. The most important thing above all else is that it is prohibited by the Qur'an, and that is the final word. However, what the prohibition refers to exactly is still under discussion. Are all interest rates forbidden or only very high ones? Should interest charges as approved rates be permissible? Does riba apply to real or nominal interest? Can one get round the laws by use of service charges? How can one form a profit making base for the economy? All these are questions which the mention of riba provoke in the mind of the Muslim scholars of our time.

1.3 The Instruments of Islamic Finance.

For the establishment of an Islamic state it is first of all necessary to form a Bait al-Mal (15) for this state. This financial institution was well advanced by the time of the second Caliph, 'Umar b. al-Khattab, who had charge of all the monies paid into it as Allah's trustee. His duty was to spend the monies on the common concerns of all Muslims. The Bait al-Mal is never actually mentioned in the Qur'an, although the sources from which funds flow into it are: however it is mentioned many times in the Hadith literature. Its aims can be taken as a model for the aims of the modern Islamic banks.

The funds for this Bait al-Mal came from;

a) Zakat - one of the pillars of Islam which demands that each Muslim gives up 1/40 of his savings for the poor;

b) Sadaqah - involuntary charity from the individual;

c) Jizyya - a tax levied on non-Muslims in the Muslim state;

d) Kharaj - a tax levied on the produce of the landed property owned by non-Muslims in the Islamic State;

e) 'Ushr-the taxation to be paid by the landed Muslims at a rate of 10%;

f) Khums - booty from victory which is accorded to the state;

g) Fay' - property captured from the enemy without recourse to battle;

h) Dara'ib - taxes levied by the state;

i) Waqf - revenues from religious trusts;

j) 'Ushur - revenue collected from the proceeds of the trade of the state;

k) Kira al-'Ard - The profit generated from the government lands;

l) Amwal al-Fadilah - Any income from the government owned natural resources.

The constituent elements of the Bait al-Mal can be seen as a good cross-section of all the dealings carried out in the first century after the Hijra (16): these funds are to be distributed evenly to help the poor and needy and to support the state.

Even though Islamic banks now work in isolated pockets, they are working for the day when they shall all be directed by the central bank of the Islamic state, which would equate roughly to the Bait al-Mal. This overpowering view means that the Islamic banks should be seen to be instruments of the central bank; that is that by their own instruments they must help to direct the economic life of the Muslims in an equitable fashion, with a socially respectable attitude. There are seven instruments which the Islamic banks have to offer which are worth considering in detail here.

The Mudaraba loan offered by Islamic Banks is well founded in Islamic law. It is where two parties combine to form a business; one (the Mudarib) provides the management skills, and the other (the Sahib al-Mal) provides the funds or resources. (In some schools of thought this is called "Qirad" but comes to mean exactly the same). There are two sets of Mudaraba agreement: restricted and unrestricted. If any one of the four factors of time-period, place of business, specific line of trade of the customers or suppliers to be used is dealt with in the "'aqd" (contract), then the arrangement is a restricted one. In the case of unrestricted Mudaraba, the Mudarib is free to act as he desires as long as it is with the successful outcome of the venture in mind. The profit from the Mudaraba will be shared in a just proportion as agreed, only when all costs have been covered and the original loan paid back (17). All losses are to be borne by the Sahib al-Mal, who loses the principal if the venture fails. If the Mudarib in the contract agrees to take all the profit, bear all the losses and repay the loan, then the loan is called a "Qard Hassan." This sort of a loan can be used by the bank in exceptional circumstances of dire need. In this situation the bank expects no profit at all, and therefore only offers the facility of "Qard Hassan" very rarely.

The second instrument of an Islamic bank is the "Shirka" which implies more sharing of responsibilities, with joint ownership being the key to the arrangement. Again the contract is drawn up, and usually written down; so that the responsibilities of the participating parties are made clear. There are basically four sorts of "Shirka" arrangement: firstly "Shirkat al-Mufawada" where the partners (the Bank and its client) are equal in their capital contribution, and are jointly ,and severally, responsible for the liabilities of their partnership, so each partner can be a "Wakil" (agent) for the business and also stand as guarantor.

Secondly "Shirkat al-'Inan" where the partners need not have an equal share in the capital, and accordingly are not equally responsible for the management of the business. Profit and loss are agreed in the contract according to the amount of capital invested by each party. In the third form of "Shirka", "Shirkat al-Abdan", the partners contribute to the management without contributing to the capital: finally "Shirkat al-Wujuh" is where the partners lend their influence to the busisness but contribute no capital.

The "'Inan" agreement is the one most widely used, as it allows for unequal shares according to the contract, and is therefore the most negotiable form. The bank and its client would both bear the profit and loss of the venture, with all decisions agreed upon by both parties.

If a Mudaraba or Shirka works out well, then the bank which has given the loan stands to make a profit, and will normally sell off its stake after about four or five years. Some schools of thought say that profit should only be related to capital invested, but the "Shari'a" also recognises business effort as grounds for earning profit. Every "'aqd" is different and decided by mutual agreement, although a bank, if it is involved in many such contracts, will probably formulate a basic standard pattern.

To be able to bear the possible loss of capital ,the bank must be prepared to invest in diverse businesses. If it is drawn by greed into too many ventures in one field, then it would suffer dramatically if that field were to become unprofitable. The profit and loss sharing system should lead to more intelligent investing, because of the responsibility the bank holds in respect to the application of venture capital. The loan system in the West means that a bank may be prepared to back a venture without good prospects, because it knows that the entrepreneur has enough capital behind him to repay the loan. This is a temptation which is ruled out in Islam, as such a guarantee of return cannot be given because no funds from other sources can be used to repay loans on a new venture. Therefore an

Islamic bank has to be even more careful in its auditing of projects than normal commercial banks in order to assure a good return.

In this system small businesses would have as much chance of gaining a loan as big businesses, because the criterium for the loan is not the credit worthiness of the client but the expected profit rate of the venture. This helps to reduce the concentration of wealth in the hands of a few and creates greater efficiency in resource allocation. The above arrangements mean that banks can assure long term profit, but they must find other means to secure short term gains. One method is "Murabaha" or "resale": the bank buys a commodity for the client and the client pays the bank for the commodity after three or four months (18). The commodity may be in the form of a new machine, a new building or new livestock which is delivered directly to the customer. The bank deals with all the paper work and makes a profit as a reward for its agency activities. This profit is permissible in Islamic law, as trading is deemed honourable and can in no way be viewed as usury.

A bank may be able to organise discount if it buys in mass for a few businesses at a time, and so the client may end up paying even less for the commodity than if he bought it himself. It also saves the client the paper work, as this is all carried out by the bank in order to make life simple for him.

Another method open to the bank is "Ijara" or "leasing." As in the case of Murabaha the bank buys the commodity and agrees to loan it to the client for a period of time. In this contract the bank is normally assured enough rent to cover the initial cost, and at the expiry of the contract is left with several options.

Although the commodity will have depreciated in value it can be sold off, either to the original client or a new buyer. This sale could be arranged at the time of signing the contract and can be seen as a combination of both "Ijara" and "Murabaha". Secondly the bank could hire the commodity out for a second or third time in order to continue profiting from it. The arrangement is obviously favourable to the banks and favourable to the clients who cannot be levied for the commodity in their tax assessment, just as in the West (19).

1.4 Customer Accounts.

The one customer service that any bank must offer in order to compete for customers has not yet been discussed : that is the facility to deposit and withdraw money from a personal account. It is possible to open a current account which carries no interest; from this account one can draw such cash as is needed for every day transactions (20). Another sort of account is a "Mudaraba" account, where the returns on the original principal deposited will vary according to the profits of the bank. This ensures return because the bank is likely to make an overall profit because of its wide portfolio, and because of the certainty of profit in the "Murabaha" and "Ijara" agreements.

The "Mudaraba" deposits are of many different sorts, depending on the agreed maturity of the deposit and the agreed notification before a withdrawal can be made. Deposits can function from year to year or for even longer periods, but the full agreement must be fulfilled for any profit to be gained.

1.5 The Advantages of an Islamic Financial System.

The social and economic advantages of an equity based system over an interest based one lie in the community feeling of greater responsibility for the welfare of each other. There is a duty to ensure the just distribution of wealth, and to replace it by equity as the great human motivator (21). This in turn leads to a fair distribution of resources among the population, because of the ability of a skilful~~l~~ entrepreneur, in any field, to gain capital. If a society achieves this wide base, it is assured of greater economic stability and growth, which is the aim of an Islamic financial system. The "Ijara" and "Murabaha" make it possible to expand a business without too great an initial layout, and so are of benefit to the entrepreneur who starts off with very little capital behind him.

The abolition of interest removes one great source of bitterness between a bank and its customers, as people struggle to pay off high interest rates. If this rate goes too high it tends to deter new investment and capital growth, which is translated into low growth rates: if the interest rate goes too low it penalises savers and provokes the consumer to overspend, which leads to high inflation. The western system has to believe that there is a middle value which ensures justice for everybody, but Muslim economists believe this value is purely theoretical and cannot be achieved: therefore they see the abolition of interest as a major step to a more equitable world.

With no loans being granted unless someone has a really sound investment proposition, the result would be an end to purely speculative financing. The application of Islamic law in finance favours potential not capital, and the more thorough auditing necessary (as discussed in section 1.3) gives the bank more stability, which can only help the economic growth of a country.

The banking system described above has principles which pre-date any modern political thinking and avoids being the ideology of one party. In Europe we find the extremes of the capitalist system and the Marxist one: both of which Islam is seen to reject, because it sees the need for an individual economic freedom which is bound by Islamic principles. The fact that the economies of the non-Muslim world are directed by the political leanings of the ruling party, makes for a system based on emotion, whereas a totally apolitical economic system means that its actions are directed rationally.

Socially Islam ensures a caring society, if it is adhered to: trade is seen as an extension of caring social conduct. Forward dealing, and therefore fraud, become non-existent so there would be less injustice and less need for insurance, which Islam so reviles. Loyalty becomes the key to successful financial operations, because one needs to be loyal to one's bank to gain the advantage of all the instruments it offers, and the bank is loyal to you because it is your partner in business.

On a country-wide scale the abolition of interest rids us of the major souce of inflationary pressure, and so reduces the instability in exchange rates and money supply. The advantages are potentially great because the underlying principle to the system that Islam predicts, is one of social responsibilty and accountability, where risk sharing leads to greater desire for enterprise and innovation, and man is not afraid of risk which leads to growth.

Notes.

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1. Sami Hassan Homoud, "Islamic Banking" (Arabian Information, London 1985).Introduction, pp 1-5.

2. Abdur Rahman I. Doi. "Shari'a: The Islamic Law". (Ta Ha Publishers, London 1984). Page 350. "Jihad" means "striving in the path of Allah".

3. Ibid. Page 352.

4. "Haram" means "unlawful" in Islamic jurisprudence.

5. "Zakat" -see section 1.3.

6. M. 'Umar Chapra, "Towards a Just Monetary System", (The Islamic Foundation 1985), pp 36-7.

7. Chibli Mallat (Editor) "Islamic Law and Finance" (Centre of Near and Middle Eastern Studies, School of Oriental and African Studies, University of of London, 1988).

   Dr. R. Wilson and Mr. D. Baldwin, "Islamic Finance in Principle and Practice".Page 124.

8. op. cit. M. Umar Chapra, Page 33. "The Goals".

9. Dr. Wilson, "Islamic Business: Theory and Practice" (The Economist Intelligence Unit, The Economist Publications Ltd, 1984). Page 12.

10. Ibid. Page 22.

11. op. cit. Sami Hassan Homoud, Page 19.

12. op. cit. Abdur Rahman I. Doi, Page 379.

13. op. cit. Dr. R Wilson. Page 23.

14. op. cit. Umar Chapra, pp 58-61.

15. Ibid. pp 387-289.

16. "Hijra" is Muhammad's flight from Mecca to Medina. The "Hijra" took place in 610 A.D., and the Muslim calendar dates from that year.

17. Muhammad Nejatullah Siddiqi, "Partnership and Profit Sharing in Islamic Law", (The Islamic Foundation, 1985). Page 19- includes discussion on the differences in the Islamic Schools of Thought.

18. op. cit. Dr. R. Wilson, pp 28-29. The use of Murabaha for Short-term Profit.

19. Interview with Mr. Jassar Al-Jassar, Asst. Manager International Banking and Investment Department, The Kuwait Finance House. 3/4/89.

20. op. cit. Abdur Rahman I. Doi, pp 397-398.

21. The failure of the existing financial system to foster healthy morals is well documented.

CHAPTER 2

Venture Capital in the West.

(With Particular Reference to the UK.)

2.1 Introduction to Venture Capital.

Traditionally there has been an equity "Gap"(1) which made it very difficult for new companies with no track-record to raise funds for new business ideas. However, there now exists a bewildering array of sources of finance in the West to fill this "Gap" from an ever-widening range of suppliers, who are willing, as venture capitalists, to pump money into business, for either start-up or expansion schemes. In the last decade the venture capital market has grown tremendously, but has restricted itself to certain areas of growth, which means that there is still not enough backing for a young entrepreneur with a good idea in seed form.

The main aim of the new venture capitalists at the outset was to enable the formation of small and medium sized businesses (SMBs). These SMBs have a major advantage over their larger rivals, in that they find it easier to adapt to a changing market because their size makes them very flexible. In 1970 the Department of Trade and Industry (DTI) released a report enumerating the benefits of SMBs, and condensed them into seven points (2). They said firstly, that where sales outlets and production units are small, often the most efficient form of business organisation is the small firm and secondly, that it was possible for SMBs to flourish in a limited or specialised market which would not be worthwhile for a large firm. The report went on to say that SMBs provided good competition for multi-product firms and could even act as specialist suppliers to the larger companies. They are ideal for some independent-minded people who would feel limited in a larger organisation, and they are a low cost source of innovation and a traditional breeding ground for new industries. The report finally remarked that SMBs were being stifled because of their difficulty in finding long-term finance, which was due to investors seeking a quick return on their investment.

The idea of venture capital then was to fill the "Gap". At this point we require some definition of the term venture capital: "A venture capital investment is an equity, or equity-related investment in a growth-oriented small or medium sized business to enable the investee to accomplish his corporate objectives in return for a minority share holding in the business or the irrevocable right to acquire it" (3). The venture capitalist provides advice and support in many ways in an attempt to revitalize the dynamic subsegments of the SMB sector. The investment need not be made in return for equity, but can be in the form of a convertible debt or long term loan with attached options. Typically a venture capital investor is actively involved with the evolution of the business and will have a representative on the board of the company. This continuing involvement sets the venture capitalist apart from the banker and the stock market investor, who are more interested in their return from interest and the dividend yield.

The idea of specialised institutions for venture capital was born in the United States after World War II, when the American Research and Development Corporation (ARDC) was formed in Boston (4). This organisation was a beginning, but the movement really took off in 1958, when the Small Business Act was passsed by Senate and Congress. This enabled the formation of Small

Business Investment companies (SBICs) as vehicles for small business financing. Progress continued into the early sixties, when five hundred and eighty-five SBIC licences were approved. This first movement faltered because of unreasonable expectations, short-term orientation, excessive government regulations, lack of experience and widespread misunderstanding of venture investments. From the ashes of this early experience was born the modern venture capital industry, which took-off in the States in the early seventies. From 1969-1973 $450 million was raised in venture capital and the industry has continued growing. The major area of venture capitalism is still the United States, but the European community is catching up, Britain being at the forefront, desiring to encourage SMB growth in the most efficient way possible.

2.2 Risk and rejection.

Starting up in business, or expanding, is always a matter of risk; there is risk in the choices taken, the management chosen, in the inherent lack of liquidity and in the dynamic movement of markets (especially innovative markets). The venture capitalist wants to back new business whilst minimising any risk he takes. He has to be bold yet sensible in investing in small businesses with great growth potential, but he rarely has enough confidence to invest capital in an untried idea. The capital needed for this is called "Seed Capital": the analogy can be continued by saying that the venture capitalist hopes to nurture the seed to maturity, when it can be set free to fend for itself. There are two major reasons why there is a dearth of seed capital: firstly there is a great risk that the seed will be killed off early in its fight for life, and secondly it is not possible to make a large enough equity-related minority investment, which means there would not be sufficient return. Therefore, either less time must be spent monitoring the project in order to save money, or else the venture capitalist must take up a majority equity position: the latter option goes against the philosophy of venture capitalism, which advocates only a minority holding in an array of different companies.

The first process which a potential investor carries out is basic screening. For bigger firms it is necessary to have standards by which they stick in order to choose which ideas to consider. If a suggestion satisfies the pre-determined criteria, it can then be accepted for further examination. In his book "Venture Capital: The Complete Guide for Investors"(5), D. Silver establishes three laws to guide venture capitalists: firstly accept no more than two risks per investment (and he lists the five areas of risk as "development, manufacturing, marketing, management and growth"); secondly form a little equation using four terms, V for value of investment,P for size of market place, S for elegance of solution and E for quality of the entrepreneurial team. He says that for a good investment V=PxSxE; that is the value of the investment should be equal to the confidence one has in the firm; finally he says to invest in companies with a great market, because, if this is so, the importance of the values of S and E is minimised (6).

The questions that a venture capitalist will ask are manifold. There are sixteen possible points that are worth consideration:

1) Is the business a new venture?

2) How good is the management team?

3) Is the company capable of significant sales?

4) What is the size of the investment requested?

5) Is something novel about the company?

6) Is the company entering a new market?

7) What is the state of the market?

8) Is the management hungry for success?

9) Will the management be motivated in the long term?

10) What is the customer base?

11) How dependent is the business on its suppliers?

12) At what stage of development is the company?

13) How will external factors effect the market?

14) Is the company subject to radical technological change?

15) What is the potential size of the investee?

16) How good is the plan of the request that the investee has offered up?

The last question is very important, as it is necessary to structure your ideas very carefully when approaching a venture capitalist in order to show a professional, winning outlook. Figures from the U.S. show that 30% of all venture companies failed within two years, 30% failed at a later date, and only 25% were deemed to have done well (7), therefore a venture capital firm will place great stress upon, and spend great time in, the screening processes outlined above.

A typical breakdown of all the plans submitted is as follows (8):

60% - rejected straight away after a cursory glance.

25% - rejected after a few hours study.

15% - remaining after initial study.

10% - rejected after further investigation.

5% - the companies the venture capitalist is prepared to invest in.

3% - unsatisfactory price negotiations.

2% - investment made.

This illustrates how competitive the market place is.

2.3 Stages of Investment.

2.3.1 Innovation.

The very first stage is that of innovation, where a loan is needed to prove a concept. At this stage it is very difficult to enthuse potential investors because of the failure of some new technology outlets in the early 1980s. This is the investment area that needs to be encouraged, as it offers the greatest potential whilst offering the greatest risks. Governments sometimes see the need to help in this field, as did the British government when it founded the National Research and Development Council (NRDC), whose work is described later. Seed capital for a product should end at a successful prototype.

After the innovative stage comes the "business start-up", the actual forming of the business. There have been many start-ups in Britain in recent years, but this may reflect higher unemployment rather than the flowering of an enterprise economy according to a new study by Colin Mason, Lecturer in Economic Geography at the University of Southampton. He attributes very little of the share of encouragement for start-ups to the government's SMB support schemes. He compared his study to a report he wrote in 1980 about the 1970s (9).

Table 2.1

Percentage of Start-up Businesses Motivated by,

Decade	a) Positive Reasons e.g. Identification of a market opportunity.	b) Negative Reasons e.g. Redundancy or failure of a previous venture.
1970s	60%	6%
1980s	14%	42%

The results shown above would suggest that start-up ventures are motivated by necessity. There is no evidence to show that start-up finance has become easier to get hold of, however the businesses formed in the 1980s are making a definite economic contribution to society. A possible reason is that people start up new businesses from their redundancy money, and only then do they look for further capital to expand.

The NRDC (10), mentioned above, is one of the government sponsored organisations which are supposed to open up business opportunities in the U.K. It was founded in order to maximise the national benefits resulting from the country's investment in research and development through the licensing of patents and advice on expansion and exports. Only later did it become a source of funds, and is now even willing to share the cost of developing any technological innovation that it believes has a reasonable chance of succeeding commercially and is in the public interest. It is an independent public corporation financed by the government, which dictates its progress.

It is split into two departments: Applied Sciences and Engineering.

Applied Sciences	Engineering
Businesses.	Mechanical and Civil Engineering.
Industrial Chemistry.	Production Machinery.
	Computers and Automation.
Scientific Equipment.	Electrical Engineering.

Some of the above sub-groups take innovations from laboratories and universities, and advance funds to bring them to a commercially viable stage, when an effort must be made to find a willing manufacturer.

The sub-groups participate in Joint Development Contracts (JDCs), where the government is usually the major customer and so continues to define the specifications of the new entity. Advances are made against invoices relating to an agreed percentage of expenditure on the approved programme. Recovery is provided for by a levy on turnover at an agreed rate over a specified period. This system is called "Revenue Funding" and supports individual projects, not the company's cash flow, while permitting the company to undertake more new product development than its own resources or corporate strategy would allow.

The NRDC's operations are limited in that once the product or process has been successfully developed and can be manufactured, the revenue ceases. It is precisely at this stage that more funds are needed, because often expansion is more expensive then development. In Britain this is where venture capitalists should come into their own. There is now an organisation called "The Local Investment Networking Company" (LINC), which seeks to link those requiring finance to those that have it. Hopefully this will mean that capital from the richer parts of the country may now spread to the poorer parts more quickly.

2.3.2 Second Round Development.

After the start-up the concern is ready to build up orders, and to make modification for production - engineering. The company will usually be operating at a loss therefore a second round of financing will be necessary. This stage is backed up by marketing so that the company can find its own niche, which is the potential a venture capitalist should have seen at the beginning.

2.3.3 Expansion.

This is the next stage which a venture capitalist hopes to promote in the business he has helped to father. The initial providers are asked for another contribution in proportion to their original share of the capital committed to the project. This stage will probably come shortly before the company is expecting to go public, in which case the finances are structured so that they can be brought level by funds from the public issue. The expansion may be preceded, or succeeded, by a rescue bid, if the company's fortunes have taken a down-turn, but generally the expansion capital should be the last lay-out before the realisation of the investment, the processes of which will be described later.

The venture capitalist can choose three basic ways of being involved (11) in the company: firstly he can practise "hands-on" involvement, which means he acts as a permanent strategy consultant. In doing this he shows little faith in the management he has backed, and this approach leads to bitterness between the purely entrepreneurial staff and the staff of the financier, who direct operations. In this case the financing role of the venture capitalist can often take a back seat to the directing role.

Then there is "reactive" involvment, where the venturist reacts to any failures within his investment. He retains the right to play a role in the directing of affairs, but only if he sees faults or warning signs that necessitate intervention. Finally there is "hands-off" involvement, where the investor busies himself with financial analysis while trusting the entrepreneurial management. Whatever extent of involvement is chosen, continuous observation is necessary: from progress reports, to a member on the board of the company, or to a monitor; the venturist will try to have some control over the direction of his money, but he must also form a partnership of respect with the management team as a whole.

All the above actions are taken to avoid failure, but the prospect of failure must be seen early to avoid its occurence. There are some points to look out for such as late payments, losses, late financial reports, poorly prepared reports, the unavailability of the entrepreneurs, large thefts, director resignations and wholesale selling of shares. A company that faces liquidation will be reluctant to publish its reports for obvious reasons, and so this will lead to delay.

There are certain pitfalls (12) which many early venture capitalists could not avoid, but now, as the business comes of age, the lessons should be absorbed. There was a tendency to over-invest because of over-enthusiasm, and to leave the agreement too flexible. The deal should be as simple as possible with all loans to be repaid at a fixed rate of interest, in order to reduce uncertainty. All figures given should be audited thoroughly, and it is necessary to give the management an equity stake, but not so that they have a controlling percentage. All these are basic principles for the venture capital industry.

When a venture fails, the venturist is left with five options:

a) add more funds;

b) sell the company at a reduced price;

c) initiate foreclosure proceedings and leave itself with the option of acting as a secured creditor;

d) appoint a receiver to run the company;

e) liquidate.

All the options mean a loss.

In contrast, if a venture is successful, the venturist will hope to realise his initial investment. He will hope to gain additional capital while he is involved in the venture either in the form of dividends or as interest on loan capital. On a development project it is definitely possible to expect to bear income which would not be expected with a seed project. However the aim of the venture capitalist is to sell his minority investment for a substantial profit. This can be achieved in four basic ways; by

a) an internal sale of shares to employees and other shareholders;

b) an external sale of shares to another organisation;

c) having the company merged or sold to another company;

d) floating the shares of the company in a public issue.

The final way of realising is the most desired, because it shows that the venture capitalist has achieved his aim and becomes respected as a sound business. A floatation in Britain can take three forms: the "Full Listing" for which a five year trading record is required, and which is very expensive because of advertising and fees to be paid on entry and annually. Then less expensive is the USM(Unlisted securities market),which means that your share prices are only quoted once every two or three days, but for which only a three year trading record is needed. Finally there is the OTC (Over the Counter Market) which is less prestigeous and less advantageous. On the OTC, trading is outside the stock exchange, therefore it does not come under as much scrutiny as the USM or official list. Costs and methods of entry are not so strictly regulated as in the other two markets and consequently the OTC is less prestigious, which reduces the liquidity of the shares of a company in this market. Despite its drawbacks it is a useful alternative for those companies unable to fulfill the requirements for the more prestigious listings. The OTC is " a higher risk market and is more attuned to venture capital situations".(3)

At this point the venture capitalist can be seen to have done his job and can go on with any other ventures he wants to undertake.

2.4 From the Entrepreneur's Point of View (14).

So far we have discussed the idea of venture capital from the point of view of the large investor, now we shall discover the other side to the business; that of the entrepreneur. He/she has to present a plan to the venture capitalist but has a wide choice of which backer to choose. In picking a venture capitalist he/she must first find the one which will give the the best service at the most competitive price. The best service can mean that the firm wants an entrepreneur specialised in a certain field, with the right personality to service the new venture. If a businessman/woman wants to have very little outside interference in the business, he/she may choose a hands-off investor, but if he/she feels very unsure and wants as much real guidance as possible, a hands-on venturist will be chosen. If he/she chooses the second sort it may be because of a need for contacts in the new field to boost business performance.

The very fact that the business is reliant on venture capital means that certain restrictions and limitations will be placed on it. The time-scale for development will be very heavily dependent on when the venture capitalist is willing to make more funds available, if indeed he is willing to do so at all. It is necessary to realise that in the partnership both sides will be relying on each other and must adapt to the desires and limitations of the other. One problem could arise when venture capitalism comes to dictate to entrepreneurs their method of working, and so stifles the genuine risk taken in innovation.

The agreement between the two parties consists of legislation on "involvement", and the make-up of the financial package which is intended for the investment. Here is the breakdown of a typical financial deal showing how much finance comes from each source (15).

Management Equity.	5%
Venture Capital Equity.	15%
Venture Capital Convertible-Preference Capital.	20%
Venture Capital Loan.	20%
Bank(s) Loan.	40%

The loan will be repayable in instalments out of the cash flow of the company.

The management team can be given an incentive to perform well by arranging that the conversion rights of the preference shareholders are reduced to the extent that certain pre-arranged profit targets are achieved: therefore management interest in the total equity increases with profitability. On this equity the management is liable for tax relief.

For success a management team must think big and be over qualified at the beginning. This is in order to save new recruitment at a later date, and so that the venture capitalist will see no need for excessive intervention. An investee must realise that he will not lose control of his company, and that obtaining the money to realise plans is far more important than the percentage share: if the entrepreneur is so worried, the share of voting can be totally separate from the equity share. U.K. company law decrees that the owner of more than 50% of the shares collectively controls the company, but the law also safeguards the minority shareholders against abuse of this control. Ownership of more than 25% gives the owner the right to veto certain actions which the majority shareholders wish to take. In an agreement all share allocations are to be decided, and the rights of the minority shareholders are to be protected.

