

## Banking on Faith: Islamic Banking in the Middle East

## Introduction

Investments history was recently re-written with the release of the first index series premised on faith-based investing. The companies included in the Index are screened according to principles found in religions, though the belief is that its range of environmental, social, and governance (ESG) screens will appeal to a spectrum of investors, inside and outside of these religious practices.

In this era where trends flourish around increasing aspirations to identify with socially conscious initiatives it comes as no surprise that Islamic Banking is booming.

The concept of interest is fundamental to the business of banking. So how can banks function without interest and still be profitable? Islamic banks do just that. And not only are they profitable, but they also are growing at an astonishing rate in terms of assets, customer base, and popularity.

From Jakarta to Jeddah to Jordan, 280 Islamic banks operate in over 50 countries, with assets estimated between \$250 billion and \$300 billion. Some 35 percent of these institutions are in the Middle East.

It is estimated that Islamic banks will account for 40 to 50 percent of the total savings of Muslims in 8 to 10 years. Moreover, according to the International Islamic Finance Forum, the banks' holdings are growing by 15 percent a year. The value of Islamic loans is growing at an annual rate of 40 percent, which is likely to increase. With rising demand, the number of banks offering Islamic products worldwide is expected to grow 50 percent by 2009.

Keeping such rapid growth in view, this thought paper explores Islamic banking in the Middle East – specifically in the Gulf Cooperation Council (GCC) countries, the opportunities that beckon and the challenges that need to be overcome.

### In a Sharia-compliant bank:

- ▶ Industries considered sinful – or **Haram** – such as those involved in gambling or alcohol, are banned
- ▶ **Riba** – which means Muslims are prohibited from taking or giving interest – is barred
- ▶ **Gharar**, meaning excessive risk-taking or uncertainty, is avoided
- ▶ The customer and the bank share the risk of investments and divide the profits between them
- ▶ Money cannot be simply traded for money. Instead, it is used to buy goods or services, which are then sold for profit

### Islamic Banking in the Middle East: An Overview

Though Islamic banking has been around for quite some time, the first experiment in modern times began in 1963 in Egypt. Now, local players led by Saudi Arabia's Al Rajhi Banking & Investment Corporation and Islamic Development Bank, Kuwait's Kuwait Finance House, Bahrain's First Islamic Investment Bank and Al-Baraka Islamic Investment Bank, and UAE's Dubai Islamic Bank and Abu Dhabi Islamic Bank have been joined by global financial institutions across the Middle East.

Attracted by the region's \$1.5-trillion funds, Western banks such as HSBC, Citigroup, Société Générale, ABN AMRO, Deutsche Bank, Standard Chartered, and BNP Paribas have set up Islamic divisions or even spun off separate banks to cater to this unique segment.

The key drivers behind this gold rush are clearly the recent economic boom in the Gulf region, a steep rise in per capita income and large volume repatriation of funds long parked overseas.

With rising crude prices (as high as \$100 a barrel in January 2008), oil revenue is surging to fill companies' and investors' treasure chests further. Among other sectors such as realty, the boom has triggered new growth in the financial sector with a rise in demand for Sharia-compliant products. The total bank deposits in the region are expected to increase at a cumulative annual growth rate

(CAGR) of 19.18 percent during 2007-2011. Clearly, Islamic banking is on the cusp of a huge opportunity.

To see how Islamic banking is faring in the Gulf Cooperation Council (GCC) countries, let us take a look at the banks, the competition, the winning strategies, and the complexities.

### Islamic Banking in the GCC Countries

Propelled by rising oil prices and economic diversification, GCC countries are growing rapidly. Islamic banks, or banks that offer Islamic banking units, have a market that holds half of the world's oil reserves and whose citizens have an estimated \$1.5 trillion in private wealth, according to the International Monetary Fund.

The banking industry here has taken on global benchmarks when it comes to growth and profit. Total bank assets rose 24 percent in 2005 to \$506 billion, while net profit on an average zoomed 58% in 2005. Research predicts that Gulf banks will continue to display solid financials, capitalization and liquidity in the foreseeable future.

Islamic banking is expanding even faster. Deposits in Saudi Islamic banks had a CAGR of 17.4 percent between 2002 and 2005, compared to 12.9 percent for the banking sector as a whole across the Kingdom.

### Business Models

GCC's financial strength has attracted local, regional and international players who are offering Islamic products either through Islamic 'windows' or by setting up fully Islamic banks.

The 'window' strategies include separate brands for Islamic services (HSBC's Amanah and UBS' Noriba) or branches offering only Islamic banking products (Samba Financial in Saudi Arabia). Some, like Emirates Bank International and Mashreqbank, have created full-fledged Sharia-compliant subsidiaries – Emirates Islamic Bank and Badr Al-Islami respectively.

Pure-play banks — Sharjah Islamic Bank, Kuwait Real Estate Bank, Emirates Islamic Bank, and Dubai Bank — have moved to total Sharia compliance. This strategy has been adopted by smaller players hoping to attract devout adherents of the faith.

While some consumers opt for a pure-play bank, a hybrid one may be sufficient to satisfy others. In Saudi Arabia, 75 percent of consumer deposits and half of all bank deposits are in non-interest-bearing accounts. In the UAE, such accounts constitute only 25 percent of total deposits.

### Era of Competition

With new entrants and foreign banks now seeking a piece of the action, GCC's established Islamic banks are facing competitive pressures. Large banking entities in the GCC like Al Rajhi, the Kuwait Finance House and the Dubai Islamic Bank have a bright future. But several start-ups – like Al Rayan Bank (which has \$2 billion in capital), Gulf Finance House, Arcapita Bank, Unicorn Investment Bank, Al Masref, Boubyan Bank, and Bank Albilad – are now shaking up the market.

