Islamic banking: the case of Algeria

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Abstract

Purpose – The purpose of this paper is to provide a detailed analysis of the Islamic banking in Algeria following the financial liberalisation initiated in the 1990 s. It seeks to examine the performance of the sole bank offering Islamic financial products in Algeria, Banque Al Baraka d'Algérie. The study also aims to analyse the methods adopted by the bank to improve the allocation of its financial resources and to boost its earnings.

Design/methodology/approach – Interviews were conducted to learn about the performance and risks associated with Banque Al Baraka d'Algérie operations. All interviews were held one-to-one with each respondent in Algeria. Statistical data and financial ratio analyses are also used to support the arguments made in this study. Analyses are carried out on major factors affecting the bank operations.

Findings – The study reveals four key findings: Banque Al Baraka d'Algérie offers only a few Islamic financial products to its customers; most of the instruments are geared towards short-term financing; the bank's overall performance has improved since its operations in Algeria; and credit risk remains the main obstacle facing the bank.

Research limitations/implications – This research uses a single country case study. The study also refers to the case of one Islamic bank with no competition from other Islamic finance providers.

Practical implications – The analyses presented in this research can be used by policymakers and managers as a guide to developing the existing Islamic banking practices in Algeria.

Originality/value – The study makes a contribution to the literature on Islamic banking in Algeria. It is the first study to particularly investigate the issue of Islamic banking performance in Algeria. The findings achieved in this research will be of interest for practitioners and academics concerned with developments of the Algerian banking industry.

Keywords Islam, Banking, Algeria

Paper type Research paper

Introduction

Although Muslims have practiced Islamic financial rules since the fifth century, the first study on Islamic finance did not appear until the mid–twentieth century (Mawdudi, 1961; Siddiqi, 1983). Political influence in countries such as Pakistan and the development of Islamic banking ideas among Muslim economists have contributed to a growing literature on Islamic finance. In the past two decades, many Muslim and non-Muslim researchers have conducted investigations into Islamic banking (Mills and Presley, 1999; Warde, 2000; El-Hawary *et al.*, 2007).

The key point to Islamic banking is the forbiddance of usury. From an Islamic standpoint, usury occurs when a buyer of a commodity pays an additional amount of money above and beyond the current price (this is "*riaba al-fadl*", an increase based

The author would like to thank the respondents from Banque Al Baraka d'Algérie who gave generously of their time for his interviews. He is also grateful to two anonymous referees, whose comments made valuable contribution to the research calibre of this paper. Finally, the author would like to acknowledge the financial support of the Harrow Business School.

International Journal of Islamic and Middle Eastern Finance and Management
Vol. 1 No. 2, 2008
pp. 113-131

1753-8394
DOI 10.1108/17538390810880973

on difference in quality) or when he receives reward from a loan in advance, making any positive return (this is "*riba-nasi'ah*", an increase related to deferment). The borrower has to pay only the current commodity price. However, the seller can justify receiving more money if the trading of commodity achieves economic growth in the society. In contrast, in a market economy, the interest is permissible and is defined as the fee paid by a borrower to a lender for the use of borrowed money.

Islamic banking is based on the profit and loss sharing mode of financing. In technical terms, Islamic banks play almost the same role as conventional banks: they are intermediaries between lenders and borrowers. However, many practical differences exist between the two banking models. For example, conventional banking model maintains a creditor–debtor relationship among banks, but in Islamic banking model the relationship is principally a partnership.

This study aims at analysing the development of Islamic banking in Algeria. The research uses a single country study (Algeria) because it has a unique experience in relation to Islamic finance. The economy of Algeria is also unlike those of other Middle Eastern and North African nations (Abed and Davoodi, 2003). Besides, Algeria has adopted a distinctive approach in liberalising its financial market.

The first Islamic bank to open its doors in Algeria is Banque Al Baraka d'Algérie in 1991. The bank's operations are still limited in scale and scope. However, there is steady increase in the number of savers and borrowers using the bank. The bank also expanded its network to include 18 branches across Algeria. The other bank which is due to start offering *Sharia* compliant products is Bank Salam of UAE. Because the bank is not in operation yet the study will focus on Banque Al Baraka d'Algérie.

The remaining of this paper is organised in six sections. The second section examines the main differences between Islamic and conventional mode of financing. Section three addresses the main developments within the Algerian banking industry, particularly after the introduction of financial liberalisation. In section four, we discuss the research methodology. Section five analyses the performance of Banque Al Baraka d'Algérie. In the last section, we produce some concluding remarks.

Islamic banking *vis-à-vis* conventional banking

It has been argued that the main difference between Islamic banks and conventional banks is "the time value of money" (Moore, 1997, pp. 248-50). The function of both banking models is the same, i.e. to act as an intermediary between savers and borrowers. In conventional banking model, the interest rate determines the yield on financial products. Whereas, the Islamic banking model uses profit- and loss-sharing criteria to distribute net profits to the bank, to depositors, and to entrepreneurs.

Warde (2000) notes that conventional banking performance is based on trial and error. This is why conventional banks are free to select instruments that match their strategies. By contrast, Islamic banks' products must conform to principles set by *Sharia* boards, and this prevents Islamic banks from diversifying their portfolios. To avoid this problem, Warde proposes that Islamic banks improve their lending policy and exploit all market segments that fit with the Islamic mode of financing.

Profit- and loss-sharing modes of financing mean that instead of lending to borrowers at fixed interest rates, a bank forms a partnership with the borrower. *Mudaraba* (sleeping partnership) and *musharaka* (long-term equity) are the two main forms of this mode of financing. A bank has a proportion of the profit generated by a borrower.

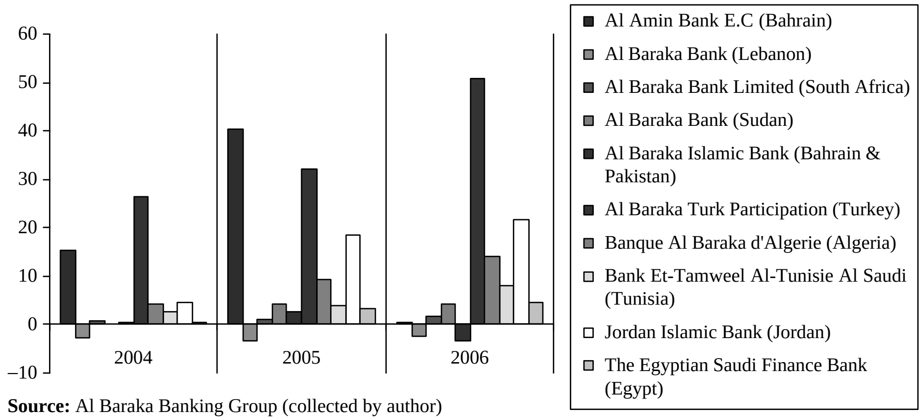
Warde stresses that depositors and bankers in this financing scheme associate their loyalty with the success of the project. Besides, entrepreneurs focus on the project's long-term profit instead of debt servicing; this reduces the rate of default on investments (Warde, 2000, pp. 135-6).

