

DETERMINANTS OF THE FINANCIAL STRATEGY OF ISLAMIC BANKS

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Recently, there has been a move towards the Islamization of the financial system in countries like Sudan, Kuwait, Bahrain, Jordan, Egypt, United Arab Emirates, and notably Pakistan. This process of Islamization has concentrated mainly on establishing Islamic banks that operate in accordance with Islamic Law which advocates, among other things, the prohibition of interest, speculation, hoarding, and gambling in all economic transactions.¹

In their mobilization of funds, Islamic banks operate on a system based on profit and loss sharing (PLS) in all financial transactions. Hence, the basic difference between Islamic banks and Western banks is that the former functions on an equity-based system in which economic agents are not guaranteed a pre-determined rate of return. Rather, the depositor shares in the profits made by the bank as well as in the losses incurred by it.

The shift towards the institution of an Islamic economic system has attracted considerable attention on the part of economists in Islamic countries (see Siddiqui, 1981). However, while there has been an outpouring of literature examining a wide variety of aspects of the structure and operation of the Islamic economy, very little has been done to study the financial management of Islamic banks (e.g. Bashier 1983; Tomkins and Karim 1987). Therefore, this paper attempts to shed light on that important aspect of Islamic banks which we believe will contribute to both the theory of finance and Islamic banking.

In particular, this research endeavours to investigate the interaction between the environment and financial strategy of Islamic banks in order to explain the changes in their capital structure. This was made possible by studying two banks in the Middle East, namely Faisal Islamic Bank of Sudan (FIBS) and Kuwait Finance House (KFH). The study covers the period 1979–1985 which reflects the period since the inception of the two banks and up to their last available financial data.

The financial strategies which emerge from the analysis of the two case studies suggest that under conditions of high strategic choice Islamic banks would opt for an increase in investment deposits rather than equity capital to fund their investments. However, under conditions of low strategic choice, equity capital would be their main source of funding.

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This paper has the following structure. The first section gives a general background of the Islamic banking system. The second section reviews the organization theory literature on the interaction of environment and strategic choice. In the third section we discuss the research methodology. The details of the two case studies are presented in the fourth section and analysed in the fifth section. The concluding remarks are stated in the final section.

CHARACTERISTICS OF ISLAMIC BANKS' CAPITAL STRUCTURE

The prohibition of the payment and receipt of interest in all financial transactions means that Islamic banks cannot have access to debt financing, nor can they take part in any investment or lending transactions that would generate a predetermined rate of return. Hence, the interest mechanism is substituted by PLS which means that in the funding of their operations, Islamic banks have to depend on equity financing. So far, the capital structure of Islamic banks has comprised shareholders' equity and three forms of deposit accounts. These are investment account deposits, savings account deposits, and current account deposits.

Shareholders' Funds

This is the only source of equity funds which is raised through the sale of shares to the public. As in all other similar organizations, the shareholders of an Islamic bank have sole control over the management of the bank.

Investment Deposits

This type of deposit comprises the main source of funds for Islamic banks and is similar to savings and time deposits. Holders of investment deposits are not guaranteed a predetermined rate of return. Rather, they share in the profits and losses of the bank and are treated as if they were shareholders. However, unlike shareholders, they do not have any control over the management of the bank or the distribution of its earnings.

Before the bank invests the funds raised by investment accounts, it has to agree in advance with the holders of these accounts on the ratio in which profits and losses will be shared. This is done on the basis of the proportionate amount contributed by the investment deposit holders vis-a-vis the shareholders. In determining the profits to be shared by both parties, shareholders alone bear all the administrative expenses, while investment depositors partake in all funds generated, except earnings from normal banking services.² Moreover, the bank deducts a fee from the share of the investment deposits for managing their funds on the depositors behalf.

It has been suggested by Kharn (1985) that this system of investment deposits does not differ greatly from proposals made in the United States and other countries aimed at changing the Western banking system to an equity basis so that they could respond more easily and rapidly in the face of a banking crises.³

Savings Deposits

The treatment of this type of account varies from one Islamic bank to another. In some banks (e.g. FIBS) funds deposited in savings accounts do not receive any returns while in others (e.g. KFH) they are invested on a profit and loss sharing basis and are considered to be part of the investment accounts. However, the latter deposits are concerned with earning profits rather than holding funds for precautionary or transaction purposes which are the functions of savings accounts (Karsten, 1981).

Current Deposits

The basic function of this type of account is to facilitate transactions and other types of payments. Hence, it is a service offered by the bank to its customers and accordingly the bank would tend to levy a fee on depositors to cover the costs of administering this type of account. Funds mobilized through this source can be invested by Islamic banks; however, depositors do not receive any return on their funds.⁴ Such investments would naturally be of a short-term nature.

To summarize, it is clear that Islamic banks consider PLS to be the appropriate base for economic transactions.⁵ Hence, the Islamic banking system substitutes debt financing for equity financing and guaranteed returns of capital for returns that are a direct function of profit. In the next section, we examine the literature on environment and strategic choice to find out what insights can be derived from it in order to explain the financial strategy pursued by the two banks.

