Comments on the IMF Working PaperIslamic Financial Institutions and Products in the Global Financial system: Key Issues in Risk Management and Challenges Ahead

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The paper is well written, informative and generally reflects the writer's good command on the subject. It did include insightful observations and very useful suggestions which, if implemented will go a long way in enhancing the growth and soundness of Islamic banking. However, the writer didn’t seem to be aware of Islamic banking as it is practiced (not theorized) especially in the Gulf (and in Saudi Arabia more specifically). For example:

1- The author appears to be under the impression that PLS contracts are the "core" and main stay of Islamic banking assets. This is the "academic model" of Islamic banking. In practice Islamic banking is basically Murabaha which, unfortunately, not even mentioned in this paper.

2- It is correct that Mudarabah Contracts, (which were discussed at length by the author) do have imminent risks. However, Islamic banks are well aware of these risks. It is not surprising then that very little Mudarabah assets are found in the books of Islamic banks. In the relatively small portion of Mudarabah assets, Islamic banks introduced many "innovations" for the purpose of managing the risks involved. To name just a few:

a) When they enter in a Mudarabah Contract (over and above selecting reputable and high standing counterparties) will only finance "transparent" operations. Ones that can be easily monitored by the bank at reasonable costs. For example, many banks in Saudi Arabia did enter with the installment sale companies in Mudarabah Contracts to finance purchase (cash) and resale (installment) of automobiles. Although it is Mudarabah, the bank is effectively involved in every stage of the operation starting from the opening of the L/C to import cars, to collecting from consumers who buy these cars. Hence the "fate" of such Mudarabah contracts are not left to only the "best judgment" (p. 5) of the client as the writer appears to think.

b) Very rare that Islamic banks will go in Mudarabah Contracts with "individuals" as the writer mentioned. Rather Mudarabah, unlike Murabaha, only entered into with companies who do have a good tack record and well known to the bank.

c) While it is true that PLS can't be made dependent on collateral (p.5), however, banks are not as disadvantaged as the writer seems to think. In fact collateral is used not to guarantee return, but to remove moral hazard from this "Agency" agreement.

d) The writer says "there is no recognizable default on the part of the agent-entrepreneur until PLS contract expires. (p.4). But Islamic banks do have sufficient exist strategies. In most cases a Mudarabah Contract is divided in several tranches. In some cases daily "constructive liquidation" is done even in Mudarabah.