Figure 1 shows the net profit (loss) realised by Al Baraka Banking Group subsidiaries from 2004 to 2006. It is evident that almost all subsidiaries of the group are making positive return from their investments with two exceptions of Al Baraka Bank of Lebanon (across the period) and Al Baraka Islamic Bank (in 2006). The net loss made by the two subsidiaries is due to high operating expenses and to financing loss provision. The figure also indicates a fluctuation in the net profit achieved by some of the subsidiaries because of the continuous change in the economic conditions of the country in which they operate and their portfolio base.

The sources and allocation of Islamic banks' capital funds are different from those of conventional banks. First, Islamic banks can use current account funds to offer short-term credit to people in financial difficulties, but lenders should not be charged any fees. It is forbidden to use current account deposits for financing or investing in securities. Second, depositors in conventional banks receive interest on their savings accounts. Whereas, in Islamic banking, depositors receive part of the profit generated by the bank each financial year. Islamic banks do not pay premiums in loss-making cases, and usually returns are higher for long-term deposits than for short-term ones. Saving account funds are also invested in short-term projects. However, the nominal value of deposits is not guaranteed.

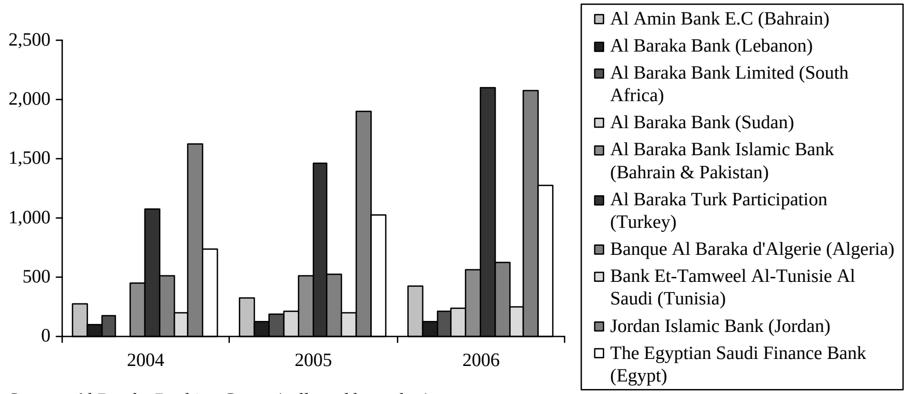
A large amount of Islamic banks' credit is in the form of short-term loans. Duncan (1996) suggests introducing products that can be used for long- and medium-term financing; he also notes that Islamic banks need to reduce their overall short-term lending. Because investment projects can be risky, banks are required to analyse their investors' credit-worthiness accurately. The development of project financing is certainly a major step towards modern Islamic finance (Duncan, 1996).

Wealthy Muslims are the main source of capital for most Islamic banks. The exceptions are Iran, Malaysia, Pakistan and Sudan, where governments play a primary role in converting conventional banking into Islamic banking. In those countries, banks are forced to make all their services fulfil profit- and loss-sharing paradigm of financing (El-Hawary *et al.*, 2007). Figure 2 shows a steady increase in the total assets



Source: Al Baraka Banking Group (collected by author)

Figure 1. Net profit of Al Baraka Banking Group Subsidiaries in Million USD, 2004-2006



Source: Al Baraka Banking Group (collected by author)

Figure 2.
Total assets of Al Baraka Banking Group Subsidiaries in $US millions, 2004-2006

of Al Baraka Banking Group subsidiaries, which operates in countries where both banking models exits and countries where Islamic banking prevail. This increase attributes mainly to the growth in *murabaha* sales receivables (sale of assets at cost plus mark-up) and *ijara muntahia bittamleek* (form of leasing in which the lessee has the option to purchase the leased asset by the end of the lease term). However, there is clear variation in the assets' growth rate realised by each of the subsidiaries. This can be explained by the differences in the economic environment in which the group subsidiaries operate. For example, the Egyptian economy is more dependent on services than the Algerian economy where exporting oil is the main driving force of economic growth and demand for financial services.

Islamic banks open both savings and investment accounts. In an investment account, the bank applies a profit- and loss-sharing mode of financing (Gafoor, 1995). The return is a percentage of the profit, in accordance with an agreement made between the depositors and the bank, and between the bank and the borrowers. Gafoor also stresses that most Islamic banks guarantee the nominal value of saving account deposits. Depositors can withdraw their money at any time and may hold a chequebook. The advantage of Islamic banks is that both bankers and borrowers share responsibility for depositors' funds. Profits have to be distributed between stakeholders according to the first agreement. Gafoor suggests that Islamic banks should provide both short- and long-term loans to exploit the market fully.

Expected returns and risk-taking has affected Islamic banking performance. The return to depositors and shareholders vary when high-risk high-return projects are financed. Because of this, most Islamic banks finance short-term projects that allow them to generate high returns and to take low risks (Zineldin, 1990). Zineldin presented three investment philosophies in his analysis of Islamic mode of financing:

(1) The financial system must be market-oriented. Investments should be financed according to demand and supply rules.

(2) Demand for long-term investment accounts is low, compared with the demand for short-term investment account.

(3) The return from investments depends upon "*the marginal efficiency of investment*". The profit must be shared between banks, depositors and investors.

In his study of 16 Islamic banks, Zineldin (1990) finds that the return on their investment deposits differed from the return on their equity. Islamic banks have more autonomy in using their own capital in financing high-risk high-return investments than depositors' funds. Moreover, the return on long-term investment deposits was always higher than the return on short-term investment deposits. Losses are shared between the bank and depositors.

Zineldin uses four ratios for measuring Islamic banks' profitability: average net profit, average net profit to total assets, average net profit to total deposits, and average net profit to total equity. The ratio of average net profit to total assets illustrates the risk of the project funded and its business sufficiency. He found that profitable banks always have a high average net profit/total assets ratio. Because, Islamic banks have to perform in a "*group of business enterprises*" that includes shareholders, depositors, and entrepreneurs, profit must be maximised to satisfy the group (Zineldin, 1990, pp. 212-9).

