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The development of Islamic finance in the GCC

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The Development of Islamic Finance in the Gulf Cooperation Council States

RODNEY WILSON

Abstract

Modern Islamic banking originated with the establishment of the Dubai Islamic Bank in 1975. The study evaluates the development of Islamic banking in the GCC since then, an industry which now encompasses Islamic *takaful* (insurance) and *shariah*-compliant asset management, as well as retail and investment banking. An examination is made of the extent to which government policy, through both legislation and regulation, has facilitated the development of Islamic finance. *Shariah* governance systems are appraised, in particular the workings of the devolved form of self-governance by Islamic financial institutions. The deposit facilities offered by Islamic banks in the GCC are discussed, as well as the financing provided, notably trade finance, consumer credit and mortgages for real estate, which are the dominant types of funding by Islamic banks. The issuance and trading of Islamic *sukuk* securities is also considered, as well as the role of the region's financial centres.

The Gulf Cooperation Council (GCC)¹ is at the heart of the Islamic world, with the two holiest shrines under the guardianship of Saudi Arabia, a kingdom that prides itself on being governed under *shariah* law. It might therefore be expected that the GCC states would be at the centre of the rapidly expanding Islamic finance industry, which encompasses retail and investment banking, insurance, fund management and the issuance and trading of *shariah*-compliant securities known as *sukuk*. This study appraises the extent of Islamic banking and financial development in the GCC and attempts to identify the major factors explaining its expansion. The size of the industry is examined, and the extent to which government policy on legislation and regulation has facilitated the development of Islamic finance is discussed. Systems for *shariah* governance are considered, as these are crucial for the reputation of Islamic financial institutions. The deposits and financing offered by Islamic banks are also reviewed, including the adequacy of these facilities in meeting customer needs. Islamic investment banking is less developed than retail operations in the GCC, but there have been significant developments in recent years, notably in *sukuk* issuance. The GCC has seen a proliferation of financial centres, and Bahrain has become the major centre for Islamic

¹ The GCC member states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

banking, although questions about its sustainability remain. How far competition between different centres is helpful to or detrimental for Islamic finance will be considered.

A major aim of this study is to assess the extent to which the countries of the GCC are the global leaders in Islamic banking and finance. Other countries, notably Malaysia, have done much to encourage Islamic finance through legislation, tax breaks and indirect subsidies, all of which have to be viewed in the context of its affirmative action programmes to enhance the economic role of the Bumiputera Muslim Malays. The Islamic Republic of Iran introduced legislation to make its entire banking system *shariah*-compliant in 1983, a precedent that none of the GCC states have sought to follow.² Even the UK government has sought to promote London as a centre for Islamic finance, largely because of the business and employment it could generate for the City, as well as demonstrating to the British Muslim community that if its members wish to use the services of Islamic banks, no obstacles will be put in place to prevent this.

On most criteria however, the GCC states are ahead of potential rivals. The GCC countries collectively account for a higher percentage of *shariah*-compliant global financial assets than Iran, and Saudi Arabia is likely to overtake Iran in 2010, despite the size of the latter and the monopoly which Islamic finance enjoys there. Furthermore, the Islamic banks in the GCC states have been more innovative than their Iranian counterparts in terms of product development, and provide a much more attractive range of services, possibly because of the need to compete with conventional banks in their domestic markets. As the banks in Iran are state-owned, this arguably makes them more bureaucratic than innovative. Sudan was the only other country to attempt to convert its entire financial system to being Islamic, but the process was subsequently reversed in the largely non-Muslim south, and Sudan's Islamic banks remain small, reflecting the limited size of its economy and its low living standards in comparison with the GCC. Beyond banking the GCC states have played the leading role in the development of *shariah*-compliant mutual funds and *takaful* (Islamic insurance).