2.5 Categories of Venture Capital.

Increasingly a venture capitalist must fit into the two categories: large or small. The large ones have £ 50 million or more under management and focus on buy-outs and later stage developments, whereas the smaller ones have less than

£ 25 million and are interested in a particular industry or geographical area, and are more prone to make early-stage investments. Out of one hundred and seven venture capital organisations recorded on the Database of the British Venture Capital Association (BVCA) in 1987, 25% were in the first category and 60% in the second. Of the £ 4 billion invested or available for investment by these companies, almost 70% was accounted for by the 25% representing the large firms: the group of smaller companies accounted for only 16% of the total invested. .

We can deduce that 15% of the companies fell between these two categories and were in the medium range. They have between £ 25 and £ 50 million to invest and account for 14% of all investments (15). These companies are faced with a choice; to find more funds or to change from a broad based to a focused fund, which is hard because the management team consists of generalists rather than specialists.

Specialisation can be centred on a particular industry, a stage of financing, the terms of investment, the size of investment or a geographical area. Sometimes a venture capital company may even form a subsidiary to deal in one field, as the French government innovation investment scheme (Soffinova) did with their subsidiary, "Battinova", which deals in the building trade.

It is easier to gather together experts in one field than to have one representative for each different area. The assembled experts can formulate a standard agreement as a basis for all agreements in the specialised field; an agreement which fits the needs of any of the five categories of specialisation named above.

In the U.K. venture capital business, there are basically five different sorts of funds;

1) clearing bank related funds;

2) institutionally backed funds;

3) government owned funds;

4) corporate and private sector funds;

5) Business Expansion Scheme (BES) funds.

These will be dealt with one by one, except for the BES fund which will be explained later in this chapter, along with tax incentive schemes.

The main source of clearing bank funds is called "3i". It started in 1945 as on organisation set up by the Bank of England, which enlisted the major clearing banks to provide long-term finance for business: this was known as the Industrial and Commercial Finance Corporation (ICFC). Then in the early 1980s it set up a technologically-oriented arm, "The Technical Development Capital", which in 1983 became known as "The Venture Division of Investors in Industry" (commonly known as "3i"). Other clearing banks do participate in venture capital, but usually in partnership with a merchant bank (such as is the case with Midland Montagu) or another finance house.

The second group consists of funds set up by, and financed by, one of the public institutions such as British Rail or the National Coal Board. The third set of funds are government owned: at central government level the British Technology Group (BTG) was created by the merger in 1980 of the National Research and Development Council (NRDC) and the National Enterprise Board (NEB), to undertake the financing and the commercialisation of technological and scientific development in U.K. universities and research institutions. Since 1982 there have also been local government enterprise boards who have contributed to the venture capital industry.

The fourth category of corporate and private sector funds accounts for roughly 1% of the U.K. venture capital funds, with such companies as Shell and BP contributing as well as private foundations, such as that set up by the supermarket chain Sainsburys (16).

Another way of categorising venture capital firms is into those that invest their own funds and those that organise the deals on behalf of other parties. The latter (the 'Dealmaker') is a genre we will not deal with here, as the venture capital we are looking at requires risks to be taken by all those involved for it to have any relevance to an Islamic system. An example of the former group is Hambros Bank Ltd., a leading merchant bank in London. Since the late 1960s it has been organising direct investments through an informal but permanent syndicate. Hambros usually finances a major part of the deal (roughly 30%), and the rest is divided in equal proportions among the other investors, such as pension funds. The arrangement is such, that it is up to Hambros to identify the investment, and no member of the syndicate can refuse to go along with a specific deal and still remain a member of that syndicate.

Next we come to the question of how the venture capitalist is financed, and again we see two clear patterns (17); those that are debt financed and those that have raised their funds primarily in the form of equity. The example of The Industrial and Commercial Finance Corporation (ICFC) will be used to portray a debt financed concern, while the example of the French organisation "La Societe Financiere d'innovation" (Soffinova) will be used for the equity financed one.

As mentioned before the Bank of England was a major force in the organisation of the ICFC, and subscribed to 5% of the £ 40 million initial share capital, while the clearing banks subscribed to the rest. Formed in 1945, it had found its own niche, providing long-term fixed-interest, debt and equity capital to private companies by the late 1940s. It had a virtual monopoly in this field and so grew to have a portfolio of £225 million. Since their share capital is only £ 55 million, and a major part of its portfolio is made up of interest bearing investments, it is clear that the ICFC had to rely on long term debt to finance its operations.

Recently it has begun to face opposition from the banks offering longer term loans, but the ICFC has the advantage of fixed interest rates even though its costs are higher. The ICFC is prepared to make a fixed interest long term loan to an SMB, even if it is not insured, in return for the right to acquire a minority stake in the company.

"Soffinova" was created in 1976 with about one hundred shareholders (mainly French and foreign banks). (It is to be remarked upon that one of the smaller shareholders is "Advent", a venture capital organisation closely connected to a Boston based company, T.A. associates, which advises the Soffinova group. This fact bears witness to the domination by the U.S. of the world venture capital market). By the end of 1976 it had screened one thousand five hundred projects and was investing F Fr 32 million in seventy of them. Their format leads to a firmer base for growth and has become the format which is a major creative force in the European venture capital industry.

The single-sponsored venture capitalists, which abound in Britain, are mainly extensions of the merchant banks. The oldest one of this group is Charterhouse Development Ltd. (18), a subsidiary wholly owned by the Charterhouse Group Ltd. For fifty years it has provided minority equity or equity-related finance to private companies: it became involved in so many majority investments after the war that in 1958 a holding company was formed, of which Charterhouse Development is now a subsidiary.

The very fact that there is so much risk involved means that most institutions prefer to become shareholders in situations where they receive an immediate reward for their risks. This was tried on a pan-European level by the European Enterprise Development (EED), formed with the avowed intention to limit itself to marketing equity investments in return for minority shareholdings.

The EED ran into great difficulties as it channelled 90 % of its equity capital into four investees, which became partly or wholly owned by it. This led to a debt of US $ 7 million in 1974, and so urgent action was required: they managed to raise $5 million in equity and obtained a $ 2.5 million unsecured loan. They also organised $2 million from new shareholders and a revolving credit line of $9 million, to be repaid from the proceeds raised from the sale of its investees.

On a national basis, a multi-sponsored venture is much more viable because of specialised loans such as in France, where companies can immediately deduct from their taxable income 50% of their investment in a Societe financiere d'innovation

(Soffinova). The multi-sponsored format makes it easier to provide secondary or tertiary finance, while it serves to spread the risk. The trend must move more towards this format in order to avert an over-competitive market with an excess of unqualified staff.

One method which is of major significance in the USA is "corporate venturing" (19), which has provided large companies with "a window on technology and advancement " by investing in smaller specialised concerns which respond more quickly to a changing market, as remarked in the DTI report of 1970. A failure to recognise the potential in corporate venture funds has left the U.K. behind the U.S. in the field of new technology. (Figures show that 40% of new technology in the U.S. is from corporate venturing.)

The main method is that of "sponsored spin-out", where a new company is set up and run by managers drawn from the original larger group. The equity investment is provided by three groups: the management team, the parent company and the venture capitalist. One example of a spin-out involves the British firm ICL; in 1986 it spun out one of its innovative technologies employing large numbers of micro-processors working simultaneously on a computerised problem. "3i" helped to establish the "spin-out" (called Active Memory Technology (AMT)), so that ICL benefits by keeping in touch with the modern market while not having the burden of all the risk.

In Britain, corporate venturing is expanding, as the government, in the form of the National Economic Development Office (NEDO), has set up a corporate venturing centre to handle large corporate subscribers, and a regional network is being set up for smaller companies, so from now on early-stage equity-related backing should be easier to obtain.

2.6 Management Buy-outs (20).

The term "Management Buy-out" (MBO)(21) refers to the case where a company is acquired by its management and outside investors, by using a high proportion of debt secured against the assets of the company. Many people argue that although this is a process in which many venture capitalists participate, it is not a part of the venture capital industry. Their argument is that most MBO deals are not equity-oriented deals in which the investor seeks to add value to the company, but are instead, highly leveraged deals which are basically exercises in financial engineering. However it is worth discussing such deals because of their relevance to the way an Islamic system could work.

Lately there has been a shift in corporate thinking which has led many large companies to divest themselves of unwanted entities as a process of deconglomeration. The depression and high interest rates made it desirable for the large businesses to concentrate on their central core in order to survive. An improved cash flow can then be used to streamline operations and invest in new technology and recovery strategies. This rationalisation can even be a way of finding capital to fund development in new areas in which the company sees potential.

The workings of an MBO are thus (22); a management group and investors put up some money and use the company and its assets as collateral to borrow a large sum of money to buy the outstanding equity. The management will be expected to put up a small amount of the finance to show their committment, and the fact that they are part owners will spur them on to work better. They are among the group of equity investors who are joined by three other partners, or sets of partners in the deal. Finally there is the "dealmaker" who assembles all the parties, negotiates the finance and structures the deal; then there are the senior lenders, who supply most of the capital needed, and finally the subordinated lenders join the agreement.

The dealmaker can be involved in the finance himself or can be purely an administrator. The norm is that the dealmaker takes charge of a 'pool' of capital collected together from all the sources: the pool can be "conventional" or "blind". A "conventional pool" means that the investors have a say in the recipient of their cash, whereas in the case of a "blind pool" the investors let the dealmaker decide everything in order to save time. At a later date it will be the deal-maker's job to ask for further funds from the initial investors. Accounting firms such as Peat Marwick have put forward valid claims to being the best sort of dealmakers (23), as they have an overall view of the financial world, and so are becoming more and more involved in MBOs.

The pure dealmaker, with no financial interest, gains roughly 1% of the selling price and 20% of the capital gains made by the equity pool, when an investment has been realised. If a deal falls through, then he is liable for all the fees accumulated and consultancy fees. His most common difficulty is in matching the different goals and desires of all involved, while his every move is being heavily influenced by the senior lenders, who are normally the big commercial banks.

The senior lenders usually provide 50% - 90% of the MBO price against fixed assets, with other assets used as collateral. In the U.S. commercial banks are not allowed to hold equity, therefore interest rates are very high and can sometimes be crippling. The senior lender can demand to see all documents, and has such power that he can attach conditions such as restrictions on additional borrowing, and the repayment of his loan in full before any other investors are paid back.

The subordinate lenders are senior to the equity investors but junior to the senior lenders(24). Their loans are secured not against assets, but against projected cash flow in true venture capital style. They participate in the equity hoping for a very high return because of the high risk. The loan is given in return for both interest income and significant participation in the equity of the investee on advantageous terms (often referred to as "Mezzanine financing").

MBOs now account for roughly one in five of all financings. In the UK £ 3 billion was invested in MBOs compared to £ 26 million only nine years ago, and the figure is expected to rise to £ 6 billion by the end of the eighties. In 1988 Peat Marwick reckoned there were 210 MBOs involving £ 2.33 billion, and so the trend carries on. Management buy-outs, encouraged by the government's privatisation policy of the bus companies, the shipyards and British Rail etc.,will continue to grow in number in the 1990s.

Lately the management teams have begun to dictate terms to the venture capitalists (25), with the result that the proportion of loan finance in the deals is becoming higher and higher, while the amount of equity held by the venturist is decreasing. This does not please the purist venture capitalists, who are now turning to "Management Buy-ins" (MBIs). The risks are higher, because an outside management team, unfamiliar with the business, is backed by the venture capitalist. In this case it is usually he who seeks out the target company and puts together a financial package, then he brings in new managers to run the business. "3i", which has financed 55% of MBIs so far in the UK, has been overwhelmed by interest in its new MBI unit, set up in the summer of 1987.

2.7 Government Support For Venture Capitalism.

The first European country to realise the need to encourage venture capitalists by offering them privileges was France (26).. In return the venturists had to abide by certain guidelines, and the minimum conditions were the following:

1) Within six years they will have invested 80% of their capital in innovative situations, where the criteria to decide whether a project is is innovative or not are decided by the government.
2) They will not invest more than 20% of their capital in any one situation.
3) They will turn their portfolio over by 33% every 3 years.

For all this they are allowed to deduct 50% of their investment from their taxable income immediately. Some people feel the agreement is too restrictive and have thus stayed outside this lucrative scheme.

In 1983 the British government introduced the Business Expansion Scheme (BES) in a Finance Act, with the goal of facilitating accessibility to risk capital, by giving tax relief at the marginal rate of tax for investments up to £ 40,000 per year. To qualify for BES relief, the investor must be a UK resident and may not be connected with the company: the money must be invested in ordinary shares, which must be held for at least five years (27). The amount of the investment must be a minimum of £ 500 and a maximum of £ 40,000 per individual (or couple) (28); this money may be invested in as many investments as the investor wishes. As for the company invested in, it must be resident in the UK, the shares must not be dealt with on the stock exchange or the USM, and it must be a single company unconnected with any others. It has to be engaged in a qualifying trade: these trades do not qualify -: commodity dealings, leasing, banking, insurance, legal or accounting services, farming and property development. What is more, all the above conditions must continue to be satisified for three years after the share issue. In March 1986 (29) the Chancellor introduced new legislation in a Finance Bill, so that the BES, which was originally intended for only four years, could continue indefinitely, and BES shares issued after March 1986 became exempt from capital gains tax on their first disposal.

The scheme benefits everyone concerned, and the five year limit on selling shares relieves the pressure on the entrepreneur of having to produce short-term profit at the expense of his long-term plans. In practice the BES has been very successful as is shown in the figures for its first year (1983-4), when between £ 80 and £ 85 million (30) was invested in small companies under its rules, and more than 10,000 investors (4% of the top two rates of tax-payers) participated in over 400 company investments.

Both the French and British schemes show how governments can encourage healthy expansion and development by 'incentivising' the investee and the investor at the same time. This is one way of filling the "Gap" mentioned at the beginning of this chapter ; now there is a real appetite for growth sponsored by the central government.

2.8 The State Of the Venture Capital Industry and its Future.

The venture capital industry in Britain is now very well organised under the auspices of the BVCA, which was formed in 1983 to coordinate the activities of its members. It comprises one hundred and seven members with fifty associate members, and is chaired by Mr. John Nash. It reveals many interesting figures and trends, and advises the government on start-up schemes and other venture capital matters (31).

It estimates that there is £ 4.5 billion worth of venture capital ready to be invested in the U.K. 1987 was a very healthy year with £ 1.03 billion being invested in 1,300 companies, and in the first six months of 1988 £ 550 million was invested.

Fund-raising was slower in 1988, and if all funds meet their targets the final figure of funds raised should be £ 705 million. This is evidence that the market boomed in 1987 and is now pausing for breath and reassessment. There is still a lot to learn from the U.S., where there are over 1,200 venture capital companies investing roughly $ 2.6 billion per year. A study released by the U.S. General Accounting Office concluded that "The venture capital process can greatly contribute to the nation's economy and can significantly improve productivity in the 1980s"; they have been proved right so far.

2.9 The Relevance of Venture Capitalism to the Islamic System.

Many of the points made above are relevant to the Islamic financial system; the role of a venture capital investor equates roughly to the role an Islamic bank could play, except that the Islamic bank would have no recourse to any slight loan investment. Some things are exactly the same, such as the rules for business success, which necessitates sound, convincing planning and an entrepreneurial team qualified and hungry for growth. To judge the merits of a proposed investment, a large auditing and decision-making section would be necessary in the bank in order to minimise the failure rate and to check continually on investments.

One thing that has become clear lately is that syndicates are able to support businesses more competitively than single-sponsored ventures. Just like a venture capitalist the Islamic banker has a role to play as an equity participating dealmaker, however government support will be needed, if we are to set any store by the U.S. and European experience.

In the Arabian peninsula there is a necessity to broaden the economic base for survival. This can only be achieved by encouraging economic development and business formation. Maybe it is time for the big family-run corporations to divest themselves of some of their concerns for the good of the country. Could we see the Islamic banks involved in MBOs in the next decade as the businessman desires a 'window on technology', 'a path to the future'?

Notes.

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1. The "Gap" was originally diagnosed in the UK as "The MacMillan Gap" - MacMillan Committee 1931.
2. S.A. Coutarelli, "Venture Capital in Europe". (Praeger Publishers, London: 1977) pp 3-5.
3. Ibid . Page 17.
4. C.A. Bohn, "Venture Capital and the Leveraged/ Management Buy-out". Durham University Business School, 1984.
5. D. Silver , "Venture Capital: the complete guide for Investors".
6. K. Saravanamuthu, "The Venture Capitalist's Viewpoint in Meeting the Financial Needs of the Small to Medium Sized Companies." Durham University Business School, 1985.
7. Investors' Chronicle, 28th October 1988 - 3rd November 1988 Venture Capital Survey, pp 71-78. "Corporate Venturing: Benefitting from the American Experience" (pp 77-78) Derrick Sach from 3i.
8. op. cit. Saravanamuthu. pp 34-5.
9. Dr. C. Mason, "Explaining Recent Trends in in UK New Firm Formation Rates."(1988). Urban Policy Research Unit, Department of Geography, Southampton University.
10. op. cit. Coutarelli. pp 9-13.
11. op. cit. Saravanamuthu. pp 61-2.
12. Ibid. pp 66-69.

13. Arthur Andersens, Chartered Accountants. Booklet: "Guide to the Unlisted Securities Market." (1987)

14. PMG, Chartered Accountants. Booklet: "Venture Capital." (1987)

15. Ibid.

16. op. cit. Investors' Chronicle, 28th October 1988 - 3rd November 1988. Article: "The Industry Changes Shape", Susan Lloyd.

17. op. cit. Coutarelli, pg 37.

18. Charterhouse Group Ltd. Booklet: "Charterhouse Development Capital" (1988)

19. op. cit. Investors' Chronicle , 28th October 1988- 3rd November 1980. Article: "Corporate Venturing; Benefitting from the American Experience" (pp 77-78) by Derrick Sach, 3i.

20. PMG, Chartered Accountants. Booklet: "Management Buy-outs" , (1987) .

21. For further information see EIU Special Report No. 115 "Management Buy-outs. A guide for sellers, managers and investors" (1982). Also European Supplement, December 1986. "The Lucrative World of Management Buy-outs."

22. Robson Rhodes, Chartered Accountants. Booklet: "Should you buy your company? A guide to Management Buy-outs". pp 5-8. (1988)

23. Ibid. Page 12.

24. op. cit. Investors' Chronicle, 28th October 1988 - 3rd November 1988. Article: "Buy-ins and Buy-outs: Making Waves". pp 87-91. by D. Hutching.

25. The Guardian, 15/11/88. Article: "Finding Your Way Through the Financial Maze." Page 12.

26. op. cit. Coutarelli. pp 43-44 "Charter Limitations."

27. Hodgson Impey, Chartered Accountants. Booklet; "Technical Bulletin: BES" 1987. pp 1-4.

28. Ibid. Page 4.

29. Ibid. pp 34-35.

30. op. cit. Saravanamuthu. Page 17.

31. op. cit. Investors' Chronicle, 28th October 1989-3rd November 1988. Interview with Mr. John Nash, Chairman of the BVCA. "BVCA aims to Educate". pp 95-97.

CHAPTER 3

The Kuwaiti Economy.

3.1 Kuwait: History and Social Values.

The surveys in the first two chapters must now be viewed, for the purpose of this thesis, in the context of the Kuwaiti economy. In order to do this the reader must first gain some knowledge of the history of Kuwait and its economic performance, especially since the discovery of oil which transformed Kuwait's economy from a subsistence one to a very affluent one. However an understanding of the character of the modern state of Kuwait can only be developed by delving back to the eighteenth century.

Until this time Kuwait had been by-passed by the world of trade, because it could not compete with the south Iraqi port of Basra with its more economically significant hinterland. Then from 1710 it was taken over by the tribe of "'Utab" from the "'Unaiza" confederation, who took control from the Ottomans, and developed it as a terminus for trade from Syria. When the "'Utab" split up in 1760, the "Khalifa" faction went to Bahrain while the "Sabah" section stayed on as rulers to form the modern state of Kuwait. In 1776 the East India Company set up a base there, partly for commercial advantage, and partly because the Gulf was seen as part of the geographic process that controlled the Indian trade which was so important to Britain (1).

Till the late nineteenth century Kuwait was ruled in stability by the Al-Sabah family, when it became the centre of international focus for two reasons: firstly the awakening of Ottoman desire to reassert itself; and secondly the German plans to include Kuwait in the Berlin - Baghdad railway. From this time on Mubarak , the then ruler of Kuwait, looked to the power of His

Majesty's Government in Great Britain for protection. After the outbreak of the First World War Kuwait became a British protectorate in exchange for a series of exclusive economic concessions in Kuwait (2).

When oil was actually discovered there, Britain therefore was in a very strong position to exploit it. In 1934 Britain formed the Kuwait Oil Company (KOC) to search for oil, and in 1938 oil was discovered at Burgan. However the first export had to wait till 1944 when the second world war was almost settled : the oil industry quickly replaced any other nascent industries as it was very lucrative. Till 1961 the growth was tremendous, there was an overwhelming influx of immigrant workers, and Kuwait sought independence. In 1961 this last goal was achieved and immediately Iraq attacked; Kuwait was saved by the returning British forces, and the independent Kuwait was now ready for self-determined development. A welfare system was set up, a constitution penned, a civil service manned, and the Kuwait Fund for Arabic Economic Development (KFAED) formed: Kuwait was at last asserting itself.

It has developed into a consumer economy dependent on one commodity, oil, which finances the importing of many necessary goods. The move towards industrialisation has been hampered by the lack of a market, and this has led to the bizarre situation where, because of foreign investments, GNP comes to exceed GDP. Some diversification has been carried out, but the lack of urgent need has made progress difficult (3).

Social change has been both the target and the result of the government's development programme. However, throughout the upheavals of the last fifty years the links with the past have remained very strong, so that family and tribe play a key role in the cohesion needed for a modern state (4). In this, the second most populous Gulf Cooperation Council (GCC) state, the government has done all it can to provide for the welfare of the society; it has created what is arguably a model welfare state, where health care, education and housing are free for all Kuwaitis and most non-Kuwaitis. In 1976 the government published the social security law, which ensures strict application of the principles of social justice, and provides for all citizens of the state adequate protection in employment, assuming the ability to lead a normal life (5).

All adult education services are government funded and lead the field in trying to bring Kuwaitis into all sorts of jobs, in order to decrease the reliance on immigrant labour. One such establishment is Kuwait's Institute of Banking Studies, which has made it a matter of policy to develop financial and managerial skills. At present they have one thousand people attending 53 courses, and a spokesperson for the institute recently said:
"The proportion of Kuwaitis is very much increased compared with 1982-83. We are also getting better qualified people entering the profession with an enthusiasm to learn new things so they can perform better" (6).

There are now 13,000 students at the University of Kuwait, and the number is expected to double by 1995, because 60% of all Kuwaitis are under fifteen years of age. However the shortage of qualified Kuwaitis remains a major problem in all spheres, especially among the female population. In 1985 the deputy to the General director of the Public Authority for Applied Education and Training, Mr.'Isa Al-Rifai put the situation into perspective when he said:

"Of course our aim is to maximise the Kuwaitisation of all economic sections of the country, but this will not happen overnight" (7).

The influx of immigrants has changed the society, giving it more awareness of its role among the Arab nations; this awareness has been heightened by the sizeable Palestinian representation. In 1946 the population was taken to be 90,000, but had risen to 1,000,000 by 1975 (8). In a country with 17,818 km square of land area there are four main areas of population: Kuwait City, Hawalli, Ahmadi and Jahra. The last census in 1985 was split into these four areas and made a further split between Kuwaitis and non-Kuwaitis.

Table 3.1

1985 Census Population

	Kuwaiti	Non-Kuwaiti	Total
Kuwait City	60,272	107,478	167,750
Hawalli	257,153	685,297	943,250
Ahmadi	147,582	157,080	340,662
Jahra	213,794	65,672	279,466
Total	679,601	1,015,527	1,695,128

Source: Central Statistical Office, Ministry of Planning.

From this Table we can see that the population total of 1,695,128 was made up of 40% Kuwaitis and 60% non-Kuwaitis; the latter containing 22% Palestinian, 40% Egyptian, 15% other Arabs and 10% Asians (9).

In 1980 it was calculated that in the non-Kuwaiti sector, 93.2% of the men were part of the labour force, as were 29.6% of the women. At the same time in the Kuwaiti sector, 66.8% of the men and 10.3% of the women were economically active. Some of these non-Kuwaitis remain in Kuwait, but the majority return home depriving Kuwait of their expertise and their spending power. The main source of employment for Kuwaitis is the civil service which, in June 1984, employed 135,310 people, 38.1% of whom were Kuwaiti. However, on the whole, there has not been enough Kuwaitis working in the consumer productive industries such as manufacturing and construction (10).

There is a need to promote a balanced labour force in order to maintain social stability and political harmony. The optimum structure is one that realises a balance between Kuwaitis and non-Kuwaitis; one way to achieve this would be the easing of the constraints on gaining citizenship. For the 22.9% of the non-Kuwaiti Arabs who have been living there for over fifteen years, the path to citizenship should be smoother than it is now. By doing this Kuwait would develop a larger workforce proud of its home state, and more willing to make it a success (11). The five year plan (instituted in 1985) aims to lift Kuwaiti participation in the economy from under 20% to 23.7% by 1990, in order to ensure continuing growth and success into the next century (12).

3.2 Problems of the Kuwaiti Economy in the 1980s.

It is generally accepted that the 'boom' years are over, and this will be shown later in this chapter when growth ratios are detailed. There has been a recession during which the private sector has been restructured to be more competitive. The government, having for so long adopted a total 'laissez-faire' attitude, now intends to have a higher profile in private business: it now offers industrialists long-term loans, low-cost utilities and tarrif protection whilst encouraging more trade with other GCC countries.

The need for the economy and for its components to reorganise came about because of the destabilising problems of the last four years. The oil price collapse, the unstable dollar (on which all oil prices depend) and the disastrous Kuwaiti stock market crash in 1982 all affected business confidence, which has also suffered because of the Gulf War.

After a couple of years of restructuring we now see leaner, meaner public and private sectors, and a diversifying economy where non-oil industries play a larger part. In the early 1980s there was an oil glut because no nation wanted to sacrifice short-term profit for long-term pragmatism. The result is that the present low price of oil has forced the Kuwaiti and other Gulf governments to make cut-backs in development projects, in salaries for government employees, and there have been delays in paying of contracts. All this led to depressed business activity, bankruptcies and an exodus of immigrant workers, which crippled the system. The government has been forced to spend less than was needed for a full growth rate and so much development has had to be curtailed.

The Gulf War caused many divisions in the Arab world, but inside Kuwait it has led to a pulling together, an inner cohesion which will stand the country in good stead. During the eight years of the war shipping activity in the Gulf was slack due to tension, but the flow of oil was not really affected. What was hit was the re-export trade which accounted for only 3% of imports in 1987 against 30% of imports in 1985 (13). The war has also affected oil prices as Iraq is now determined to make up for its war losses. It has angered many Gulf states by producing too much oil, a fact which will be seen more clearly when we look at the structure of the Organisation of Petroleum Exporting Companies (OPEC) (14).

The year 1987 saw many policies and programmes drawn up to face the challenges emerging from domestic and foreign developments of recent years. Support was given to the development of new and old industries, and as a result the GDP rose, as did the level of activity, especially in the non-oil sector. After a decline of 10.2%, 3.7% and 1.5% respectively for the years 1983, 1984 and 1985, the non-oil GDP (at current prices) rose by 7.5% to KD 3,156.2 million in 1986. These figures will be further defined when we discuss the non-oil sector in more detail.

The most remarkable sign of inner turmoil was the crash of the Kuwaiti unofficial stock market, the "Suq al-Manakh". It had emerged in the 1970s due to financial surpluses and the inability of the domestic economy to absorb them. People had invested large sums abroad but they wanted a home market. At first they ploughed their money into real estate, but the surplus continued to grow, and so they moved into stocks and shares in order to gain a quick return. The private investors took shares in companies which were of no real value; money was wasted which the government should have channelled towards productive investment. The government failed to realise the need for constraints and controls, and did not even form a regulatory stock market committee to oversee all transactions. Companies did not have to prove their profitability to anyone and so to gain a listing was too easy, which resulted in a market that was floating on air.