ENVIRONMENT AND STRATEGY AN OVERVIEW

The recent literature on organization theory and business policy has attempted to place the debate on the relationships between environment and strategy in perspective. The issue is that both disciplines have focused on the environment-organization co-alignment process, yet each has viewed the subject from different analytical perspectives and a different set of variables. The business policy literature has been to view organizations as playing a proactive and opportunistic role. This view of adaptation is seen as a process of reflecting choice and selection (Child 1972), and much of the research in this literature

Figure 1
Four Views of Organization and Management
Deterministic Orientation . . . Voluntaristic Orientation

<p>Natural Selection View <i>Schools</i> Population ecology, industrial economics, economic history <i>Structure</i> Environmental competition and carrying capacity predefine niches. Industrial structure is economically and technically determined. <i>Change</i> A natural evolution of environmental variation, selection and retention. The economic context circumscribes the direction and extent of organizational growth <i>Behavior</i> Random, natural, or economic, environmental selection <i>Manager Role</i> Inactive</p>	<p>Collective-Action View <i>Schools</i> Human ecology, political economy, pluralism <i>Structure</i> Communities or networks of semiautonomous partisan groups that interact to modify or construct their collective environment, rules, options. Organization is collective-action controlling, liberating, and expanding individual action <i>Change</i> Collective bargaining, conflict, negotiation, and compromise through partisan mutual adjustment <i>Behavior</i> Reasonable, collectively constructed, and politically negotiated orders. <i>Manager Role</i> Interactive.</p>
<p>Q3</p>	<p>Q4</p>
<p>System Structural View <i>Schools</i> System theory, structural functionalism, contingency theory <i>Structure</i> Roles and positions hierarchically arranged to efficiently achieve the function of the system <i>Change</i> Divide and integrate roles to adapt subsystems to changes in environment, technology, size, and resource needs <i>Behavior</i> Determined, constrained, and adaptive <i>Manager Role</i> Reactive</p>	<p>Strategic Choice View <i>Schools</i> Action theory, contemporary decision theory, strategic management <i>Structure</i> People and their relationships organized and socialized to serve the choices and purposes of people in power. <i>Change</i> Environment and structure are enacted and embody the meanings of action of people in power <i>Behavior</i> Constructed, autonomous, and enacted. <i>Manager Role</i> Proactive</p>
<p>Q1</p>	<p>Q2</p>

MACRO LEVEL
 (Populations & communities of organizations)

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MICRO LEVEL
 (Individual organizations)

Source: Astley and Van de Ven (1983, p. 247)

has therefore centred on the strategy variable (Hatten, et. al., 1978; and Mintzberg, 1972). On the other hand, the organization theory literature has adopted a more reactive position by considering the environment as a deterministic force to which organizations respond (Aldrich, 1979; Duncan, 1972a; and Lawrence and Lorch, 1967).

A number of recent studies (Bourgeois 1980 and 1984; Smirich and Stubbart 1985; Astley and Van de Ven 1983; and Hrebiniak and Joyce 1985) have attempted to develop a conceptual integration of the diverse literature which addresses the dichotomy of choice and environmental determinism in the adaptation process. Central to these studies is the interpretation of Astley and Van de Ven (1983) and that of Hrebiniak and Joyce (1985) to which we shall focus our attention to ascertain what insights can be derived from them in explaining the changes in the capital structure of Islamic banks.

Astley and Van de Ven (1983) propose a framework that classifies the different schools of organizational analysis on two dimensions: (1) deterministic versus voluntaristic orientation in theories of organizational adaptation, and (2) micro and macro level of organizational analysis. Their typology yields four schools of thought (see Figure 1).

Astley and Van de Ven (1983) then attempt to juxtapose the four views to address six debates which 'focus on structural forms versus personal action . . . and on part-whole relationships . . . as well as on the interaction of these two sources of organizational tension' (Astley and Van de Ven 1983, p.265).

Recently, Hrebiniak and Joyce (1985) have questioned both the mutually exclusive nature of the debate on organizational adaptation and the implicit assumption that the dichotomy of voluntarism and determinism captures the reality of organizational behaviour and change. They argue that choice and determinism represent two independent variables and that the study of the interaction process between the two variables is necessary to explain organizational adaptation.

