

## ISLAMIC BANKS – After 9/11

### Bouncing Back

Islamic banks are furious. All of the immense thought and hard work they had invested in the industry was tarnished post-September 11 by Western law enforcement agencies which blamed Islamic banks for funding terrorist activities.

In fact, so riled up were the Islamic bank chiefs that it was the over-riding theme of a recent Islamic banking conference in Manama. Prince Mohammad Saud bin Faisal, an Islamic banking veteran and chairman of the Geneva-based Dar Al Maal Al Islami (DMI) Group, argued strongly: "There are many misperceptions about Islamic banking today. The problem is that the questions are addressed not to Islamic banks, but to so-called experts who have no idea what they are talking about. And we have recently faced an unprovoked attack by the media which is characterised by fabrication of facts.

"There is a conspiracy to besmirch the reputation of institutions that have always been good citizens of the countries they have been a part of. The question here is not one of morality, but professionalism, and the protection of the interests of our investors. Let us not fall into the trap that the criminals had perpetrated against human values on September 11."

Echoing Prince Mohammad's sentiment, Saleh Kamel, chairman of the Jeddah-based Dallah Albaraka Group and of the Bahrain-based General Council for Islamic Banks and Financial Institutions (GCIBFI), said: "I wonder why only Islamic banks having such (terrorist) accounts are under attack and defamation, while they are ignoring accounts of charities frozen in other banks all over the world. Islamic banks are neither charities nor terror facades. They are banks operating under the supervision of central banks, receiving clients' deposits and investing them... There are no surplus funds to finance terror, nor are they corridors for circulation of funds among terrorists."

Dangers and challenges Iqbal Khan, chief executive officer of Amanah Finance, the Dubai-based Islamic

banking division of HSBC, added: "September 11 is like any crisis - it has dangers and opportunities. This is a difficult period, but I think the Islamic banking industry will come out stronger."

It seems that because of the complexities of the Islamic banking sector and the guarded nature of Islamic banks, the rest of the world views the industry with suspicion. Quite a few Islamic banks lag far behind their conventional banking counterparts in publishing half-yearly reports, or quarterly reports, and they are notoriously secretive about their investors. This reluctance to allow access to their business activities has propelled them into the limelight - for all the wrong reasons.

But there are very good reasons for the Islamic banking industry to gain global recognition. It is a completely home-grown entity with innovative services and products pioneered by local and regional entities. The Islamic banking industry is worth \$200 billion and is growing at 15 per cent annually, much higher than conventional banking.

Still, Islamic banks are mindful that it is just a drop in the financial ocean. While conventional banks are not under any imminent threat, even within the region, of being upstaged by Islamic banks anytime soon, virtually all major banks have opened Islamic windows. Saudi American Bank and Saudi British Bank, for example, have opened up Islamic banking windows, while international players such as HSBC and Citibank have all launched Islamic banking units as well.

Michael Langton, director at Bahrain Institute of Banking and Finance, says that despite the clout and financial muscle of international conventional banks, it does not give them a clear advantage over Islamic banks. "The way I see it, they are promoting Islamic banking. Islamic banks by and large will continue to attract the lion's share; that's going to happen. It is not in the best interests of large international banks to have a huge Islamic banking window. The progress will be driven by Islamic banks."

HSBC recently launched its HSBC Amanah Finance

division, focusing on Islamic financial products. Chief executive officer of Amanah Finance, Iqbal Khan said: "At the end of the day, Islamic banking is a market-driven phenomena, it is educated, middle-class Muslims with a corporate responsibility who are demanding it. The biggest challenge has been the legal and regulatory framework around which we have to build Islamic financial products. The laws are so onerous that it makes it expensive for banks to launch a variety of products."

But this has not dissuaded ANZ Grindlays, Chase, Citicorp, HSBC and Morgan Stanley from introducing Shariah-compliant products and services. The importance of Islamic banking is also evident by the decision of major stock exchanges such as the Dow Jones and FTSE to offer Islamic indices. V Sundararajan, a senior executive at the IMF, notes that the Dow Jones Islamic Market USA index had an annual return of 27 per cent from 1996 to 1999, compared with 24 per cent for S&P in the same period. "While current industry data are unavailable, evidence from the International Association of Islamic Banks suggests that assets managed by those banks have tripled in four years."

And, despite the recent short-term setbacks, the Islamic banking industry is expected to emerge stronger than ever.

But while external pressures are critical, the industry itself has to withstand many internal challenges.