At the same time, there are signs of consolidation in the market: Recent examples include the March 2007 merger between the National Bank of Dubai and the Emirates Bank International, which created the largest bank in the Middle East by total assets.

Adding to the action in the region are some of the largest international banks including Citibank, HSBC and Standard Chartered. Although their market share here is small when compared to local counterparts, these global players are at the forefront in offering new products, such as credit cards.

In this scenario, as competition increases, small local players may face sustainability issues. While some may merge, others may become targets for foreign takeovers. Some banks, on the other hand, may opt for joint ventures. For instance, in June 2006, Deutsche Bank announced a joint venture with Ithmaar Bank of Bahrain and Abraaj Capital of Dubai to launch a \$2-billion Islamic fund.

HSBC has established a strong presence through its UAE and Saudi Arabia-based subsidiary, Amanah. UBS has an Islamic bank in Dubai while Citigroup offers Islamic mortgages in UAE. Citigroup, Merrill Lynch, Morgan Stanley and Deutsche Bank are gearing up to list Islamic-structured products on the Dubai International Financial Exchange. Other banking majors such as Standard Chartered, BNP Paribas, Société Générale, and Credit Suisse are all at various stages en route to Islamic banking.

Apart from aggressive start-ups and foreign banks, Middle Eastern banks also face competition from South-East Asian Islamic banks based in countries such as Malaysia and Singapore.

### GCC Countries

Up until 2004, Kuwait had allowed only one Islamic banking institution to operate within its borders. The oil-rich nation has since relaxed its rules allowing new banks such as the Boubyan Bank to set up shop. The Kuwait Real Estate Bank has moved on to being an Islamic entity.

In the UAE, the Abu Dhabi Islamic Bank and Dubai Islamic Bank have dominated the financial market for years. However, there is more competition now with banks like the Emirates Bank Group setting up Islamic divisions.

The three major banks in Qatar (Qatar National Bank, Doha Bank and Commercial Bank of Qatar) entered the Islamic banking sector in 2005. Now, there are three others providing Islamic banking products.

In Saudi Arabia, the Al Rajhi Bank has enjoyed a virtual monopoly position for decades. But the story has changed with Al Jazira turning into an Islamic bank and the National Commercial Bank all set to become a full-fledged player in five years. A new bank, Al Bilad, will focus on developing retail products in this space.

### Challenges to Growth

Despite all the progress, Islamic banks have a long way to go. To keep on a sustainable growth track, they must address critical issues.

One key challenge arises from the varying interpretations of the Sharia across regions, countries and sometimes even within the same country. What constitutes an Islamic practice is determined by a bank's Sharia council, an independent bank-appointed panel of scholars. Therefore, what is considered Islamic in Malaysia, may be 'haram' (or prohibited) in Saudi Arabia. This absence of uniform standards affects the banks' ability to replicate and implement Islamic products across geographies, attract external investors and expand to newer markets. The council must approve all innovative products but, without a uniform interpretation, it is difficult for banks to know whether the committee will give its nod for a particular region or country.

### Panel finds many 'sukuks' un-Islamic

Recently, scholars at the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) said many of \$50 billion worth of sukuk (financial instruments popularly known as Islamic bonds) worldwide are "un-Islamic" ab initio. The sukuk is an asset-backed certificate of ownership of an asset and/or its earnings. The organization, which sets standards across the Middle East, said the promise violates the principle of risk- and profit-sharing on which Islamic bonds should be based. If there is unanimity in deciding which products are based on Islamic norms, the Islamic finance market can grow substantially.

Another challenge is that of the regulatory frameworks that govern Islamic banking. These frameworks are often at variance leading to operational road-blocks. This is further compounded by the absence of accounting, auditing and credit analysis standards for Islamic banks. Not only must Islamic banks satisfy the Sharia, but they also need to measure up to national policies.

To operate in the globalized economy, these banks must also meet international requirements such as IAS 39 and Basel II. While the AAOIFI has formulated its own accounting standards, several Islamic banks also have to work in accordance with GAAP or International Financial Reporting Standards (IFRS).

Being part of the international banking committee also means following corporate governance requirements (e.g. the Combined Code, Sarbanes-Oxley) which have not been designed for the Islamic business model.

Another cornerstone of global banking – financial risk management – is under-developed in Islamic banks since many conventional risk management instruments are unacceptable under Sharia. This could force Islamic banks to either opt for riskier portfolios or accept lower returns for reduced risk.

The sector also faces IT-related challenges – in part due to the systemic complexities of this market – because core banking solutions are not perfectly tailored for the Islamic market. Without fixed standards for Islamic financial products, customization becomes crucial.

## Conclusion

Islamic banks are on the threshold of a historic opportunity. Oil prices are rising; the banks are flush with funds and are driving growth on the back of strong recent performances. However, to deliver on the promise they need to address certain issues.

Of primary concern are the disparate interpretations of the fundamental Islamic financial principles. The emergence of a clear standard and a common framework will help bring about improved products along with more effective accounting, governance, transparency, and management practices at Islamic banks. This can help these banks build stronger brands for improved scale and performance leading to faster growth and higher margins.

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## Authors

**Rajashekara V Maiya,**  
Product Manager  
Infosys Technologies Ltd.

**Basudev Banerjee,**  
Principal Consultant - Finacle Strategy & Consulting at Infosys Technologies Ltd.



Infosys Technologies Limited, Plot No. 44, Electronics City, Hosur Road, Bangalore - 560100. India • Tel.: +91 80 28520261 • Fax: +91 80 28521747  
e-mail: [finaclemktg@infosys.com](mailto:finaclemktg@infosys.com) • [www.infosys.com/finacle](http://www.infosys.com/finacle)

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