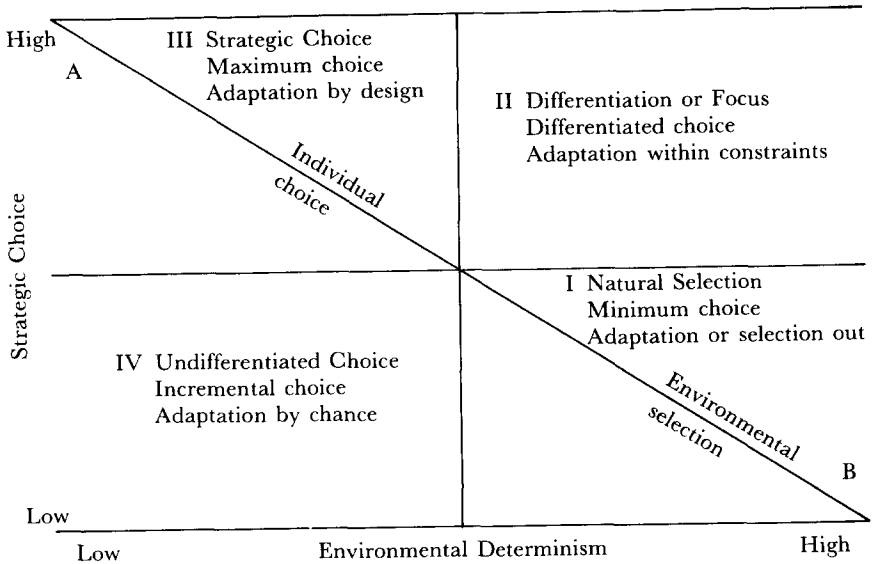
Hrebiniak and Joyce base their model on the two variables, strategic choice and environmental determinism, with each of the variables ranging from low to high as shown in Fig. 2. The interactions of the two variables result in four main types.

In quadrant I, organizations confront a situation of low strategic choice and high environmental determinism. Under such conditions, organizations lack control over exogenous factors and become dependent on the environment to select those forms with appropriate variations to remain. However, although managerial action is limited, individuals may attempt to search for alternatives that would buffer environmental demands or even endeavour to shift the organization's domain, task environment or industry.

In quadrant II, organizations enjoy high strategic choice but at the same time face a high environmental determinism which affect decision making. Such conditions would include (1) organizations in highly regulated industries that have to comply with certain rules and conditions in the environment, but at

Figure 2

Relation of Strategic Choices and Environmental Determinism in Organizational Adaptation



Source: Hrebiniak and Joyce (1985, p. 339)

the same time are able to pursue their strategies within those constraints; and (2) organizations in multiple niches (e.g. multi-product or multi-divisional organizations), each with its own constraints, opportunities, and population of competing organizations.

In quadrant III, organizational choice is high and environmental determinism is low. Under these conditions strategic choice has control over exogenous factors due to the benign environment and enjoy autonomy over the organizational domain. Managers would tend to pursue a proactive behaviour and organizational innovations are easier.

In quadrant IV, organizations face a low strategic choice as well as low environmental determinism, a situation reflecting lack of strategic thrust despite a benign environment. Such a situation can be explained by mismatch between the capabilities of the organizations and their exogenous conditions and opportunities. The organizational change depicted in quadrant IV can be labeled 'adaptation by chance' (Hrebiniak and Joyce, op. cit: p.342).

Moreover, Hrebiniak and Joyce suggest that the above four types of organizational adaptation influence the number and forms of strategic options of organizations, the decisional emphasis on means and ends, political behaviour and conflict, and the search activities of the organization in its environment.

The interesting aspect suggested by Hrebiniak and Joyce's analysis is that the 'adaptation process is dynamic; over time, an organization's position may shift as a result of strategic choices or changes in the external environment' (p.343). Indeed, what is being advocated is to be able to 'think in circles' (Weick, 1979, p.25). In the next section, we discuss the research methodology adopted in this study.

RESEARCH METHODOLOGY

Two case studies have been written on the two banks that have agreed to participate in the study. This is in line with the call by Hofer (1973 and 1975) to investigate the content of business strategies (i.e. implemented strategy) as well as in line with his case study oriented approach (Hofer, 1973) and others (Glueck, 1986; and Jauch et. al., 1977).⁶ However, while these studies have used large numbers of cases (up to 358 in Clueck's study), we opted for a very small number of cases in order to secure the depth needed to gain closer knowledge of these newly established type of banks. Indeed, this enabled us to study the major changes that took place in the environment and the financial strategy implemented by the two banks during the period 1979–85. This reflects the period since the first published information by the two banks and up to the last available one. On the other hand, the establishment of only one bank in the various countries that have initiated the Islamization process of its financial system (with the exception of Sudan and Pakistan which have recently Islamized the whole financial system) has greatly affected the size of our sample.

The data of the case studies was derived from the annual reports of the two banks and from publicly available studies (e.g. Quarterly Economic Review on Sudan and Kuwait). These were supplemented by interviews conducted with the staff that were in charge of the financial strategies and decisions in the two banks. Such an approach is supported by Bourgeois who argues that

'The main appeal of looking exclusively at strategy content is that no attention need to be given to management's goals, or "intended" strategies, nor to the political activity inherent in arriving at strategies, and the academic researcher can rely almost exclusively on secondary data sources' (Bourgeois, 1980, p.29).