Another finding of Zineldin is that small- and medium-sized banks are more profitable than large banks. This means that dealing with large assets is a difficult process for Islamic banks, especially when there is a mismatch between assets and return on investments. Conventional banks, however, seem to have higher returns on their assets than Islamic banks when it comes to short-term lending.

Drummond (2000) stresses that the absence of a money market for short-term assets has prevented the growth of Islamic banking. Money markets play a key role in meeting the short-term financial requirements of the ultimate borrowers. To escape this problem, Islamic banks should finance commerce through *murabaha* transactions. Drummond also argues that bonds can fund long-term projects. Because the Islamic banks' small market share may put pressure on their long-term products, it is necessary to launch money markets for secondary instruments to help Islamic banks manage their balance sheet effectively.

Another criticism of the modern Islamic finance is that borrowers may escape paying their debts, causing inevitable escalations in banks' losses. In Malaysia, the authorities have induced penalties for borrowers who fail to manage their business properly. In this context, Gafoor (1995) claims that Islamic financial products are unsuitable for long-term financing because of delay in capital recovery.

Bokhari (2000) notes four factors that would facilitate the growth of Islamic banking. First, it is imperative to establish an Islamic central bank to act as a lender of last resort to the Islamic financial institutions. Second, Islamic scholars have to be flexible and must accommodate new products. A third factor is flexibility by Muslim practitioners in their approach of designing Islamic financial products. Finally, banks have to use their capital effectively.

Wilson (1990) stresses that competition is a key element for improving innovations, reducing prices, and enhancing business control for Islamic banks. On the other hand, he advises Islamic banks to minimise their market risk to boost domestic financial market stability and to enhance financial innovation. Newly created financial instruments, however, must satisfy the Islamic *Sharia* board. In this context, Islamic banks can use *urf* (custom), *darura* (overriding necessity) and *musharaka* (the general interest) to create new products (Warde, 2000). It is also possible to make conventional instruments, such as zero coupon bonds, conform to Islamic law. Classic *fiqh* creates new products by combining two financial instruments. *Fiqh* applies five basic criteria in initiating the new products:

(1) analogy deduction;
(2) subjective opinion;
(3) moral or social preference;
(4) inference; and
(5) public interest and consensus of opinion.

This section shows that profit and loss sharing mode of financing dramatically affects the techniques used by Islamic banks in managing their portfolio. It has been stated that Islamic banks are tightly restricted in their lending as most loans are short-term. There are also limited financial products available to investors. Therefore, Islamic banks are required to introduce new products and focus on financing high yield industries. Portfolio diversification also enables Islamic banks to reduce the price of their products and enhance their competitive position in the market.

The Algerian banking industry

Modern banking began in Algeria in the mid-nineteenth century (Ernest-Picard, 1930). The French authorities established many commercial and merchant banks to facilitate the financing of commerce (Rossignoli, 1973). Those banks operated only in major cities; they did not serve rural areas. Some projects acquired credit through issuing, deposit and merchant banks; people's banks funded small firms; and the Caisse de Crédit Agricole Mutuel served the financial needs of the agricultural sector.

After independence, many European investors left Algeria. This had negative implications on the national economy as whole and on the banking sector in particular. Credit to the public and private sector declined dramatically because of the fall in the amount of deposits held at French commercial banks and credit institutions. To improve the mobilisation of financial resources and to obtain control over the national banking sector, the Algerian financial authorities established several state-owned banks and nationalised almost all foreign banks. Both measures led to the creation of a state-owned banking sector and to the disappearance of foreign players.

The main roles of state-owned banks were collecting deposits at low interest rates and financing government expenditures and state-owned enterprises. This meant that interest rates on deposits and loans were negative in real terms. Banks were also forced to lend to particular sectors of the national economy such as agriculture and real estate. The central bank provided the commercial banks with liquidity by rediscounting their bills at fixed rates.

State-owned enterprises were operating according to the government's plans for employment and consumer prices, and were not concerned about productivity and profitability. This resulted in a decline in state-owned enterprises capital output ratios. The increase in the state budget deficit due to declining oil revenues led to a fall in the amount of subsidies the government extended to the public sector. State-owned enterprises became unable to service their debts and non-performing loans began to augment. These non-performing loans caused an imbalance in the state-owned banks' balance sheet. The sudden decline in oil prices in 1986 made matters worse, and non-performing loans accounted for a high proportion of commercial banks' assets. To reduce the pressure on state-owned banks, the government initiated financial liberalisation in the 1990 s (Benhalima, 1998).

The financial liberalisation programmes introduced in the 1990 s had the following goals:

(1) to decrease the government's role in the financial sector;

(2) to organise local savings;

(3) to introduce market-oriented banking mechanisms;

(4) to improve banks' solvency; and

(5) to enhance competition in the banking sector (Jbili *et al.,* 1997).

The Law on Money and Credit of 1990 was the first step to be taken by the Algerian government to remove many barriers towards domestic and foreign banks. The law enabled both private banks and foreign banks to operate in parallel with state-owned banks. It also allowed state-owned banks to select their borrowers and to finance other businesses, which were not their speciality.

Direct lending to state-owned enterprises and the treasury was gradually removed to enable banks improve the quality of their credit. This led to an increase in the amount of credit extended to the private sector. Table I shows that the credit to private

	2001	2002	2003	2004	2005
			In billions of USD; end-of-period		
Public sector	9.587	56.5	56.5	56.5	56.5
Private sector	4.376	43.5	43.5	43.5	43.5
Local administration	0.002	0.0	0.0	0.0	0.0
Total	13.965	100.0	100.0	100.0	100.0
			In percent of total credits		
Public sector	68.6	56.5	56.5	56.5	56.5
Private sector	31.3	43.5	43.5	43.5	43.5
Local administration	0.1	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0
			In billions of USD; end-of-period		
Short-term	6.64	7.88	9.99	11.49	12.61
Medium-term	6.85	7.56	7.22	9.08	10.93
Long-term	0.46	0.45	0.61	0.72	0.72
Total	13.95	15.89	17.82	21.29	24.26
			In percent of total credit		
Short-term	47.6	49.6	56.1	54.0	52.0
Medium-term	49.1	47.6	40.5	42.6	45.0
Long-term	3.3	2.8	3.4	3.4	3.0
Total	100.0	100.0	100.0	100.0	100.0

Note: The author calculated the amount of credit in $US using the current exchange rate between the Algerian Dinar and $US for each consecutive year. This is done on purpose because the value of the national currency has fallen sharply towards $US since the start of trade and payment liberalisation
Source: Bank of Algeria

Table I.
Distribution of credit to the economy by sector and by maturity, 2001-2005

sector increased by 58.5 per cent from 2001 to 2005. The total amount invested in the private sector almost levelled the investment made in the public sector by the end of 2005. The table also exhibits that most of the credit granted is in the form of short- and long-term loans. In 2005, for example, long-term loans accounted only 3 per cent of the total credit to the economy.