Regulating regulation Islamic banks argue that their industry is well-regulated, in fact over-regulated. "I think the regulations are enough," says Dr Jamil Jaroudi, group head investment banking at Shamil Bank. "All the rules that apply to conventional banks apply to us as well. If you find some malpractices in conventional banking, you also might find them here; but it does not mean you enforce more regulations, because you don't want to cripple and tie the hands of the bankers. The regulations are up to speed, in some countries more than others definitely."

Luma Saqqaf, senior associate at legal firm Allen & Overy, adds: "There is a common misconception that there are no specific rules or structured laws in Islamic Shariah. This is inaccurate; the principles of Islamic financing are well-known to those involved. The differences arise in the details and practices. Similar differences exist in conventional banking. In terms of statutory laws, most Arab countries, including the UAE, have recognised Islamic concepts expressly in their laws, for example types of Islamic musharakah are provided for in the UAE civil code."

In the area of regulation, the role of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) cannot be overstated. The Bahrain-based AAOIFI was established in 1991 by several major Islamic financial institutions to regulate international accounting and auditing standards for the industry. Although it does not have the authority to enforce the standards it promulgates on Islamic financial institutions, it does work closely with respective central banks and governments. And, this approach has proved successful with the supervisory authorities in Bahrain and Sudan, asking Islamic banks to adhere to AAOIFI's standards in preparing their financial statements.

Some Islamic banks in other countries, for example, Malaysia and Saudi Arabia, have also started to voluntarily use AAOIFI's accounting standards to prepare their financial statements. Furthermore, international rating agencies have also started to take AAOIFI's standards into consideration when rating Islamic banks. Recently, Bahrain and Malaysia, who are both striving to co-ordinate their Islamic banking efforts, signed an agreement of co-operation based on the AAOIFI.

"Both governments recognise the role of AAOIFI in establishing appropriate accounting and auditing standards pertaining to the operations of Islamic financial institutions and shall endeavour to work towards adopting these standards and the promotion of AAOIFI, specifically in relation to the Islamic Financial Services Organisation (IFSO) and International Islamic Financial Market (IIFM)," says

the agreement. "This is a major breakthrough for AAOIFI and its work," said the organisation's secretary general Dr Rifaat Abdel.

Still, AAOIFI standards are only enforced on a voluntary basis, rather than a compulsory one, and smaller banks in less developed countries have been guilty of not following the rules to the letter. Ensuring that these banks adhere to the rules presents a huge problem for the industry, as there is no singular Islamic banking authority to set the rules.

Teething troubles But these issues, say many, are simply teething troubles in an evolving industry. "We must not forget that Islamic banking is only 30 years old," says one sympathetic analyst. "There are so many issues to tackle, and to be up to speed with developments in conventional banks is difficult for the smaller banks to manage. But the big banks can be compared to international conventional banks in the world."

Bahrain has come closest to assuming some authority in Islamic banking. The country is using its strong financial infrastructure to launch a series of initiatives to boost the sector. Working in conjunction with Malaysia, another key proponent of Islamic banking, the Bahrain Monetary Agency is forming an Islamic ratings agency.

In addition, the Bahrain Monetary Agency (BMA) launched a new instrument, Sukuk Al-Salam bills, as a short-term investor opportunity for Islamic financial institutions. Other countries including Pakistan and Bangladesh are now contemplating issuing similar securities.

More importantly though, the BMA has launched a money market fund which it hopes will solve the incessant ill-liquidity issue faced by Islamic banks, and many see this as crucial in taking the industry forward.

"Islamic banks typically face large exposure to liquidity risk because of asset-liability mismatches and underdeveloped interbank and money markets," says IMF's Sundararajan. "Lack of Shariah-compliant,

short-term government securities, such as treasury bills or commercial paper, complicate Islamic banks' task of liquidity management. The proposed International Islamic Financial Market (IIFM) would, once operational, improve the liquidity management ability of Islamic banks.

"However, because of its international characteristics, it is unlikely that the IIFM will replace the need to develop local money centres and central banking facilities that are necessary for an efficient liquidity management operation. Furthermore, the long-term prospect of the IIFM would depend on the ability of local markets to generate the needed critical volume of real investment opportunities on which the financial securities will be based."

But other markets in and outside the Gulf are catching up. "We expect to see a lot of growth in Islamic banking in the Far East and notably Malaysia and Singapore," says Allen & Overy's Saqqaf. "Our Singapore office has reported an increased interest in this type of financing and we are currently acting for a Malaysian company in relation to the first securitisation in Asia. Only recently, we have been approached in relation to a potential project finance transaction in Malaysia for approximately \$200 million which will be financed on an Islamic basis."