The Variable of Environment

According to Dill (1958) and Duncan (1972b) a firm's task environment is composed of five external components, namely customers, competitors, suppliers, regulating groups, and technological requirements of an industry. However, the three factors that seem to be of direct relevance to this study are customers, competitors and regulatory groups. The customers are those whom the bank attracts to deposit in its three types of accounts and/or invest in its shares. The

competitors consist of the other Islamic and non-Islamic banks as well as the investment opportunities that were available to the banks. The regulatory groups comprise mainly the central bank. Hence, whether the environmental determinism confronted by each bank would be considered as high or low depends on the restrictions and regulations enforced by the central bank, the number of Islamic banks, the ability of the bank in attracting customers and whether the investment opportunities available to each of the two banks were adequate or inadequate.

The Variable of Strategy

In spite of the difficulty spelt out in the literature in defining the concept of strategy, there seems to be an acceptance on the functions of strategy. These are (1) to define the segment of the environment in which the organization will operate; and (2) to provide guidance for subsequent goal-oriented activity within that niche (see Bourgeois, 1980; and Hofer and Schendel, 1978). Both these functions form what is known as the corporate and business strategy, respectively. The former is concerned with the set of businesses in which the firm will operate, and the latter with the decision made by the firm to compete in each of the chosen product-market segments.

This study is concerned with the secondary level of strategy. It examines the pattern which the two Islamic banks pursued with regard to their capital structure over the span of time studied. Hence, we refer to such a level as the financial strategy. In the next section, the two case studies are presented.

THE CASE STUDIES

Faisal Islamic Bank — Sudan

FIBS was opened in 1978 and was granted unprecedented concessions which involved exemptions from all types of taxes including personal income tax on salaries of all its employees and the funds deposited with the bank for investment purposes. Furthermore, FIBS was exempted from several other laws, the most significant one being the temporary relaxation of the credit policy imposed by the central bank on other commercial banks. However, in 1983, the government decided to waive the latter exception and FIBS was fully subjected to the credit policies issued by the central bank. Moreover, the tax concessions granted to FIBS ran out in 1984. Accordingly, we shall examine the eras 1979–82 and 1983–85 separately.

The 1979–82 Period

During this period, FIBS was not subject to the credit ceiling measure enforced by the central bank or any of its monetary policy guidelines (of course the

changes in the rates of interest were irrelevant to FIBS). The population of the commercial banking sector consisted of six national banks, three foreign banks, and FIBS which was the only Islamic bank during that period.

During this period the Sudan economy was facing very severe difficulties and the government was exerting efforts to tighten up on the commercial banks' lending limits (but FIBS was not included in these controls).⁷

Table 1 shows that FIBS experienced rapid growth during this period both in its available resources and investment operations. The bank's paid up capital, current accounts, savings deposits, and investment accounts increased by 433 per cent, 601 per cent, 875 per cent and 2271 per cent, respectively, during this period.⁸ On the other hand, the dividends paid by the bank increased by 67 per cent while the returns on the investment deposits increased about 6.7 per cent.

The high increase in the bank's resources was also matched by a high increase in the use of these resources. The number of investment operations conducted during this period and the amount invested in them increased by 780 per cent and 390 per cent, respectively.

During the early years of its growth, FIBS attempted to adopt a strategy of short-term investments in order to realize 'reasonable profits in the shortest

Table 1

The Financial and Investment Profile of Faisal Islamic Bank — Sudan: 1979–85
(In Millions Sudanese Pounds)

	1979	1980	1981	1982	1983	1984	1985
Capital: Authorized	10.0	10.0	50.0	100	100	100	100
Paid-up	3.6	4.5	10.2	19.2	57.6	58.4	58.4
Current Accounts*	18.3	40.3	59.5	128.2	165.8	178.4	194.4
Savings Accounts	0.8	1.3	2.7	7.8	11.9	15.1	23.0
Investment Deposits	2.8	8.6	40.1	66.4	79.3	67.5	59.2
Funds Allocated to . . .							
Investment Operations	27.6	56.5	73.7	135	74	121	100
Number of Operations . . .							
Contracted	208	799	1471	1831	1141	1373	2118
Investment in Subsidiaries and Sister Firms**	0.40	0.50	0.50	0.91	0.52	11.7	18.2
Dividends	15%	20%	25%	25%	18%	16%	17%
Return on Investment . . .							
Deposits	15%	16%	16%	16%	10%	6.7%	9.2%
Net Income***	0.92	2.42	9.8	20.5	10.3	0.83	15.4
Retained Earnings	0.12	0.32	0.87	0.87	0.52	—	0.07

Source: Faisal Islamic Bank — Sudan Annual Reports 1979–1985

* Amounts include foreign currency deposits

** Per annum

*** After Zakah but before Tax. Zakah is similar to tax. It is 2.5 per cent of the total of paid-up capital, reserves, net income, and allowance for bad debts, minus fixed assets.

possible time'. The bank's investments were mainly in imports, exports, domestic trade, and working capital of certain industries. None of the projects in these sectors was financed for more than one year. FIBS also invested in two subsidiary firms and by 1982 the total amount of these investments was 2.31 million Sudanese Pounds.