Public banks arranged new credit terms for the benefit of profit-making enterprises. Meanwhile, many short-term overdrafts were replaced by medium-term loans. Enterprises applying for those loans were required to have equity participation from banks, performance contracts, and proof of commercial viability. Extending the maturity date of loans helped state-owned enterprises to stay alive and thus avoid job losses. Because of the small size of the private sector and delays in privatisation, state-owned banks continued to fund public projects.

The government replaced non-performing loans of state-owned banks with bonds (Nashashibi *et al.*, 1998). The first bonds issued in 1992-93 and they accounted for about 23 per cent of GDP. The treasury used external debt rearrangement to pay back most of those bonds. In 1994, an audit of public banks' balance sheets showed that banks, except Banque Nationale d'Algérie, needed injections of capital. In 1997, the financial authorities issued the second loan-bond swap. Those bonds accounted for 8.5 per cent of GDP and they were not serviced in cash (Iradian *et al.*, 2000).

The new law phased out direct financing of the government budget deficit. Instead, the government established an auction market to sell treasury bonds to financial institutions. Short-term securities, such as treasury bills, are also made available to market dealers. These securities are traded twice a week. However, the small numbers of traded securities and market dealers have weakened the market substantially.

The government established the first inter-bank foreign exchange market in 1996. Since then, foreign exchange rates have been determined by market mechanisms. Conventional and Islamic banks are given the autonomy to trade both local and foreign currencies. However, the revenues generated from foreign exchange activities are insignificant due to the small size of the trading.

After 1994, the authorities initiated further financial restructuring to improve commercial banks' accounting standards. All banks, conventional or Islamic, are required to meet the capital/risk-weighted asset ratio. In 1995, the government introduced new financial regulations for provisioning, risk concentration, and loan classification (Nashashibi *et al.*, 1998). The new rules oblige banks to record overdue interest payment as income and to make provisions for off-balance sheet items.

In the early years of financial liberalisation, the nominal interest rate on both deposits and loans rose dramatically (this only had direct effects on conventional banks, but not on Islamic banks because of their mode of financing). Nonetheless, a few years later the nominal interest rate seems to be declining because of the increase in monetary aggregates such as M1 and M2. For example, the interest rate on loans dropped from 18.5 per cent in 1995 to 8 per cent in 2003. However, these changes are not uniform and depend on the risk and maturity of the loan. The falling interest rate reflects the decline in the inflation rate and the stabilisation of exchange rates.

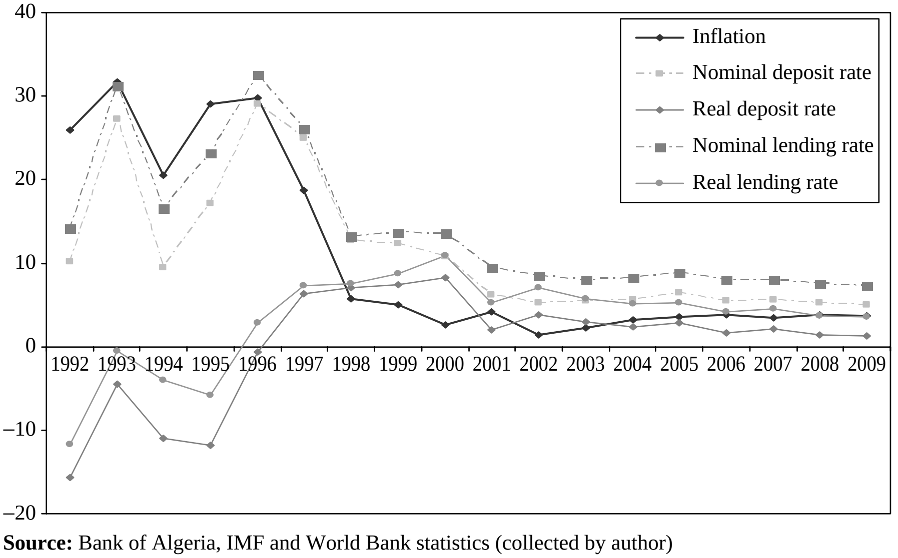
The inflation rate, which has a direct impact on real interest rates, increased considerably in the early years of financial liberalisation. This was due to the removal of price control and the liberalisation of foreign exchange. This resulted in negative real deposit and lending rates, with the lowest rates occurring in 1992 and 1995.

The real lending rates become positive from 1996 and for real deposit rates from 1997 (Figure 3). This is explained by the macroeconomic stabilisation, which was achieved after the full liberalisation of foreign exchange and the creation of market-based instruments to finance the government budget. Algeria's foreign reserves increased to around USD97 billion and foreign debt declined to USD4.7 billion in 2007. The government has also continued its liberalisation of various sectors of the national economy resulting in an increase in foreign direct investments.

The decline in M1/M2 ratio was in parallel to the increase in real deposit rate. The ratio tends to rise as the financial system develops and new saving instruments offered by conventional or Islamic banks. This support the argument that M1/M2 aggregate and savings are positively correlated when financial liberalisation is completed (McKinnon, 1973). Meanwhile, the M2/GDP ratio is more sensitive to oil sector developments than scope of financial liberalisation in the case of Algeria.

Financial liberalisation did not result in a decline in the number of commercial banks, which instead has increased by 280 per cent over the past ten years. Altogether, there are 19 commercial banks operating in the market, one for every 1,615,793 citizens (Bank of Algeria, 2007). The consequence is an increase in competition between the former and the emerged banks as they try to attract large numbers of depositors and investors.

Another stage in financial liberalisation is the entry of foreign banks into the national market. The techniques adopted by these banks are different from those of local banks. For instance, Citibank's strategic orientation in Algeria is to provide its clients with innovative financial products and enable individuals and firms, local or foreign, to access modern financial services (Citibank, 2007). Banks from the Gulf, such as the Arab Banking Corporation, have engaged mostly in financing trade and small businesses (Arab Banking Corporation Annual Report, 2006).