GCC Islamic financial institutions are taking an increasingly global perspective. Al Rajhi Bank has established subsidiaries in Malaysia, where it has a network of nineteen branches, and Kuwait Finance House (KFH) has expanded into Turkey, where it

² Islamic Republic of Iran, *Law on Interest Free Banking*, Tehran: Central Bank of Iran, 1983, pp. 1–12.

is the country's largest Islamic bank, with eighty-eight branches – more than it has in Kuwait. KFH started retail, commercial and investment banking operations in Malaysia in 2006 and it has opened representative offices in Singapore and Melbourne. Dubai Islamic Bank is rapidly expanding its branch network in Pakistan, and it purchased the Bank of Khartoum in Sudan as well as three real-estate companies in Egypt. It also owns offshore real-estate investment companies based in the Cayman Islands as well as leasing companies in the Bahamas and Ireland, and has a 27.3 per cent stake in Bosnia International Bank, 31 per cent of a bank in Northern Cyprus and 18.5 per cent of Saba Islamic Bank of Yemen. Dubai Islamic Bank has also a 43 per cent investment stake in real-estate companies in Turkey, Lebanon and the United Kingdom.

The significance of these developments is that what is starting to emanate from the GCC states is a new form of Islamic capitalism, where accumulation is free of *riba* (interest) and other elements of western capitalism which are objectionable from an Islamic perspective (Wilson 2006). Some of the major takeovers funded by the GCC, such as the Dubai Ports World acquisition of P&O Ports, have been largely financed through the issuance of Islamic *sukuk* securities. The Saudi Arabia Basic Industries Corporation (SABIC), the largest non-oil company in the Middle East and the fifth largest petrochemical company internationally, has also funded its global expansion through *sukuk* issuances. By acquiring production facilities at Geleen in the Netherlands, Teesside in the United Kingdom and Gelsenkirchen in Germany, it has been able to secure captive markets for its basic petrochemical output.

THE SIZE OF THE ISLAMIC FINANCE INDUSTRY IN THE GCC

The value of *shariah*-compliant assets is impressive in the GCC, as total assets are worth over US\$262.6 billion when the figures for Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain and Qatar are aggregated, compared with \$235.3 billion in the Islamic Republic of Iran. As total *shariah*-compliant assets worldwide amounted to around \$640 billion at the end of 2007, this implies that the GCC countries accounted for around 41 per cent of the total. Furthermore, the assets have been growing rapidly as table 1 shows, although most of the very high growth in 2007 was due to rapidly rising oil and gas prices which feed through to government spending in the GCC, and consequently a buoyant level of economic activity.

Table 1. *Shariah-compliant financial assets by country*

Rank	Country	Assets (US\$ billion)	Growth, 2007 (%)
1	Iran	235.3	27.5
2	Saudi Arabia	92.0	26.1
3	Malaysia	67.1	32.3
4	Kuwait	63.1	44.3
5	United Arab Emirates	49.1	35.9
6	Bahrain	37.4	42.8
7	Qatar	21.0	77.5
8	United Kingdom	18.1	60.7
9	Turkey	15.8	65.5
10	Pakistan	6.3	39.0

Source: *The Banker*, Supplement on the Top 500 Islamic Financial Institutions, October 2008, p. 24. The data refers to December 2007.

The performance of Islamic financial institutions in the GCC was also impressive, with profits and rates of return much higher than in Iran's state-owned Islamic banks. As table 2 shows, Al Rajhi Bank was by far the most profitable Islamic financial institution, partly reflecting the high margins between its minimal costs of funding and the rates charged for its financing. Nevertheless, it is important to note that six of the world's ten largest Islamic banks are Iranian, and given their growth despite US sanctions and years of economic mismanagement in the Islamic Republic, their potential, if these constraints can be overcome, is enormous. Iran has a much larger customer base than the GCC,

Table 2. *Leading Islamic banks by asset values*

Rank	Institution	Country	Assets (US\$ billion)	Profits (US\$ million)	ROA (%)
1	Bank Melli	Iran	48.5	542.1	1.2
2	Al Rajhi Bank	Saudi Arabia	44.0	801.1	1.8
3	Kuwait Finance House	Kuwait	38.2	633.1	1.7
4	Bank Saderat	Iran	32.6	228.0	0.8
5	Bank Mellat	Iran	32.5	162.2	0.6
6	Bank Tejarat	Iran	26.3	0.0	0.0
7	Bank Sepah	Iran	24.1	28.8	0.1
8	Dubai Islamic Bank	UAE	23.1	471.0	2.0
9	Bank Keshavarzi	Iran	16.3	0.0	0.0
10	HSBC Amanah	UK	15.2	n/a	n/a

Source: *The Banker*, Supplement on the Top 500 Islamic Financial Institutions, October 2008, p. 34. The data refers to December 2007, except in the case of Al Rajhi Bank, Kuwait Finance House and Dubai Islamic Bank, where December 2008 data was available.

reflecting its population size of over 70 million, but because of its relative economic and financial isolation it has been largely cut off from international developments in Islamic finance. In contrast, the financial sectors of the GCC countries are much more open, with foreign international Islamic banks such as HSBC Amanah having a presence as well as the Iranian banks. In Dubai, the Islamic Republic's major source of imports, both Iranian and local Islamic banks are financing much of this trade.