The 1983–85 Period

This period witnessed further deterioration of the economy and the government had to introduce additional measures which included, among other things, the enforcement of new credit ceilings on commercial banks towards the end of 1983. FIBS was included in these new measures. In addition, while state owned banks were banned from financing medium and long term capital investments, foreign and Islamic banks were ordered to direct 10 per cent of their authorized lending funds towards medium and long term productive projects.

In 1984, the tax concession of FIBS ran out and by the end of that year there were seven more Islamic banks operating in the Sudan out of 26 banks. However, early in 1985, the central bank instructed all banks to end the payment and receipt of interest and to bring all customer obligations into line with Islamic principles.

In 1983, FIBS stopped accepting any investment deposits. These deposits later started to decrease in 1984 and continued to do so in 1985. The decline of these deposits was believed to be due to

'the annual returns on investment deposits affect the deposits of the following year' said the assistant general manager for investment.

Dividends also decreased from 25 per cent in 1982 to 16.5 per cent in 1985.⁹ On the other hand, FIBS managed to increase the deposits in its current and savings accounts as well as its paid up capital which was increased in 1985 by 204 per cent. According to the assistant general manager for investment, the reason behind the increase in the paid-up capital was 'to enable the bank to embark on long-term investments and thereby endure its lengthy gestation period, and to increase our credit ceiling limit'.

FIBS continued its short-term investment strategy which was concentrated mainly on internal trade, exports, and imports. It allocated a small percentage to the industrial (working capital) and agricultural sectors. This seems to be due to

'credit ceiling¹⁰ force Islamic banks to extend finance to short term operations only, which they have to watch and see to it that they are executed within a very short period'. This is because 'to achieve the same profits before the imposition of credit ceiling [Islamic banks] will be forced to utilize their credit ceiling in quick turnover ventures and they have to spread it over as many profitable avenues as possible' (Salama, 1984, pp.17–18).

The imposition of the credit ceiling on FIBS also led to the decline of the number of investment operations that were conducted in 1983 and 1984; however, in 1985 the bank contrived to increase its investment operations even though its credit limit was lower than that of 1984 (see Table 1).

An important change in the investment profile of FIBS is the significant increase in its subsidiaries and sister companies. The increase was from 0.91 mn. in 1982 to 18.2 mn. in 1985.

Kuwait Finance House

KFH was opened in 1979 as the only Islamic bank in Kuwait. The bank is owned 49 per cent by the government and, unlike the other commercial banks and financial institutions, it reports directly to the Ministry of Finance and not to the central bank.

The financial sector in Kuwait comprises the central bank, eight commercial banks (including KFH) of which three have majority government control, three development banks, about 40 other financial institutions, and one official stock exchange.

Kuwait has the most sophisticated banking system in the Gulf (The Times, 1978) and it has a large capital surplus and limited absorptive capacity. One of the most significant events was the collapse of the unofficial stock market in 1982 which has undoubtedly caused a set-back to the country's banking sector. We shall, therefore, study the eras 1979–82 and 1983–85 separately.

The 1979–82 Period

During this period the Kuwait economy experienced several ups and downs in domestic liquidity. Trading in the unofficial stock market (Souk Al-Manak) comprised mainly the shares of the Gulf companies which were established in neighbouring Gulf countries, but whose shares were not allowed to be traded in the official stock market.

Towards the end of 1982, trading in the shares of such companies reached a feverish level fueled by the practice of paying for shares with postdated cheques. Buyers have counted on being able to honour their cheques with profits from future transactions. However, due to the fall of share prices, the market slumped and cheques worth a staggering \$92 bn. were found to be outstanding.

From 1979 up to 1982 the paid up capital of KFH increased by 498 per cent while savings accounts, deposits of limited period, and deposits of unlimited period increased by 754 per cent, 223 per cent, and 724 per cent, respectively. Dividends and the returns on savings deposits, limited period deposits, and unlimited period deposits increased by 50 per cent, 47 per cent, 48 per cent, and 48 per cent, respectively during 1979–81. However, in 1982, dividends decreased by 33.3 per cent and the returns on the three deposit accounts decreased by 11 per cent (see Table 2).