Source: Bank of Algeria, IMF and World Bank statistics (collected by author)

Figure 3.
Inflation, nominal and real deposit and lending rates, Algeria, 1992-2009

Foreign banks outperformed local banks in Algeria. The ratios of net margin/total assets, non-interest income/total assets and net profit/total assets of foreign banks exceeded those of domestic banks (Lee, 2002, p. 39). The high standard lending strategy adopted by foreign banks enabled them achieve high return on their borrowings and to have low level of inputs. Loans are only granted to reputable and mainly large foreign and local firms, those with strong financial position. The increase in capital productivity has also enabled foreign banks boost the return on their assets.

The new law allowed the creation of the first Islamic bank in Algeria. Techniques adopted by the bank differ from those of state-owned banks as *sharia* guidelines are followed in accepting depositing and granting loans to individuals and businesses. In this mode of financing, the rules that manage Islamic financial transaction are based on four main sources: *Quran*, *Hadith*, *Ijmaa*, and *Qiyas*. These four sources are used to determine what is *halal* (permitted) or *haram* (forbidden) according to Islamic law.

The rules governing Islamic banking in Algeria are similar to those adopted in other markets across the globe. Profit and loss sharing mode of financing is used in the allocation of funds. Therefore, Banque Al Baraka d'Algérie only engages in activities that are considered *halal* according to the Islamic law. Savers receive part of the profit generated by the bank each financial year. The bank also deals with the central bank under the same principle (not paying interest on borrowed funds).

The absence of real Islamic inter-bank market in Algeria has constrained the liquidity of Banque Al Baraka d'Algérie. The bank is also not allowed to raise funds from conventional financial markets as this is not allowed under Islamic rules. Likewise, the secondary market for Islamic financial products is tiny and illiquid. Investors are not able to exploit the market potential due to the limited number of financial products available. As a result, it becomes necessary to develop the current money market to improve Islamic bank(s) liquidity.

Research methodology

This study uses qualitative research methods and financial ratio analyses to examine the issue of Islamic banking in Algeria. We interviewed senior managers from Banque Al Baraka d'Algérie. Interviews were held face-to-face with each respondent in Algeria. In total, 18 interviews were conducted. To achieve high level of accuracy we followed Salant and Dillman (1994) guidelines. First, the sample is considered to be significant and this has increased the accuracy of the information obtained. Second, the researcher gave equal chance to the people included in the sample. Finally, the people selected for the sample were allowed to answer the questions willingly and with a high level of precision.

There are two main reasons for using interviews as the main tool for collecting primary data. First, quantitative data are inadequate on banks in Algeria. In an empirical investigation carried on financial reforms in Algeria, Morocco, and Tunisia, Jbili *et al.* (1997, p. 23) assert that "the scope for quantitative analysis is severely limited by data constraints". Second, interviews allow the researcher to gather valuable information on banks strategy of allocating financial resources and means of boosting their earnings and growth. This has enabled us to address the research aims and objectives set for this study.

All people selected for the survey were holding key positions within the bank. Interview questions are clustered around the issue of Islamic banking operations and performance in Algeria. The criteria used in setting of the questions are the role of the interviewee within the bank and his knowledge of the issues being discussed.

Questions were also translated into French and Arabic to help managers understand the exact meaning of each question. Confidentiality was assured throughout the survey, but respondents were encouraged to answer the questions with accuracy. The answers were recorded in tapes to enable us to examine the responses.

The response rate of the survey was 100 per cent. This high-response rate was achieved by making several appointments with each interviewee. Respondents were also given enough time to answer the questions. Because interviews were held with senior managers who had worked for the bank for many years, it is believed that the accuracy of the results obtained in this study is significant.

We used face-to-face rather than telephone and mail surveys to avoid problems, which can be attributed to the wording of the questions. On the other hand, interviews in-person are suitable for unknown population samples when respondents are reluctant to answer questions through the mail or over the telephone. Besides, as noted by Salant and Dillman (1994), face-to-face interviews enable interviewers to explain the significance of the research and to ensure respondents' confidentiality.

Inverted funnel techniques were used when interviewees could not express their opinions of the concepts introduced in the question(s). This technique has enabled the researcher make the respondent concentrate more on the topic under investigation. General questions were also presented before the specific ones to fulfil this purpose. Respondents were reminded of major events throughout the interview and they were asked for second interview when time has not allowed to cover all the questions set for the first interview.

Fielding and Gilbert (2000) note that the sample must be representative of the relevant population to achieve sound conclusions. In this study, the sample was clearly identified in terms of size and knowledge of the respondents of the topic under investigation. The number of interviews conducted was sufficient to gather good quality primary data. The sample population also included people with good knowledge of Islamic finance and have been with the bank for a long period of time.

The questions are formulated in a way that ensures a good validity and reliability of information gathered. For example, questions related to services provided were asked before questions that are linked to the issue of profitability and other performance indicators. Similarly, questions related to risks facing Banque Al Baraka d'Algérie were asked before the questions relevant to the strategies adopted by the bank to enhance its overall performance. Further questions were asked as necessary to cover issues, which were developed as a result of the conversation between the researcher and the interviewees.

The content of each interview has been examined thoroughly. The researcher used a comparative approach to determine the similarities and differences in the views of the respondents. To achieve cohesion of arguments themes are organised on a topic by topic basis. The author also compared the existing theories on Islamic finance with those that are directly applicable to Banque Al Baraka d'Algérie.

The author followed the three main steps stated by Miles and Huberman (1994) to ensure good data analysis: data reduction; data integration and display; and drawing conclusions. The aim of data reduction is to select and organise data in a way that allows unrelated themes to be eliminated. Relationships between related themes are also established and mapped out to arrive at an implicit conceptual framework. Data integration and display is used as a tool of compressing and assembling of information in order to reduce the complexity of data gathered. Conclusions are verified by considering the scope of data collected about the bank.

The sequence of arguments made is based on Miles and Huberman (1994) suggestion that a researcher should consider the various components relating to his area of study. The author ensured the cohesion between the different parts of the analyses by linking the concepts as well as condensing and clustering information. In addition, confirmatory approach is applied, as outlined by Gherardi and Turner (1987), to deal with issues relevant to data selection and transformation.