The Suq al-Manakh dealt in shares from companies inside and outside the Gulf, and in transactions where post-dated cheques were answered by instant delivery. In some cases people were buying and selling shares in their own company and often in cash. This made for a high liquidity rate and a sharp rise in prices.

In August 1982 the rot started as a couple of investors failed to make payments, which in turn set off a chain reaction of defaults. The banks were left with many bad debts - the collateral for which is worthless because of the dummy companies formed on the unofficial stock market. A trail of debt amounting to KD 27 billion was created from 29,000 post-dated cheques, which took two a half years to sort out. Two government schemes were instituted. The first was an equity purchasing scheme on which the government spent KD 756 million of general resources in order to keep prices on the stock exchange up, and KD 500 million was spent to reimburse small investors. In the end only eighty eight companies were declared bankrupt including some major concerns such as the money changing company of Jawad and Haidar Abu Al-Hassan (15).

The second government scheme was the "Difficult Credit Facilities Settlement Programme" (DCFSP) announced on the 10th August 1986. It has had a favourable impact, not only on the debtors, some 90% of which have reopened, but also on the creditors such as the commercial banks. The KD bond market also suffered in the crash : in 1981-2 as share prices were doing well the bond market lost its appeal, and after the crash it lost any appeal at all (16).

The crash has been expensive for the government in the short-term, and now there is a lot of confidence building to be done for the long-term. Foreign banks are more reluctant to deal with Kuwait so the Kuwaiti Dinar has suffered in an already depressed oil market. In an effort to stabilise the country His Highness the Amir of Kuwait Sheikh Jaber Al-Ahmad Al-Jaber Al-Sabah has suspended the National Assembly (the democratically elected representative body) and has appointed his own men to the ruling body. He seems more determined to keep a tighter hold on economic development plans, which has necessitated a regression of the nascent political system. More controls are needed, along with guidelines for new industry: the economy is in the process of being streamlined for survival.

3.3 The Oil Industry in Kuwait.

We have briefly referred to the fact that the economy of Kuwait is dependent on oil, the product which has brought affluence and growth. We must now look into the structure of the oil industry in Kuwait, and how it fits into the global energy system.

The Kuwait Oil Company (KOC) was formed in 1934, 50% being owned by the Gulf Oil Company (GOC) and 50% by the Iranian Oil Company (which later became BP). In the original agreement the KOC was given the exclusive rights for exploration, production and marketing of Kuwaiti oil for seventy-five years, excluding the neutral zone in the very south of Kuwait, which was under Saudi-Kuwaiti joint rule, and was to be exploited by Aminoil, an American company. The agreement provided a fixed payment of three rupees (the former monetary system) per long tonne of crude to Kuwait in addition to a slight return for tax exemptions. This all changed in 1951 when the 'Tax law' was introduced, and oil companies were subjected to income tax at 50% of profits: as a consequence government resources rose greatly and had reached the princely sum of $30,000,000 by 1953 (17).

Then two years later the system of 'Posted Prices' was introduced, and oil was taxed on the posted price per barrel rather than the actual price. This was merely for tax reference purposes, so that if oil prices fluctuated taxes remained the same. A system of royalty payments was worked out amounting to 12.5% of the posted price.

The next major step was the 1959 initial Arab Oil Congress in Cairo, after the big companies (18) who ruled the oil production in Kuwait and her neighbours decided to cut prices, a move which badly affected the economies of the said countries. As a result the Organisatioin of Petroleum Exporting Countries (OPEC) was formed to protect oil-producing countries against their foreign exploiters. The original members were Kuwait, Saudi Arabia, Iran, Iraq and Venezuela: in the 1960s Qatar, Indonesia, Libya, Abu Dhabi and Algeria joined the original five as did Nigeria and Ecuador in 1971 and 1973 respectively.

The aims of the original five were:

a) to restore oil prices to the level immediately preceding the reduction of the late 1950s;

b) to eliminate the quantity discounts given by concessionaries to their parent companies;

c) to gain a better deal for themselves.

Kuwait was a major force in the OPEC administration at its inception, and still is today (19).

A major breakthrough by the OPEC countries was in 1970, when Iraq, Libya and Algeria agreed to coordinate their efforts to win a fair deal from the major oil companies. The Suez canal was closed down, and so 95% of the oil from the three above countries was inaccessible to the West and the oil companies that held power in the industry. Libya led the field and won an increase in prices, and all the others followed suit. At last the power of the big companies had been broken by a unified effort, and this worried the western powers (20).

Vienna had already witnessed a meeting of OPEC (at which producers demanded higher prices) when the 1973 Arab-Israeli war started, pushing Arab nationalism again to the top of the agenda:

the producers looked for more control over their revenues. On the 16th October 1973 the tremendous price rises were announced in Kuwait, and the next day all countries deemed sympathetic towards Israel were boycotted. The Arab nations had wanted to do this after the six-day war in 1967, but they lacked the cohesion then. It was true that they had joined together in 1968 to form the Organisation of Arab Petroleum Exporting Countries (OAPEC), but they lacked any power to make a real impact. Kuwait, Libya, Saudi Arabia, Algeria and Iraq were the founder members and sought to put combined pressure on 'unfriendly' countries. The OAPEC headquarters were set up in Kuwait, which, by its position in these two major organisations, now had the power to influence world events (21).

In the early 1970s Kuwait had already raised its oil prices, and income tax was also raised. In 1972 Kuwait took a further step in the way of self-determination, when it limited the KOC's output to 3,000,000 barrels per day (bpd), in order to preserve oil, and to ensure that there were no price-lowering surpluses.

On the 1st January 1974 the government of Kuwait turned to equity participation, taking over 60% of the KOC, leaving 40% to the two original firms, Gulf and BP. Royalties rose from 17.5% to 20% and income tax from 55% to 85%. Then exactly one year later, Kuwait terminated the Gulf and BP concessions: the Kuwaiti government now had full control over its revenues (22).

In the meantime since 1934, different oil-related industries had grown up in Kuwait. In 1960 the Kuwait National Petroleum Company had been formed for the purposes of refining and marketing; in 1957 the Kuwait Oil Tanker Company (KOTC) was set up for transport services and in 1967 the Petrochemicals Industry

Company (PIC) was formed. In the vital year of 1980 these four were joined under the umbrella organisation, the Kuwait Petroleum Company (KPC), with each subsidiary being represented on the board. To complete the picture the Kuwait Foreign Petroleum Exploration Company (KuFPEC) was formed in 1981 and joined the umbrella organisation (23).

KPC
(Est. 1980)

PIC	KNPC	KOC	KOTC	KuFPEC
(Est. 1967)	(Est. 1960)	(Est. 1934)	(Est. 1957)	(Est. 1981)

As a member of OPEC, Kuwait, with all other members, reached the height of its power in the 1970s, when it had total dominance over the world market; a dominance which has now been cut to only 50%. It has tried to regain its power by once again making oil a more precious commodity by restricting its output, but the ceiling levels it imposed on its members have been openly flouted. It has been a victim of its own success, because it managed to keep prices high for so long that an oil glut was the result.

Since 1986 OPEC has had a hard time, because when one of its members starts over-producing all its members follow suit. In October 1988 the OPEC president, Rilwano Lukman, admitted that the cartel was producing 21 million bpd against a target of

17 million bpd. It faced the prospect of oil prices sinking as low as $ 5 per barrel. This would have crippled countries such as Kuwait, who aim for a steady price of around $ 20, which is low enough to attract buyers while not damaging revenues. Kuwait now insures itself against the unpredictability of oil prices by diversifying, and by moving downstream in the oil market.

Revenues to the OPEC countries from oil in 1988 will be down 9.5% from the previous year to $ 110,000 million: the figure is only just higher than in 1986 when the oil price crashed. So we can see that oil is not the money-earner that it once was, in fact oil revenues in Kuwait decreased by 16% and 29.2% in 1985/6 and 1986/7 respectively. Kuwait itself has been decreasing its production, but has still been exceeding the limit imposed on it for the last two years (24).

Table 3.2

Kuwait's Crude Production in Millions of Barrels per Day

OPEC Quota	Actual Total		
	1986	1987	1988
0.996	1.2	1.1	1.1

Oil revenues have dropped consistently since 1981, although they still accounted for 45% of the GDP, 85% of total export earnings and 45% of general State revenues in 1986. After the price crash, however, the revenue for investments was 119% of oil revenues.

Kuwait has moved more and more into downstream activities of which the first which will be discussed is refining. In 1986 this area of exports started to take over from crude oil, and at present more than 50% of Kuwait's oil is being refined at home. The refineries are now being modernised and the great hope is the Mina Abdallah refinery, where there are now facilities for making fuel oil, naptha, turbine kerosine, high speed diesel, marine diesel oil, green coke and sulphur. This trend towards refining is justified in a quotation from Mr. Bader al-Baijan, general manager of the Major Projects Group:

"The modernisation of Mina Abdullah is part of an overall expansion and updating of crude processing facilities in Kuwait ... However the most significant idea behind the move is shifting the market more towards the finished product, where profit margins are higher and market demand more reliable".

He went on to say that this goal is being helped by the KOTC, who now transport 65% of Kuwait's oil, and the PIC, who lay down the pipelines (25). Exports of refined products have been increasing since 1981 and that trend looks likely to continue.

3.4 Retail Operations in Kuwait.

In 1983 the KPC acquired the downstream assets of the Gulf Oil Corporation (GOC) as it headed for less reliance on the crude products. It acquired two thousand European service stations and two operating refineries, and has grown immensely since then. By clever marketing, it has established a niche in the market alongside such companies as Shell and Esso, while maintaining a permanent staff of only fifty-five based in London.

Under the name "Q8", chosen for its eye-catching humour factor, and the emblem of two sails (representing Kuwait's sea-faring past), they undertook to reformulate all types and grades of lube oil in order to keep ahead of the rest. They have faced teething problems, such as how much stock to hold, and how to deal in seven European currencies instead of just the U.S. Dollar.

With a new service station lay out and new uniforms (with "Q8" emblazoned on them), the image is full of vitality and is sure to protect Kuwait from ever again depending on the volatile prices of crude oil. "Q8" wants to expand its operations and to cover more and more countries in the near future: the company is young and has a lot of potential to fulfill (26).

There is ever more research into alternative sources of energy, but so far no one has come up with a fuel more suitable than oil. Kuwait, with oil reserves of ninety-two million barrels, has enough for two hundred years if oil retains its position as the most important source of energy.

3.5 Kuwait's Non-oil Economy.

With an idea of the oil industry in Kuwait we can now look at the areas of the economy where oil plays no part. The traditional agriculture and fishing now form a tiny part of total revenues. The fact that only 2% of Kuwait is cultivated is the major problem, but the lack of good quality irrigation water does not help. There is very little scope for expansion in these two areas, which, combined, account for 1.3% of GDP and 0.6% of the labour force (27). Most of Kuwait's food is imported, witnessed by the $670 million bill for 1984. Self sufficiency ratios of 60% for eggs, 27% for poultry, 20% for tomatoes and 18% for milk do not augur well.

On the industry side the quest for development goes back to 1952 when the National Industries Company (NIC) was formed as part of the Ministry of Works, in order to generate new resources for national income and a new base for industries to be formed. The company began by purchasing the Saudi Arabian lime brick and cement factories, which are connected to the construction and housing industry, which will be discussed below.

Kuwait has done quite well in petrochemicals, which were first produced by oil companies in July 1963, in order to utilise the gas given off as a by-product of oil extraction. However this industry is now facing a hard time as it has been starved of gas by the reduction in oil production. In the period 1982-86 it lost $ 70 million, and required a fresh capital input of $ 108 million to set it right again. As oil prices fell so did the price of the gas (liquid petroleum gas (LPG)), so there is now less motivation to improve the country's gas utilisation capacity, and consequently the petrochemical industry has taken a step backwards. Although not part of the oil industry, it is dependent on the production of crude and is therefore affected by low oil production (27).

There are other problems to overcome, such as the lack of desire of the Kuwaitis to form a viable workforce. The government has tried to encourage new industry by tarrif protections and by requesting that government departments give priority to procuring local products, but there has been little success. The main problems are the lack of an indigenous market, and the lack of desire of Kuwaitis to participate fruitfully. How can diversification be achieved with the high labour demand that it necessitates? The present policy of worker immigration must be curtailed, but that will lead to a shortage of labourers, whose jobs the Kuwaitis are reluctant to take over.

There are areas which are ripe for development such as information and communications, housing and trade (after the Gulf war). The GDP for the non-oil sector continues to grow by about 3% per year, but still falls way behind the GDP of the oil sector.

3.6 The Construction Industry in Kuwait.

Construction is an area that has developed quite considerably, encouraged by the National Housing Association (NHA) set up in 1974. This is a government sponsored agency, which has the goal of ensuring that all Kuwaitis have a place to live. As the idea of a whole extended family under one roof is becoming less fashionable, more young couples want to have a house of their own. The NHA distributes housing as it becomes available, by means of a lottery among those on the top of the waiting list, and for those who want to build their own houses long-term loans can be obtained from the Savings and Credit Bank (see chapter 4 - "The Specialised Banks").

Most of the work is carried out by local contractors, as part of the NHA policy to involve the private sector whilst maintaining control over standards and prices. The NIC is a major client supplying cement, tiles, and bricks for the standard government design villas, with five bedrooms and enough space for a family of eight. According to a recent study carried out at the Kuwait Institute for Scientific Research, more than 62,000 new homes must be built by the year 2,000, if demand continues at its current rate. The government is expected to return to a policy of high-rise housing because of a problem of space: the five year plan, 1991-1996, will see more high rise buildings in areas such as Kuwait City, and new towns established in the South at Khiran and in the North at Subiya.

There is major construction underway, such as the Amiri Diwan, a contract worth KD 70 million to provide offices for the

Amir, Crown Prince and the Council of Ministers. This is being managed by two companies; one Kuwaiti, The Kuwaiti Project Analysis and Control Systems, and the other is American, Turner International Industries. There are plans for further development of the waterfront, a University campus extension, a postal services complex, a headquarters for the KPC, and an Olympic sports complex. All these should provide work and revenue for local private contractors (28).

Although some projects have had to be shelved due to the economic deceleration, the construction industry seems to be expanding. In 1987 the number of building licences grew by 80%, encouraged by the government increasing its budget for construction from KD 724.9 million in 1985/6 to KD 750 million in 1986/7, in an attempt to mobilise the private sector in this sphere, which is one of the success stories of Kuwait's recent history (29).

3.7 Trends in Kuwait's Trading Performance.

Having looked inside Kuwait, now is the time to examine its economic relationships with other countries. Later Kuwait's substantial investments abroad will be dealt with, but first her imports and exports will be examined.

Kuwait takes very seriously its policy of non-alignment, and looks to deal equally with East and West, with European and non-European, although past links with old colonial powers still exist. In 1987 imports fell slightly to KD 1,314 million due to reduced activity in the re-export sector (see below), although other areas are quite healthy. The five major sources of Kuwaiti imports were as follows:

Japan	21.2%
U.S.A.	10.8%
W. Germany	8.1%
U.K.	8.0%
Italy	6.2%

Japan is traditionally the largest source as it is also the major receiver of oil exports (30).

The predicted total value of imports for 1988 was $90,000 million, 42% lower than the value of imports in 1982 (at current prices) because the country can afford less than it could in the 'boom' years (31). Evidence of this is that in the early 1980s, the port of Shuwaikh handled 7 million tonnes of cargo per year, whereas for the period March 1985 - March 1986 this was down to 4.5 million tonnes. There has been a slight recovery, but total tonnage is still down on the peak period of 1982 (32).

As for exports in 1987, the total value climbed 11% from the previous year to KD 2,306 million, whereas from 1985 to 1986 there had been a 33% decrease. Oil exports, which accounted for 90% of the whole, rose in value by 13%, because of increased prices and volume. The non-oil sector continued its downward trend, started in 1982, because of the decline in the value of re-exports and non-monetary gold exports by KD 16 million and KD 4 million respectively. The major receivers of exports from Kuwait in 1987 were as follows:

Japan	17.3%
Italy	9.6%
Singapore	8.3%
Holland	8.2%
Taiwan	6.9%

Again Japan leads the field, giving evidence of its severe lack of fuel resources and its dire need for raw materials (33).

Re-exports have fallen as a consequence of the Gulf war which made Kuwait an unacceptable transit point. In 1985 30% of all Kuwaiti imports were for re-export; now the figure is only 3% (34). Having said all this, it is predicted that figures for 1988 will show that Kuwait is the only OPEC country to have avoided a current account deficit: in fact the surplus will total US $ 3,500 million.

The Arab countries, as developing countries, feel they are not given a chance to develop their export trade to its full potential because of "European tariffs and the protectionist attitudes which dominate in Europe" (35). They still hold grievances and are looking for more opportunity to expand. They look to the OECD countries, whereas there is very little trade with Arab or GCC countries.

This leads on to another point; the potential for more cooperation among the Gulf countries. Prior to 1968 the status of 'British Protectorate' ensured uniformity in economic practice, with the Rupee being the common currency of the Trucial States (those with which Britain had signed a truce). Kuwait played a key role in the development of these Trucial States, channelling aid into the Gulf Permanent Assistance Committee (GuPAC) set up in Kuwait in 1962. She signed her first economic agreement in 1964 with Iraq, which other GCC states have only recently imitated. In 1966 GuPAC was replaced by the General Authority for South Arabian and Gulf States, where Kuwait and Saudi Arabia are the main protagonists (36).

In the period 1966-1972 there were great attempts to form a federal union of the Trucial States and Bahrain and Qatar. This failed, but out of the discussions was formed the United Arab Emirates (UAE), which have their own internal governments but a coordinated foreign policy. Meanwhile Kuwait was working with Iraq to exploit Iraq's sulphur deposits, but the project had to be halted because of the inevitable border disputes.

The period 1972-1977 was the most promising for the Gulf but all the promises of cooperation have come to very little. The different states are basically divided in two: those who favour economic and social cooperation such as Kuwait and the UAE, and those who want to concentrate on military and security matters led by Oman. Saudi Arabia and Bahrain act as mediators between the two sides, but it is very difficult to make any progress(37).

The starting point for this discussion of the Gulf was its internal trade, which is surprisingly small. The total value of Kuwait's trade (import and export) within the GCC reached KD195.1 million in 1987, or 5.4% of Kuwait's total trade with the outside world, with industrial products making up 85% of total trade.

In the field of exports from Kuwait to other GCC countries there has been a real decrease in value from KD 95.1 million in 1986 to KD 73.1 million in 1987 : this is because of the

Table 3.3

Acts of Cooperation in the Gulf till 1977

1969	Interchange of students to provide cultural and technical exchange.
1969	Interconnecting roads built.
1969	Chambers of Commerce in Kuwait and Bahrain joined to form a union to encourage the private sector.
1971	Kuwait-Bahrain Bank incorporated.
1972	Delineation of off-shore boundaries.
1972	Settlement of border disputes, including the neutral zone between Saudi Arabia and Kuwait.
1973	Kuwait-Bahrain : economic, educational, media agreement.
1973	Qatar - UAE: agreement guaranteeing the free movement of capital, labour and products.
1975	Attempt at currency coordination, but the strength of the KD and the instability of the other currencies ensured failure.
1976	Kuwait-UAE economic Agreement.
1977	All seven Arab Gulf States meet (Saudi Arabia, Kuwait, Bahrain, Qatar, Iraq, Oman, UAE). Agree on the principles of a Gulf Common Market.
1977	Joint Kuwait-Saudi Arabian committee to advise on cement, glass, iron and steel.

expansion in other GCC countries of commercial sea ports and the establishment of free trade zones such as the Jabal 'Ali zone in Dubai. As for imports from GCC countries, they have risen from KD 81 million in 1986 to KD 122 million in 1987 (38).

In December 1987 some economic decisions were taken by the Riyadh summit conference confirming the determination of the GCC countries to progress towards a Gulf Common Market. Steps include;

1) the unifying of levels of customs tariffs,
2) protecting national products from foreign competition, and
3) utilising the productive capacity of the Gulf in the most efficient way.

If their efforts prove effective, they would leave the Gulf in a much stronger position, but we can only wait and see.

3.8 Kuwait's Investment Policy.

There exist in Kuwait, alongside the many banks and specialised financial institutions, several companies specialised in investments. The four major ones are:

1) The Kuwait Investment Authority (KIA), 100% government owned;
2) The Kuwait Foreign Trading Contractor and Investment Company (KFTCIC), 96% government owned;

3) The Kuwait Investment Company (KIC), 65% government owned;

4) The Kuwait International Investment Company (KIIC) - Privately owned;

There are many other smaller investment companies which specialise in stock market trading, foreign exchange operations, investment advice and real estate investment.

The abundance of investment companies is evidence of the surpluses of oil money which the private and public sector wanted to invest. A lot of money was placed in the Euro Dollar market and in the European banks, which together form the biggest centre for re-cycling Kuwaiti money.

The KIA was formed in 1982 by Amiri decree as part of the Ministry of Finance, to manage government funds and to take charge of the General Reserve Fund (GRF). It has nine members as well as the Ministers for Oil and Finance and the governor of the Central Bank on its board, and profits from domestic and international investments. It has a branch in London which deals in diverse investments such as stocks, bonds, venture capital and real estate in Europe, the U.S.A., Japan and the Far East (39).

One high profile area of investment is Spain, where the Kuwait Investment Office (KIO - The European section of the KIA) acts through its Spanish affiliate Torras Hostench, a paper manufacturer, in which it holds a 45% stake. The KIO plans to divest Torras Hostench of its paper manufacturing concerns and to turn it into a holding company. To achieve this end the KIO took a 15% stake in a major Spanish media group "Ediciones Zeta". The KIO has also recently taken a controlling interest in a Belgian paper manufacturer "Cellulose des Ardennes", with Torras Hostench buying 50.1% of "Cellulose des Ardennes" shares. On top of these equity investments, the KIO announced an $ 11.5 million stake in "Trilla", Spain's largest injection moulded plastics producer, through its Dutch subsidiary "Koones" (40).

In the banking world the KIO has made important purchases, admitting that it had a 6% share in Spain's largest commercial bank "Banco Central", which it swapped for a 48.8% share in a new joint-venture holding company called "Cartera Central": this is in conjunction with another shareholder "Construcciones and Contratas SA", which owns 51%. Recently the KIO has drawn up plans to sell its 48.8% share of the 10.3% joint shares it participates in at the Banco Central. It will sell all the shares to its joint investor, "Construcciones and Contratas SA", for $ 362.4 million, and will also divest itself of its own singly owned 2.1% share of the equity in Banco Central to the same firm.

The intention is to finance the investments of the KIO's Spanish holding company Torras Hostench SA and to push further into the real estate sector, where the KIO already owns a company called "Prima Immobiliariasa", which is already involved in many ambitious projects in Madrid and the rest of the country. All these moves followed a request by the Bank of Spain that the KIO should reduce its involvement in the banking sector: its only bank shares are now the 1% it owns of Banco Santander. This completes the picture of the broad base of Kuwaiti investment abroad before we look at the case of BP.

The KIO built up a 21.9% stake in BP by investing £ 900 million when the shares were offered to the public (41). This act saved the British government much embarrassment, because the BP shares were not going well at all and were proving very difficult to get rid of. When British shareholders became suspicious that Kuwait would exert too much influence over company policy in favour of itself and other OPEC countries, the Monopolies and Mergers Commission (MMC) was called in. The MMC ordered the KIO to cut its stake to 9.9% because its 21.9% stake was against public interest. The Arab British Chamber of Commerce called the measure "draconian" and cited it as a proof of British protectionist attitudes (42). Some people inside Kuwait such as the economist Jassar Al-Sa'adam said that the steps taken by the British government put into question the wisdom of investing the state's reserves in oil companies, rather than diversifying away from the oil sector (43). On the British and Kuwaiti sides there is great embarrassment, and the Kuwaiti Oil Minister, Sheikh Al-Khalifa Al-Sabah has been criticised in and out of cabinet for the unwise moves that he himself orchestrated. As a result, a three man committee has been set up by the Ministry of Finance to assess future investment policy.

In the final section of this chapter the reader will observe investments as part of the national budget, but suffice it to say here that there is $ 80 billion of Kuwaiti money (public and private) gaining value abroad (44). In the early 1980s this money was generating more income than Kuwait's oil. Although this way of making money is contrary to Muslim law, Kuwait continues to profit by it.

3.9 Summary.

Kuwait is politically a very stable country with very little record of civil unrest, which is surprising considering the high proportion of non-Kuwaiti nationals in the 1.84 million population.

Table 3.4

Population (million)	% of Expatriate Population	Labour force (thousand)	% of Expatrates in labour force
1.84	60%	670	81%

Source: Economist International Unit 1988 Survey.

There is a heavy dependence on workers from the Indian sub-continent which may have a detrimental effect in the future. The great source of hope for Kuwait is the more active role women are playing in business, and, according to Mr. Blackley of the Commercial Section at the British Embassy in Kuwait, they are "the great hope of the future" (45).

The oil and government sectors together contribute 67.2% of Kuwait's GDP, which is evidence of the reliance on one industry upheld by a massive public administration. The GDP as a whole has risen over the past couple of years after an unsuccessful period in the early 1980s.

Table 3.5

Sectoral Contribution to GDP

Agriculture	1.0%	Oil and Mining	38.0%
Manufacturing	11.1%	Construction	3.1%
Trade and Hotels	7.8%	Finance and Insurance	4.4%
Transport and Communications	5.4%	Govt. and others	29.2%

Source: EIU Economic Report 1988-89.

Table 3.6

Total GDP ($ million) and GDP Per Capita ($)

Year	1982	1983	1984	1985	1986	1987
Total	21,579	21,045	21,558	19,390	17,258	18,835
Per Capita	14,386	13,490	13,145	11,511	9,696	10,236
Growth Rate (Nominal)	-13.9%	-2.5%	+2.4%	-8.7%	-15.6%	+5.0%

Source: EIU Economic Report 1987-88.

GDP looks set to improve in the next few years after the present programme of reorganisation.

Kuwait's account surplus decreased to its lowest level for at least ten years to $ 4,414 million in 1987 (latest figures available) (46). This was because of a much smaller increase in exports than had been expected, coupled with a sharp decline in investment income. Both these factors negated the positive effects of a decline of $ 534 million in imports.

Table 3.7

External Balance ($ million)

	1983	1984	1985	1986	1987
Trade Balance	4,584	5,603	4,712	1,910	3,546
Exports	11,473	12,156	10,374	7,123	8,315
Imports	(6,889)	(6,553)	(5,662)	(5,303)	(4,769)
Balance on Services	703	770	103	3,428	868
Services	2,254	2,148	1,676	4,694	2,128
Private Transfers	(865)	(963)	(1,044)	(1,084)	(1,102)
Official Transfers	(686)	(415)	(529)	(182)	(158)
CURRENT ACCOUNT BALANCE	5,287	6,373	4,815	5,338	4,414

Source: EIU Economic Report 1987-88.

The key to understanding Kuwait's economy is the government's financial policy. Revenue from government owned oil fields accounted for more than 90% of total revenues between 1970-1983, so it can quite clearly be seen that government expenditure is always connected to oil income.

There are three categories of government spending:

1) Current - wages and salaries to government employees.

2) Development - Capital formation in the form of Industrial Investments.

3) Other - a) Contribution to the Reserve Fund for Future Generations (RFFG)

   b) Direct Transfer of wealth to native Kuwaitis.

   c) Direct Transfer to foreign governments and organisations.

As for income from government investments abroad, it is not included in the fiscal budget, but is accounted for separately as a flow of income adding to the already existing stock of reserves in the "Reserve Fund for Future Generations" (RFFG). This means the official government revenues are always underrated, but government expenditure is overrated by the amount of the transfer to the RFFG. Simply stated, reported surpluses are under-estimated and reported deficits are over-estimated.