Table 2

The Financial and Investment Profile of Kuwait Finance House: 1979–85
(In Millions Kuwaiti Dinars)

	1979	1980	1981	1982	1983	1984	1985
Capital: Authorized	10.0	10.0	10.0	15.0	18.8	18.8	18.8
Paid-up	2.5	2.5	9.6	14.96	18.7	18.7	18.7
Current Accounts	16.1	29.2	55.2	70.1	79.7	69.1	123.4
Savings Accounts	21.4	55.1	116.7	182.7	332.8	383.2	411.2
Investment Accounts:							
Limited Period	3.19	7.95	10.6	10.3	4.4	1.1	0.1
Unlimited Period	25.5	56.4	111.7	210.1	281.1	257.7	189.7
Real-Estate Investments	94%	92%	90%	84%	77%	72%	69%
Investment in Trade	3.4%	3.2%	4.8%	7.4%	4.5%	4%	3.7%
Foreign Investments	—	3.1%	3.4%	6.1%	15%	17%	17%
Dividends	10%	11.25%	15%	10%	20%	—	—
Returns on Savings							
Deposits	6.13%	6.75%	9%	8%	5%	—	2.66%
Returns of Investment							
Deposits:							
Limited period	8.13%	9%	12%	10.67%	6.67%	—	3.55%
Unlimited period	9.13%	10.13%	13.5%	12%	7.5%	—	4%
Net Income	3.48	9.68	25.1	45.9	36.7	—	17.5
Retained Earnings	0.35	0.97	2.5	4.6	—	—	—

Source. Kuwait Finance House Annual Reports 1979–1985

The pattern of investment pursued by KFH during this period was influenced by a number of factors. According to the investment director:

‘The bank was at its development stage and was overwhelmed by a flood of liquidity which we had to invest on behalf of our customers and secure them a quick return’. However, ‘the investment opportunities were very limited except for certain sectors and, in a way, that shaped our investment strategy’.

Almost all of KFH’s resources were directed towards medium and long term investments. As can be seen from Table 2 the bank allocated more than 90 per cent of its resources in the real-estate industry which

‘the management of the bank considered to be the most successful local investment at this stage . . . and was one of the few types of investment available to us . . . Moreover, there was a boom in that industry and the risk was very low’ said the investment director.

Part of KFH’s resources was invested with Islamic financial institutions abroad reaching 6.1 per cent of the total investments in 1982. However, it seems that the concentration of KFH’s investments in the domestic market was to a large extent due to the bank’s

'lack of caliber and expertise that would enable us to tap the international markets . . . The only other alternative available to us abroad was to deposit our funds with other Islamic banks since the international markets were not familiar with the Islamic modes of financing' argued the deputy investment director.

An insignificant percentage of KFH investments was invested in associated and subsidiary companies (less than one per cent) as well as in the trade sector (around five per cent). Of course, the option of trading in the stock and bond markets was not available to the bank because of the speculative nature of the former at that time and the interest included in the transactions of the latter, and both are prohibited in Islam.

The 1983–85 Period

Following the collapse of the unofficial stock market, the government approved a package of measures which included a thorough review of the commercial banks' (excluding KFH) annual accounts by the central bank and the latter's approval before any dividends could be paid.

The most significant step taken by KFH during this period was the decision in 1983 not to accept new investment deposits and to direct new deposits to savings and current accounts. Accordingly, from 1983 to 1985 both investment deposits of limited and unlimited periods decreased by 98 per cent and 32.5 per cent, respectively. On the other hand, savings and current accounts increased by 19 per cent and 35 per cent, respectively. In 1983, the paid-up capital increased by 25 per cent and remained unchanged until 1985.

It was not surprising therefore that KFH decided not to pay dividends in 1984 and 1985 whereas in 1983 it used part of its reserves to pay 20 per cent dividends unjustifiably. Investment deposits of limited and unlimited periods as well as savings deposits did not receive any return in 1984. In 1985, the returns of these three accounts were less than those of 1983 by 47 per cent.

KFH continued to invest in real estate but at a decreasing rate. The 1985 figures show that trading in real-estate declined by 27 per cent compared to 1979. Of course, the collapse of the unofficial stock market had a serious impact on the real-estate market because of the close relationship of the investors in the two markets. Prior to the collapse, most investors used to invest the profits they earned in the stock market in real-estate. This led to a huge increase in the latter's prices. However, after the crash, the prices of real estate declined sharply (see Kuwait Finance House Annual Reports, 1983, 1984 and 1985).

Such a recessionary trend seems to have forced KFH to expand its investments with other Islamic financial institutions abroad as well as to tap possibilities in the international markets. By 1985, KFH contrived to increase its share of foreign investments by about 183 per cent compared to 1982. The bank's investments in the trade sector and subsidiaries and sister firms remained around the same level as in the previous period.

Having presented the experience of the two banks that participated in the

study, the next section examines what insights could be gained from analyzing their behaviour over the period 1979–85.

ANALYSIS OF THE CASE STUDIES AND RESEARCH FINDINGS

The 1979–82 Period

While FIBS seems to have enjoyed high strategic choice and low environmental determinism during this period, KFH appears to have confronted a situation where both strategic choice and environmental determinism were high. Both FIBS and KFH confronted no competition from other Islamic banks since none existed at the time. Moreover, neither of the banks was subject to the tight monetary policies enforced upon the other commercial banks. Thus, there were no restrictions on the investment activities of either banks. However, while FIBS encountered ample investment opportunities and was able to utilize them as well as to diversify its growing resources, KFH did not have similar opportunities except the real-estate sector in which it invested heavily. Possible reasons for such environmental determinism include religious factors (the speculative nature of the stock market prohibits Islamic banks to trade in shares) and competitiveness of the market in certain sectors (KFH was unable to increase its investment in the trade sector beyond 7.4 per cent). In addition, KFH failed to expand its investments abroad because it lacked the necessary expertise and at the same time the international markets were unfamiliar with the Islamic modes of investment.