To realise conceptual and theoretical consistency, the data are interpreted and explained within the context of the theories being generated from the existing literature and the evidence gathered from the specific case study. This is in line with Yin (1991) recommendation that theory and real practices should be compared and contrasted to assess patterns in the data being analysed. Triangulation is also made across the various data sources to assess the quality of information gathered about the bank. Feedback is obtained from the interviewees, when necessary, to ensure a good validity of responses made on the questions being asked (see Miles and Huberman (1994) for more details in using feedback from informants).

Reasons are given to support claims being made in this study using interviews notes and published reports. To provide good explanations the tactic of clustering is used. This includes putting the details received from each respondent into group of themes and then subsuming them into a general content. The various groups of issues are then made to fit the data collected (Glaser, 1978). Assessing noting patterns enabled the researched to identify the core themes and to establish casual statements.

Data credibility is maintained by observing plausibility, reducing the volume of data and creating patterns in them. The researcher also considered relationships between factors with direct influence on bank performance. Each factor is assessed independently to sharpen the understanding of the case study. Moreover, particulars related to each factor are examined.

Besides of qualitative research methods, a set of key financial ratios are calculated to assess the profitability and efficiency of Banque Al Baraka d'Algérie. Elliott and Elliott (2008) note that financial ratios allow for the measurement of performance. However, the financial items used in the calculations of ratios need to be interpreted correctly to reflect exactly the financial position and performance of the reporting entity. The author selected ratios providing useful financial information about the bank. Analytical interpretations are also made for each of the computed ratios.

Analyses of data collected on Banque Al Baraka d'Algérie

Banque Al Baraka d'Algérie offers four principal instruments: *taadjir* (leasing), *musharaka* (equity participation), *murabaha* (profit sharing agreement), and *salam* (deferred delivery payment). *Taadjir* is used by the bank to finance the acquisition of products such as vehicles, machinery and other equipment. The most important form is a lease where a proportion of the instalment goes towards the final purchaser. This instrument accounts for about 10 per cent of the bank financial transactions. Another product offered by the bank is *musharaka*, which is similar to a classic joint venture.

This product has two main characteristics. First, entrepreneurs contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the business venture. Then returns and risks are shared according to an agreement.

This product is designed to finance working capital of medium- and long-term duration. *Musharaka* product is subdivided into definitive and sliding *musharaka*. In definitive *musharaka*, the bank has a stake in the company and receives part of its profit on the basis of the money invested. In sliding *musharaka*, the bank finances new projects, which are expected to be profitable. The profit earned from the project is used to cover the initial capital invested in the project and the rest is shared between shareholders. *Murabaha* product is similar to an investment fund in conventional banking. In *murabaha* transaction, the bank has an agreement with the managing trustee. The agreement shows that the bank purchases the product from the first supplier and then resells it to the contracting party. The bank also owns a proportion of the existing company's capital or of its new projects. *Salam* product encompasses two types of financial instrument: *bay' muadjal* (differed payment sale) and *bay' salam* (differed delivery sale). *Bay' muadjal* is designed for spot sales as well as managing credit sales. In *bay' salam*, the commodity is delivered immediately, but the payment is delayed for an agreed period. The price of the commodity can be paid in instalments or in full. There is no extra charge for the delay. In the *bay' salam* contract, the payment is made instantly though the product is delivered at future date.

One of the new financial products introduced by the bank is real-estate financing. It is offered to individuals who are willing to renovate or expand their houses, to build new houses or to buy new properties. The bank is also funding some professions including doctors and lawyers. Car financing is another facility offered by Banque Al Baraka d'Algérie. The users of the facility are given 5 years to repay their loans. Senior managers agree that the bank is aiming at attracting net-worthy individuals and one of the methods used to achieve this goal is to offer first-class services and to diversify its existing portfolio.

In short-term financing, the bank offers five products:

(1) *murabaha*;

(2) *salam*;

(3) *débiteurs divers* (divers debit);

(4) *istisna'a*; and

(5) securities.

Out of these products, *murabaha* is the bank's main product, accounting more than 80 per cent of its financial transactions. It is a favoured product for financing domestic and foreign trade (interview notes). *Salam* is the second most popular financial instrument. Other financial products are used in less than 5 per cent of financial transactions.

Banque Al Baraka d'Algérie offers two types of investment account: the non-committed participative accounts and the committed participative accounts. The holder of a committed participative account has the right to invest his savings in one or several specified projects. The project earnings are shared as stated in the agreement. The holder of a non-committed participative account can choose where to invest his funds in accordance with the amount of capital required for each project. Profit is allocated in proportion to the duration and amount of deposits.

The bank activities are highly concentrated due to the absence of financial products geared towards medium- and long-term financing. The largest proportions of the bank loans are used to finance trade. The industry sector, transport, agriculture, and public works receive only a small proportion of the bank loans. Interviewees argue that it is safer to finance trade than other sectors of the national economy. They also note that existing products are more suitable in financing trade. Figure 4 shows the operating incomes and operating expenses of Banque Al Baraka d'Algérie compared to those of Al Baraka Banking Group subsidiaries. The bank is ranked fourth in terms of operating income and third in terms of operating expenses in 2006. The high operating incomes achieved by the bank attributes to an increase in the bank services, to a robust position in foreign trade financing and to high economic growth of Algeria. The raise in operating expenses is due to the increase in staff costs, amortisation, and depreciation following the expansion of the bank network.

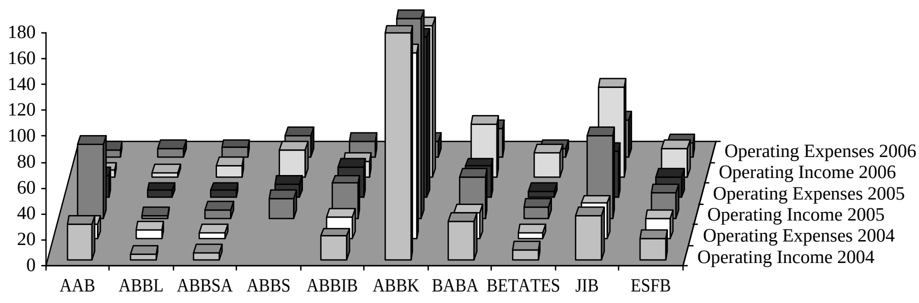
Respondents pointed out that Islamic financial products are widely accepted by individuals and investors in Algeria, as shown by the steady increase in the demand for the bank financial solutions over the past ten years. The bank customer base reached 65,000 customers in 2005. Depositors are also satisfied because the bank practically guarantees deposits in both current and investment accounts. The survey also indicates that clear financial rules determine conventional and Islamic banks' activities in Algeria:

> There are commercial and economic criteria that permit Banque Al Baraka d'Algérie to have its market share in the national financial market (financial manager, Banque Al Baraka d'Algérie).

