East meets West

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The Islamic banking industry is a growth sector, particularly with regard to high-net-worth customers. Roisin Killeen examines its presence and potential in western markets

THE FIRST Islamic bank was set up in 1963 in Egypt, and 34 years on, it is estimated that total assets in the industry stand at $165 billion, with 144 institutions in 25 countries offering Islamic banking services. And the future of this niche banking sector seems favourable, with industry experts estimating annual growth of about 10 percent to 15 percent in the next few years.

"There is a lot of interest worldwide, and total assets could potentially be ten times larger, but it will take time to realise," said Rodney Wilson, professor of economics at Durham University in the UK and author of a recent report on Islamic finance.

Most Islamic financial institutions are based in the Gulf. High profile players include Kuwait Finance House, Al Rajhi Banking and Investment Corporation and Al Baraka. But, today, international institutions are beginning to make a significant dent on the market - Citibank, Robert Fleming, ANZ and Dresdner Kleinwort Benson all have branches in the Gulf offering Islamic banking services.

Citibank set up its dedicated Islamic bank in Bahrain in July 1996. From Bahrain it targets customers throughout the Gulf - these customers are mainly high-net-worth individuals, corporate and institutional investors. "In some ways Citibank has an advantage over Islamic banks because customers are attracted by the reputation of Citibank and its worldwide contacts," said Wilson.

What are the principles behind Islamic banking? Islamic banking complies with Muslim beliefs and is governed by the sharia religious law. In particular, it prohibits interest for banking transactions - a bank cannot make money for doing nothing and there must be an amount of risk involved. In place of interest Islamic banking uses profit sharing and a transaction is a partnership between the bank and the customer.

"Depositors with conventional banks are certain at least that the money they deposit will be paid back but this is not the case with Islamic banking and profit sharing," said Rifaat Ahmed Abdul Karim, secretary general of the **Accounting and Auditing Organization for Islamic Financial Institutions**. "With Islamic banking the provider of funds bears the full loss," he added.

To avoid interest, most Islamic investors invest their money through leasing arrangements. Morabaha or deferred payment is such a method - the bank buys a product for a customer and then sells it back to the customer at a mark-up price, which is paid back in equal instalments.

As exemplified by Citibank, western banks are gaining a foothold in Islamic banking in the Gulf. Islamic banks, however, are also trying to establish themselves in the West.

Earlier this year the United Bank of Kuwait introduced the first Islamic mortgage in the UK, which has been approved by the Council of Mortgage Lenders. This product is again based on the morabaha method. When a customer agrees a price for a house, the bank then buys the house and sells it on to the customer at a higher price, which again the customer pays back in equal instalments.

Though Islamic banking is growing at an impressive rate, it has not yet made a significant impact in the West. And especially in the US and the UK, there is a large pool of affluent Muslims, which could be targeted.

High street banks, such as Barclays, can be confident for the moment that they will retain their Muslim business. The downfall of the Bank of Credit and Commerce International made the public wary of investing in small, relatively unknown institutions and though it was not an Islamic bank, it was an Arab-owned bank.

So, Islamic banking has several stumbling blocks to negotiate before it will be able to offer full banking services to Muslims in the West. In fact, it does not yet comply with the requirements of the Bank of England (BOE). In 1993 the BOE obliged the Saudi Arabian-based Al- Baraka Bank to surrender its banking licence and Al-Baraka now only operates as an investment company in the UK.

"With Islamic banking the products are similar but there are no central standards," said Wilson. "Different banks in different countries with different regulations. Malaysia, for example, is known to be more adventurous than the Gulf."

BOE's main reservations were outlined at a conference on Islamic banking in London in September, where Michael Ainley, a BOE senior manager in supervision and surveillance, gave a talk.

One of the main concerns is that regulation is not adequate and the role of the sharia board (a group of scholars which vets all the bank's business) has to be clarified - there is often differing opinions between sharia scholars.

Standardisation of accounting and auditing is another issue, which needs to be addressed. For instance there are six different ways to recognise profit under the morabaha accounting method.

Liquidity is another grey area. Interest is usually the tool for managing liquidity but since this is prohibited under sharia, Islamic banks need to hold higher levels of liquid assets.

One organisation which is fighting to overcome these obstacles is the Bahrain-based **Accounting and Auditing Organization for Islamic Financial Institutions**.

"If things are made more transparent, then people will have a choice and will know what they're entering into," said the organisation's secretary general, Karim. "We issue standards which do not have any enforcement powers, but we work closely with central banks and auditors." A recent boost for the organisation was that Sudan just announced it would treat these guidelines as mandatory.

Ainley is hopeful that Islamic banking will soon meet the BOE's requirements. "London has an excellent record in developing new financial products. Indeed, the fact that London is often quoted as a leading centre of Islamic financial products supports this and should offer encouragement to Islamic bankers (and regulators) when searching for solutions to the problems I have outlined today."

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