FT FINANCIAL TIMES

SURVEY OF ISLAMIC BANKING - CONSENSUS STILL SOUGHT ON IMPORTANT ISSUES

1,462 words
28 November 1995
Financial Times
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English
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In three decades, **Islamic banking** has grown into an industry with $50bn- $80bn in deposits.

By ROULA KHALAF.

For decades, devout Muslims who follow the Koran's prohibition against interest were happy to leave their savings in conventional banks without asking to be remunerated.

But as oil money began to flow in the 1970s, and filled many Gulf pockets, the Islamic deposits accumulated. Some of these devout Muslims then decided they could build a business catering for depositors who, like them, shunned interest but accepted profit.

Thus was born the curious concept of **Islamic banking**, which has since developed into a substantial niche market with between $50bn and $80bn in deposits, spanning several continents and attracting the attention of western bankers.

Islamic banking began over three decades ago with Mit Ghamr, a small bank which started operations in Egypt. It gained prominence in the early 1970s with the establishment of an Islamic bank in Dubai in 1975 and a year later the Islamic Development Bank in Jeddah.

The industry now has more than 100 banks and finance houses. Interest is banned - at least in name - in the banking systems of Iran, Pakistan and Sudan. Malaysia has implemented a parallel system, with Islamic banks operating alongside conventional ones.

Despite an impressive growth rate estimated at around 10% a year, most banking done in Moslem countries remains of the conventional type. In the countries of the Gulf Co-operation Council, which groups Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain and Oman, Islamic deposits represent less than 10% of the total available in the banking system.

Part of the reason is that no consensus exists among Moslem scholars on the Koran's prohibition against interest. 'God has permitted trade and forbidden riba,' says the Koran. The problem, however, is that riba is interpreted by many Moslem scholars as usury, by others as interest.

Those who insist on the latter interpretation say conventional interest-based banking forces users of capital to shoulder all the risk in a project while unjustly rewarding the owners of capital. Muazzam Ali, chairman of the London-based **Islamic Banking** and Insurance Institute, says the concept of **Islamic banking** stems from Islam's teaching that money should not be created out of money but generated by taking risks on productive investments.

Such a profit-sharing system was encouraged by Moslem scholars as a means of facilitating entrepreneurs' access to funds and helping to develop the economies of Moslem countries. Indeed, **Islamic banking** is at the heart of a new discipline of Islamic economics. Some Moslem economists have looked at the sorry state of Moslem economies and concluded that neither socialism nor **capitalism** are suited for Moslem societies. What these countries need, say the economists, is a system of their own - a kind of moral **capitalism** that resembles a welfare state.

In practice, however, Islamic banks were soon faced with the sober realisation that depositors, however religious they may be, had little taste for risk-taking and were not likely to stick with an institution that invested their funds in money-losing projects.

As a result, instead of investing in long-term development projects, Islamic banks have been forced to mirror conventional banking's fixed rate products which provide a pre-determined rate of return in a short term. Nearly 80% of Islamic funds are thus invested in short-term commodity trades and trade finance deals, where in return for a fee, a middleman - often a western bank - arranges for a trader to buy goods on behalf of Islamic banks and resell them at a predetermined mark-up.

Moslem scholars can find solace in the fact that market pressures are now forcing Islamic banks to reconsider their focus on short-term deals and seek longer-term projects. Two reasons lie behind the shift. The first is that as the market expanded and newcomers to the industry multiplied, conventional banks began offering **Islamic banking** products, which widened depositors' choice and made them demand higher returns.

For example, by June this year, National Commercial Bank, Saudi Arabia's largest institution with $18.4bn in assets, had already converted more than 30 of its 240 outlets in the kingdom into **Islamic banking** branches, with more conversions on the way. Bahrain-based Arab Banking Corp (ABC), the largest Arab international bank, also announced the opening of a new **Islamic banking** subsidiary.

At the same time, the drop in interest rates (although Islamic banks do not deal in interest, the mark-ups charged are directly linked to market interest rates) has lowered returns for the Islamic bank and the western arranger of commodity trade deals.

The trend towards longer-term transactions can be seen on the balance sheet of Saudi Arabia's Al Rajhi Banking &Investment, one of the largest Islamic banks. According to Cyprus-based Capital Intelligence, a bank research and rating agency, Al Rajhi is increasingly taking a long-term exposure. In 1994, 33.9% of assets were maturing over one to five years, up from 25.8% in 1992. Assets maturing over more than five years, meanwhile, went from 9.8% in 1992 to 10.2% last year.

The trend towards long-term projects, however, has forced Islamic banks to face up to several problems. The first is the dearth of Islamically-correct products. As Peter Bruss, an analyst at Capital intelligence, says, the challenge is that what seems a commercially viable instrument may be religiously unacceptable. 'There are two forces moving in an Islamic bank: the financially educated and the religiously educated,' says Mr Bruss. 'Management is having to blend these two forces.'

Leasing for international aircraft deals and other project-based finance transactions have gained prominence in the past few years. Al Rajhi, for example, is now engaged on an $800m construction project sponsored by the Saudi ministry of education to build girls' schools in the kingdom.

To diversify further, Islamic banks are seeking western institutions to help them design new products that can pass muster with their religious boards, which must approve every transaction. A Harvard University research group is studying the industry and looking at product development.

Another problem facing the industry is that while going long-term on investments, deposits remain for the most part very short-term. This creates a potential mismatch of assets and liabilities, compounded by the fact that the long-term products are not securitised and there is no interbank market to help fund daily liquidity. 'The problem with longer-term finance is liquidity. You need securitisation and more Islamic products will be securitised in the future,' says Duncan Smith, head of Islamic finance at London-based United Bank of Kuwait.

However, there is little agreement among Moslem scholars on what can be securitised. Sharia boards in Malaysia, which favour a pragmatic approach to Islamic finance, are happy to see mortgages securitised, a move rejected in the Arab Gulf. Indeed, the main drawback for the development of the industry is the lack of uniformity and standardisation of products. What one sharia board regards as Islamic is considered heresy by another.

'The lack of central sharia authority means you cannot have standardisation across the market,' says Richard Duncan of ANZ International Merchant Banking. 'Without standardisation, you cannot have a market. Otherwise, if you want to trade a product, you can only trade it back to people who issued it.'

This is why new products sold by ANZ and other western banks have a built-in liquidity facility, allowing the buyers to put back their shares to the western bank within a specified period.

ABC has formed a clearing company which acts as a fund that invests in Islamically-acceptable products. Banks can invest their excess balances in the clearing company for two to three days and receive a guarantee from ABC on the principal they put in plus the accrued profit for the period. At a recent conference in Bahrain, sponsored by ABC, Islamic banks discussed the idea of developing the concept further to create an interbank market, although not all sharia boards present agreed with the structure of such a market.

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Bankers say that once such a system is set up with the agreement of a few leading banks, other institutions and sharia boards will be encouraged to participate. This, they say, is the only way for the **Islamic banking** industry to develop further.

'If the industry is to grow, you need solid underpinnings as accepted foundations for this market,' says Roy Salameh, executive director in charge of the Middle East at J. Aron, Goldman Sachs's commodity trading arm. 'With time, effort and commitment, this will happen; otherwise, the sector will not realise its full potential.'

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