Innovation is fuelling the development of the Islamic banking sector, according to most analysts. But the industry is slow on the uptake, particularly given that every new product is an expensive proposition because of the legal and regulatory issues which banks have to comply with before their introduction.

Uncharted territory Still, some banks are pushing the industry into uncharted territory. First Islamic Investment Bank (see box) is looking at offbeat investments in the United States, such as kayaks and coffeehouse chains to expand its horizons, while HSBC's Amanah Finance unit has launched its HSBC Amanah Currency Fund as a wealth management product for Islamic investors in close co-operation with Kuwait Finance House and Dubai Islamic Bank.

Similarly, Bahrain-based Gulf Finance House has started work on a \$40 million 4ibank based on Islamic principles. According to Esam Janahi, chief executive officer of Gulf Finance House, the new entity is a "coin with two faces. Firstly, it is an additional unit for other Islamic banks, and secondly it allows you access to the products and services of Gulf Finance House."

Janahi also says that its other bank partners will be announced soon, and 4ibank is expected to be launched by the summer of 2002. "It will be different from a portal. Many Islamic services will be there in addition to a new range of Islamic product funds, private equity."

Bahrain Monetary Agency is already in the process of developing the laws regulating Islamic banking in Internet space, according to Janahi. "They have already done it and are in the process of going through the channels to be approved."

"There are limitless horizons of innovations open for Islamic banks, which are not available for conventional banks due to their limited and fixed mechanisms," says Dallah Albaraka chairman Shaikh Saleh Kamel. "The modes of istisna, mudaraba, musharaka and other modes combining capital with effort, experience and craftsmanship, open wide spheres of innovation, paving the way for introducing new finance instruments following Shariah guidelines."

Takaful and retakaful (insurance and reinsurance) is another neglected area of Islamic finance. Mohammad Ajmal Bhatti, chief executive of Takaful International, says that the global takaful industry stands at \$550 million, with around \$1.5 billion of assets under management. "It is estimated that the global takaful premium could grow to \$7.4 billion in 15 years' time, at the rate of nearly 20 per cent growth per annum. This is not an unachievable task when we have Malaysian takaful business initially growing at 60 per cent per annum, and in the Middle East it is growing at 10 per cent."

Bhatti adds that the annual premium income of \$7.4

billion would generate approximately \$27 billion of funds, and the takaful system would ensure that the Islamic banking sector completely adheres to the Shariah. "The sector needs to develop the retail side, having done very well in the wholesale banking side such as corporate finance and investment management.

"The Islamic retail financial services sector is in a void without a strong takaful system. A strong takaful system similarly, needs retakaful. Without good and strong retakaful companies, the takaful industry is feeding a major part of its income to the conventional system."

The next generation While regulations and innovations are critical to the industry's growth, human resource development is also equally important. There are no degrees in Islamic banking and finance, and banks currently conduct most training in-house. "Human resources is a challenge in the sense that Islamic banking is very much in its infancy," says Michael Langton of BIBF. "What you have is a fair number of individuals, who have, at one point or another, been conventional bankers or conventional insurers and so they bring with them the fundamentals of banking. But the real challenge is going forward: how do we recruit the younger generation of Islamic bankers? There are not many Islamic banking degrees, and Islamic banking training institutions. I think there is a clear need for it.

"The BIBF is probably doing the major work in training and development in the area of Islamic banking, so you are going to need reputable international universities in Islamic studies. Interaction between Islamic scholars, international banking scholars, and sharing information will also help Islamic banking principles to be understood and learned. That will attract conventional institutions to the industry.

"The BIBF itself offers a diploma in Islamic banking, which is developed by the industry. We offer 25-30 skills training courses each year, and customise them for different banks in Saudi Arabia, Sudan, Malaysia and Indonesia. We have about 600-700 participants a year. Interestingly, a fair percentage of those



individuals are from conventional banks which have Islamic banking windows."

Several international intermediaries are also investing heavily in training their employees and that, for some, is an expensive proposition. Most, however, are on a vertical learning curve. Guided by their respective Shariah boards, most senior managers learn, and consequently teach, other team members the intricacies of the Islamic banking system. But there is a general consensus that the industry needs fully-fledged Islamic finance degrees and education to bring some conformity and common principles to which every bank could adhere.