Table 3.8

Public Finances ($ million)

	1982/83	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Government Revenues	9,039	10,893	9,100	8,006	6,055	8,118	7,247
Government Expenditure	11,283	10,375	10,625	10,603	10,006	10,115	11,350
Surplus (Deficit)	(2,244)	518	(1,525)	(2,597)	(3,951)	(1,997)	(4,103)

Source: EIU Economic Report 1988-89

The budgeting policy of the government artificially boosts or reduces government spending when oil revenues rise or fall. The government has seen its role as ensuring income distribution rather than encouraging growth and development. It fosters false worries to divert some of the attention from the dependence on oil so that peoples' questioning minds are mis-directed.

The early 1980s witnessed the vulnerability of Kuwait's economic growth, as oil revenues continued to decline. Much government money was spent on things which should have been left to the private sector, such as construction and agricultural projects. Three major reasons have led to a decline in government expenditure which led to a slow down in the whole economy:

1) The country is close to saturation level in infrastructure.

2) A decline in oil revenues.

3) Government policy of directing increased subsidies to Kuwaitis involved in small industrial projects which will flower in the near future.

In the present period of restructuring and reorganising the government should apply fiscal and direct control policies. On the 1st April 1989, an airport tax of KD 2 was introduced for every person leaving Kuwait: although this is a minor tax accepted by the people because of the insignificant dent it puts in their finances, it may be the first step in the process of forming a responsible fiscal system to ensure Kuwait's economic survival and growth.

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CHAPTER 4

The Kuwaiti Financial System.

4.1 The Role of the Central Bank.

Under the jurisdiction of the Central Bank of Kuwait (CBK) are four groups of financial institutions:-

i) the commercial banks,

ii) the specialised banks,

iii) the investment companies, and

iv) the money changers.

All groups have a part to play guided by the CBK, which was founded in 1968.

The CBK is owned by the government and acts as its banker, all government profits being handled by it. Its main functions are the issuing of currency and legal tender money, the forming of credit and monetary policies and the supervision of all banking in Kuwait. Only in 1979 did it become a lender of the last resort to the commercial banks, becoming totally a government tool. The role of agent for the government precludes dealing with any private customers, as it remains a regulating bank.

On the assets side, CBK foreign assets have fallen quite dramatically since September 1978 (1). At that point foreign assets were worth KD 1,201.9 million, but the figure had been reduced to KD 476.9 million by November 1988 (2). The major reduction in foreign assets has been in "Investments and Deposits in foreign currencies", the September 1987 figure being KD 960.3 million, whereas by November 1988 this had been more than halved to KD 415.8 million. This drop in foreign assets was because the Central Bank went ahead with its borrowing scheme, despite the fact that government revenues had increased and spending decreased. This meant that there were plenty of spare Kuwaiti Dinars, therefore the Ministry of Finance cut back its deposits of foreign currency with the Central Bank - deposits which would otherwise have been converted into Dinars to help pay government expenses.

This decline in foreign assets has been offset by the Central Bank local bonds in Kuwaiti Dinars and public debt instruments, which will be discussed shortly as one of the ways that the CBK controls liquidity in Kuwait. However, as remarked before, loans in the local market and deposits with local banks were reduced, which has left the total assets (and therefore liabilities) of the CBK 25% down, if we compare the figures for the 30th June 1987 and the 30th June 1988 (3). This is also because of the withdrawal of Ministry of Finance credit facilities worth KD 200 million in 1987.

On the liabilities side the 25% decrease is due to two major changes. Firstly, in the financial year 1986/87, the bank was liable for an amount which represented the face value of outstanding bills issued by itself and purchased by the local banks, however in the financial year 1987/88 the bank ceased issuing these bills (4). The second major change was that at June 1988 there were no deposits from local banks at the Central Bank, whereas the year before there had been KD 537 million (5). In 1987 the Central Bank had, deposited in local banks, KD 469 million, and so was a net taker of deposits, whereas in 1968, it was a net depositor having only KD 97 million in local banks.

As banker to the government, the CBK managed KD 1,097,612,627 worth of public funds and in contra accounts, against KD 626,414,105 for 1986/87 (6). Also with regards to the government, the CBK issued certain public debt investments totalling KD 2,327,510,000 on behalf of the government, of which KD 1,394,510,000 was still outstanding at June 30th 1988 (7).

4.2 Control of the Domestic Economy by the Central Bank.

During the last few years the Central Bank has exerted intensive efforts to enhance domestic economic activity and to restore stability to the banking system. This has been by dint of several procedures such as the "Difficult Credit Facilities Settlement Programme" (DCFSP), the issuance of public debt instruments on behalf of the Ministry of Finance and the amending of the discount and interest rates in the banking system. Added to this were the CBK's efforts to regulate liquidity levels and to maintain a stable exchange rate and money supply.

The "DCFSP" was announced on 10th August 1986 to tackle the problem of non-performing loans left after the Suq al-Manakh crisis. Up till the first half of 1988, the Kuwaiti banks were able to implement the settlement of most of their difficult credit facilities. The fact that it was possible for 1,007 out of 1,083 settlements, already delivered to debtors, to be authenticated at the Ministry of Justice, is proof of the success of the "DCFSP". It has made both debtors and banks face reality after the madness of the early 1980s; the boards of directors of the banks have been cleared out because of the regulation that no bankrupt person can be the director of a bank, and new directorship has breathed new life into the system (8).

The debt burden will affect bank profitability for years to come, just as it will affect the grandiose, unreasonable investments undertaken by the old boards of directors (9). The completion of the "DCFSP" in December 1987 improved confidence in many loans made by the banks, but there is still a long way to go before confidence is fully restored.

During 1987/88 the Central Bank began to issue public debt instruments after an absence of some time. Law Decree No.50 of 1987 authorised the government, within a period of not more than ten years, to have a public loan with a value not exceeding KD 1,400 million (10), by issuing treasury bills and bonds, or by direct borrowing from financial institutions. They went through with this plan, even though it was clear that oil revenues would cut the overall deficit.

The purpose of the issuance of these instruments was to exercise some control over open market operations, and influence interest rates in order to maintain stability in the money markets. The public debt instruments were to have maturities of between three months and several years in order to help structure interest rates.

These instruments provided the banking and financial institutions, listed at the beginning of this chapter, with new guaranteed investment outlets in order to develop the money and capital markets in the country. The local financial institutions were provided with good financial instruments, giving reasonable yields, which helped them diversify the uses to which they put their financial resources and improve the quality of these resources. This aim was successfully fulfilled, witnessed by the extent of secondary market activity in treasury bills among local banks.

By June 1988 the CBK had offered sixteen issues of public debt instruments, totalling KD 2,327.51 million, and the balance of public debt instruments totalled KD 1,394.51 million. The success story must be tempered by the realisation that when announcing the over-subscription of treasury bills in 1988, the Central Bank omitted to point out the fact that it had flooded the market with liquidity before every issue, being so keen for a successful subscription.

As for domestic bond issues, which had been resumed in 1987 after a break of nearly four years, they were curtailed in October of that year to make way for the Central Bank issues. Recently at the end of 1988 the National Bank of Kuwait, the most successful of all the banks, was allowed to lead-manage a KD 10 million three year bond flotation for the Kuwait Real Estate Bank, one of the specialised banks.

In 1976 the Central Bank was empowered to fix the maximum rate of interest--subject to approval by the Minister of--Finance. The Central Bank sets a discount rate for Dinar transactions on which the rates of lending and depositing are based. In the past few years interest rates have been kept low , in order to help the banks and the business community recover and stabilise. As the discount rate was reduced in 1987 from 5.5% to 5%, this had the effect of reducing the cost of funds obtained by local banks, and thereby reducing the cost of financing domestic productive economic activities. The balance of discount operations grew 36%

from November 1987 to June 1988, from KD 259 million to KD 351 million (11).

However this created problems, as international interest rates climbed in 1988, so huge sums were deposited in Dollar accounts abroad in one month deposits. In September 1988 when the Dollar firmed, it was taking less Kuwaiti Dinar to buy back the Dollars, and so investors picked up 2% on the buy-back exchange differential, which is one of the reasons why there was the fall in the CBK's foreign assets pinpointed above. In the commercial banks, foreign currency deposits soared to KD 1.2 billion, almost doubling, while other deposits fell considerably: in fact it was said that some commercial banks were actually refusing large Kuwaiti Dinar deposits.

On the 11th December 1988 the discount rate was raised to 7.5% in order to balance the system. This affected the lending and deposit rates thus, because of the law introduced in 1976:

Lending Rate for 1 year or less = discount rate + 2% = 9.5%

Lending Rate for more than 1 year = discount rate + 2.5% = 10%

Deposit Rate for 1 month to 90 days = discount rate = 7.5%

Deposit Rate for 91 to 180 days = discount rate + 0.5% = 8%

Deposit Rate for more than 180 days = discount rate + 1% = 8.5% (12).

The increase was in order to restore the credibility of Dinar deposits, but it caused uproar in the banking sector because of the outstanding debt, but the government and the Central Bank feel the need to compete in the international market.

As for consumer loans extended in Kuwaiti Dinar to finance the purchase of consumer and durable goods, the Central Bank decided, as from 15th November 1987, that this should have a maximum limit of 6%, provided that the loan maturity is not more than four years. This maximum limit has remained stable in order to activate trading activity and encourage growth.

The Central Bank has made great efforts to regulate liquidity in the banking system, mainly by use of treasury bills and bonds. Before 1987 the government saw no need to finance expenditure by such methods (because of the surplus oil revenues), which meant that the Central Bank had no influence over liquidity levels. Now, with the public debt instrument system instituted, the CBK has almost withdrawn its 1973 invitation to commercial banks to hold favourable interest rate deposits with it.

At the time of writing the last CBK Annual report available was that for the financial year 1987/88 (13), which showed evidence that from June 1987 to December 1987 the CBK was a net KD borrower from the banking system, in order to absorb a liquidity surplus. However from then until June 1988, the CBK became a net lender to local banks in order to provide them with sufficient liquidity. This was because the balance of discount operations at the CBK grew by KD 92 million, whereas CBK bills and deposits with local banks decreased by KD 152 million. Furthermore, the balance of local banks' holding of CBK bills and their deposits with the CBK diminished to KD 710 million, while their balances with the CBK decreased by KD 69 million. All this reflects the CBK interest in supporting liquidity in the banking system.

From the above passages it can be ascertained that the CBK has sought to meet the requirements of domestic economic activity, whilst retaining stability in the banking system. It has also managed to regulate the financial system regarding the rules for regulating the management of third party portfolios, in order to introduce a more responsible system, totally answerable to the government. It is always looking to improve efficiency by new controls in order to restore stability to the financial institutions of Kuwait.

4.3 The Commercial Banks of Kuwait.

In Kuwait there are seven commercial banks. All are wholly Kuwaiti owned as foreign banks are not allowed to operate in the country.

Table 4.1

The Commercial Banks of Kuwait

Name	Year of Incorporation.	No. of Branches in Kuwait.
The National Bank of Kuwait.	1952	48
The Commercial Bank of Kuwait.	1960	35
The Gulf Bank.	1960	31
Al-Ahli Bank of Kuwait.	1967	17
The Bank of Kuwait and the Middle East.	1961	19
The Burgan Bank.	1966	12
The Bank of Bahrain and Kuwait.	1977	-

Source: CBK 1987 Economic Report.

At the end of 1987 (the last year financial figures were available on an overall scale), the aggregate balance sheet of the commercial banks realised an increase of 6.3%, to bring it up to KD 9,894 million (14). There was a major growth in assets as a result of the claims of commercial banks on residents , which showed marked growth. For the financial year 1987/88 these claims grew by 14.2% to KD 6,257 million, whereas the year before they had only grown by 6.8%. The major part of this, roughly 60%, was concentrated in the form of the public debt instruments discussed above, and land acquisition bonds, while the remaining 40% of the claims were in the private sector. The claims on the private sector were attributed to an increase of 9.7% of credit facilities offered to the industrial and real estate sectors, financial institutions and for personal facilities. For example the credit facilities extended to the industrial sector rose by 31.9% (15).

There were also increases in their financing of Kuwaiti imports, and local investments in bonds and shares. In 1987 there was also an increase in foreign assets, which the CBK has tried to reverse by increasing interest rates as noticed above. On the liabilities side, the growth in the balance sheet was represented by an increase in sight deposits, quasi-money and shareholders' equity, even though government deposits fell.

In 1987 Kuwait's commercial banks turned the corner towards recovery after the Suq al-Manakh crisis. All of them were able to reward shareholders with dividends ranging from 8% to 22%, whereas the year before only the NBK had managed this feat.

Questions remain about the quality of all the banks' assets and the level of their reserves. The "DCFSP" has restored confidence after its completion in December 1987, but it is generally assumed that more provisioning will be necessary. Reserves of some of the banks still fall below the Central Bank requirements, so these will have to be made up from future profits, putting a drag on dividends.

The National Bank of Kuwait is the oldest of all of the banks, and is generally regarded as the most successful. It is the leader in personal banking services with the highest number of branches in Kuwait. Its confidence is well noticed in its bond issues of 1987 and 1988. In 1987, before the Central Bank bonds came to prominence, the NBK lead-managed a KD 30 million bond issue for the World Bank (16), and then in 1988 they were the first Kuwaiti bank to lead-manage another bond issue after the lull brought on by Central Bank activities. What is more remarkable is, that in a survey in the magazine "The Banker" in March 1984, the NBK was pinpointed as the only one of the Kuwaiti banks not heavily underpinned by government support. Its profits in 1987 remained ahead of its rivals, with net profit only slightly less than that of all its rivals put together.

Next in the order of merit for personal banking is the Bank of Kuwait and the Middle East (BKME), which originated out of the old British Bank of the Middle East; 57% of its shares (KD 29.8 million) (17) are owned by the government. The share of the government in the NBK is only 1%, which makes its success all the more remarkable.

The Burgan and Commercial Banks, being two of the less successful ones, completed structural reviews in 1987, when the Burgan Bank was the only one to record a fall in performance. It appointed a new chairman and a new Managing Director, whose influence has yet to be seen. The Commercial Bank, however, reappointed their manager, trying to restore confidence in him.

In early 1989 the Gulf Bank of Kuwait (GBK) appointed a new chairman and managing director for its board of directors; he is Dr. 'Abd Al-'Aziz Sultan Al-'Isa, one of the owners of the prominent local consulting engineering partnerships, the Kuwait Engineers Office (KEO). His new bank increased profits by 9% in 1988 to KD 7.7 million, and so was able to reward shareholders with total dividends of 12% (split between 5% cash and 7% bonus issue). Total assets have only increased a little as has the bank's loan portfolio, indicating steady, rather than spectacular growth (18).

The final one of the commercial banks whose record will be highlighted here is Al-Ahli Bank of Kuwait. This is because it is the only bank to have reported a decline in profits since the "DCFSP". This reflects the view of the Central Bank that it is time to wean the commercial banks away from their protection. The fall in profits of Al-Ahli Bank, from KD 5.09 million in 1987 to KD 4.28 million in 1988, has necessitated a considerable change in top management and heavy investments in new technology, as it was falling behind all the other banks.

Maybe we could see Al-Ahli Bank falling out of the market altogether in what many people see as an overbanked local arena. Surely as the Central Bank retracts its over-protective hand, which coddles the commercial banks at present, there will be some casualties, but the system as a whole will become stronger and more self-dependent.

Table 4.2

The Gulf Bank (All figures in KD million).

Year	1986	1987	1988
Net Profit	4.36	7.06	7.70
Cash Dividend %	-----	11.00	5.00
Bonus Issue %	9.00	---	7.00
Loans	986.44	913.80	930.55
Total Assets	1,811.08	1,838.15	1,897.39
Deposits	1,647.69	1,637.11	1,700.50
Shareholders' Equity	160.81	192.04	196.89
Return on Assets %	0.24	0.38	0.41
Return on Equity %	2.71	3.68	3.91
Equity/Assets %	8.88	10.45	10.38

Source: GBK Annual Reports 1986-1988.

4.4 The Specialised Banks of Kuwait.

There are three so-called specialised banks in Kuwait:

Table 4.3

The Specialised Banks of Kuwait.

Name	Year of Incorporation	No. of Branches in Kuwait
Savings and Credit Bank.	1960	2
Kuwait Real Estate Bank.	1973	4
Industrial Bank of Kuwait.	1974	-

Source: The Economic Report, CBK 1987.

These banks have been incorporated in order to finance certain sectors of the economy, as is evident from their names. They concentrate most of their investments overseas: for example in 1987 foreign assets totalled KD 242.3 million (11.8% of total assets), and domestic investments totalled KD 89.4 million (4.3% of total assets). They specialise in offering credit facilities to local residents and in 1987 this service accounted for 65.7% of all assets, a 5% increase from 1986.

During the last few years it has become clear that specialised banks have depended mainly on their own funds (in the form of shareholder's equity) to enhance their financial positions and to secure wide safety margins against the risks of investment. At the end of 1987 shareholder's equity represented 50.8% of total liabilities, a rise of 10% since 1982. This leaves the specialised banks very inflexible and ponderous, but they are nevertheless very resilient and have not suffered in the past few years as much as the commercial banks.

4.5 The Investment Companies.

In the last chapter, three independent investment companies were highlighted as the major ones next to the government owned Kuwait Investment Authority (KIA). In the full list published by the Central Bank in 1988, there were twenty-two investment companies subject to the supervision of the CBK. The first was the Kuwait Investment Company, established in 1961, and the latest, Al-Mubarakia, was founded in 1987. The mid 1970s saw a great growth in the number of these companies, as thirteen were incorporated in that era of overflowing cash surpluses. Only in January 1987 did the Minister of Finance pass a decision regulating Central Bank supervision over these companies, whereas before they had only been subject to certain articles in the third chapter of law No. 32 of 1968 concerning "currency, the Central Bank of Kuwait and the organisation of banking business, as per decisions issued by the Minister of Finance" (19).

The 1987 decision required a special register for the investment companies at the Central Bank, and the CBK board of directors was empowered to set the regulations to be observed by the companies. They were particularly worried about credit-worthiness and maintenance of a ratio of own funds to the company's financial obligations towards a third party. Since 1987 the CBK has supervised the companies' ability to face risks on extended loans and the value of their investment portfolios, as well as setting rules for the bonds to be issued in favour of the investment companies. There are also stipulations over lending limits, and a central bureau has been set up to monitor all the activities of the investment companies. At last they have been brought under central control as the CBK seeks to monitor the development of the Kuwaiti economy more closely than ever.

Again the proportion of foreign assets in the aggregate balance sheet of the investment companies is very high, representing more than half the total assets. They had been in decline since 1982, but in 1987 they saw the first increase in their aggregate balance sheet for 6 years. During that period the issue of KD bonds witnessed great activity, while foreign resources decreased. However the main thing to note is how much these investment companies base themselves on KD investments in customer portfolios; KD investments accounted for 99.2% of all portfolios, indicating a tangible shift to investment in KD, which can only go to help the local economy.

4.6 The Money Changers.

Money changing activities are the last financial activity under CBK control, because of their importance in effecting the cash flows into, and out of, Kuwait. The CBK needs to obtain information on the volume of foreign transfers transacted by these money changing companies. These companies also need to be kept in check to make sure they do not practise the business of banks.

In 1987 the aggregate balance sheet of money changing companies was KD 78 million, showing that they are by far the smallest group of financial institutions under CBK supervision. The thirty-nine companies so far registered have a small but significant part to play in regulating the Kuwaiti economy (20).

4.7 The KHF in the Kuwaiti Financial System.

With the Central Bank now taking more control over the official Kuwaiti stock market, the tightening up of the economy, managed by the Ministry of Finance under the guise of the CBK, looks to be developing very well. Certainly since 1984 there have been great leaps forward in overall supervision.

In March 1989 there was much rumour that Mr. J. Al-Kharafi, the Minister of Finance, would take a well earned rest, in order to devote himself to his considerable business interests. His post was expected to be taken by Mr. Salem 'Abd Al-Aziz Al-Sabah, who held the post of Central Bank governor. His place in the Central Bank was taken by another member of the Al-Sabah family (20), Mr. Ahmed Al-Sabah, who was governor of the Burgan Bank.

As in the political system, the financial system is now under very tight state-control, as a reaction to the laxity of the early 1980s. In the political system there should maybe be more flexibility, but in the financial system this central control is what was called for. One can only hope that the concentration of financial muscle in the hands of the governing family will not lead to abuse of the power entailed.

In 1978, when the Kuwait Finance House became the first Islamic financial institution in Kuwait, times were easier for the country's financiers. Now, in what is clearly an overbanked market, customers and funds are that much harder to attract. Although the KFH draws devout Muslims to its ranks, it also needs to draw the people less intent on adhering to the letter of the Shari'a. This can only be done by securing better profits and higher profit-shares for its customers.

The KFH is an 'all-purpose' bank which has many different hats to wear. As the only Islamic financier in Kuwait, it has to compete against two sets of regulated financiers: it has to compete against the commercial banks in their specialised fields, and with the investment companies in managing investments and investment portfolios (22).

However, where the KFH has an advantage over all its rivals, is in that it is a participant in direct trade, not as a supplement to its banking and investment activities, but as an inherent part of the philosophy it has adopted as the core of Islamic banking.

The new responsibilities that the CBK has assumed, means keeping a close watch on interest rates, balancing the needs of depositors and deposit takers. The discount rate may rise and fall, and the KFH is at its mercy without being in any way linked to it. The House is in competition with the other banks and must therefore offer attractive profit sharing rates. If interest rates depended on the profitability of the country, that would mean that the KFH's fortunes would consequently rise or fall at roughly the same rate as the conventional banks. However the decision on interest rates is taken not so that they react to the country's profitability, but so that they presage it - interest rates are no longer re-active but pro-active. This has grave consequences for the KFH, which has freedom to compete only within the jurisdiction of the Shari'a inside a society where it is regulated for but not nurtured.

The fixing of interest rates may cripple the commercial banks and the financial system, as many Muslim economists say it already has done in the West. In this case the KFH would survive as a detached but shining beacon. For the present, however, it must try to compete, which curtails the effort to plan for the long-term because of the need for short-term profits.

The government supports the KFH and has nominal control over its policies, but the crux of the matter is whether its role should be to cushion the KFH (as the only Islamic financial institution under its wing) against the vagaries of the Kuwaiti economic system, so that the KFH works in a flattering vacuum, untouched by the fortunes of the 'secular' banks, or should the KFH be left to fend for itself?

The reality is that the House must now adapt itself to a post Suq al-Manakh Kuwait, where banks are more closely monitored and accountability is the word on everyone's lips. The caution that this attitude engenders is dangerous for a pioneering unit such as the KFH, because it needs to be brave and therefore begs for tolerance in a society that is prepared to let its financial institutions suffer, so that they either go under or emerge stronger.

In the system described above the KFH will have to fight for customers and also for a respectable rise in profits within the ever harsher Kuwaiti climate, while keeping in mind that the Shari'a is the most important part of its survival kit.

Notes.

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1. Kuwait Interim Economic and Financial Report, Winter 1988. Page 22. Published by the National Bank of Kuwait.
2. Magazine "The Banker", March 1984. pp 67-74. Report on Kuwait.
3. Central Bank of Kuwait. 19th Annual Report for the Fiscal Year 1987/88.
4. Ibid. Page 23.
5. Ibid. Page 23.
6. Ibid. Page 23.
7. Ibid. Page 31.
8. op.cit. "The Banker", March 1984.
9. In this area Al-Ahli bank will suffer more than most as they invested heavily in high rise office blocks.
10. The Middle East Economic Survey, 9/11/1988. Volume 32 No. 49, "Kuwait: Budget Deficit slashed". Page 23.
11. op.cit. Central Bank Annual Report, 1987/88.
12. Interview with Mr. Muhammad Haydar Ghulum at the Central Bank. 27/3/83.
13. op.cit. Central Bank, Annual Report 1987/88.
14. "The Economic Report" 1987.CBK.
15. Ibid.
16. Middle East Economic Directory, 30/1/89. 1988. "Kuwait 1988 - A model for development ". pp 19-86.

17. Commercial banks listed on the Kuwaiti stock market in 1987.

Table 4.4 The Government's Share in the Commercial Banks

Bank	Government share of Capital	Capital (KD million)
The National Bank of Kuwait.	1%	70.3
The Gulf Bank.	12%	47.3
The Commercial Bank of Kuwait.	11%	41.7
Al-Ahli Bank of Kuwait.	11%	45.7
Bank of Kuwait and the Middle East.	57%	29.8
The Burgan Bank.	58%	58.1
The Kuwait Finance House.	32%	23.1

18. The Gulf Bank, Annual Report 1988. Page 31.

19. op.cit. The Economic Report 1987. CBK. Page 47.

20. Ibid. Page 51.

21. The family of the Emir of Kuwait.

22. The KFH is not in direct competition with the money-changers as it cannot indulge in forward dealing of any sort. All foreign exchange deals are done on spot values.

CHAPTER 5

The Banking Sector of the KFH.

5.1 Accounts and Services offered by the KFH.

5.2 The Visa Card at the KFH.

5.3 The Credit Department.

5.4 Cash Documentary Credits.

5.5 Murabaha Sales.

5.6 Documentary Bills for Collection.

5.7 Letters of Guarantee.

5.8 Aims of the Department of Documentary Credits.

5.9 Volume of Transactions Handled by the Credit Department.

5.10 The Future of the Credit Department.

5.11 Foreign Dealings.

5.12 Summary.

Notes.

5.1 Accounts and Services Offered by the Kuwait Finance House.

Just like any other bank servicing the needs of private customers, the Kuwait Finance House has to attract customers by offering them a safe place to keep their money, where they can always retrieve it or where they can leave it to grow. Consequently the Kuwait Finance House offers different deposit accounts to its customers according to their needs.

The current account service is where a customer deposits his money and expects it to be one hundred per cent liquid. The amount represents an interest free loan (Qard Hassan) from the client to the KFH. The current account money can be invested by the KFH if the client authorises it, but he/she will not be liable for any loss. There is an age limit on this account - the depositor must be at least twenty-one years of age and he/she is not allowed to be overdrawn at any time. In reality this account works very much the same as in any commercial bank as far as the customer is concerned.

Then come the investment accounts which are conducted on a Mudaraba basis, where the client is the Rabb al-Mal and the KFH is the Mudarib, so all profits are shared. In meetings at the bank it was explained that, on the whole, with investment accounts, the KFH takes 20% of the profit while the client takes 80%; they claim this is a much fairer deal than the commercial banks, where it is normal for the client to gain only 10% of the profit which the bank has made with his money. Of course the share of profits depends on the type of account chosen, the duration of the account and the amount invested (1).

In an "Investment and non-investment savings account" the client, aged eighteen or over, pays in the money and is issued with a savings account book to show the movement and balance of the account. This service is the most important source of funds to the KFH, because it is very liquid but still makes a reasonable profit (2). The profit is calculated on the lowest balance for each month - it is normal for 60% of this account to be invested, but if the client stipulates that he/she does not give the authority for the Bank to invest the money, the Bank is bound to obey. As seen in Table 5.1, this sort of account attracted more than half of all KFH deposits in 1988.

The general consensus about the above two sets of deposits, and especially the current accounts, is that a bonus is allowed to the depositor as a carrot dangled in front of him/her, but this practice may not be repeated regularly as then it equates to a secured return.

Next are the accounts which yield profit (or loss), and these are known as the "investment deposits". The fixed time investment deposits are where a depositor leaves his money with the bank for a period of not less than one year. They are renewable at the client's request, but if a renewal is not demanded then the deposit is cancelled, and the amount is put in a suspense account in favour of the client. The minimum is decided by the management, but can be held to be no less than KD 500, and no amount can be added to, or withdrawn from the account before its maturity; but of course, another similar account can be opened at any time (3).