Many individuals and investors want their funds to be invested on the basis of Islamic codes of financing. Most of the investments appear to be profitable and generate high returns.

Interviewees note that the bank can use financial instruments launched by other major Islamic banks – such as *Faysal* Islamic Bank of Bahrain and Jordan Islamic Bank – to improve its lending and borrowing capabilities. Examples of innovative Islamic financial products are syndication and revolving finance. These instruments would enable the bank to diversify its portfolio and to hedge against market risks. The bank can also create new financial instruments by making conventional banking products comply with Islamic modes of financing.

Banque Al Baraka d'Algérie uses two main methods in the allocation of profit generated from its investments in Algeria. In *musharaka*, the profits are allocated according to the contributions of the entrepreneur and the bank to the business enterprise. In both *murabaha* and *mudaraba*, the profit is distributed according to the income generated from the business venture. The techniques utilised by the bank in managing its assets and liabilities has direct effects on profit allocation in the three main types of financial contracts made available to local and foreign investors.



Source: Al Baraka Banking Group (collected by author)

Figure 4.
Al Baraka Banking Group Subsidiaries operating incomes and operating expenses in $US millions, 2004-2006

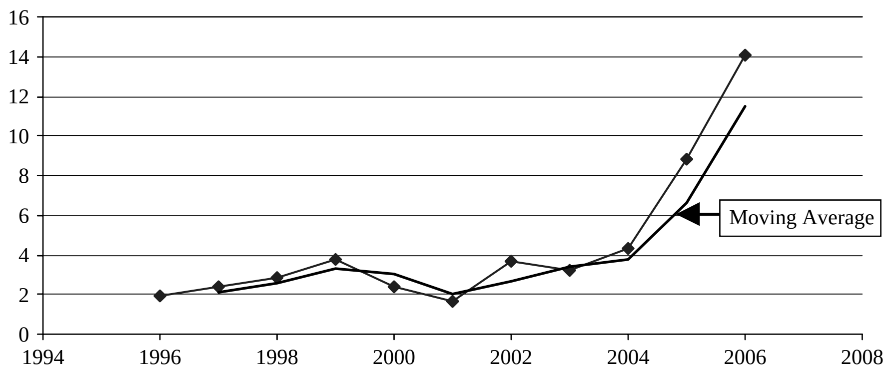
Profit is determined after the business venture financial position becomes strong. It is related to the earning capacity of projects, which is also connected to the amount, the currency and the duration of the deposit. To satisfy depositors, the bank always strives to select good projects for investment. However, depositors' funds are also at risk if the projects financed yield negative returns. Banque Al Baraka d'Algérie shares the losses incurred with entrepreneurs and depositors as stated in the agreement.

The profit of the bank fluctuated over the years of its operation in Algeria. The highest profit figure was achieved in 2006 (Figure 5). The moving average shows an upward trend for the net profit across the period. Senior managers note that the increase in profit attributes to an effective investment strategy adopted by the bank. The bank is funding various projects in construction, transportation, groceries, and oil industry. The income generated from fees and commissions has also mushroomed over the last 10 years. Respondents also argue that the bank has a potential to boost its profit by expanding its customer portfolio, offering various financial solutions, reducing the costs associated with their investments and developing the bank IT systems.

Currently, a large proportion of the bank earnings are generated from financing trade and small businesses. This is because the bank has limited capital and deposits are insufficient to finance large projects. Existing financial products are also unsuitable for long-term financing. Therefore, co-operation with other Islamic banks would enable the bank to fund large investments and expand its portfolio base.

One of the items affecting the financial performance of the bank is bad debts. Most of the bank's bad debts derive from financing by *murabaha* and leasing – these accounted more than 70 per cent of doubtful debts in 2006 (Banque Al Baraka d'Algérie Annual Reports, 2006). The bank uses the two products to fund a large portion of its activities – commerce in particular. Bad debts incurred because of securities trading accounted for 14.9 per cent of total debts. Doubtful debts related to other forms of financing such as *Salam* and *Istisna'a* amounted to less than 5 per cent.

Banque Al Baraka d'Algérie has three types of bad debt provision. It constitutes 100 per cent provisions for debts without real guarantees, for projects that are in jeopardy or for entrepreneurs who are unable to service their debts. The provision on high-risk loans is 50 per cent. Loans are considered highly risky when the repayment is delayed by 6 months to 1 year from the date of maturity. The bank allows 30 per cent provisions for debtors who are in slight financial difficulties. The bank has introduced



Source: *Banque Al Baraka d'Algérie* Annual Reports (1996-2006)

Figure 5.
Banque Al Baraka d'Algérie net profit, 1996-2006

strict working methods to improve the allocation of its financial resources. For example, managers provide full details of loans extended to different sectors of private and public enterprises. The financial information is used to make appropriate provisions for bad debts and to classify credits according to their size and maturity. Similar financial ratios used by Zineldin (1990) and Halkos and Salamouris (2004) were calculated for Banque Al Baraka d'Algérie to assess its profitability and efficiency. As shown in Table II, there is a decline in the average net profit to total assets and the average net profit to total deposits. This is due to the significant increase in total assets and total deposits compared to profit achieved for the period concerned. The main financial items contributing to the increase in the bank assets are *murabaha* sales receivables, customer accounts, *ijara muntahia bittamleek*, and unrestricted investment accounts. In 2006, sales receivables went up by 19 per cent and *ijara muntahia bittamleek* increased by 20 per cent. Table II also exhibits a steady decline in the ratio of total financing to deposits.

This indicates that the bank is relying less on borrowed funds, which reflects an improvement in its financial performance. The return on total assets ratio increased steadily from 2001 to 2004. This indicates that the bank is effective in investing its funds and utilising its earnings. Revenues are generated primarily from financing sales and investments and from fees and commissions. Return on total assets was low in 2002 and 2003 and then increased substantially to reach its highest value in 2006 at 7.09 per cent. This reflects an improvement in the use of the bank assets to boost its earnings. The ratio of profit/loss per employee is satisfactory indicating that the bank's labour is highly productive. Finally, the net interest margin is fluctuating and low in average. This implies that the bank investment decisions are resulting in high operating expenses and as a result reducing the bank's yield. In general, the calculated financial ratios point to a continuous increase in the bank's profitability and efficiency.