GOVERNMENT POLICY ON ISLAMIC FINANCE AND LEGISLATIVE PROVISION

Historically in the countries that now comprise the GCC there was much suspicion of, indeed even antagonism to, interest-based banking, notably from King Abdul Aziz, the founder of modern Saudi Arabia (Young 1983), and Sheikh Isa ibn Al Khalifa, the ruler of Bahrain until he was deposed in 1932 by the British in favour of his son (Wilson 1987). There was, however, no Islamic banking model which could be applied to meet the financing needs of the region, and in the absence of this conventional banking filled the vacuum, although few local citizens opened savings accounts which paid interest, instead simply maintaining current accounts which paid no return.

The Royal Decree of 1952 establishing the Saudi Arabian Monetary Agency (SAMA) was similar to other central banking laws, the main distinguishing feature being the designation 'monetary agency' rather than 'central bank'. The Saudi Arabian Banking Control Law of 1966, which still governs regulation in the kingdom, specifically mentions bank lending under Articles 8 and 9, which is not permitted under *shariah*, and Article 10 prohibits banks from engaging in wholesale or retail trade, which could be interpreted as ruling out *murabaha* transactions. Much of the emphasis during the oil boom years of the 1970s was on building up a modern banking system to serve the kingdom's financial needs, but the sensitive issue of *shariah* compliance was not really addressed by SAMA. There was nevertheless support for international Islamic finance initiatives, notably the establishment of the Islamic Development Bank. This opened in Jeddah in 1975, its aim being to serve as a development assistance agency for the Islamic world. However, those Saudis who wished to establish Islamic banks in the kingdom, notably Prince Mohammed bin Faisal and Sheikh Saleh Kamel, were frustrated in their efforts, and they subsequently turned their attention to promoting Islamic finance overseas.

Elsewhere in the GCC there was a more supportive attitude from the authorities for those who wished to establish Islamic banks, as the Emir of Dubai passed a decree on 12 March 1975 authorizing the establishment of Dubai Islamic Bank and Kuwait passed legislation on 23 March 1977 to allow the establishment of KFH these being for over two decades the only Islamic banks in these states (Saeed 1999). Bahrain and Qatar followed, establishing Islamic banks in 1979 and 1982 respectively.

The developments might have been expected to influence the attitude of the Saudi authorities to Islamic banking, but they remained surprisingly cautious. Indeed, there was a reluctance to provide Al Rajhi Bank, today the world's largest listed Islamic bank, with a banking licence, the concern being that this might highlight the interest transactions of the conventional banks in the kingdom (Wilson 2002). Al Rajhi Bank was finally given a banking licence in 1987, largely because it already had significant deposits, and it was felt that it would be preferable to have it regulated by the SAMA. The danger was that if there had been a run on its deposits this could have severely damaged confidence in the whole banking system, including the regulated banks.

With the launch of Al Rajhi Bank five out of the six GCC states had Islamic banks, the exception being Oman, which for political reasons concerned with limiting the influence of the Ibadi sect, refused to award any Islamic banking licences. It is only recently that Islamic finance has become available in Oman, Sohar Aluminium raising \$260 million for a smelter project through Citi Islamic Investment Bank in Dubai, but there is still no local Islamic bank (Alam 2006).

Other governments have been much more supportive in recent years, notably Kuwait, which in 2004 passed an amendment to the Central Bank Law 32 of 1968 bringing KFH under the regulatory authority of the Central Bank of Kuwait. The new legislative framework aimed to ensure that competition within the Islamic financial sector was opened up, with other banks permitted to apply for Islamic banking licences.³ As a result the Kuwait Real Estate Bank converted to being an Islamic bank, changing its name to Kuwait International Bank. A new Islamic financial institution, Boubian Bank, was also awarded an Islamic banking licence. The legislation also contained provisions on Islamic financial governance, especially Articles 86, 87, 93 and 96, including a

³ Central Bank of Kuwait, Legislation, Safat, 2004, Section 10.