The unlimited time investments work much as the fixed time investments apart from the fact that they yield a slightly higher rate of return (see later), and they are automatically renewed at the end of every year. To cancel the continuation process three months notice must be given.

On top of these it is possible to open accounts in the currency of West Germany(DM), the U.S.A.($), the U.K.(Sterling), Japan(J.Yen) and Saudi Arabia(S.Riyal). Fixed time deposits can be a short as three months.

The 1988 total of KD 918,990,366 represents 15% of the Kuwaiti deposit market (4) - a very good share for a bank which started only ten years ago. It is important to note the one blank space in the table on the next page, when limited period investment accounts were discontinued because they had proved the least attractive of the accounts; however they were restarted because of customer demand.

Other important observations are that the total deposits have risen every year except 1984, when even the KFH was affected by the Suq Al-Manakh crisis, when ready cash was needed by customers. However in 1985 the KFH recovered more quickly than most banks and has continued its maturing process. It attracts a lot of customers who were wary of putting their money in interest bearing banks, but still a lot of people keep accounts with the KFH and also with one of the commercial banks.

In 1988 over 50% of all deposits were in investment and non-investment saving accounts, showing that this remains the most popular way of deploying money on a casual basis for the normal customer: the account is simply the most flexible, and flexibility is a characteristic which appeals to every client of any bank.

Table 5.1

Current and Investment Accounts

(All amounts in KD million)

Year	1983	1984	1985	1986	1987	1988
Current Accounts	79.6	69.1	123.4	133.4	107.8	143.3
Investment and Non-Investment Saving Accounts	332.8	383.1	411.2	428.8	493.3	503
Investment Accounts (Limited Period)	4.4	1.1	0.1	0.1	-	6.5
Investment Accounts (Unlimited Period)	281.1	257.6	189.7	196.5	239.4	266.2
TOTAL	697.8	641.9	724.4	758.8	840.5	919

Source: KFH Annual Reports, 1983-1987.

When dealing with the House's investments it will be noted approximately how much of each deposit account is invested and how much is kept liquid, but here the overall liquidity held by the KFH will be highlighted. Liquid funds are held for precautionary purposes and yield very little or no return at all. Most commercial banks keep a 20-30% liquidity, but Islamic banks require an even higher liquidity, because they do not have the option of holding easily movable money in an interbank market such as trusts for commercial banks. In fact the KFH holds enough cash reserves to cover more than its current account liabilities(5). The fact that there is no Islamic capital market to depend on means that the KFH must show great caution in liquidity to investment ratios. Lately the Islamic Development Bank has formed its own special deposit funds for Islamic banks, which might be the crystal around which will form a complete Islamic inter-bank market.

In this section it has been shown how the Kuwait Finance House carries out its account services, and it is very noticeable that the KFH likes to forge ahead by facilitating the life of the customer in this field. There is an easy system of cheques, although, because this is the Middle East, a lot of people still prefer cash, as use of a cheque incurs a charge. Standing orders function as they do in a conventional bank, as does the Automatic Teller Machine (ATM) system. The newest addition to the services offered is the Visa Card (6).

5.2 The Visa Card at the KFH.

The KFH Visa card is called "Al-Tamwil" card which means literally "The Financing card". It works much like any ordinary Visa card except that the KFH does not charge interest on late payments and limits are set according to the financial accountability of the customer.

Below is a comparison of the application forms for the Visa Al-Tamwil card and the Visa Barclaycard in Britain(7)(8). In the area of "Personal Details" the KFH needs to be more vigilant because of the varying nationalities that are resident in Kuwait, therefore it asks for nationality, passport number, ID number and the number of years of residence. In both cases details are required about the applicant's work and how much he/she is paid, but the KFH includes a section for the person to outline his/her "Educational Qualifications." This is evidence of the high value that Kuwait puts on education, and of the fact that the standard of education of a person is considered directly relevant to his/her dependability. The British application form is less specific in terms of annual income but more so in terms of "Monthly Expenditure", because in the British system most people have a mortgage to pay, which often reveals the financial state of a person. Both application forms ask for all bank details but the main difference here is that for an "Al-Tamwil" card the applicant must have a bank account at the KFH. The differences are minor but significant, as is the fact that on the KFH application form a large space is left for "Remarks (Properties, Reputation and Branch Manager Reccomendation)." This is proof that the gaining of credit in an Islamic bank is much more severely regulated than at a normal commercial bank.

The terms and conditions of use are basically the same, with both organisations issuing the usual disclaimers, but the KFH puts great stress in section eight that "Deposits, goods, all accounts and any amounts related to the card holder in the House (KFH) are considered mortgaged as a security for payment of due amounts against him for any reason."

In addition the KFH outlines the charges the card holder will have to pay in Kuwaiti Dinars:

"A - Joining fees, paid one time on accepting the application.

B - The card holder subscription fees paid one time every year when specified by the House.

C - Expenses and amounts resulting from use of the card including any telegraphs, telexes, telephone calls or the like.

D - Expenses and charges incurred in requesting the card holder to settle his account."

From the department dealing with the card, figures on how many customers had obtained cards and how much they used their cards were impossible to obtain, as they were understandably very secretive. The only way one can judge the success of the Al-Tamwil card is by asking the customers, who on the whole seemed pleased to have an internationally useable instrument such as the Visa card. With enthusiasm from the customers it is very difficult to see how this new instrument of the KFH can fail.

5.3 The Credit Department.

The Credit Department is a department in the House which functions on many different levels and has to coordinate many activities. For purposes of investment the credit department issues letters of credit for Murabaha investment, but here we are looking at the credit department as a way of replacing the loan system operated by the established commercial banks, which base themselves and their business on interest.

There are four services offered in what is termed the Department of Documentary Credits. Firstly the ordinary cash documentary credits, secondly Murabaha sales, thirdly documentary bills for collection and finally the the issuing of letters of guarantee. Each one of these will be described, and the whole system will be evaluated after the reader is familiar with the internal machinery.

5.4 Cash Documentary Credits.

The KFH provides the opportunity for cash documentary credits coupled with the receiving and delivering of imported goods. Below are the stages of a cash documentary credit deal, where the important factor is that the House shares responsibility for the goods with the client who desires these goods.

Stage

1: The client approaches the bank for a credit facility.

2: The credit department decides on the credit limit of the client.

3: Client applies for a letter of credit (L/C).

4: The House reviews the client's credit facilities and his/her L/C application.

5: L/C sent to foreign bank which notifies the supplier of the intended goods.

6: The goods are covered by Marine insurance.

7: Before transportation the client's requested amendments are carried out if the seller agrees.

8: The goods are transported to Kuwait.

9: The documents are received by the KFH and are all given serial numbers.

10: The client is notified of the arrival of both the goods and the documents.

11: Delivery of the documents to the client and deduction of the value of the goods from his/her current account (9).

The Kuwait Finance House, typically, takes on a lot of the responsibility for the transaction as agent, guarantor and initial provider of funds for the transaction. For its role as agent the KFH charges a 0.5% commission on the value of the documentary credit. However, as guarantor of the importer to the seller's bank, no charge is taken. Neither is there any charge for providing a free loan (Qard Hassan) to pay the supplier's bank: a loan which is only paid back when the client has appropriated both the goods and the documents for those goods.

5.5 Murabaha Sales.

This next section deals with the Murabaha sales which are split into two sorts; external and internal. The external Murabaha sales involve importation from abroad, whereas internal Murabaha sales involve goods in the local market. In an external sale the client informs the KFH of the goods he/she wants to purchase and agrees with the KFH on the profit it will charge when the goods are sold to the client. Each stage of the transaction will be shown in the same way as with the cash documentary credits.

Stage

1: The client approaches the bank for a credit facility.

2: The credit department decides on the credit limit.

3: The customer specifies the goods he wants to buy.

4: The KFH reviews the specification and prices of the goods.

5: Review of client's credit facilities.

6: Approval of importation of goods.

7: L/C opened in favour of the beneficiary.

8: Goods insured against transport risk.

9: Receipt of shipping documents for the L/C.

10: L/C value determined by the KFH.

11: Signing of sales contract with client and settlement of value by means of cheques.

12: Delivery of documents to the customer coupled with authorisation from the KFH.

The mark-up profit charged by the KFH is agreed upon when the goods are sold to the client even though the subject will have been broached before.

In order to ensure payment, the KFH took advice and gained a Fatwa from their own Shari'a committee to the effect that, because they had to compete with other banks they could extract from the client a legally binding promise to take the goods after the KFH had received them. This compulsion is allowed now but in a perfect Islamic system it would not be necessary: maybe it is very hard to justify under Islamic law, but it is a practical and pragmatic step.

If the goods required are on the local market, the KFH makes its own study considering the economic feasibility and the social benefits in purchasing the goods. The KFH buys the goods, and the client then buys them from the House, paying on a Murabaha basis on pre-arranged terms, either in installments or a lump sum on a set date (10).

In an interview with Mr. W. Qatami, assistant manager in the credit department of the KFH, it was explained that the Murabaha deals discussed above did not compare very well with the services offered by commercial banks in 1988, because interest rates for loans fell to as low as 6%. However these Murabaha deals are the mainstay of the credit department and exhibit the necessary attributes of social responsibility necessary in an Islamic system.

5.6 Documentary Bills for Collection.

The next section describes a very simple service offered by the KFH whereby it acts as an intermediary. The process is as follows (11):

Stage

1: The KFH receives the documentary bills and shows them to the importer.

2: The importer either accepts or refuses to receive the bills.

3: The KFH informs the overseas supplier of the importer's decision.

4: If the importer accepts the bills he/she pays their value either at once or by installments.

5: The KFH receives the sum from the importer and transfers it to the supplier's bank.

6: The KFH charges a service fee to cover the expenses incurred.

There are no complications in this area where the KFH is facilitating international trade in a very smooth fashion.

5.7 Letters of Guarantee.

The KFH can issue letters of guarantee for its clients and either blocks the client's account with the value of the guarantee, or witholds collateral to cover the value of the guarantee. In a book of Fatawa (legal decisions) published by the KFH there is one question tabled asking whether the taking of a fee is permissible for a letter of guarantee? The universal decision is no; but the Fatwa says;

"I know of no Faqih (learned man) who allows the taking of a fee for guarantee, but if the customer entrusts the bank to take charge of his interests , a charge is permissible either relative or settled." (12) In reality the KFH charges a service charge on all letters of guarantee, which is in no way dependent on the value of that letter.

5.8 Aims of the Department of Documentary Credits (13).

The Kuwait Finance House hopes to build a team in the credit department with the necessary attributes of "durability, diligence, commitment to work and the capacity to satisfy customers." By using to the full the newly installed computer the department is ever looking abroad (as are all agents in the Kuwaiti economy) for expansion. The goal is to expand exports and trade between Islamic countries, and to cooperate with the international banking sector to increase the network of correspondents abroad. They are concentrating especially on those countries which import from the EEC, and in this they are determined to link up with the Jeddah based Islamic Development Bank (IDB).

In all this they realise that they form essentially a service department which offers a personal service to the client, and therefore must be flexible enough to cater for individual needs and requests. It is of vital importance that people stay in this department for a long time in comparison with their colleagues in other departments, because so much of the dealing is on a personal basis. This leads an employee to feeling that his work in the department represents an obstacle to the promotion, that would be offered to him if he worked for the same amount of time in another department. There is a lack of incentive schemes for employees of the credit department which leads to disillusionment: this must change.

5.9 Volume of Transactions Handled by the Credit Department.

It is very difficult to find figures on the actual amounts handled, but it is possible to make general assumptions from the amount of "Letters of credit, acceptances and guarantees on behalf of customers" which are the unsettled transactions of the credit department.

Table 5.2

Growth or Decline of Letters of Credit, acceptances and guarantees on behalf of customers. (All amounts in KD).

Year	Amount	Percentage Difference From Previous Year
1983	35,902,160	+22%
1984	26,918,164	-33%
1985	27,677,181	+ 3%
1986	25,117,364	-10%
1987	28,732,516	+14%
1988	33,508,170	+16%

The two years of decreasing Letters of Credit (1984 and 1986) are mirrored in the annual reports by the slackening business in deposits which the bank noticed in the same years, as people affected by the poor economic state of the country had very few funds to disburse.

Table 5.3

Growth or Decrease in Deposits From Previous Year.

1983	+47%
1984	-17%
1985	+13%
1986	+ 4%
1987	+11%
1988	+ 9%

1984 was a poor year for the whole of the Kuwaiti economy, and it is evident from the above two tables that the KFH is still recovering. As the House grew, deposit growth was expected to slacken off as a natural result of maturity, but not in such a dramatic fashion as is given evidence of above (14).

5.10 The Future of The Credit Department.

In the interview with Mr. Qatami it became clear that he was of the opinion that the optimum way for the credit department to function would be on a Musharaka basis as opposed to a Murabaha one. This would require the bank to take more risk, which it is often reluctant to do. In fact Mr. Qatami was put in charge of studying the possibility for Musharaka deals in the credit department, and he was recently in Egypt to study such deals already carried out there by Islamic banks. He attended a seminar on the subject and saw the workings of many deals.

He indicated that the credit department had considered four Musharaka deals, but that these had been discounted for different reasons, and one was still being considered. Firstly one person had come with the idea of importing marble for a building project - the deal was tempting because the company was very good in its field and the project promised a good profit margin. However, the company had a lot of bad debts and could not be trusted enough, so eventually a Murabaha deal was decided on. The other three projects involved the import of cars; one of which failed because the proposed partner of the bank adjusted the prices in order to avoid customer tax, so he was considered too dishonest to deal with. In the second case the potential business partner was out of the country when he had arranged a meeting with the board of directors to discuss the deal; this was considered as a discourtesy and proof of unreliability, so the deal was dropped. The fourth plan is still pending a decision at the time of writing , so no details about it could be given out.

Musharaka represents the sharing of responsibilities which is the crux of Islamic economics, but it is a very risky way of dealing, requiring the bank to be on a solid base before it takes on such risk. Mr. Qatami agreed that no deal can be riskless, but there needed to be more ways of insuring against loss in Islamic banking before it could fulfill its ideals. More interaction between the Islamic banks and close cooperation in monitoring customers would help to solve the problem, but in reality it is a matter of confidence; each partner in a Musharaka deal must have confidence in his co-partner and confidence in the project - it can be seen as a business marriage.

There are weaknesses in the credit department, the main one being that there is no way of financing small personal loans for which a customer must go to a commercial bank at present.

It was strange to note that at the KFH the credit department finds it very difficult to give short term extra finance to cover the early teething problems of any venture. This is a weakness which must be dealt with if there is to be any progress. However, to be positive the credit department works strictly within Islamic morals, refusing to deal in any un-Islamic items which do not benefit society, such as alcohol and cigarettes. Just over half the Letters of Credit are for foodstuffs: an essential for life, therefore a very fitting commodity for an Islamic institution to deal in. In the highly organised credit department, with more innovation and trust, it will be possible to ensure the success of Islamic banking.

5.11 Foreign Dealing.

The KFH seeks to offer to customers an international service and in 1983 (15) reported one hundred and forty-eight correspondent banks covering most of the globe. In addition the Foreign Transfers section in the banking hall provides clients with exchange and transfer facilities. It issues and accepts foreign transfers in most major currencies, purchases and sells foreign currency notes and travellers cheques drawn on international banks. In this it works like a normal bank.

There is also a dealing room where the KFH provides foreign currencies to cover their transactions, and it also deals with buying and selling foreign currencies in the local and international markets. All these latter deals are carried out on spot basis according to Islamic law.

One experiment which was tried in 1981 was the provision of exchange facilities on the Hajj. The execution was left to Mr. Zuhair Bibu, who was at that time the branch manager in Fahahil (16). He had decided to go on Hajj, so the management encouraged him to open offices in Mecca and Medina, at the appropriate times, for customers of the KFH. He was issued with SR 1,000,000 and a letter which gave him the authority to draw money from the Al-Rajhi bank in Saudi Arabia. The service offered was advertised and an office was taken in the medical centre, because the venture was only semi-official. It was a badly organised affair with all the pressure being placed on the shoulders of one person, who had to carry great stocks of cash with him. This awkward arrangement was never repeated because it was deemed too difficult and impractical to form a permanent reliable service on Hajj. However, this is proof of how the KFH is always looking to extend its customer services.

Finally, in 1988, the KFH began to offer the possibility of opening accounts in five foreign currencies: namely the U.S. Dollar, the sterling Pound, the Deutsch Mark, the Japanese Yen and the Saudi Riyal. Deposits and withdrawals are to be made by means of cheques or bank drafts or are conducted in KD. Being a relatively new service, the figures are not included in the current accounts, so no exact figures can be given.

5.12 Summary.

"80% of our job here [at the KFH] is the same as any other financial trust."(17)

This applies especially to the banking section which is split into the seven administrations of:

a) The Banking Hall.

b) Documentary Letters of Credit.

c) Financial Controls.

d) Foreign Exchange.

e) Credit.

f) Computer Services.

g) Branches.

This organisation has been very successful in instilling confidence in the depositors, so that in this area it is bigger than the Burgan Bank and the Bank of Kuwait and the Middle East. It has attracted many people who would not have used banks at all before the rise of this Islamic institution, as it provides them with all the facilities of a bank, but they need have no qualms about dealing with a riba-based institution.

As its computer network spreads the Kuwait Finance House will become more efficient by being able to offer all its services at each branch. The branches now cover every area of Kuwait, and Mr. Zuhair Bibu, when interviewed, said that there were no immediate plans to build any more.

The faults in the credit department have been underlined above, but the major one is that there is very little use made of the Musharaka instrument. One can only hope that the teething problems in this field will be overcome, but this will take great courage and innovation from the top management. In this area there are certainly lessons to be learnt from the Western Venture Capital Industry (See Chapters 2 and 9). The Banking section will continue to grow in strength, if the KFH does not become complacent because of its success.

Notes.

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1) Interview with Mr. Zuhair Bibu, 28/3/89.

2) See Table 5.1.

3) op. cit. Interview with Mr. Z. Bibu.

4) Dr. R. Wilson "Islamic Banking in a Consumer Society". Page 12.

5) Interview with Mr. Adnan al-Bahar, General Manager at the KFH. 4/4/89.

6) KFH Annual Report, 1988. Page 5.

7) Application form for Visa Al-Tamwil Card.

8) Credit Agreement Regulated by the Consumer Credit Act 1974.

9) Interview with Mr. W. Qatami at the KFH, 8/4/89.

10) op.cit. Interview with Mr. W. Qatami.

11) Interview with Mr. F. Zaki Al-Din, Deputy Manager of the Letters of Credit Department, KFH. 1/4/89.

12) Fatwa Book of the KFH: Volume 1.

13) From a KFH internal document entitled "The aims of the Credit Department" (Arabic).

14) All figures from the KFH Annual Reports, 1983-1988.

15) KFH Annual Report, 1983. Page 11.

16) op.cit. Interview with Mr. Z. Bibu.

17) "Interest Free Banking Kuwaiti Style" From the Magazine "International Management", November 1983. pp 50-53. Quotation from Mr. Khalid Budai, Assistant General Manager at the KFH.

CHAPTER 6

The Real Estate Sector of the KFH.

6.1 Introduction.

Now having dealt with the way in which KFH offers services to its customers, it is necessary to see how the House makes best use of its money to ensure high return. In this chapter the Real Estate sector will be examined, and in a subsequent chapter the trade and investment sectors will be dealt with.

The KFH realised early the potential in the real estate market, and in the annual report of 1979 it was noted: "The period 1975-1978 witnessed an increased demand on housing and that demand was unduly matched by short supply..." (1). The vacuum had been spotted and the House realised a potential growth area because of the "private sector's reluctance to continue investment in real-estates, especially in the first half of 1979, when the licences and gross space licensed dwindled against the same period of the previous year."(2)

At this stage construction in progress only amounted to KD 571,410 (3), but this figure was to rise rapidly to KD 51,140,663 in 1985 (4). In 1979 construction in progress accounted for 0.75% of total assets, but in 1985 this figure had risen to 6% showing how important the KFH considered real estate. In the last annual report the figure was down to 2%, as there has been a slow down in the real estate boom of the early 1980s. This is an indication of the fact that the House is putting less reliance on this sector than before, although it continues to have heavy commitments.

In the 1980 annual report, when covering its investments, the major subject discussed is real estate, as the House advertised that it was beginning to widen its interests by getting involved in the buying of large estates to divide into parcels for sale purposes. The next year the reader of the annual report notes that the KFH has entered the field of construction whole-heartedly, and that after the construction, the management and rental of the new buildings was undertaken (5).

In 1989 the Real Estate Division was split into three different areas which depend on each other. Firstly there is the "Real Estate Department", which deals with the evaluation, purchasing and selling of land: next is the "Projects management" division, which copes with the building from pre-planning to the completed article; and finally there is the "Management and Maintenance Department", which takes care of leasing and upkeep of all properties. There is a natural progression and overlap between all three sections which will become clear below (6).

6.2 The Real Estate Department.

This department is described as the "mother" (7) department, as it gives rise to the necessity for the other departments. Its primary jobs are to purchase land for resale and for construction purposes, and to provide real estate for the maintenance and management division. The area involved ranges from real estate plots, to office buildings, to appartment blocks and to large land plots yet to be upgraded and specified by the government(8).

For customers with ready liquidity, real estate can be sold for cash, but for those that lack liquidity it is possible for the customer to pay a downpayment of 20% - 30% of the purchase price, and the rest can be made up in installments. This is the normal "Bai' Al-Ajal" arrangement or "deferred payment" (9).

There is also provision for sale by Murabaha, where the customer desires some real estate that the KFH does not own. After studying the market worth, the House will buy the real estate in order to resell it to the customer if he/she still chooses to buy it. Payment may be made in cash or in installments. The aim in such dealings is to provide people with the opporunity to acquire land or real estate according to their own desires; because the KFH is such a big dealer, the prices it offers will naturally be very competitive.

The competition is very strong in this field as all banks give credit loans, with the Real Estate Bank offering the best deal in terms of interest rate and experience in the field. There is also a company called the International Financial Advisors (IFA), which has an overall balance sheet of KD 410,000. They build to the customer's specifications and are able to get loans at an interest rate as low as 6 %, which enables them to sell the completed article for a percentage profit (10).

Competition has led to the necessity for participation deals, where the KFH Real Estate Department participates with local companies or individuals. The share in participation ventures varies from deal to deal, and at completion the Real Estate Department is usually given the job of selling the real estate.

In the accounts the income directly related to the Real Estate Department is impossible to calculate exactly. Income from this department and the Real Estate Projects Department have never been given separately but were included under the heading, "Net income from property, commercial and construction operations." In the 1988 report the issue has been further obscured by giving the income "from the banking, property, commercial and contruction operations", whereas before "Income from banking operations" was a separate figure(11). This state of affairs is very confusing and is evidence of a mild covering over of the tracks, but for what reason it is not totally clear.

The one figure which can be judged is that for "Trading Investments in Property", which accounts for all the real estate held by the KFH at the end of the year. The main problem here is that until 1983 this figure included real estate held outside Kuwait, but in 1984 the auditors decided to include the latter asset under "Other Investments", which led to a great discrepancy in the figures. However, in the next year, 1985, real estate held outside Kuwait was re-instated in "Trading Investments in Property". Now the "Trading Investments in Property" components have been settled since 1985. If in the 1984 report this settled set of components had been specified, it would have shown that the value of the KFH real estate assets were KD 450,871,917 , which is the highest total so far achieved. Since then the overall value has fallen because of the Suq al-Manakh crash and depreciation, to the 1988 total of KD 389,219,525. "Commercial Investments and Stores" have always been the largest single item, but it was particularly noticeable that in 1988 "Land and Buildings" (meaning divided flats and buildings) took a larger share of the total; 28% in 1988 as compared to 21% in 1987. This is an area in which the KFH is consolidating, rather than ambitiously expanding after the euphoria of the early growth.

6.3 The Real Estate Projects Department (RPD).

The Real Estate Projects Department (RPD) is where the KFH has concentrated its investment in the early part of its life. The RPD can undertake a construction right through from pre-planning to completion, supervising feasibility studies, design and execution of projects. It has the skills to develop both commercial and residential buildings in order to "introduce various opportunities for growth and development .... to serve their clients."(12) The project can be left totally in the RPD's hands and is only handed over after the power has been connected, and the free-maintenance period has been determined.

The total cost of the project is calculated (including design, execution, supervision and management) and agreed upon with the client, who may be the KFH itself; then the profit margin of the RPD is decided on. Below, the progress of the department will be followed and two projects will be singled out: the commercial and residential complex "Al-Muthanna" and the new Head Office of the House. These two were chosen because of their sheer size, and the ease with which it is able to follow every step until the successful outcome.

Already in 1979 the RPD was participating in ten investment and commercial projects, while it was still learning the trade, and it was not until 1981 that a full service was offered. In this year the fixed assets of the House rose by about 1400% as KD 3,978,000 worth of freehold land was acquired for development purposes, and the worth of construction in progress continued to rise to KD 1,631,160 (13).

The next three years till 1985 were years of tremendous growth, with a decision being taken in 1982 to build residential complexes in Jabriya (14) and other parts of the country. Work proceeded on twenty-seven investment buildings at a worth of KD 9 million, but as the price of land was declining there was also a move into residential investment. All this took place in Kuwait, but in 1984 we have the first mention of a construction investment outside Kuwait, as a deal was concluded with the Bahrain Islamic Investment Company to build a residential complex in the diplomatic area of Bahrain for around KD 7 million (15). In that year the RPD started tendering out its services to help manage and finance projects for others, because it had gained the experience. The 1984 figure for construction in progress was a massive KD 37,881,669 including storage space and showrooms at Farwaniya to be used by the House's trade sector.

The Suq al-Manakh crisis brought no halt to the expansion of the department; in 1985 five new sites and buildings were chosen for commercial buildings, while eight buildings and complexes for Kuwait and elsewhere came to the design stage. Success bred success, as two new KFH branches were completed at Shiab (16) and Salmiyah (17), and three more were under construction.

In 1986 all the commercial buildings were completed and handed over to the Real Estate Management and Maintenance Department (See next section), four more branches were completed, and the Al-Safwa supermarket was opened for the Trading Department (18). In addition a total of twenty-five more investment buildings were planned for construction in 1987 for a cost of KD9,750,930. These were heady days for the RPD, but it is at this point that things started to slow down because of the dearth of commercial development.

The years 1986 and 1987 saw the start of the cooperation with the Supreme Housing council in order to help solve the Kuwaiti housing problem (19). This policy fits in very well with the social responsibilities of the RPD as part of an Islamic Institution, which is supposed to foster economic and social equity. The RPD was contracted to build two hundred houses in the Al-Qurain project, according to government specification (20).

In the affluent society that Kuwait had become, personal freedom had gained more importance and the old family values, although still intact, were changing (21). A private house was now a necessity for married youngsters, and the country was well enough endowed to comply with their desires. In 1987 more cooperation with the Public Housing Authority was envisaged, and although the 1988 figure for construction work in progress was only KD 26,890,586 (22) (well below the halcyon days of the early 1980s), a bigger percentage of this was concentrated on residential investment rather than commerical.

6.4 The "Al-Muthanna" Residential and Commercial Complex.

Any Kuwaiti, when asked about the KFH, will immediately mention the "Al-Muthanna" Residential and Commercial complex on the corner of Fahd al-Salim and Hilali Streets. It is situated in a very prominent position in the town centre about half a mile from the main banking area near the Meridien Hotel. The bottom two layers are for shops and even a branch of the KFH, while the upper floors are very desirable city-centre appartments.

The plan to build the "Al-Muthanna" complex was mentioned in 1979 when the intention was announced to invite international tenders to bid for the project in 1980. Work started in November 1981 after the site had been prepared and a construction contract awarded for KD 24.7 million. Up until this time, and for the next year, the value of the complex was listed as part of "Investment and other assets", but after 1983 it was considered a big enough project by itself to figure in the assets accounts on its own.