With the industry showing strong signs of moving forward on many fronts though, Islamic banks are expected to become a force to be reckoned with in a few years time. Major Islamic banking players - more staunch than ever in the face of the current crisis - will see to that.

But a clear need remains to introduce a range of Islamic investment and retail products to ensure that the considerable assets of people in the Muslim world, an overwhelming majority of which is locked in conventional equities, funds and banks, can be repatriated and ploughed back into home turf. That was, after all, the underlying principle of the home-grown industry to begin with: to fund economic growth from within the region.

(Gulf Business)

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### Islamic banking set to expand

ONE of the consequences of the events of Sept. 11 has been the attempt by the United States to implicate various Islamic financial bodies and institutions with involvement in terrorism, either knowingly or unknowingly. These charges have been vehemently and categorically denied. Indeed, despite such attempts, Islamic banking has continued to grow at a speed that has forced many to study and analyze what is a

relatively new phenomena. The reality is that millions of people all over the world are seeking to make money in ways that do not run counter to Islamic teachings and in so doing, Islamic banking has been born and has added a religious element to conventional financial services.

From a bare handful of financial institutions set up in the 1970s to provide services compatible with Shariah law, the number of Islamic banks have grown to more than 200 in some 50 countries. They manage assets of around \$120 billion in addition to investments of another \$150 billion. The great desire by Muslims everywhere to conduct their financial dealings in accordance with Islamic teachings by using banks that do not pay or charge interest, and thus avoiding riba or usury which is forbidden to them has propelled financiers to adjust and adapt Western-style services.

The system uses a variety of mechanisms including murabaha, a profit and loss-sharing system, musharaka, a profit-sharing joint venture, mudaraba, a profit-sharing agreement, istisna, supplying industrial products to client's orders, and ijara which is a globally recognized mode of leasing. These are all used in addition to the more conventional funds and portfolios which follow Islamic teachings.

"Islamic banking is not a negligible or a temporary phenomenon. It is here to stay and there are strong signs that it will continue to grow and expand. Even those who do not subscribe to the injunction against interest may find innovative ideas in Islamic banking which could add more variety to the existing financial network. Moreover, the speed with which Islamic banking has sprung up and the rate at which it has progressed has made it an academic discipline to be studied systematically," said Dr. Said Al-Shaikh, chief economist at the National Commercial Bank. He says that while Islamic banking derives its rationale from the prohibition of interest, it is widely believed that there is greater value to Islamic banking - such as contributing to a more equitable distribution of income and wider equity participation in the economy. The role of Islamic banks in stimulating economic development is underlined by the

fact that they would be ready to finance acceptable projects which might be turned down by conventional banks for lack of collateral. Islamic banks, on the other hand, might involve themselves in these projects on a profit-sharing basis.

The notion that Islamic banks are here to stay is shared by Dr. Najatullah Siddiqui, an eminent economist and winner of the King Faisal Prize for Islamic Studies. He emphasized the viability and success of the system. According to him, the growing number of Islamic financial institutions and the opening of Islamic banking counters by major conventional banks are proof of its attraction and are themselves proving successful.

Insurance, especially life insurance, has always been a contentious issue in Muslim countries when it comes to financial dealings. Recently a Saudi bank, Bank Al-Jazira, announced the introduction of what it described as the first authorized Islamic life insurance ever launched in the Kingdom.

Mishari Al-Mishari, the bank's general manager and CEO, said the new program known as Takaful is the first in the world to offer the wakala contract concept. It provides participants with the opportunity to save on a regular basis through a range of bank-approved investment funds. The program, he added, has been approved by the Saudi Arabian Monetary Fund and the bank's Shariah advisory board. Its first phase consists of three individual products: Retirement, term protection and a waqf (endowment) charitable donation savings plan as well as two corporate group plans for term and credit protection. Later as the program grows, savings and protection plans for education and marriage expenses will be incorporated. In addition, a special savings plan for women will be introduced.

The NCB recently launched a new Shariah-compatible product which it said would enable a large number of clients to raise cash for immediate personal use without resorting to conventional borrowing. Under the service, known as Tayseer, the bank would sell the client goods it stocks and help to sell the same goods

for cash in the international market. "This service is the first of its kind not only in the Kingdom but in the whole world. It satisfies the needs of a large number of our clients who have been looking for an Islamic means of retrieving cash for immediate use. It is intended to save the client both time and money," said Abdul Raziq Al-Khuraiji, manager, Islamic Banking Services. The service adds to the bank's 16 Islamic investment and financing products with assets of more than SR14 billion. The largest of these is the low risk, high-liquidity Saudi Riyal Trade Fund which purchases goods and sells them at mark-ups on deferred payment terms and has SR8 billion in investment.