stipulation that each institution should have a *shariah* board with at least three members. Although Kuwait's legislative provision is only part of its wider banking law, there is more detail on specific Islamic banking issues than in Malaysia's dedicated Islamic banking law that created its dual system.⁴

In sum, the smaller GCC states apart from Oman have passed legislation which has facilitated the development of Islamic finance, and Kuwait in particular has updated and augmented its banking legislation to ensure healthy competition between Islamic banks in its domestic market. Bahrain's official support for Islamic finance has not yet been discussed in detail, as much of this is at the regulatory rather than the legislative level. Ironically it is Saudi Arabia which has been the laggard as far as specific laws governing Islamic finance are concerned, with no mention of Islamic banking in its banking legislation or even in the Capital Markets Law of 2003, although there have been *sukuk* issuances in the kingdom and all the mutual funds governed by the law are *shariah* compliant. SAMA and the Capital Markets Authority have yet to issue a single document pertaining to Islamic finance, in contrast to Bank Negara and the Securities Commission of Malaysia, or even the Financial Services Authority in the United Kingdom, which have issued numerous documents and guidelines. SAMA is involved in the deliberations of the Kuala Lumpur-based Islamic Financial Services Board (IFSB), but this represents a continuation of the policy of being interested in international developments in Islamic finance, but not in domestic matters within the kingdom.

SHARIAH GOVERNANCE SYSTEMS

For financial transactions to be *shariah* compliant there needs to be a credible assurance mechanism. In the GCC it was the Islamic banks rather than governments which took the initiative in this respect, as, from their establishment, boards of specialists in *fiqh muamalat* – the branch of Islamic jurisprudence that is concerned with civil contracts, including those governing financial transactions – were appointed to provide advice on the financial products offered. This system of each Islamic financial institution having its own *shariah* board has worked well, as in practice the members of the boards have been constructive rather than restrictive, and have been quite willing to approve new types of

⁴ Laws of Malaysia, Islamic Banking Act, Government Gazette, Kuala Lumpur 1983, Act 276. Reprinted incorporating amendments A1145 in 2002.

deposit and finance facilities. Indeed, the system of *shariah* compliance has become market driven, which has resulted in product differentiation and extended customer choice.

There have, of course, been critics of the lack of standardization of the *fatwa* of different *shariah* boards, and even an assertion that it can result in *shariah* arbitrage (El Gamal 2006). There is little evidence of such arbitrage in practice, and indeed it could be regarded as implausible that the sort of bank clients or investors wanting *shariah* compliance would shop around for the least restrictive *fatwa*. However, bank management, often get the *fatwa* they want approved, most notably in the case of *sukuk*, where some scholars have been having second thoughts about structures they previously approved. These issues will be considered later in the section on *sukuk*.

In the UAE consideration is being given to the introduction of a new law establishing a higher *Shariah* Council which could oversee the work of the *shariah* boards of the seven Islamic banks now operating in the country (Elewa 2008). This would be similar to the Malaysian system, where there are national *shariah* boards serving both the Central Bank⁵ and the Securities Commission.⁶ Only these bodies have the power to issue *fatwa*, the remit of the *shariah* boards of each financial institution being confined to ensuring that activities within the institutions comply with the *fatwa*. This contrasts with the position in the GCC, where in the absence of national *shariah* authorities, the boards of each financial institution can issue their own *fatwa*.

Inevitably there are conflicting *fatwa* reflecting different interpretations of *shariah* as each board preserves its power to make independent pronouncements. Appointments to *shariah* boards in the GCC are usually the responsibility of the board of directors of each institution, which will approve the terms and conditions of service, including remuneration. Normally qualifications in *fiqh muamalat* will be required, together with some knowledge of banking and finance, but there is no accreditation system. By contrast, in Malaysia all those appointed to the *shariah* boards of Islamic banks have to

⁵ Bank Negara Malaysia, *Shariah Resolutions in Islamic Finance*, Kuala Lumpur, 2007, pp. 8–11.

⁶ Securities Commission of Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, Kuala Lumpur, 2nd edn, 2006, pp. 1–7.

apply to the central bank and obtain accreditation.⁷ There is no comparable system in the GCC, where some argue that the lack of standardization has caused confusion and uncertainty, although, as indicated above, it has also resulted in healthy discussion, which in many respects has been helpful for Islamic financial development.