The structure was completed a few months behind schedule but opened in 1985 with a final value of KD 29,241,306(23); an amount which has depreciated slightly to KD 28,223,276 in 1988(24). The deal is that the KFH takes all the profit for forty years, and then the complex is handed over to the government. By this time the KFH will have profited greatly from its initial investment. This, as explained by Mr. Zuhair 'Abd al-Rahim Bibu (25) is "a sort of Musharaka deal with the government, as both sides take the responsibility for profit or loss.

The KFH can be seen as taking a more entrepreneurial role than the government, as it was the House that organised the attracting of business to let the space in "Al-Muthanna". The sort of shops they attracted were catering for a highly sophisticated, westernised clientele, with the main bookshop/newsagent "The Kuwait Bookshops Co. Ltd." being a slick American type of organisation. "Al-Muthanna Electronics Centre" is a spin-off of the trade department of the KFH, and fits in very well with the brightly lit state-of-the-art interior design.

One of the biggest coups for the complex was the decision by the French chain store "Prisunic" to open a store on the Mezzanine floor of the building. Prisunic was chosen because of the high standard of its own brand of children's clothing which is of great importance in Kuwait (26). The advertising for "Al-Muthanna" and for Prisunic in particular has assured the success of the whole operation.

Table 6. 1

Value of the KFH Investment in "Al-Muthanna".

Year	Value(KD million)
1980	0.24
1981	3.77
1982	6.82
1983	11.87
1984	24.56
1985	29.24
1986	29.16
1987	28.90
1988	28.22

Source: The Annual Reports, 1980-1988.

6.5 The Head Office.

Situated on Abdallah al-Mubarak St, the KFH head office is a monument of Islamic architecture, highly acclaimed all over the world. It is an impressive modern building that harnesses centuries old designs, reflecting the way that the House plans to breathe new life into old theories in its financial activities.

Construction was started in 1983 and the building was ready for the KFH staff to move into in mid-1986. As a freehold property it is listed under Fixed Assets or "Property, Plant and Equipment", and at the time of writing represents KD 13.7 million of a fixed assets total of KD 18.4 million, that is 74%.

All other freehold properties, such as branches of the House are depreciated over 7-20 years, but the Head Office is depreciated over 30 years, because it is such a highly acclaimed building. The KFH had great foresight in building such an impressive structure and their investment will certainly pay off.

6.6 The Outlook for Construction in Kuwait.

The competition in Kuwait in the field of real state projects is quite intense, with five major companies holding most of the power. The RPD has now declined to take these "big 5" head-on, and is preferring to further promote its healthy links with the government and with its house building programme. Mr. Yusuf 'Abdallah Al-Hatim (27) stressed that there were no big projects planned for the near future, but the overall strategy was to make inroads abroad.

Expansion into the Gulf is a distinct possibility, but plans for working outside the Gulf area are merely being mooted at the moment. The problem is lack of knowledge of the market, but once that obstacle is overcome there is no reason why the RPD, with its hard-earned expertise, cannot export its skill and ability to bring to fruition successful investments in many areas of the world.

6.7 The Real Estate Management and Maintenance Department.

The Real Estate Management and Maintenance Department (REMMD) carries out three basic jobs.

a) Preparation of contracts for leasing, management, supervision and maintenance of all real estate of the KFH and other clients.
b) Receipt of all complexes and buildings and undertaking of all aspects of their management, maintenance and supervision.
c) Management and maintenance of real estate of clients against service fees.

The management side is responsible for lease contracts and rent collecting, recommending changes where it sees necessary. The maintenance side takes care of plumbing systems, electrical faults, ensuring the efficiency of the mechanics of a building while keeping an eye on the security and safety systems present. Both sides have a wide network of offices, and the whole organisation seemed very competent in aiming to please the customer.

The first mention of any business to do with the REMMD comes in the annual report of 1983, where it is stated that the KFH leases one hundred and twenty buildings at what it stresses are reasonable rates, and they point to a 33% rise in net rental income from 1982: this is in fact erroneous information as the rise was actually from KD 2,311,810 to KD 4,092,959 which represents a 77% rise; why this discrepancy should arise is unfathomable. In the next year, 1984, it is noted that the REMMD has begun to tender its services out to look after buildings other than those belonging to the KFH; so it is really from that year that the present department began to take its present shape.

Net rental income (NRI) has risen every year with the increase per year now seeming to steady out at between 20% and 30%. The only time NRI has actually decreased from the previous year was in 1985 as a knock-on effect of the Suq al-Manakh crisis. Even in this year NRI only decreased half as much as Total Income (TI), as the big fall really showed in the real estate and investment transactions.

In 1988 NRI was 17% of TI, a figure which has been rising since 1982, because the KFH understands that rental income is very secure income and provides a virtually risk-free transaction.

Of course the rental income shows the figures for only part of the REMMD because more than half the department's work is the managing and maintenance of other people's property. This field in Kuwait is a very competitive one, because the great numbers of foreign workers are not allowed to own property, therefore they are obliged to rent. As in Britain many Kuwaitis buy property solely in order to rent it out, but there are three main sources of competition. Firstly there is a company called KREMINCO which owns sixty buildings and sells its services through different companies and ministries; because they only own sixty buildings, they can afford to offer five star service. Also in Kuwait there exists an institution, dealt with in the Shari'a, which takes care of a dead man's remaining property when his family can cope no longer; this organisation has a lot of buildings in Kuwait which it rents out and shares the profit among the deceased's family. Finally there is the Bait Al-Zakat, which buys property to rent in order to feed the profit into the Islamic social security system of Zakat. In the last case it is an ironic situation, because the KFH pays its Zakat to the Bait Al-Zakat to disburse, therefore it is effectively feeding one of its own competitors.

Table 6.2

The Relationship Between Rental Income and Total Income.

(All amounts in Kuwaiti Dinar Million)

Year	Net Rental Income (NRI)	Total Income (TI)	NRI as % of TI	Rise (or fall) of NRI from Previous Year	Rise (or fall) of TI from Previous Year
1978	0.28	0.92	30.5%	---	---
1979	0.69	4.67	15.0%	+146%	+301%
1980	1.25	14.54	8.5%	+ 81%	+211%
1981	1.92	34.01	5.5%	+ 53%	+134%
1982	2.31	52.11	4.5%	+ 21%	+ 53%
1983	4.09	42.08	10.0%	+ 77%	- 20%
1984	4.38	41.35	10.5%	+ 7%	- 2%
1985	3.60	26.69	13.5%	- 18%	- 35%
1986	4.62	31.24	15.0%	+ 28%	+ 17%
1987	5.68	35.22	16.0%	+ 23%	+ 13%
1988	7.34	43.30	17.0%	+ 29%	+ 23%

Source:The Annual Reports 1979-1988.

6.8 The Real Estate Portfolios.

In addition to the above services the KFH has issued four real estate portfolios, the last being issued in 1988. In the 1988 Annual report these portfolios were highlighted as one of the "new products" that were still in the development process. The fact that all four portfolios are fully subscribed by KFH customers shows that there is room for expansion in the field.

The total value of the portfolios is KD 34,375,953 spread amongst 4,229 subscribers. Below is a breakdown of how customers have subscribed.

Table 6.3

Breakdown of Amounts Subscribed to in the Real Estate Portfolios.

Number of Subscribers	Amount of Subscription
30	More than KD 50,000
325	Between KD 10,000 and KD 50,000
2,733	Between KD 1,000 and KD 10,000
1,137	Less than KD 1,000

The thirty people with more than KD 50,000 subscribed actually own KD 13,429,442 of the shares or 39.2%. THe KFH has itself taken a 3.6% overall stake in the portfolios (28).

The value of each portfolio was hard to obtain, but from the aggregate total it is possible to assume that all the portfolios are worth roughly KD 10 million, but in the absence of more information it is impossible to say how profitable they are. However they must be doing well because the KFH plans to open up more such portfolios in the near future.

6.9 The Future of the RED at the KFH.

Property is regarded by the House as its safest long term asset with a depreciation system which is fairly conservative. However they have had to lessen their dependence on real estate because of the slump in its prices in the Gulf. The Suq al-Manakh crisis weakened them even further, so that the past four years have seen a development away from real estate with more emphasis being given to trading.

Although the KFH always has to justify its operations by sharing profits, it can do this whilst showing regard for social values and equity. In most of its real estate involvements the House has been considerate of social values, participating with the government to complete all Kuwait's housing developments.

There is one section of the Real Estate Department which is given over totally to researching into new directions in order to keep ahead of the field. This research section was responsible for seeing the potential market in real estate portfolios, whose success has been steady if not dynamic. At the moment studies are being carried out on vacant flats, single or double, of which there are said to be about one thousand vacant at the moment; these flats would be perfect for redevelopment. Research is also carried out as to the composition of people who deal with the KFH in real estate matters. It has been established that groups such as ambassadors and students are unaware of the services offered by the KFH, so they must be singled out for special attention. The whole department is looking to widen its clientele and its services; it can only be hoped that it does not lose sight of the fact that what it is providing is a sort of public service for an Islamicising society.

Notes.

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1. KFH, Annual Report 1979. Page 27.
2. Ibid. Page 29.
3. Ibid. Page 34.
4. KFH, Annual Report 1985. Page 16.
5. KFH, Annual Report 1981. Page 12.
6. See Explanatory Brochure. Printed by the KFH about the Real Estate Division. 1988.
7. Interview with Mr. Yusuf Abdallah Al-Hatim, Head of research in the retail division of the KFH. 10/4/89.
8. In the Real Estate Division the KFH cooperates with the government as much as possible, and endeavours to fit in with the government's overall plan.
9. See Explantory Brochure on all the KFH's activities. Printed by the KFH, 1984. Page 15.
10. op.cit. Interview with Mr. Yusuf Abdallah Al-Hatim.
11. KFH Annual Reports 1987 and 1988.
12. op.cit. Explanatory Brochure 1984.
13. KFH, Annual Report 1981.
14. Kuwait City emanates from the point on the shore where the impressive Kuwait Towers now stand. Each sector is bounded (in a wave like pattern) by ring roads, which are numbered first ring road, second ring road etc., until the sixth ring road. Jabriyah lies between the fourth and fith ring roads.
15. KFH, Annual Report 1984. Page 13.
16. Third Ring road.
17. Fifth Ring road.

18. In Farwaniyah on the very outskirts of the city very close to the airport and near the KFH trading department headquarters.

19. op.cit. Interview with Mr. Yusuf Abdallah Al-Hatim.

20. See Note 8.

21. Interview with Mrs. Fadia al-Zu'bi - journalist. 1/4/89.

22. KFH, Annual Report 1988. Page 20.

23. KFH, Annual Report 1985.

24. KFH, Annual Report 1988.

25. Assistant Manager in charge of Human Resources.

26. Article by Dr. R. Wilson.

27. See note 7.

28. Figures quoted in correspondence with Mr. Yusuf 'Abdallah al-Hatim, 11/7/89.

CHAPTER 7

The Kuwait Finance House's Investment and Trade Departments.

7.1 Introduction to the Investment Department.

7.2 The Turkish Connection.

7.3 The Search for New Fields for Investment.

7.4 The Social Responsibility of the Investment Department.

7.5 The Future of the Investment Department.

7.6 Introduction to the Trading Department and its Car Sales.

7.7 Murabaha in the Trading Department.

7.8 Other Trading Department Services.

7.9 The Trading Department's Contribution to the KFH body.

Notes.

7.1 Introduction to the Investment Department.

The Investment department in the Kuwait Finance House often quotes as its aims, the aims of everybody involved in investment, such as a high return on investments and the forming of new channels for investment in the short, medium and long terms. However the House also sees itself involved in an overall plan to encourage investment between Islamic countries and to promote Kuwaiti exports on the foreign markets. The aim of promoting Islamic investment is phrased thus:

"Surveying the Islamic countries for establishing a network of Islamic financial institutions whereby Islamic economic ideas can be promoted and ties among Islamic countries and institutions can be strengthened."(1)

This is a practical step as the local investment market is now very unrewarding; therefore a move to countries where the Kuwaitis have a good understanding of the local culture seems an obvious move. The problem is that an investor always desires a stable political environment for his investment, which many people at the KFH believe is difficult to find in close proximity to Kuwait, in the countries where investment was needed, such as Iraq or Jordan.

There is definitely a desire to invest abroad, but the alarming lack of cooperation between the financial institutions in Kuwait (which still depend on government initiatives in the foreign markets) has hampered efforts. In this section all the international developments in the investment field will be discussed, while sometimes relating their success to the home market in such instruments as investment portfolios.

The KFH has sought to increase the investment instruments available and, in this field, has shown the innovation which is necessary for the continuing development in Islamic finance. Their participation in many companies of an Islamic nature is quite bold, with holdings in affiliated companies outside Kuwait ranging from 0.2% to 50% of their capital.

With the Islamic aims of the House being emphasised by phrases such as "the strong desire to establish Islamic banks and companies" and "a desire to hold equity participations in concerns with Islamic inclinations"(2), the KFH, as the biggest of the fifty five Islamic banks, has supported the formation of many other Islamic institutions.

In the form of equity stakes the KFH is presently involved in five Islamic banks; the Dubai Islamic Bank, the Bahrain Islamic Bank (8.7% share of the capital), the Tadamon Islamic Bank of Sudan (5% share of the capital of $20 million), the International Islamic Bank in Luxemburg and the Kuwait-Turkish Finance House (50% share capital). The last mentioned institution will be discussed later as a special case. The other institutions that are participated in are the Bahrain Islamic Investment Company, the Islamic Insurance and Re-insurance Company (5% share of capital of $50 million), the Islamic International Audio-Visual Company (10% of capital) (3) and the Paints and Dyes Company (10% share in capital of 2 million Egyptian Pounds)(4).

This is a very varied portfolio but it is necessary to mention the failed participations such as that in the Bangladesh Islamic Bank in Dekka and the Faisal Islamic Bank of Sudan. This is a pity especially after the efforts that were needed to persuade the Bangladeshi government to grant a licence for an Islamic bank. However, as one official at the KFH explained, it is very difficult to carry out what is essentially a financial experiment in such an economically traumatised country, whose thoughts are on survival rather than innovation.

In 1984 there was talk of opening an International Islamic Bank in Kuwait in conjunction with the Central Bank of Kuwait and the Islamic Development Bank. The plan fell through as the market was not ready for such a bank. Some people mooted that the KFH, while discussing the new venture, discouraged action because this would have presented them with Islamic competition in the local and foreign markets. This is a dubious explanation for the plan not being carried through, because the KFH management realise that competition is a good way to encourage growth of ideas (5). They have pinpointed this problem that there is very little competition to gain the custom of Kuwait's Islamic investors, but the aim of the top management is for the KFH to become so well established that its position is unassailable, before any competition is introduced.

A prime mover in many of the Islamic institution participations is the Islamic Development Bank (IDB) based in Jedda. The IDB was established in 1974 by thirty-seven Islamic countries, and the number of member countries has now swelled to forty-two. According to its statutes, it was established along the same principles declared by the Organisation of Islamic Conferences: to promote cooperation and strengthen ties between member countries in all aspects of life with special emphasis on economic development and financing. This it does by the co-financing of projects, trade financing, equity participation, promotion training, research into Islamic banking and by encouraging cooperational coordination between Islamic banks.

It has been a sort of model on which the nascent Islamic banks have based themselves, 75% of its assets are in Murabaha deals with still a negligible amount in Mudaraba deals. Its equity participation, which can be counted as Mudaraba dealings, is only 5% and is concentrated in the Islamic financial institutions. It assimilates deposits from outside banks motivating its depositors for the long term, so that the capital is available for participation investment. It is a leader of the Islamic banks whose eventual role will be discussed later in this study.

Recently the KFH has had two major investment participations involving the IDB. The first was in 1987 when it participated with many other Islamic institutions in the IDB trade portfolio of $65 million and the second is the recently opened Kuwait Turkish Finance House (KTFH) (6), which is a very interesting development on the investments side.

7.2 The Turkish Connection.

The names, nationalities and shareholdings of the founder members of the KTFH are as follows:

Table 7.1

Name of Subscriber	Shares Subscribed	
	Turkish Lira (Million)	%
The Kuwait Finance House	7,500	50
Turkiye Vakiflar Bankasi (7)	4,500	30
The Islamic Development Bank	1,350	9
The Kuwait Institute For Social Security	1,350	9
Turkiye Diyanet Vakfi (8)	150	1
Ninety-six Individuals	150	1
TOTAL	15,000	100

Source: The Articles of Corporation of the KTFH.

From the above table it can be seen that 59% of the original share subscription is taken by Kuwaiti institutions, 31% by

Turkish institutions, 9% by a Saudi institution and 1% by individuals. All the six contributors above are represented on the board of directors which includes three Turks and four from the Gulf. The two KFH representatives on the board are Mr. Ahmed Bazi' Al-Yasin (Chairman of the board of directors, KFH) and Mr. Adnan Al-Bahar (General Manager, KFH).

The general manager of the KTFH is Mr. Fehmi Akin, who was, until recently, manager of the Feisal Financial Institution, a subsidiary of the Geneva based Dar al-Mal al-Islami headed by Prince Feisal of Saudi Arabia. Mr. Akin left in controversy as Prince Feisal's two foreign trade marketing companies are under investigation from the Turkish authorities for tax irregularities. He claims innocence and maltreatment, and therefore resigned at the end of 1988. His experience in Islamic financial practices bodes well for the new company.

The staff were brought in from various fields; for example Mr. Huseyin Avci, who is a Canadian trained computer programmer with no experience of the financial world, but whose computer know-how and knowledge of western markets will be valuable to the KTFH later on. However many of the staff such as the project manager were drawn from Islamic banks and other banks in Turkey.

The Bank opened on the 31st March 1989 and operates through its head office in the Medicikoy area of Istanbul, where the main banking centre is. It does not plan on expansive growth of branches as it will work through the network of the Turkiye Vakiflar Bankasi branches, of which there are three hundred in Turkey. Current accounts are available in Turkish Lira, German Marks or U.S. Dollars, and account holders have access to a cheque book and card. There are also profit and loss sharing accounts for between one month and five years, and the amount invested must be at least TL 250,000 , DM 1,000 or US $ 500, and these accounts operate as in the KFH.

Inside Turkey there is an intention to look for projects to finance without deciding on a specified field of investment, and maybe later a specialised niche will be found. The Islamic banks already working in Turkey have invested in the retail end of the car market, but Mr. Akin has rejected the idea that the KTFH would follow suit even though the experience of the KFH trade department could have been used to their advantage.

For the holders of the fifteen hundred accounts opened in the period March to June 1989, the Turkiye Vakiflar Bankasi and the KFH are acting as lenders of the last resort. However in most other areas the KTFH is trying to be as independent as possible, such as in finding its own correspondent banks. With some connections, suggested by the KFH, they have managed to form associations with one hundred foreign banks including most countries, but notably excluding Iran and Iraq.

On the import-export side, the KTFH is trying to further connections with the Middle East, and especially Kuwait. Five years ago Turkey exported only foodstuffs to Kuwait and occupied thirteenth place in the list of countries from which Kuwait imported its food. By 1988 Turkey had risen to first place in that list and was also improving in other fields of export, so that Turkish exports to Kuwait grew to US $ 300 million as opposed to Kuwaiti exports to Turkey of US $ 150 million (9). By attracting Kuwaiti trade the idea is that it will also attract Kuwaiti investment, which is now centred on Europe and the USA. Turkey also desires to use Kuwait as a re-export point to send

Turkish goods to many other Gulf countries. The KTFH sees the Kuwaiti connection as vital, because the relationship with Turkey is a relationship of partners who complement each other superbly.

On a wider scale Turkey has a lot to offer to other Islamic countries, as it possesses the population and industry base which is lacking in so many Islamic countries, with the exception of Egypt. By participating in 40% of the share capital of a trading company being set up in Bahrain by the Kuwait Finance Corporation, the KTFH is contributing to the development of trade between Islamic countries, especially those on the Gulf and in North Africa.

One further point to make about the Turkish connection is that it may facilitate the entry of Kuwaiti finance into the post war Iraqi construction business (10). Although this has been slow to take-off there is still the potential for substantial future gains.

With Kuwaiti backing Mr. Akin is looking to a rosy future when Turkey becomes part of the single EC market in 1992. He hopes his institution will be in better shape to contribute to European growth because of Middle East investments and finance related muscle. He sees Turkey as very much a bridge between the Eastern and Western cultures, which, because of its demographic situation and historical background, it always has been. Aiming for a depositor base of about TL 120 billion by the end of 1989, Mr. Akin foresees that the KTFH will soon be in a strong position to influence the economy of Kuwait and in turn the economic liaisons between two very different cultures.

7.3 The Search for New Fields for Investment.

The new channels mentioned at the beginning of this section refer to the way in which the KFH has challenged the staid system of investments by beginning some courageous experiments. Firstly mention must be made of the company International Turkey Systems (ITS), which is 100% owned by the KFH. It has the sole licence to market Tandem computers in the whole of the Gulf. The company's profit is noted in the table of investments (see Table 7.2) and is listed under "subsidiary companies", but the actual accounts of the company are deemed of no interest to the reader of the Annual Reports. However it can be seen that profits are quite steady and in 1986, 1987 and 1988 have represented 20%, 18% and 12% respectively of overall income from investments for the KFH. There has not been too much growth but rather consolidation in the ITS. (See Table 7.2)

In 1985 Investment portfolios were introduced with the idea of improving customer returns. Again it was difficult to ascertain exact figures, but the profitability of these portfolios was said to be inbetween that of the shares and the deposit accounts. Two sorts of portfolios are offered; firstly a portfolio in which at least US $ 10,000 or SR 50,000 must be invested by each investor with maturities ranging from three months to one year. The second type is looking for people to invest more for a longer period so the minimum investment is US $ 0.5 million or SR 2 million with maturities up to two years. The KFH sees this all as part of the ever widening services offered.

There is also the so called 'Tanker Fund' where the KFH consulted with the the Kuwait Oil Tanker Company (KOTC) to buy a share in some tankers; one a very large crude carrier (VLCC) and another of the Swissmex variety. Mr. Jassar (11) in the investment department admitted that this was a very risky investment, where the KFH is acting as the major financier of a group including the KOTC itself, Citicorp and the Norwegian shipping concern Fred Olsen and company. The investment fund was finally launched in 1988 and enables investors to own stakes in the oil tankers bought. The fund is known as "KFH Olsen Tankers" and is registered in the Cayman Islands. So far it has raised $30 million of which $7.3 million is subscribed by the KFH itself. A half share has been bought in the VLCC and the Swissmex tankers, both of which are second hand. The ships are managed by Fred Olsen, and profits are to be generated from both chartering fees and capital gain. After five or six years the KFH will sell the tankers for a profit and should have shown itself an inventive and capable investor.

The timing of the launch of the tanker fund was perfect as the KOTC needs more tankers, yet has recently been put off buying new tankers of its own because of the 100% rise in prices quoted by the major shipyards. In October 1987 Samsung the South Korean shipbuilders quoted a price of US $ 28 million for a 120,000 dwt tanker; in 1989 this has risen to US $ 51 million. The VLCC that the KFH has, increased in price by the same margin to cost US 85 million in the South Korean shipyards and US $96 million in the Japanese yards. The KFH is sitting on a very, very sound investment (12).

Table 7.2

KFH Investment Figures (All amounts in KD million)

Year	1984	1985	1986	1987	1988
Affiliated Companies a)	-	-	3.86	5.23	7.55
Less:					
Provision for diminution	-	-	0.81	1.01	1.01
in value					
Net Investment	3.10	3.5	3.05	4.22	6.45
Subsidiary Companies b)	3.13	2.5	1.16	1.16	1.16
Less:					
Provision for losses	1.88	0.8	0.36	0.26	0.26
Net Investment	1.25	1.7	0.80	0.90	0.90
Joint Ventures in					
Commercial Activities	0.43	0.1	0.11	0.08	0.08
Less:					
Provision for					
Anticipated losses	0.11	0.07	0.07	0.04	0.04
Net Investment	0.32	0.04	0.04	0.04	0.04
TOTAL	4.68	5.28	3.89	5.16	7.48

a) Affiliated companies are Islamic institutions incorporated outside Kuwait.

b) Subsidiary companies are represented by 100% of the shares of International Turnkey Systems.

Source: KFH Annual Reports, 1984-1988

7.4 The Social Responsibility of the Investment Department (ID).

One tool for investment is 'Murabaha' financing which is at the core of the ID's strategy. Any assets can be financed as long as they are not in contradiction with the Shari'a. It is at the moment participating in a US $ 100 million Murabaha facility for the Rice Export company of Pakistan. The syndicate financing the deal was lead-managed by the Feisal Islamic Bank of Bahrain and the Islamic Banking section of the Arab Banking Corporation. This is typical of the way the ID sees the Murabaha investment being used, so that it promotes social equity and harmony.

However in an interview with Mr. Jassar Al-Jassar it became obvious that he would like the department to be involved in more Mudaraba and Musharaka deals, and he quoted the tanker fund as a "typical" Musharaka deal with the real profit being realised after an extended period. He conceded that Musharaka, especially on an international scale, was very costly and risky as nobody will guarantee an Islamic institution. In Sudan there is an encouraging trend whereby the Inter Arab Guarantee Investment Corporation , established by a handful of Arab governments, gives a 70% - 90% guarantee on deals, but still the unacceptable risks remain. If the credit department at the KFH can find a way to conduct riskier deals in the local market, then and only then will the international investment department try to emulate the feat.

The desire to promote an equitable, habitable society is seen most clearly in the 1985 deal to purchase US $ 20 million worth of crude oil for Morrocco in cooperation with the IDB, and the providing of KD 14.8 million worth of education materials for Sudan. Such deals reaffirm the ideology of development for a better society, which the KFH has adopted.

7.5 The Future of the Investment Department.

In all dealings the law of the Shari'a must be adhered to, but more importantly a spirit of cooperation must evolve. So far there are three major cooperative bodies within the world of Islamic financing; the first is the Dar Al-Mal Al-Islami which is based in Geneva and is the parent of the Feisal group. The second is the Al-Baraka group parented in Jeddah and the third is the only real forum for discussion apart from the IDB; that is the Association of Islamic Banks established in 1977 to encourage cooperation, an aim which has largely been a failure. The problem is how to form the basis for investment of funds in the long term rather than the short term maturities which are prevalent at the moment. If an Islamic capital market were to be formed maybe this situation would change.

In 1984 the KFH profits from investments were KD 4,681,282 and total foreign investments totalled KD 112 million. The income for 1988 has grown to KD 7,485,954, the major rise coming from "affiliated companies"; whether this increase is reflected in total investments can only be conjectured. The search for new investment tools is on; the geographical area being covered is wide, and if the imagination of the KFH Investment Department is sharp enough there will be many opportunities for development.

7.6 Introduction to the Trading Department and its Car Sales.

As a company generating profits, the KFH has a large trading department which looks after direct trade operations, selling by Murabaha and commercial participation. In 1988 the services offered by this department were summarised as:

a) Direct trade-import and export of many commodities,

b) Cash sale,

c) Deferred payments scheme,

d) Murabaha according to clients wishes,

e) Selling of used cars,

f) Direct trade in electronic goods, and

g) Direct trade in consumer goods through the Prisunic store in the Al-Muthanna complex (13).

The seed for the development of a department which is now so diversified was the idea in 1979 to import and sell cars in the affluent Kuwaiti market. As stated in the first chapter of this study, trade injunctions are at the very heart of the laws of Islamic banking and finance, and so what happens in this department is particularly subject to scrutinisation by Islamic scholars. The aims of the trade department are "to provide consumers with essential goods at reasonable prices by means of charging low profit margins"(14). It is our job to conclude if the department is run with these aims in mind.

Cars have always been at the centre of the KFH trading policy because this market was identified as a constant one with high turnover, especially in Kuwait, where very few people do not own a car (15). New cars are imported directly and are sold at very competitive prices in three showrooms at Farwaniya (trading sector head office), Fahahil and Al-Sharq. In all these showrooms there is the possibility of buying on deferred payment (Bai' Al-Ajal);in 1989 the KFH, when selling by Bai' Al-Ajal aims for an overall profit of 28% more than the cash price, over a five year period at the most.