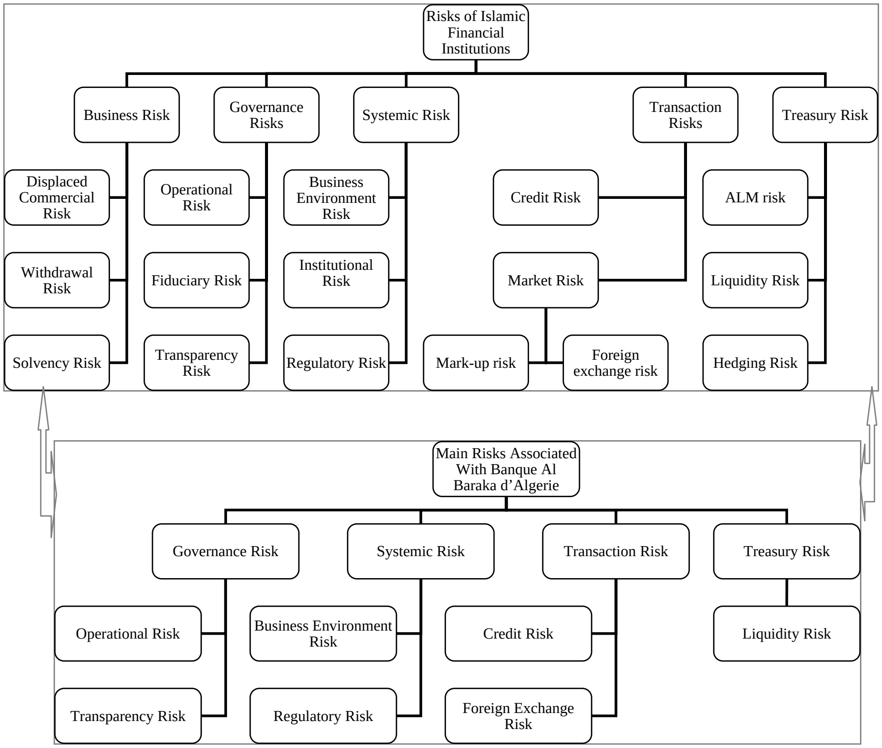
The bank considers three criteria in selecting its investments: the level of risk, the expected rate of return, and the duration of the project (interview notes). The survey shows that the bank uses its funds to finance medium-sized enterprises and to grant credit to wealthy individuals. Average income individuals and large firms receive only a small proportion of the bank funds. The bank also extends a small amount of credits to individuals with small-incomes in the form of consumer loans.

The main risks facing Banque Al Baraka d'Algérie are outlined in Figure 6. These risks are identified by assessing the key financial instruments offered by the bank and the business environment in which it operates. Out of these risks senior managers agree that

	2001	2002	2003	2004	2005	2006
Average net profit to total assets (%)	2.41	1.84	1.41	1.17	1.05	0.95
Average net profit to total deposits (%)	5.52	2.44	1.79	1.42	1.79	1.19
Total financing to deposits (%)	95.0	92.3	85.3	NA	NA	NA
Return on equity (ROE) (%)	11.60	18.36	20.28	29.30	NA	NA
Return on total assets (ROA) (%)	NA	1.42	1.35	6.24	6.13	7.09
Profit/loss per employee (P/L) (%)	NA	NA	NA	7.96	7.26	7.99
Net interest margin (NIM) (%)	NA	1.28	0.85	0.93	1.70	2.44

Note: Average net profit for the 6 year period is: USD5.95 million
Source: Banque Al Baraka d'Algérie *Annual Reports*; ratios are calculated by the author

Table II.
Banque Al Baraka d'Algérie key profitability and efficiency financial ratios, 2001-2006



Note: [a]These risks are presented in the study carried out by El-Hawary *et al.* (2007, p. 786). The risks are attributed to the various financial products offered by the Islamic financial institution

Figure 6.
Risks associated with Islamic Financial Institutions[a] *vis-à-vis* Banque Al Baraka d'Algérie

transparency risk and credit risk are affecting the bank performance substantially. They suggest that in order to improve market transparency, the bank needs to keep its records according to international accounting standards and to disclose details of its lending and borrowing regularly (interview notes). Likewise, to reduce credit risk, the bank is required to assess the creditworthiness of the entrepreneurs before extending any credit to them.

The bank's approach is to improve the standard of its current services to satisfy its depositors, the entrepreneur, and the supplier (interview notes). Its plan of action also includes improving personal contact with customers, expanding its network, introducing new products (such as insurance), and penetrating new markets. Customers are assured that all services comply with Islamic banking principles. For example, when placing excess funds with the central bank or other banks, the bank receives back the principle plus a service charge. This process aims to keep the spare liquidity in the market. The bank also borrows money from the Bank of Algeria without interest (interview notes).

To summarise, Banque Al Baraka d'Algérie mode of receiving funds and financing is still underdeveloped, as reflected by the small number of financial solutions available to its customers. However, the bank strives to improve the quality of its portfolio by initiating further *Sharia* compliant products, adopting good investment strategies and making large provisions for bad debts. The author suggests converting conventional products to create sustainable medium- and long-term Islamic financial instruments.

This would enable the bank to satisfy its customers demand and as a result increase its market share and wealth creation.

Conclusions

The study shows that the existence of Islamic banking in Algeria can be attributed to the process of financial liberalisation. However, the sole Islamic bank operating in the national financial market, Banque Al Baraka d'Algérie, offers a limited number of financial products, and most of them are used in short-term financing.

It is essential, therefore, to introduce other financial products and to have comprehensive financial guidelines from the *Sharia* board to determine if the new instruments are permitted or forbidden. The harmonisation of rules that govern Islamic banking would help the bank to effectively manage its assets and liabilities, improve market transparency and enhance the presence of the bank in the Algerian financial market.

Interviewees agreed that the bank performance has improved. Good investment strategies enabled the bank to boost its earnings. Financial ratio analyses also show an improvement in the bank profitability and efficiency. The bank has introduced various methods to enhance the allocation of its financial resources. The result is an increase in the number of bank branches and services. However, there are many constraints facing the bank. This includes: insufficient level of deposits, limited capital, high level of transparency risk and credit risk, and high concentration of banking activities. The author endorses the argument of implementing effective risk management tools and adopting more implicit and explicit set of financial rules that deal with funds invested according to *Sharia* principles. By doing so, the bank would attract more investors and meet depositors' demands of ensuring the best use of their funds.

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