It is debatable whether greater involvement of GCC governments in *shariah* compliance would actually provide greater assurance to the bank clients. Many, especially the most pious, have limited confidence in their own governments, and although central banks and other regulatory authorities are held in greater esteem, knowledge about their role and the nature of their work is limited largely to those working in the financial services sector and not the wider public interested in Islamic finance. In any case, if governments were too involved in *shariah* assurance, critics might assert that it was becoming politicized, especially if the experts in *fiqh muamalat* who were appointed were seen as being very closely connected with the state. There may well be a public preference in the GCC for *shariah* assurance at financial institution level, in other words its privatization rather than its nationalization.

In market economies such as the GCC, where Islamic banks have to compete with conventional institutions, being *shariah* compliant can be one way of differentiating the services offered and hence competing on quality rather than through pricing. Clients may be prepared to pay more for *shariah*-compliant financing or accept lower returns on *shariah*-compliant deposits. Such pricing practices could be justified by stressing the costs of *shariah* compliance, which include the fees paid to *shariah* board members, the costs of convening board meetings and the legal charges in structuring Islamic financial products.

Shariah boards have to demonstrate that they are operating effectively and taking their responsibilities seriously if client confidence is to be won and maintained. There has been widespread discussion in the media in the GCC about the alleged shortage of candidates suitable to be appointed to *shariah* boards, with some serving many institutions, raising issues about the time they can devote to the work of each board.⁸ In

⁷ Bank Negara Malaysia, *Guidelines on the Governance of Shariah Committees for Islamic Financial Institutions*, Kuala Lumpur, December 2004, pp. 18–26.

⁸ Islamic Finance Information Service, Database of Shariah Scholars, London, September 2008. One scholar serves on 35 boards.

Malaysia a *shariah* consultant can serve on only one board, but in the GCC regulators have imposed no restrictions in this respect.

There are some advantages in serving on multiple boards, as experiences can be shared, but there are confidentiality concerns and potential conflicts of interest if inside information from one financial institution is used by another. The Kuala Lumpur-based Islamic Financial Services Board (IFSB), which advises central banks on the regulation of Islamic financial institutions, will be issuing guidelines on *shariah* governance in July 2009. All the GCC states, with the exception of Oman, are involved with the work of the IFSB, but this does not necessarily mean that its guidelines will be adopted in the region.

The *shariah* board of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has arguably become the most influential international *fiqh* body. There has been some overlap between its remit and that of the Organization of the Islamic Conference (OIC) Fiqh Academy in Jeddah, but the Bahrain board has focused more on the practical issues concerning Islamic financial products and it has issued thirty *shariah* standards. The AAOIFI *shariah* board comprises twenty of the best-known contemporary scholars, nine coming from the GCC and others drawn from Iran, Malaysia, Sudan, Pakistan and the United States. Although all are appointed in a personal capacity rather than as representatives of their home countries, the influence of GCC-based scholars is obviously considerable. Furthermore, as GCC-based Islamic banks have expanded overseas, members of their home *shariah* boards have been seconded to serve on the boards of the foreign affiliates. These developments have resulted in increasing contacts between *shariah* scholars worldwide, which are reinforced by the annual international conference of *shariah* scholars held each year in Bahrain under the auspices of AAOIFI.

TRADE FINANCE USING MURABAHA

In the 1970s Islamic banking in the GCC was largely focused on business clients, with institutions such as Dubai Islamic Bank – the first modern Islamic bank, which dates from 1975 – serving a clientele of pious Muslim merchants. Dubai was already taking advantage of the first oil price boom to build on its position as a leading trading centre. The Dubai Islamic Bank's main business was financing based on *murabaha* contracts, whereby the bank would buy imports on behalf of a merchant and resell them to the

merchant for a mark-up. It was the mark-up rather than interest that represented the bank's profit, but what made the transaction *shariah* compliant was the fact that the bank assumed temporary ownership of the imports; the legal responsibilities associated with this justified the returns. In other words, instead of lending on the basis of interest, the Dubai Islamic Bank was an active trading partner sharing some of the liabilities with the merchants, for which it was entitled to be rewarded.