Car sales are doing well with the last notable increase being that of 37.5% in sales (by volume) from the previous year. The new enlarged showrooms brought in that year did help, but the major contributing element was the fact that closer cooperation with the main car agents was implemented.

The customer buys the car as he would from any normal showroom, but a run-down of the prices shows that the KFH can offer very competitive prices to give it an advantage in the local market. The stated aim is "to serve all income levels in the society"(16), which is a concession to the fact that Kuwaitis have realised in the second half of the 1980s that their money supply is not inexhaustible.

As a natural consequence of the last point made, the KFH decided to enter the world of used car dealings. Already they had built up a car maintenance service to deal with customers problems and by a little expansion of those services it was made possible to revamp second hand cars for resale. This idea was implemented in 1986, and the showroom in Farwaniya juxtaposes the chrome-plated indoor world of the new car showroom and the open-air showplace for the less glamourous dealings in second hand cars.

The way the KFH acquires these cars is one of its more controversial dealings from an Islamic point of view. Their own 'automobile technicians' estimate the value of a car which a customer wants to exchange with the KFH for a new car; naturally the customer pays the difference in cash. M.E.M.S. Rabooy, in his thesis on Islamic banking, questions if the KFH's dealings in second hand cars are allowed under Islamic law. "Is it exchange barter or separate sale?" (17).

The problem is that under Shari'a injunction, it is not allowed to have two separate deals for one sale, (literally it is not allowed for two sales to be conducted in one). A Fatwa was tabled by the KFH on the subject (18) - it concluded that the action of taking a second hand car and cash in return for a new car did not constitute two deals but one deal, which is the buying of the new car; but the price is paid in two parts, the value of the car and the cash price agreed upon. If the customer decides not to take the new car then the whole deal, being a unified entity, is cancelled. The KFH has justified its dealings, to itself in that, for the whole deal, there should only be "one handshake"(19) before a successful outcome.

7.7 Murabaha in the Trade Department.

As described before, if the customer requests to buy an article that the KFH does not own, it may buy the article to resell to the customer. The areas in which the KFH specialises are cars, furniture, heavy equipment and construction materials. In 1985 these four items made up 81% of all Murabaha deals. In this year Murabaha sales were some KD 13 million up from the KD 9 million of 1985, that is a rise of 43%. By using contacts already gained in their direct trading operations the House can procure good price estimates and therefore give its customers a good deal. One of the most perplexing ideas is that a Murabaha deal can be struck for a car while the KFH has its own showrooms, even in some cases when the KFH has the same car in stock. The explanation lies in the fact that a person may see his/her desired car at a price which meant that even if he/she paid by Murabaha, he/she would pay less than if he/she bought direct from the KFH on a deferred payment basis. In 1987, when Murabaha sales increased by 46.6%, cars by themselves made up 70% of the total.

It is a proviso on all Murabaha deals that the customer is kept informed of any price negotiations being carried out, so that the profit can be altered accordingly. Full accountability is necessary to ensure that the Islamic law is adhered to.

7.8 Other Trade Department Services.

As a way of participating in the building of an Islamic society and providing its necessities, a programme was set up to import chicken slaughtered according to Islamic law. From this beginning new products were introduced in the local market - mainly meat products. Then, marketed under the name "Al-Safwa" (20), the products were distributed to the cooperative shops that are at the heart of Kuwait's retail food industry. Also in 1986 at Farwaniya a retail supermarket selling solely Al-Safwa goods was opened, having been built by the RPD. In the trade department this year rumour is rife that the supermarket is about to be closed down in favour of marketing the Al-Safwa products for sale by other retail outlets (21). The problem is that the supermarket is just too far out for a commodities store in an area which offers natural advantages for car showrooms and industrial sales.

Always looking for new opportunities, the department is marketing the products of some local factories such as the National Industries Company, and it has also acquired the agency for distributing some Iraqi commodities inside Kuwait.

More high profile than these operations are two shops or centres, which have extended consumer services in Kuwait. Firstly is the Prisunic shop and secondly the electronics showroom, which are both situated in the Al-Muthanna complex and have been very successful because of a lavish marketing programme. The electronics complex, the first of its kind in Kuwait, has all the latest Japanese Hifi systems and is unmatched in the Gulf.

7.9 The Trading Department's Contribution to the KFH body.

As a contributor to the profits of the House, the trading sector has grown in importance since the value of land in the Gulf has weakened considerably in the second half of the 1980s, and there are still many possibilities open in Kuwait. The importance attached to the department was evident in the fact that they offered high starting salaries to graduates who had done well at university especially in economics. One young person in the trading sector, who gained the economics prize at the University of Kuwait in 1988, was offered a higher salary than he was by all the other banks and so, naturally he took up the KFH's offer; he was put straight into the trade department.

The reason that this sector of the House's activities has not been covered so fully in this work is that the services it offers are mainly those of a very powerful trading establishment which it is hard to see in a purely banking context. This is the way forward for Islamic financial institutions, but it is to be hoped in the future that the skills attained in such dealing will be used in more of a consultative role, so that Islamic financial institutions become regulators of the economic system rather than aggressive protagonists inside it.

Notes.

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1. Explanatory brochure on the KFH. Printed 1984. Page 13.

2. Ibid.

3. The Islamic International Audio-Visual Company is a firm based in Egypt which produces Radio and T.V. programmes on Islamic issues.

4. Based in Egypt.

5. Interview with Mr. Adnan Al-Bahar, General Manager of the KFH. 4/4/89.

6. Its name in Turkish is "Kuveyt Turk Evkaf Finans Kurumu A.S."

7. This is one of the bigger Turkish banks, with which the KFH participated in this project. The actual section of the Turkiye Vakiflar Bankasi that put up the money, was the association for its retired employees.

8. This is the association that looks after Waqf land in Turkey.

9. Middle East Business and Banking Journal April 1989. pp 12-14. Interview with Mr. Fehmi_Akin, General Manager of the KTFH.

10. The Middle East Journal, February 1980, Issue No. 172. Page 28. Article on the KFH.

11. Mr. Jassar Al-Jassar, in the Investments Department at the KFH . Interview 8/4/89.

12. The Middle East Economic Survey. Vol. 32 No.22. 6/3/89. Page 7. "High Prices Deter Kuwait's Tanker Building Plan".

13. KFH Annual Report, 1988.

14. KFH Annual Report, 1982.

15. Almost all indigenous Kuwaitis have cars as do most of the other Arabs and Western ex-patriot workers. However, the unskilled workers from Asia and the Far East very rarely have cars and so are the only ones who use the buses and commercial taxis.

16. KFH Annual Report, 1987.

17. "Islamic Banking in Theory and Practice". M.E.M.S. Rabooy - Thesis at the University of Exeter - 1988.

18. "Shari'a Fatawa on Economic Problems" Part II (Arabic) - Page 33. Published by the KFH, 1983.

19. "Safqa" is the word for a handclasp or handshake which is said to seal any contract.

20. "Al-Safwa" means "the best", indicating the choicest cuts of meat.

21. Interview with Mr. Fawaz Sulaiman Al-Othman, Deputy Manager for Trading Operations at the KFH. 13/4/1989.

CHAPTER 8

The Performance of The Kuwait Finance House.

8.1 Social Values at the KFH.

8.2 Income and Net Profit.

8.3 Appropriations and Disbursements of Net Profit.

8.4 The Statutory and General Reserves.

8.5 Share Capital, Bonus Shares and Dividends.

8.6 Assets and Profitability.

8.7 Review of the KFH's Performance.

Notes.

8.1 Social Values At The Kuwait Finance House.

Unlike a normal western bank the KFH includes in its yearly accounts its social and cultural activities for the year; the reason for this is to prove further that the Kuwait Finance House is a 'caring' institution. The "disseminating (of) Islamic consciousness in order to enlighten to the Muslims their religious affairs" (1) is one of the stated aims. The English may be flawed, but the intention, quite clearly, is not.

The giving of Zakat, being one of the five pillars of Islam(2), is mentioned in the Qur'an: this means giving a portion of one's wealth to the poor to provide a social security system. In fact failure to give Zakat is seen as apostasy(3), as it is at the very core of Islam. In the Qur'an it is written;

"My mercy is spread on all things. So I shall write it for those who are righteous and give Zakat and believe in our signs." [Qur'an 7:156].

The aim is to alleviate the pressure on people to commit theft because of lack of the necessities of life: if a person commits a theft because society has not looked after him, that person is not punished (4), if there was no other way out of his/her predicament. The Shari'a demands that 2.5% of a persons savings should be given to the poor and needy for sustenance, and the KFH tries to adhere to this injunction as much as possible.

There exists at the KFH a Board of Directors Committee on Zakat, which provides assistance for Islamic institutions and societies to build schools, Mosques and clinics, and provides sustenance for needy people. Representatives of this committee attend many conferences on the payment of Zakat. For the period 1979-1987 KD 2,873,513 was saved for Zakat, and KD 2,811,833 of it was distributed to 2,896 beneficiaries (5). This means that in 1987 KD 360,223 was distributed: if this were to represent 2.5% of savings then that figure would equal KD 14,408,920, which is just over half the figure of KD 24,530,610 which represents net profit for 1987. Whether the last figure quoted should be that from which the Zakat is worked out is a debatable point, as not all net profit can be seen as savings, but it is nevertheless a good point of reference for the sum of Zakat disbursements paid out by the KFH.

The debate rages on, as the KFH sees itself as giving Zakat in other ways by renting out buildings at reasonable prices and so on. Therefore the cash payout of Zakat only represents a portion of the total payout. The debate centres on whether, in such cases as an investment/profit sharing account, the Zakat should be paid on the whole amount or just the profit. In the case of investment accounts a Fatwa, tabled by the KFH, says that both principal and profit are to be considered when paying out Zakat (6).

Another form of 'charity' which the KFH is involved in, is the giving of free loans (7) where only the original principal is to be paid back at a certain date. The number of these extended to customers is almost negligible as people must fulfill very stringent conditions in order to qualify, the least harsh of which is transferring their salary directly to the KFH. Since 1987 this service has been conducted through the Bait al-Zakat

(Zakat house), but the KFH still keeps a note of how much is disbursed. For the period 1979-1988 KD 992,799 was given in free loans to 690 customers, an amount which the KFH can easily afford in what is basically a public relations exercise.

There is a genuine belief within the KFH in Islamic morality, which is upheld by the Fatwa and Shari'a supervisory authority, consisting of Shaikh Bader 'Abd al-Basit, Dr. 'Abd al-Sattar Abu Ghuddah and Dr. Khalid al-Mathkur. These three learned gentlemen have to check any proposed action by the KFH, to approve or disapprove of it. They were instrumental in publishing the KFH Fatawa books, which are excellent reference manuals for all matters on Islamic finance; they are distributed free as a moral duty.

This leads on to the next section on the publishing side of the KFH, which prints many leaflets and pamphlets explaining the workings of the House. In 1983 a monthly magazine "Al-Nur" (8) was started, to form a new platform for discussion of the theoretical and practical aspects of Islamic economics. It is produced in a very glossy format, and includes articles on the KFH itself, the other Islamic banks, and other articles which are all linked by their Islamic theme. In 1985 the circulation was 2,000 per month, a figure which has risen four fold in three years to 8,000. Other publications include booklets on Riba, Bai' al-Ajal, Murabaha and personal finance.

The other social and cultural activities are mainly concerned with the disseminating of knowledge and the providing of advice to small and large customers alike. One way of doing this is by hosting and attending the conferences that now abound in the Islamic financial arena. This involves theoretical and practical discussions, whose details are filtered down to the KFH staff in training programmes, which are held in order to provide them with induction courses in Islamic banking.

In connection with this, the KFH was very proud to announce the approving of an Islamic economic curriculum at the Centre of Community and Continuing Education at Kuwait University. It is not however a mainstream subject for undergraduates, which must be the goal in order to encourage further study in this field. Whereas now students are taught economics from a western viewpoint, the aim of the KFH is to contribute to the providing of a course which will help students to immerse themselves in the Islamic economic theories.

In the future conferences will continue, as there does seem a genuine desire among the KFH staff to build for a world ruled by Islamic ideals. The role the KFH has to play, in a social sense, may well prove invaluable in moving towards a society where Islamic financial principles can be adhered to as a natural extension of the normal affairs of one's life.

8.2 Income and Net Profit.

Having covered all the major departments within the Kuwait Finance House the reader is now ready to see how the KFH has fared in its overall performance. It was noted how dependent the House was on income from its real estate involvements, and during the early 1980s income from the purchase and resale of property was especially significant. Property is now of less importance as the KFH has matured, out of necessity, into an institution drawing its strength from many different areas. In the Table on the following page it can be seen that aggregate income was at its highest in 1982, but declined in consonance with the growth patterns of Kuwait as a whole. Since then the aggregate income has been clawing its way back up, but is still some KD 17 million less than the 1982 level.

Until 1983 the commercial activities made up over 90% of all income, but in 1983 real estate prices fell and so did the KFH's overall income. In 1984 the turmoil in the Kuwaiti economy is reflected in the fact that banking activities income more than doubled from the previous year, and for the first time accounted for over 50% of all income. Since then banking and commercial activities have shared approximately equally in the profit.

The worst year in respect of overall profit was 1985, but since then income levels have attained their highest figure in the House's career, apart from the 1982 bumper year. There is evidence here that the Bank is maturing very well. In comparison with assets, income has stayed in line with other Kuwaiti banks. Assets have risen every year from a figure of KD 569 million in 1982 to KD 1,173 million in 1988. In 1982 the ratio of aggregate income to total assets was 1:11, whereas it is now 1:27, giving evidence of the decline in the whole Kuwaiti banking sector, and of the consolidation undertaken by the KFH to insure its future.

Table 8.1

The Aggregate Income of the KFH (All Amounts in KD) (9).

Year	Income from Banking Activities	Income from Commercial Activities	Total
1978	26,287	890,140	916,427
	2.9%	97.1%	100%
1979	370,531	4,302,272	4,672,803
	7.9%	92.1%	100%
1980	1,139,706	12,761,647	13,901,353
	8.0%	92.0%	100%
1981	1,569,985	32,444,453	34,014,438
	4.6%	95.4%	100%
1982	3,358,304	48,749,840	52,108,144
	6.4%	93.6%	100%
1983	9,907,505	32,175,569	42,083,074
	23.5%	76.5%	100%
1984	22,178,688	19,169,588	41,348,276
	53.6%	46.4%	100%
1985	13,798,099	12,896,189	26,694,288
	51.7%	48.3%	100%
1986	17,664,001	13,576,374	31,240,375
	56.5%	43.5%	100%
1987	17,242,540	17,976,749	35,219,289
	49.0%	51.0%	100%
1988	---	---	43,303,362

Source:KFH Annual Reports 1979-1988 (10).

The income having been accounted for, it is now essential to see the pattern in the figure for "Expenses and Provisions", before we assess the net profit and its disbursement. From Table 8.2 it can be noted that "General Administration and Salary Expenses" have risen every year except 1988, as staff levels have been constantly rising but are now tailing off. A rise in this area is only natural for a new bank, but the progress was almost halted in 1984, when the aforementioned figure rose only slightly.

"Provisions for losses and contingency" was higher than the general administration figure only in 1981 and 1984. The 1981 shock was because of a rise of 600% in the provisions for doubtful accounts, whereas the seemingly ludicrous figure for 1984 is because of the generally bad performance of all KFH assets, and the extraordinary need to set aside KD 28,496,509 for contingencies. It was necessary to write off a proportion of the non-performing assets, and many clients simply ran out of liquidity. Without government backing at this point the KFH would surely have had to fold.

With regard to the Suq al-Manakh affair, the Kuwait Finance House fared very well in comparison to the other banks. This was firstly because of the ideology of the bank, which decreases the possibility of lending on the basis of insecure plans, and secondly because the KFH was quick to make debt provisions in 1984, one year before the Gulf Bank, the Commercial Bank of Kuwait and the Burgan Bank (11). Therefore in 1985 the KFH was able to record a profit unlike the other named banks, although it must be remembered that these other banks did not have the same extensive commercial activities to soften the blow of 1984.

Table 8.2

Expenses and Provisions (All amounts in KD).

Year	General Administrination and Salary Expenses	Net Provision for Losses and Contingency	Total
1979	943,051	250,000	1,193,051
	79.0%	21.0%	100%
1980	2,330,651	1,887,646	4,218,287
	55.3%	44.7%	100%
1981	3,234,875	5,734,317	8,969,192
	36.0%	64.0%	100%
1982	5,081,625	1,135,017	6,216,642
	81.7%	18.3%	100%
1983	6,027,541	(667,164)	5,360,377
(12)	112.4%	(12.4%)2	100%
1984	7,214,949	34,133,327	41,348,276
	17.4%	82.6%	100%
1985	7,715,801	1,458,372	9,174,173
	84.1%	15.9%	100%
1986	9,642,830	1,032,677	10,675,507
	90.3%	9.7%	100%
1987	10,932,679	296,000	10,688,679
	97.2%	2.8%	100%
1988	9,734,652	3,334,421	13,069,073
	74.5%	25.5%	100%

Source: KFH Annual Reports 1978-1988.

Since 1985 "Expenses and Provisions" have been kept down to a figure of roughly KD 10 million as the subsidiary company, International Turnkey Systems Ltd, is now forecasted to make profit rather than loss (13). The rise in the 1988 overall figure, although larger than for previous years, presents no problem as total income has risen in proportion.

As the next Table 8.3 shows, the KFH has been profitable every year and so has been able to reward its shareholders and depositors accordingly, except in 1984 when all the income was needed for the bank to keep its head above water. The pattern of net returns is much the same as that of aggregate income, showing the highest net return in 1982 and the lowest net return (apart from the initial three years and 1984) in 1985 when the rebuilding started. The figure is now almost back up to the same level as in the early 1980s, but the bank is now less reliant on one area of its activities, and can therefore be viewed as being more stable. There have been three stages in the development of the bank which can be clearly seen from Table 8.3: the first stage was of heady growth from 1978-1983; the second stage was 1983-84, and the third stage is 1985 until the present day and onwards. On the very recent past Mr. Khalid al-Budai said in February 1989;

"[Last year] we had some local debt expenses, but substantially less than other banks in Kuwait. Our provisions for doubtful accounts (in Murabaha) totalled only KD 11.33 million last year, and this year it will be much less."(14)

From this quotation it can be seen that the KFH looks to increase its net profit in 1989 and continue on its path to former profitability levels.

Table 8.3

Net Profit (KD) (15)

1980	9,683,066
1981	25,045,246
1982	45,891,052
1983	36,722,367
1984	Zero
1985	17,520,115
1986	20,564,868
1987	24,530,610
1988	30,234,269

8.3 Appropriations and Disbursements of Net Profit.

The net profit realised is normally distributed to five different areas and groups of people. Firstly there are the transfers to the Statutory and General Reserves which will be discussed in detail in the next section on "Shareholder's Equity". Secondly there is the "Contribution to the Kuwait Foundation for the Advancement of Sciences (KFAS)", and thirdly there are the directors fees. Then finally the investors in the bank, the depositors and shareholders, are allocated their share.

From the second annual report in 1979, the KFH showed its support for the KFAS. The original method of allocating money to the KFAS was worked out as follows:

Net Profit for the Year

Less: Transfer to the Statutory Reserve

Less: Distribution of Profit to Deposit and Savings Accounts.

Then 5% of the total achieved would be contributed to the KFAS (16).

This sort of arrangement is vindicated by Sami Hassan Homoud in his book "Islamic Banking";

"It is permissible to set aside part of the profit for a certain specified party other than those involved in the investment."(17)

The formula arrived at for the disbursement was deemed fair, as it was dependent on allocation of profit to those actually involved in the action of investing, and the KFAS was supported with the full knowledge of all depositors. The KFH has kept up this level of contribution except for 1984 when there was no profit to disburse.

The directors share of net profit has always been spread between ten people of whom seven or eight are ordinary members, and above whom Ahmed Bazi al-Yasin has presided as chairman since the beginning. The figure allocated has always been a round ten thousand Kuwaiti Dinar.

The figures reflect roughly the profitability of the House except in 1985, when, despite lower net profit than in 1983, the directors received a higher share of the profits. From a fleeting glance at the figures it seems that the directors fees are decided according to no set formula, being totally at the mercy of the management, however the amounts decided on are not unjust (18).

Table 8.4

Year	Directors' Fees(KD) (19)	Directors' Fees as % of Net Profit.
1979	40,000	1.1%
1980	80,000	0.8%
1981	80,000	0.3%
1982	80,000	0.2%
1983	60,000	0.2%
1984	Zero	--
1985	50,000	0.3%
1986	40,000	0.2%
1987	40,000	0.2%
1988	50,000	0.2%

The share of the depositors and investors in the bank is gained by dint of their being Rabb Al-Mal of the money which they have given the bank the authority to invest. In a sense the returns to investors should not be affected by the activities of the other banks in Kuwait, because the profit to be distributed is not dependent on imposed interest rates. However outside factors do influence the appropriations, because the House must offer a competitive investment package to stop people reverting to the commercial banks (20). In Kuwait a person may choose to use a western-style bank or an Islamic one, and some people, not motivated by religion, will simply use the one offering the best returns.

The KFH has to balance the share given to the shareholders (in the way of a dividend or a bonus share issue) against that given to depositors. Both sorts of investors are given a certain percentage of the profits which is at the discretion of the Board, to be agreed upon at the General Assembly.

To deal firstly with the depositors; earlier it was noted that there are three kinds of investment deposits for customers to choose from. Below is a breakdown of how much of these deposits is invested;

Table 8.5

Type of Investment Deposit	Percentage of the Amount Invested
Savings Account	60%
Fixed Time Deposit	80%
Continuous Time Deposit	90%

Therefore the ratio between the three deposits should always be 6:8:9. The basis for the difference in the percentage invested, is the fact that the Savings Account must be the most liquid and the Continuous Time Deposit the least liquid. The depositor is rewarded for his/her trust in the Bank if he/she decides to use an inflexible deposit system, so that someone with a continuous time deposit account will gain a larger percentage share in the profit than both the other sorts of account holders (21).

According to the 1983 explanatory brochure (22), the depositors take a share of the returns on investment. The brochure explains the system thus: if X % represents the rate of return on investment, then the rate of return on continuous time deposits is X% x 90%, the rate of return on fixed time deposits is X% x 80% and the rate of return on saving accounts is X% x 60%. Thus the 6:8:9 ratio reflects the ratios invested from each type of fund.

Table 8.6

Rates of Return on Investment Accounts (23).

Year	Investment Savings Accounts	Fixed Time Investment Accounts	Unlimited Time Investment Accounts
1980	6.75%	9.00%	10.12%
1981	9.00%	12.00%	13.50%
1982	8.00%	10.65%	12.00%
1983	5.00%	6.67%	7.50%
1984	---	---	---
1985	2.66%	3.55%	4.00%
1986	3.50%	4.67%	5.25%
1987	3.60%	4.80%	5.40%
1988	3.70%	4.62%	5.50%

Table 8.6 shows the fortunes of the Kuwait Finance House. As in all other aspects of the House's finances, 1982 was the best year before the Suq al-Manakh affair devastated the economy, but

the rate of return has been increasing steadily since 1985. In comparison with the commercial banks, whose deposit rate depends on the discount rate set by the Central Bank of Kuwait, the returns of the past few years have not been as competitive as was hoped. For the financial year 1987/88 the discount rate was set at 5.5% therefore the deposit rates were the following:

Deposits of one month to 90 days = Discount rate = 5.5%

Deposits of 91 to 180 days = Discount rate +0.5%=6%

Deposits of more than 180 days = Discount rate + 1%=6.5%

The depositor rate at the KFH was slightly lower than this, and with the discount rate set at 7.5% (24) for this year the KFH will need to realise a substantial rise in profits in order to compete with the rates offered by its competitors in the banking sector.

The shareholder's return will be discussed later in this chapter.

8.4 The Statutory and General Reserves.

In the 1983 explanatory brochure it is simply stated that "10% (of profit) is allocated to the statutory reserve and 10% to the general reserve. This 20% represents the share of the KFH as managing partner of the investments."(25) This all seems very simple but, as with anything in banking, this is far from the truth.

Firstly to deal with the statutory reserve. "The statutory reserve shall not be distributed among shareholders but may be used to secure distribution among shareholders of dividends amounting to five percent, in such years where the profits of the company do not facilitate distribution up to such a percentage. If the statutory reserve exceeds half the capital of the Company, the General Assembly may decide to discontinue deductions or to use the excess amount in such manner as it deems appropriate and in the interest of the Company and its shareholders."(27) Below it is possible to observe the progress of the statutory reserve.

1978		
Total (10% of net profit)	KD	52,966
1979		
Balance from Previous Year	KD	52,966
+10% of Net Profit	KD	347,975
Total	KD	400,941
1980		
Balance from Previous Year	KD	400,941
+10% of Net Profit	KD	968,306
Total	KD	1,369,247

1981

Balance from Previous Year	KD 1,369,247
+10% of Net Profit	KD 2,504,525
Total	KD 3,873,772

1982

Balance from Previous Year	KD 3,873,772
+10% of Net Profit	KD 4,589,150
+Premium on issue of shares	KD 4,328,054
Total	KD 12,790,976

1983

Balance from Previous Year	KD 12,790,976
+2.5% of Net Profit	KD 887,715
Total	KD 13,678,691

1984

Balance from Previous Year	KD 13,678,691
No Transfer	
Total	KD 13,678,691

1985

Total	KD 13,678,691

1986

Balance from Previous Year	KD 13,678,691
+c. 4.5% Net Profit	KD 935,063
Total	KD 14,613,754

1987

Balance from Previous Year	KD 14,613,754
+c. 5% of Net Profit	KD 1,285,713
Total	KD 15,899,467

1988

Balance from Previous Year	KD 15,899,467
+c. 5% of Net Profit	KD 1,504,284
Total	KD 17,403,751

Until 1982 the statutory reserve was quite straightforward, but in that year the Board of Directors decided to add to it the share premium to bring it to roughly half the capital of the company. This move was approved at the General Assembly as the first move in arranging contingency plans. From 1983-1988 the amounts transferred have been less than 10% of net profit, and in the 1985 Annual Report there is this explanatory note;

"In accordance with the Articles of Association and the Law of Commercial Companies the Company has resolved to discontinue the annual transfer of 10% net income for the year as the reserve is now 50% of share capital" (27). Since that date transfers have been made to the statutory reserve, but only to keep it at 50% of the value of the company's capital.

The idea behind the statutory reserve is as an insurance for the dividend of the shareholders. In 1984 when the statutory reserve should have been brought into play the shareholders voted to accept no dividend in order to facilitate the restructuring needed. This was witness to the fact that the shareholders are willing to give the House time to prove itself, and that they are prepared to forgo personal gain for the future success of the Islamic banking experience in Kuwait.

Originally it was intended that the general reserve would be a fund over whose distributions there were no restrictions. Its components made up a fund which the KFH could disburse as it desired, and were specially formulated so that the KFH could pay the 2.5% Zakat. Below it is possible to follow the progress of the General Reserve.