Local Islamic financial institutions are expanding abroad through shared capital and asset merger initiatives. The latest such deal was concluded between Dallah Al-Baraka Group of Saudi Arabia, which runs Al-Baraka banks in several Arab countries, and the International Investor of Kuwait. The two institutions heralded what Dallah officials described as "the beginning of an exciting new era in global finance" with the signing of a \$350 million asset-merger deal. The new organization will provide clients in the Middle East and Africa with a full range of banking and investment services. "This agreement marked a turning point not only for clients, shareholders and business partners but for Islamic banking as a whole. We will work together to become the first full-fledged Islamic financial services network in the region," said Saleh Kamel, chairman of Dallah Al-Baraka Group.

While some analysts attribute the success of Islamic banking simply to clients' desires that these institutions comply with religious injunctions, most analysts predict expansion and growth well into the 21st century. "The development (of the Islamic banking experiment) may still be in its early stages but what has been achieved represents a great success," said Dr. Muhammad Al-Kari, former manager of the Islamic Economic Research Center at King Abdul Aziz University in Jeddah who is now in NCB's Shariah Control and Fatwa Committee.

Making available the legitimate tools demanded by

clients who want to invest has increased financial mediation, he said. "Studies in some Muslim countries have proved that the introduction of Islamic financing tools has had a direct effect leading to an increase in financial mediation."

Another obstacle facing Islamic banking is that although the burgeoning industry enjoys a huge potential, a paucity of regulations and scarce long-term investments along with their relatively small size are all slowing its progress.

Economists say Islamic banking is growing but the services offered by these institutions lack Shariah-compatible structured instruments to absorb liquidity. These banks and financial institutions need to establish a global, internationally accepted regulatory system to help ensure continued growth. Countries where these banks are located have also been advised to set up flexible rules and regulations, as well as instruments that can be traded according to Shariah to allow the industry to benefit their economies.

(Arab News)

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Islamic finance industry 'faces major challenges'

The Islamic finance industry - which has firmly established itself in the mainstream global finance - faces many challenges ahead and, in the aftermath of the September 11 events, has been unfairly treated, according to Abdullah Saif, Bahrain's Finance and National Economy Minister.

Thus the need to underscore that this industry is also engaged in genuine economic activity and is not part of any political movement of any kind," he said while talking about the challenges faced by the Islamic finance industry in the aftermath of September 11 events and its prospects.

In his opening address at a recent Islamic Finance Summit in London Abdullah Saif dealt at length on

various issues faced by the Islamic finance industry pointing out that the first major challenge is to improve awareness of the true nature of Islamic finance and to dispel any misunderstanding.

"This industry is presented with a major challenge to create better awareness in the world at large of the ethical and well regulated business of Islamic finance, besides facing the continuous challenge of business marketing to broaden and deepen its customer base," stated Abdulla Saif.

"As Islamic finance operates in a highly competitive market, it must be seen to offer attractive risk-reward opportunities to both investors and users of funds.

"Though Islamic finance is increasingly perceived as a viable and competitive alternative, we must not forget that we do live in an universal banking era characterised by advanced technology, economies of scale and capital strengthening, together with consolidation of conventional banking - which calls for a competitive response," said Abdulla Saif.

He said Islamic finance is now on the path of sound growth and still has outstanding potential for further innovation and development.

He also highlighted the need to be innovative as innovation has been the hallmark of modern, conventional finance and most of its balance sheet items have been transformed into detachable, tradeable financial instruments - whereas Islamic finance is still in its infancy in this field with plenty of scope for further innovation.

He also dealt with the challenges to develop inter-bank liquidity and tradeable Islamic financial instruments and the need to provide an efficient market for intermediate short term liquidity surpluses and shortages in the international Islamic banking system.

"In fostering long-term commitments from Islamic investors, to take Islamic finance beyond its

historical focus on commodity financing, investors will look for a liquidity option. In this regard a genuine change of their circumstances may create the need for them to realise an investment prior to its natural conclusion.

"Legitimate finance structures need to be developed for transferable assets which could be traded. Assets subject to Islamic leases are an obvious candidate and already, Islamic equity, is a well established form of tradable instrument," stated Abdulla Saif.