Given their environments, both banks seem to have enjoyed high control over and selection of the means by which their financial and investment strategies can be achieved. The two banks managed to pursue an investment strategy which matched their resources as well as maximized their turnover. Hence, both FIBS and KFH were able to achieve high profits which they desperately needed in order to strengthen their financial position at their early stage of development, attract more customers to investment deposits by paying high returns, and pay high dividends to maintain their clientele of shareholders.

The financial strategies of both banks appear to have followed a similar pattern with respect to their capital structure. Both FIBS and KFH were able to keep their equity at a minimum and depend on investment deposits (and current accounts in FIBS and savings deposits in KFH) in the financing of their investments.

It is possible that the continued increase in investment deposits in the two banks implies that its holders may have found that the opportunity cost of investing their funds in other alternatives would have been less than what they would have received had they invested with the two banks. Another possible reason could be that the alternative investment opportunities were unaccep-

table to them from an Islamic point of view (e.g. stock market, interest-earning deposit accounts).

Such a strategy meant that the two banks managed to reduce their average cost of funds. Indeed, the returns on investment deposits were always less than the returns to shareholders, and the amounts of the former were larger than the latter's funds in both banks (see Tables 1 and 2).

Such a practice has interesting implications on the tradeoffs between risk and return. Under the profit and loss sharing system, Islamic banks can afford, possibly due to market imperfection, to permit high leverage of the equity capital (and therefore higher rewards) by attracting more investment deposits without creating more risk. If the bank does not make enough or any profits, it is entitled to eschew paying returns to investment deposit holders (as well as to equity holders).

However, the repercussions of such a possibility on attracting investment deposits in the future should be taken into consideration if the two banks were to pursue a strategy similar to the one of this period. On the other hand, if the bank makes a loss, investment deposit holders will share in that loss according to agreed ratios. Hence, under such conditions, the risk of the investment deposit holders would be higher than that of the equity holder.

The financial strategy of the two banks also meant that they were unable to retain a high proportion of their earnings in order to finance their investments. Indeed, given their capital structure during this period, such a strategy was unavoidable. This is because Islamic banks have to pay investment depositors their share of profits prior to retaining any of the earnings. Hence, since the amount of these deposits were more than the shareholders' funds in both banks, it would have been difficult to retain a high proportion of the residual profits and simultaneously pursue a policy of high dividends to meet the expectations of shareholders as seems to have been the case in the two banks.

The 1983–85 Period

The changes that took place during this period affected the adaptation processes which the two banks experienced in the previous period. It seems that in 1983 and 1984 FIBS faced a high environmental determinism and low strategic choice while in 1985 it managed to move to a situation where both environmental determinism and strategic choice were high.

The decision of the central bank in 1983 to subject FIBS to the credit ceiling policy and the running out of the tax concession appear to have stripped the bank of its control over its financial strategy. In addition, several Islamic banks were established. The credit ceiling policy had a direct negative impact on the amount of funds which FIBS could utilize for investment while the tax levied on the bank reduced the residual funds which could be distributed to both investment deposit holders and shareholders and/or retained for reinvestment.

The former effect meant that FIBS was left with excessive resources which it could not invest and which would reduce the returns to both investment deposits and shareholders. Accordingly, the bank had to give priority to its shareholders and increase its equity capital and at the same time stop accepting investment deposits. The holders of the latter were even encouraged to withdraw their funds by being paid low returns. On the other hand, the increase in equity capital would enable FIBS to embark on medium and long term projects and thereby meet the requirements of the central bank.

The investment strategy of the bank was also changed to match the changes in the bank's capital structure. To this effect, the bank concentrated on short term investments to maximize the turnover of the resources it was allowed to utilize. However, concerning the funds which were not subject to the credit ceiling policy, FIBS pursued a policy of expanding its share in its subsidiaries and sister companies since such investments were not subject to the credit ceiling policy.

The negative effects of the adaptation process which FIBS experienced during these two years were reflected in lower net income, dividends, and returns on investment deposits relative to the bank's performance in the previous period.

In 1985, the environment was becoming more deterministic when the government ordered the Islamization of the banking sector. However, by that time, FIBS seems to have passed the skimming stage of competition. In addition, the bank started to reap the benefits of the strategy it adopted to cope with the changes in the environment which took place in 1983 and 1984. This is mirrored in the bank's performance which reflected an increase in the number of investment operations conducted as well as a start of an ascending pattern in dividends, returns on investment deposits, and net income. Hence, it may be argued that in 1985, FIBS confronted a situation of high environmental determinism and high strategic choice.