1978		
Total (10% of Net Profit)	KD	52,966
1979		
Balance from Previous year	KD	52,966
+10% of Net Profit	KD	347,475
-Zakat Paid	(KD	2,648)
Total	KD	398,293
1980		
Balance from Previous year	KD	398,293
+10% of Net Profit	KD	968,306
-Zakat paid	(KD	19,981)
Total	KD	1,346,618

1981

Balance from Previous Year	KD 1,434,284
+10% Net Profit	KD 2,504,525
+Reserve Accounts Share of Net Profit	KD 410,016
+Proposed Dividend	KD 369,144
-Zakat paid	(KD 70,088)
Total	KD 4,647,881

1982

Balance from Previous Year	KD 4,647,881
+10% of Net Profit	KD 4,589,150
+Reserve Account Share of Net Profit	KD 1,306,694
+Proposed Dividend	KD 498,651
-Zakat	(KD 213,041)
-Bonus issue cover	(KD 2,953,152)
Total	KD 7,876,152

1983

Balance from Previous Year	KD 4,135,928
No Transfer from Net Profit	None
-Money given to Provide Cash Dividend	(KD 814,391)
-Zakat	(KD 516,455)
Total	KD 2,805,082

1984

Balance for Previous Year	KD 2,805,082
-Zakat	(KD 410,261)
Total	KD 2,394,821

1985

Balance from Previous Year	KD 2,394,821
-Zakat	(KD 401,837)
-Amount for Proposed Bonus Shares	(KD 343,967)
Total	KD 1,649,017

1986

Balance from Previous Year	KD 1,649,017
-Transfer to Retained Earnings	(KD 875,000)
-Zakat	(KD 391,793)
Total	KD 382,224

1987

Balance from Previous Year	KD 382,224
+Transfer from Profit of	
1) Al-Muthanna	KD 365,565
2) Net Profit	KD 184,304
-Zakat	(KD 373,398)
Total	KD 558,695

1988

Balance from Previous Year	KD 588,695
+Net Profit Transfer	KD 1,026,901
-Zakat	(KD 365,564
Total	KD 1,220,032

The first thing to note in the above figures is the discrepancy between 1980's total and 1981's balance from the previous year. The increase of KD 87,666 is because in the 1980 report "The reserve accounts share of the net profit" was not included in the general reserve, whereas in 1981 the board decided to begin allocating to the general reserve the share of the profits realised by the fully invested funds of the reserve accounts (ie. The statutory and general reserves). This was worked out at the same rate as that applied to the share capital as both are 100% invested.

Zakat has been paid every year at 2.5% for the first few years, but since then the amount has been less then 2.5% of net profit every year. In 1981 the board proposed, and the shareholders agreed, that of the proposed dividend a certain amount should be transferred to the general reserve to bolster it.

In 1982 again a sum was transferred to the general reserve from the dividend, but a sum of KD 2,953,152 was deducted to fund a bonus share issue (see section 8.5). The discrepancy between the 1982 total and the 1983 "Balance from the Previous Year" is because KD 3,740,255 was taken for the "Proposed dividend to shareholders". In this year the board recommended and the General Assembly agreed to a cash dividend of 20%. The shortfall was made up from the general reserve and the reserve accounts share of net profit, which had previously been deposited in the general reserve. A further KD 814,391 was taken from the general reserve to provide a cash dividend.

In 1984 the fund remained the same, apart from the payment of Zakat, even though no profit was realised. Also in this year the board clarified the situation as regards transfer of net profit to the general reserve.

"In accordance with the Company's Articles of Association, the directors have decided not to transfer 10% of net profit to the general reserve this year." (28) No reason was given, but the desire to offer returns to investors and directors alike must have played a major part in the decision. Bonus shares were approved to please the shareholders, and some money had to be diverted from the general reserve.

1986 again saw no transfer from net profits to this reserve fund which was again depleted by an KD 875,000 transfer to strengthen retained earnings. However no money was taken out to provide bonus shares, as the profit from the Al-Muthanna complex took over that role. In the next year transferrals from net profit were re-started, but at a lower rate than in the first years of the House's existence. In 1988, in very similar conditions to the year before, the general reserve was sustained by a roughly 1% share of net profit.

The 1988 total of general reserve funds is evidence of the struggle that the KFH has had in the last few years to reward its investors. On the other hand this fund is to be distributed in a way that will benefit the bank as much as possible, so that if its funds are almost totally used up, it is a sign that the KFH is unwilling to let any of its funds lie stagnant in order to provide a safety net.

8.5 Share Capital, Bonus Shares and Dividends.

The original authorisation for shares was 10,000,000 shares at KD 1 each (29). This has been raised periodically so that the value of all the shares held is now KD 26,151,393. In 1987 each share of KD 1 was divided into ten of KD 0.1 (100 Fils)(30), so that 261,513,930 shares are now authorised and fully paid up. These represent 1.5% of total liabilities, much less than in the mid 1980s, when the average was about 5%. From this we can deduce that share capital has grown at a lesser rate than liabilities, pointing to a large increase in depositors rather than shareholders. Although the share capital has increased, the stakes in the capital have remained the same: that is to say the ministry of finance still holds 20%, the Minister of Justice 20%, the Ministry of Awqaf 9% and the Private Sector 51% (31).

The KFH has defined two ways of giving reward to its shareholders: firstly by offering them bonus shares, and secondly by paying out a cash dividend. Each year the rate of return on investments is worked out and the rate of return on shareholders money is the same. This ensures that the shareholders always gain a slightly higher reward than the depositors, because of the higher risk that the shareholders take. This risk consists of the fact that in case of bankruptcy, the depositors would be assured of a return of some of their money, but the shareholder has very little such assurance (32).

From 1978-1983 the House concentrated on assuring a cash dividend for its shareholders. In 1984 it offered no dividend and then for the years 1985 to 1987 inclusive bonus shares were issued but no dividend. Only in 1988 were both bonus shares and a cash dividend proffered in the same year.

The years 1985, 1986 and 1987 saw bonus shares issued at 10%, 12.5% and 13% respectively (That means in 1985 one bonus share was issued for every ten held, in 1986 one bonus share was issued for every eight held and in 1987 one bonus share was issued for every 7.5 held). This was in order to provide a wider base for expansion and to make the share capital higher in proportion to the total liabilities (33), so that the boat should not be too heavily weighted on the depositors side.

In 1988 shareholders were rewarded with the bonus shares and a cash dividend. Of the KD 3,399,681 to be distributed to the shareholders KD 2,353,625 was given in bonus shares and KD 1,046,056 was given as a dividend. The figure of KD 3,399,681 was made up of:

1) Profits attributable to shares (6.16%) KD 1,612,756

2) Profits attributable to reserve accounts (6.16%) KD 992,430

3) The Net Profit of the Al-Muthanna complex after the Transfer to the general reserve KD 794,495.

It is stated in the report that the profit generated by the Al-Muthanna complex is solely for the shareholders, so how is it possible to defend the transfer to the general reserve in 1988? One answer is that it may be of indirect benefit to the shareholders as it is in the general interest of the KFH that the money is transferred.

8.6 Assets and Profitability.

The assets of the KFH have grown steadily every year, except 1984 when there was only a slight drop. Since 1984 assets have risen by 32% to KD 1,173 million in 1988, but the real mark of success is a rising profitabilty. Let us take as a mark of profitability the net profit divided by the assets, to leave a percentage which represents the profitability of the House.

Table 8.7

Profitability of the KFH

1980	5.7%
1981	7.1%
1982	8.0%
1983	4.6%
1984	----
1985	2.2%
1986	2.4%
1987	2.3%
1988	2.6%

There has been a recovery since 1984 but an average profitability of 2.375% does not augur well, even though the figure is slowly rising.

8.7 Review of the KFH's Performance.

This has been a review of the KFH accounts which gives evidence of prudent management since 1984. Profitability has been kept low in order to keep liquidity high, which maintains the confidence of the depositors. This shows a conservatism which has been necessary in the past few years, because of the lack of a developed Islamic inter-bank market. However new opportunities have arisen to deposit some of this idle liquidity in other Islamic banks, and the IDB opened a special deposit fund in 1987, which may blossom into a fully-fledged interbank market (34).

The shareholders have kept faith with the KFH partly because the shares are very little traded, and partly because most of them realise the experimental nature of the venture; they do however hope for substantial gains in the next few years. The above review shows a revitalised Kuwait Finance House ready to expand into the 1990s and beyond, "In sha'a Allah" (God willing).

Notes.

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1. KFH Annual Report,1980. Page 13.
2. The others being prayer, fasting during the month of Ramadan, the performing of the Hajj, and the saying of the Shahada: "There is no God but Allah and Muhammad is the messenger of God."
3. Apostasy also includes the non-performance of the above five pillars of Islam.
4. This is in keeping with the decision of the Caliph 'Umar b. Al-Khattab not to punish those accused of theft in time of famine in Medina in the first century after the Hijra.
5. For 1988 only the total amount distributed was available, therefore the 1987 figures were used.
6. For all the Fatawa on Zakat published by the KFH, See Part II of "Shari'a Fatawa in Economic issues" published by the KFH (Arabic), pp 167-172.
7. The Arabic name being "Qard Hassan".
8. This means "The Light" and signifies the light which leads one on the straight path towards Allah (Al-Sirat al-Mustaqim).
9. From the Annual Reports, 1979-1988.
10. In the 1988 Annual Report the income was not divided between Banking and Commercial Activities. Only net rental income was quoted separately, therefore it is very difficult to make a comparison with former years.

11. Volker Nienhaus, "The Performance of Islamic Banks: Trends and Cases" "Islamic Law and Finance." page 153. Published by Graham and Trotman, 1988.

12. This was a special year in which "Expenses and Provisions" included a figure of KD 1,454,417 for "Provision no longer required for decline in value of investments" and a figure of KD 188,266 for "Provision no longer required for absolute and slow moving inventory and anticipated losses on uncompleted contracts". This means that, after taking into account provision for losses there was a profit of KD 667,164.

13. Annual Report 1988, page 22.

14. Journal of the Middle East. Issue No. 172, Page 28. Mr. Khalid Budai is one of the Assistant General Managers of the KFH.

15. See note 1.

16. Annual Report 1979. Page 39.

17. Sami Hassan Homoud "Islamic Banking", page 249-256. Published by Arabia Information, London 1985.

18. At this point it is appropriate to point out that the wages of the House's personnel and management are counted as expenses and not approprations: that is they are deducted before the profit makers get their share.

19. See note 1.

20. See Dr. R. Wilson. "Islamic Banking in a consumer society." Page 18.

21. op.cit. Sami Hassan Homoud. For methods of calculating returns on deposits. Page 255.

22. Explanatory Brochure. "The Kuwait Finance House", Page 19. Published by the KFH, 1984.

23. See Note 1.

24. Interview with Muhammad Haydar al-Ghulum.

25. See note 13.

26. " The Kuwait Finance House: Memorandum of Agreement and Articles of Association". Page 32.

27. Annual Report 1985,page 24.

28. Ibid.

29. op.cit. "The Kuwait Finance House: Memorandum of Agreement Articles of Association". Page 16.

30. Annual Report 1987, page 37.

31. op.cit. Explanatory Brochure. page 37

32. op.cit. Dr. R. Wilson. Page 17.

33. Interview with Mr. Zuhair Bibu. 30/3/89.

34. op.cit. Dr. R. Wilson. Page 18.

CHAPTER 9

The Future of the Kuwait Finance House.

9.1 The KFH and Venture Capital.

One problem pinpointed in the above study has been the lack of risk capital available in an Islamic bank, in this case the Kuwait Finance House. The instruments of Mudaraba and Musharaka, described in the very first chapter, seem to correspond with the actions of the Western Venture Capitalists, which were described in chapter 2. There are fundamental differences, such as the fact that a venture capitalist can rely on loan capital as well as equity participation, and he also looks to have a minority shareholding whilst being the lead-manager. These differences, however, cannot mask the fact that venture capitalists do encourage growth in a way that Islamic banks would do well to emulate.

In general, most Islamic banks regard encouragement of growth as their main aim, but show very little regard for laying the foundations for long term, therefore, stable investments. Only the Feisal Islamic Bank (FIB), Egypt, the Jordanian Finance House and the Jordan Islamic Bank have had success in fostering development (mainly in industry and agriculture) in countries where they are not given too much government support. The Feisal Islamic Bank, Sudan has also had success in encouraging small businesses in order to widen the base of the economy.

The funds at the KFH's disposal are of necessity short-term because of the depositors' needs. The high liquidity rate, higher than conventional banks, is unavoidable without a Central Bank to orchestrate liquidity levels by bond issues (1) (2): this means that investments with a maturity of five or more years are very difficult to sustain. In the 'Tanker Fund' the KFH is solving the problem by lead-managing a broad spectrum of investors in a plan which reaps stable gains; however it has not led directly to the formation of new business. The venture capitalists seek to form new businesses in order to benefit society's flexible development, whereas the KFH's investments have so far been in money-management rather than trade encouragement.

The private sector must be built up by an Islamic system just as it has been in Pakistan. Pakistan now has a wholly Islamic financial system whose effect on the private sector has been very pleasing to behold; in the four years preceding Islamisation the private sector doubled from Rupees 1.5 billion to Rupees 3 billion, but in 1984/85, only one year after Islamisation, it went up by almost 50% to Rupees 4.2 billion. This is in a totally Islamic financial system, where legislation is obviously favourable, but the situation is totally different in an interest-based economy (3).

The problem for institutions such as the KFH is, that to manage risk capital, one needs specialists in the field of investment envisaged. This has been proved in the West, where firms prefer to have specialists in a small number of fields, rather than a whole host of generalists. However, many started out with no intended specialisation, just like the KFH, but drifted into one area because of the successful accomplishment of two or three plans in one arena of industry or agriculture or mining. Once the specialisation is decided on, and a financial institution becomes known for its work in that field, its job of attracting worthy projects becomes much easier.

The problems are of difficulty in finding the expertise necessary, and in being able to offer an individual, interested in participating with the Islamic financial institution, unconditional liquidity in times of trouble. To offer back-up capital after the initial outlay is essential in instilling confidence in the private sector. Another consideration of the KFH is moral responsibility, which prohibits them engaging in any business which they believe does not conform to Islamic ideals. Thus the Mudaraba deals, discussed in Chapter 5 of this study, were rejected because of moral considerations as well as commercial ones.

Can venture capitalism be seen as equivalent to the profit and loss sharing ideals of many Islamic financial scholars? Do the two systems share the same goal of desire to encourage small and medium sized business (SMB) growth? In the case of the KFH, the second question is particularly relevant for the internal economy of the state, which has been ruled since the middle of this century by the public institutions and massive family owned conglomerates. SMB growth requires a personnel hungry for personal gain, of which they will have been starved; but this personnel does not exist in Kuwait as it does in the West. Countries such as America, Britain and France have great numbers of unemployed people, hungry to generate their own profits, whereas in Kuwait it has been government policy to pander to people so they are not starved of anything. The supply of entrepreneurs, full of vitality and new ideas, has been stifled by the easy life offered to them. In short, there has been no incentive, but now the incentives must be offered to small or medium sized entrepreneurs in order to help Kuwait into adulthood. The internal aim of the Kuwaiti government should be to encourage small and medium sized businesses in order to revitalise the economy, by making people more accountable for their own standard of living. In the previous sections we have noted how the Central Bank of Kuwait has pushed for accountability in the financial sector: this is the same path that must be followed in the private, productive sector. The KFH is in a good position to lead people on to this path through Islam.

9.2 Problems in Islamically Funding Venture Capital.

The first stage in any long term commercial investment is finding and funding research on an idea, and then providing enough capital to carry the idea through to production. In this period there is no gain for any party involved, and the risks are legion: risk in the marketability of the products, risk in the management chosen and risk in the inherent lack of liquidity.

The KFH would want to confirm a "hands on" attitude in any investment, because this would be their only insurance against loss of equity capital. This is very akin to the sharing of responsibility envisaged in a Musharaka deal, which would necessitate a great extension in staffing levels, which the KFH would find inordinately large and prohibitive. A "hands off" agreement would be more akin to a Mudaraba deal, where the major investor takes a re-active, rather than pro-active role; it is a more efficient way of keeping interested in many projects, because the monitoring costs are a lot less.

In our earlier study of venture capital we identified two main movers in the contract, the major financier and the lead-manager. The point has been introduced in Chapter 7, that the KFH should become more of a regulator of the system rather than a main protagonist in it. This was a view expressed by Dr. Ja'far at the university of Kuwait, who saw the future role of the KFH as a deal-maker among Islamic investors (4). For this role a system of commission would have to be instituted, because the House is in essence a commercial venture making profit from Islamically honest trade. As a regulatory body investing small sums in varied projects, the KFH could develop into the focal point of an Islamic economy, which may well be formed in Kuwait as a reaction to dwindling oil revenues in the not-too-distant future.

In a typical venture capital deal to finance a project, 60% of the capital is made up in interest bearing loans, 5% in management contributions to equity and 35% in venturist equity capital. Only just over one third of the capital is put up by outside investors on a 'profit-sharing' basis : this is a fact that shows how much emphasis is put on being able to gain profit by riba. Islamic banks could offer a Qard Hassan, and structure their equity returns to escalate in order to make up for lack of definite return, so that in a successful venture, profit would come gradually over ten to fifteen years. The problem remains of losses following an unsuccessful venture : this is where government funds, instead of being directed to avoiding making people pay any tax, should be used to secure the system. The Amiri Decree, which was gained at the founding of the Kuwait Finance House (5), shows substantial government support for the experiment, but its concentration has lately been directed at setting right the country's economy by introducing instruments of control which were developed by western economists . This has probably set back the development of Islamic finance in Kuwait by about ten years.

The government can be prodded into action, however, and the forming of a wholly new department in the KFH (apart from the credit and investment departments) to deal with venture capitalism should be discussed. Credit managers are at the moment trying to regulate the Murabaha deals, when they should really be set free from everyday profit-earning activities, in order to form a body inside the House, which seeks ways of finding insurance in the risky world of SMB growth.

This idea fits in with the decentralisation process mentioned by Mr. Adnan al-Bahar when intervìwed (6). An article by Dr. H. Kabbara deals in detail with the need to promote National Development Finance Institutions (NDFIs) to finance industry in cooperation with Islamic banks, as both would have the same objectives and a specified role to play. One suggestion is that the NDFIs could be used in the start-up stages, and an Islamic bank could provide the back-up capital in the middle stages of growth (7).

At this point it is fitting to mention the government's possible contribution. It was noted that moves to establish a venture capital industry in the U.S.A. in the 1960s failed because of a lack of government support. Now private individuals are given incentives to invest their money in innovative schemes by dint of the governemnt offering tax incentive deals. This model has been followed in Britain in the Business expansion schemes (BES).

How can the Kuwaiti government give the personal investor the courage to invest in a venture capital industry run through the Kuwait Finance House? What allowances can be made to investors? For the present it is impossible to 'incentivise' by preferential tax treatment, although this method could come to the fore in the 1990s. One strategy would be to offer a potential investor a non-interest bearing loan, if he/she committed so much capital to a venture capital fund - his/her contribution could rise or fall annually depending on the state of his/her own investment. This would lead to a gradual building up of funds : the government would have to lay out a very large original sum (maybe coming from the Reserve Fund for Future Generations (RFFG)), but as the scheme would grow so would its reserve of private funds.

Government involvement is of the essence, that is why it is possible to see the KFH as an instrument of a government initiative. The main chink in the armour of this plan is that it could be seen by people as a tax on risk-taking, and it also requires a substantial amount of capital from the entrepreneur; however the ideas must come from the small entrepreneurs, who may be contracted to the big companies, and those entrepreneurs must show confidence in their own ability by backing themselves. An entrepreneur who is not prepared to back him/herself, should not be supported.

This brings us again to the problem of how a person with no money can bring to fruition his skill in business. The solution here is to canvass big firms to support new ideas on a contractual basis, and use the SMBs that would be created as a 'window-on-technology and advancement' (See Chapter 2). As a regulator of this sort of initiative, the KFH could be a major influence in the present financial restructuring in Kuwait.

There is one further problem created by the Suq al-Manakh affair. Stock market trading in Kuwait was substantially hit, and trading remains to this day very slack. The perfect end to a venture, sponsored by venture capital in the West, is a full listing on the stock exchange in order to realise the largest profit possible. The liquidifying of assets is therefore a problem for the prospective Kuwaiti venture capitalists. This situation will only change as a consequence of renewed confidence, which the government is trying to foster; however this renewing of confidence is not encouraging new ventures and so we have come full circle. The circle can, and will only be broken, when confidence is restored, which is not a short-term likelihood.

9.3 The KFH Future Planning.

The general direction of the KFH was summed up by Mr. Adnan al-Bahar when he referred to four essentials for continuing success. Firstly he addressed the need for a three year plan of action. This plan was to stress expansion abroad, especially in trade and in forming concrete links with as many countries as possible. He realised the need to go beyond the locally overbanked market, so it is possible to envisage the KFH spreading its wings in a country like Jordan, which is being denied income from the Gulf as the number of Jordanians (or Palestinians) in countries such as Kuwait is decreasing. For this reason it is necessary to keep on developing the departments already existing, while auspicating a venture capital department to encourage new money in denuded countries. Kuwaiti money could help development on a wider scale.

Secondly Mr. Bahar referred to the development of manpower training in order to equip the KFH with suitable personnel particularly in the middle management. Increasingly recruitment is from among Kuwaiti nationals in compliance with government policy. In 1988 the KFH was recognised as the largest employer among the Islamic banks, with only the Feisal Islamic Bank of Egypt being within 300 of the KFH staff total of 1,300(8). In ten years this number has increased almost twenty fold, and only in 1985 and 1986 did recruitment fall below one hundred. The staff are sent on specially devised training courses "as they are the only way to ensure the continuing success of the KFH" (9).

Thirdly the process of decentralisation is a major issue. This is a move to encourage a quicker, more efficient, decision making service. It also has the effect of giving middle management more responsibility and more pride in a department. The final way of directing future actions is detailed budgeting to decide how much man-power to put into one area. There will be a rise in the number of staff employed in the credit and trade departments, but banking activities will need less monitoring as more high-tech machinery is installed.

Turkey is obviously a hope for the future. At the moment the KTFH is still working its way into the Turkish financial system. The only black-spot on the horizon is the fact that Turkey already has three Islamic banks with which the KTFH will have to fight for Islamically motivated depositors and investors. The KFH has no experience in this field of competition and will have to rely heavily on the experience of the employees trained in conventional banks, who are used to the 'game' of winning over customers.

Involvement abroad will also be sought in more direct trade and more financing of import-export trade. In fact this should become the KFH's most profitable tool in the near future, although it would be preferable, from the view of experimental Islamic banking, if encouragement capital were to become the most successful tool.

The search for new financial products is a major concern. The KFH has made the first steps in the tanker fund and in the real estate portfolios, which show that innovation is possible. The next step in this direction will be a form of Islamic unit trust to offer an alternative mode of investments for small investors.

The so-called investment auctioning presaged in the eleventh report of the elimination of interest in Pakistan offers the chance for industry encouragement. The idea rests on forming a consortium between banks and investment institutions with the objectives of initiating and promoting industrial projects. The consortium would study a certain proposal, prepare a final report, and then invite bids for the contract, which is awarded to the most deserving bidder: the consortium would then reap its gain by means of a service charge. This fits in with the venture capital aspirations that many people (including the author) have for Islamic banks (10).

On the agenda for development is the forming of a life insurance instrument (11). This is seemingly an idea which goes against Islamic morality, but whose development is being actively encouraged by practical economists. One company participating in research is the Islamic Investment Company of the Gulf. It offers a deal whereby a client buys a certificate worth $20,000, paid in annual installments of $1,000, so it matures in twenty years with such profits or losses as have been realised from the invested money. If the holder dies before twenty years, the full face value (ie. $20,000) is recoverable as well as any profits made up to that time. The certificate holder expressly agrees to relinquish a portion of his/her profits in proportion to his/her participation, as a contribution to effect payment of the installments remaining until maturity for any deceased person. This system is a start, but seems to punish a certificate holder for the death of the original subscriber, therefore it is a system which must be refined.

Above are suggestions for refinements to the system already functioning at the KFH. The new paths to be followed must be researched with the other Islamic banks, so that the new instruments offered take on a standard form, and so that different institutions can benefit from each other's experience and knowledge.

Notes.

1. Dr. H. Kabbara, "Islamic Banks and Industrial Financing". In the journal "Finance and Industry", No.9 1988, published by the Industrial Bank of Kuwait.
2. Interview with Mr. Adnan al-Bahar, General Manager of the KFH 4/4/89.
3. op.cit. Dr. H. Kabbara.
4. Interview with Dr. Ja'far Hajji, lecturer in Economics at the University of Kuwait.
5. (Amiri) Decree Law No.72, 1977. "Licensing Establishment of A Kuwaiti Shareholding Company, Named 'Kuwait Finance House'".
6. op.cit. Interview with Mr. Adnan al-Bahar.
7. op.cit. Dr. H. Kabbara.
8. Table published by "The Banker", 1989.
9. op.cit. Interview with Mr. Adnan al-Bahar.
10. op.cit. Dr. H. Kabbara.
11. "The Islamic World Review", September 1982. pp 33-56

CONCLUSION

In concluding it is to be remarked upon that there are two sets of factors affecting the future of the Kuwait Finance House. Firstly how it should adapt internally and secondly how the system it works in should adapt.

Internally it remains an all-purpose bank trying to offer everything to everyone; investment opportunities, banking services, trade finance and real estate purchase. It has to offer all these services in order to form a broad base for survival, in what is still an experimental period. In doing so it is in danger of becoming 'a Jack of all trades, master of none', providing too many services under one roof. The decentralisation talked of as a major policy direction of the next three years, may lead to the different sections of the Bank becoming more distinct from each other, each one finding a separate identity. At this stage the idea is to keep all services under central management, but as specialist niches are found, it is foreseeable in the next twenty or thirty years that the different sections will be connected only by name.

All sections of the bank look healthy now, with the possibilities in investment offering the greatest hope. Direct trade carried out on such a large scale is sure to do well, as is banking if enough effort is made to keep up with modern technology so that the service becomes as slick as possible. The real estate department will have to look more and more to countries outside Kuwait in order to fulfill its potential, because Kuwait's empty spaces are being filled very rapidly.

The KFH has adhered as strictly as possible to the Islamic ideals upheld by the Shari'a committee, and has made great strides in educating people in the Muslim way of life not only with regard to finance. The fact that the House has its own department to deal with publications bodes well for the understanding of the social responsibility that an Islamic financier must bear: the KFH is always mindful of its duty to society.

The need has been mentioned for more risk-taking in order to emulate the success of the venture capital industry in Europe and the U.S.A. This means more use of the Musharaka and Mudaraba arrangements prescribed in Islamic Fiqh (law). This leads us on to considering how the system in which the KFH operates will adapt: for the KFH to show more readiness to take risk the Islamic financial movement must form an ideal way of insuring at least 90% of an investment. The cooperation is so far lacking in the Islamic financial movement, because the Islamic financial houses are not able to present a unified force united by ideals, practices and outlook.

The Islamic Development Bank will have a major role in the organisation of the movement, and this role should be encouraged by the KFH and other Islamic banks so that they have a focal point. The IDB could lay down modes of practice in order to ensure growing uniformity on a pan-Islamic level.

The KFH still relies on the Central Bank of Kuwait for guidance, because it regulates the internal system under which the KFH operates. It also has a major role because of the heavy government involvement (32%) in the KFH. The CBK does not govern the KFH as it does all the conventional banks, but its role should be to nurture the development of Islamic banking in Kuwait, even if it means allowing for Islamic competition for the KFH. At the moment Islamic banking in Kuwait is regulated by the Amiri decree which does not legislate for any other Islamic banks apart from the KFH. It is hoped this will change because the KFH needs competition, but whether the financial sector can support another institution is doubtful.

The revival in Muslim financial circles has tapped a potentially very rich seam. In 1987 there were 1,040.5 million Muslims in the world in more than sixty countries. Muslims were said to hold 77% of world oil reserves, 25% of world gas reserves, 11% of all the cultivated land in the world, 10.8% of all livestock and 6% of all the fish reserves in the world. With the financial muscle that these resources provide, Islamic banking, if it manages to convince Muslims the world over that it can provide a just and equitable system, can become a major source in the regulating of the world economy.

As for the KFH the last words must be left to the General Manager Mr. Adnan al-Bahar.

"It is not easy to operate a different system. However we are living in a world of abundance, and our role is to segment markets and fulfill the needs of our customers at a time of growing Islamic awareness."

The KFH has now matured and is ready to take up a responsible position led by a pragmatic management team. The key to future success lies in pan-Islamic cooperation in which the KFH will take a leading role.

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