On the other hand, the picture was very bleak for KFH. The bank encountered a situation characterized by low strategic choice and high environmental determinism. The collapse of the unofficial stock market hit KFH very hard. Indeed, the bank suffered badly from the sharp decline in the value of the real-estate sector in which most of its resources were tied up. Furthermore, the bank could not tap alternative investment opportunities because of the recession in the domestic market. Such conditions, therefore, forced KFH to try to expand its investments abroad in order to diversify its resources and achieve growth. Hence, the mismatch of KFH invested resources with the unstable and weak external conditions casts reflections on the bank's poor performance which resulted in its inability to pay dividends in 1984 and 1985 and deprive investment and saving deposit holders from any returns in 1984. Consequently, the decision by KFH to stop accepting investment deposits and increase equity funds was inevitable.

The financial strategies which the two banks pursued in reaction to the changes in their environments were similar to each other. Both FIBS and KFH

were forced to stop accepting investment deposits and increase equity funds. This meant that the two banks were forced to depend on equity capital in financing their investments and were thereby deprived of the benefits of low cost of funds which they had enjoyed previously at a low risk. In addition, the high increase in equity capital may have led to less control by the shareholders of the previous period over the management of the two banks during this period.

On the other hand, the deterministic environments of both banks barred them from retaining high earnings despite the shift in their capital structure. Indeed, KFH was unable to retain any earnings during this period while the insignificant amounts which FIBS retained in the previous period were reduced and even stopped in 1984.

Research Findings

Figure 3 summarizes the relation of strategic choice to environmental determinism that was experienced by FIBS and KFH. It shows that FIBS was in quadrant III during the period 1979–82, then moved to quadrant I in 1983 and 1984, and in 1985, it ended up in quadrant II. Hence, FIBS seems to have enjoyed high strategic choice for the preponderant time since its establishment. During the period 1979–82, KFH occupied quadrant II and then shifted to quadrant I for the period 1983–85. However, unlike FIBS, KFH did not seem to have experienced high strategic choice except during the early part of the time span studied.

Figure 3

The Positions of FIBS and KFH During 1979–85 Under the Four Types of Adaptation Processes

Strategic Choice	High	FIBS: 1979–82 Q III	Q II FIBS: 1985 KFH: 1979–82
	Low	Q IV	Q I FIBS: 1983–84 KFH: 1983–85
		Environmental Determinism	

Hence, the financial strategy which emerges from the study of the two banks can be summarized as follows:

Proposition 1: Under conditions of high strategic choice, Islamic banks would opt for high investment deposits and low equity capital and thereby reduce their average cost of capital without incurring more risk.

Proposition 2: Under conditions of low strategic choice, Islamic banks would opt for low investment deposits and high equity capital and thereby incur a high average cost of capital.

Proposition 3: The capital structure of Islamic banks is contingent on the availability of strategic choice.

CONCLUDING REMARKS

This research has attempted to shed light on some aspects of the financial strategy of Islamic banks. In their mobilization of funds, Islamic banks operate on a system based on PLS in all their financial transactions.

The Hrebiniak and Joyce (1985) model for interaction between environmental determinism and strategic choice offers a powerful explanation for the changes which took place during the period 1979–85 in the financial strategy of the two Islamic banks that were studied. The practice of the two organizations highlights how the capital structure of Islamic banks is dependent on the availability of strategic choice and the state of the environment.

The above findings reflect the experience of only two Islamic banks and should therefore be treated with caution. However, although the size of the sample is very small, it is believed that the insight gained from the depth of information provided in the two case studies was worth the sacrifice. In addition, it is hoped that the above findings will evoke interest in this new phenomenon which we believe will contribute to the theory of both banking and finance.

NOTES

- 1 See Siddiqui (1981) for a brief review of the Islamic economic literature on these issues.
- 2 Banking services include opening of letters of credit, administering current accounts etc.
- 3 Henry Simon (1948) proposed an equity-based financial system in connection with the banking crisis of the 1930s. Kareken (1985) has recently suggested a similar proposal (see Khan 1985, 8–10).
- 4 See Tadamon Islamic Bank, 'A Study on the Distribution of Profits Between Shareholders and Investment Deposits' paper presented in the Symposium held by Tadamon Islamic Bank, Sudan, December 1984.
- 5 In their application of funds, Islamic banks use other financing mechanisms in addition to PLS (see Karim and Ali, 1987).
- 6 See Bourgeois (1980) for a review of the various approaches to the study of strategies.
- 7 See Quarterly Economic Review of Sudan, Annual Supplement, 1983.
- 8 No returns are paid to the holders of savings deposits.
- 9 Part of this decline is due to the increase in the bonus shares distributed by the bank in 1982.
- 10 Unlike traditional commercial banks, Islamic banks are likely to be affected by the imposition of credit ceiling forces because when the revenue from their investments is received only the customer venture is liquidated. This tends to force Islamic banks to invest in short term activities to increase the turnover of the funds they are allowed to invest and thereby maximize their profits.

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