Not only could a case for *murabaha* be argued on religious and moral grounds, but from the client's perspective it had some financial advantages over conventional lending. Usually letters of credit are required by an exporter or the exporter's bank before goods are dispatched, as evidence that the merchant is creditworthy and is in a position to meet their financial obligations. Banks charge fees for letters of credit as, in the event of the merchant defaulting, they will be liable for any payment shortfall. With *murabaha*, since the bank itself is first purchaser letters of credit on behalf of the client are unnecessary, eliminating the fees. Furthermore, if the bank bulk purchases on behalf of several merchants, it may be possible to obtain the goods at a discount, which will either contribute to bank profits or can be partially passed on to the merchant through a lower repurchase price.

As a result of its religious merits and financial advantage, *murabaha* took off from the 1970s and accounted for most Islamic bank finance in the GCC. KFH, established in 1977 as already indicated, also relied on *murabaha*, as did the Bahrain Islamic Bank, which started operations in 1978. *Murabaha* was, however, much criticized both by the early advocates of Islamic finance and a sceptical wider public, who viewed the mark-ups charged as proxies for interest, and the trading transactions as serving no financial purpose even if legally they were distinct from conventional trade lending. As the payments by the merchants were deferred, the similarities with lending became apparent (Ahmad 2005). This may explain why the new Islamic banks attracted only a small share of financial business initially, and increasing market share has been an uphill struggle, even in the highly religious GCC states.

ISLAMIC BANK DEPOSIT FACILITIES

The pioneering efforts to develop Islamic financial principles for modern finance in Pakistan in the 1950s and Egypt in the 1960s involved the establishment of credit unions,

with members contributing small amounts of savings in return for being potentially eligible for modest interest-free loans, referred to as *qard hasan* in Islamic financial parlance (Warde 2000). Those who joined were relatively poor farmers, comparable to the clientele of microfinance institutions, who are too poor to have bank accounts and are without collateral to offer for loans.

In contrast, in the GCC, where there is much more affluence and only a limited agricultural sector, microfinance was largely irrelevant. Instead, the early clientele for the new Islamic banks were middle- and upper-ranking government employees and business owners, who were often very affluent. They mostly already had bank accounts, but were potentially willing to place savings with Islamic banks, partly because they found the concept of *shariah*-based banking to be morally satisfying and a way of signalling to their peers that they were pious in their financial dealings, even if they retained their conventional bank accounts.

Unlike in many developing countries where weekly wages are paid in cash, in the GCC most employees, including all those working for government, are paid monthly salaries through bank transfers. This necessitated all employees opening bank accounts, and those who were uncomfortable with *riba*-based banks naturally turned to Islamic banks as an acceptable alternative. Hence from the 1990s when the move from cash to salary transfers gathered momentum, the number of Islamic bank-account holders increased rapidly. Social benefits to local citizens are now also paid into bank accounts, so that even those who are retired, ill or eligible for other government payments have to open and maintain accounts.

Paying with Islamic bank cheques might impress recipients even though the current accounts from which the funds were drawn were identical to their conventional equivalents, with the important distinction that deposited funds could not be used to finance interest-based lending. As Islamic banks cannot provide overdraft facilities, clients had to maintain sufficient funds in their accounts to ensure that cheques were honoured. Whether this reassured cheque recipients was a debatable point, as the onus was on the payer, not the bank, to ensure that all financial obligations were fulfilled.

In practice most Islamic bank depositors in the GCC maintained substantial funds in current accounts on which they earned no return, reducing substantially the costs of

funding for the banks. As a consequence Islamic banking in the GCC has been very lucrative, Al Rajhi Bank being by far the most profitable bank in Saudi Arabia with net income exceeding SR 6.4 billion in 2007 and SR 6.5 billion in 2008, despite a stock market correction negatively affecting fees and *murabaha* repayments.⁹ Almost SR 99 billion was held in Al Rajhi demand deposits in 2008, but a mere SR 17.7 billion held in time deposits on which a return was earned.¹⁰

Elsewhere in the GCC Islamic bank clients seem more concerned to receive a return on their deposits. In the Dubai Islamic Bank only 21 per cent of deposits are held in current accounts, the remainder being held in savings or investment accounts where clients share in the bank's profits rather than receiving interest.¹¹ The returns on the investment accounts depend on the period of notice for withdrawal, with one-month deposits paying 6 per cent and twelve-month deposits paying 6.25 per cent during the final quarter of 2008.¹² How sustainable such rates are is debatable, given that Dubai Islamic Bank profits fell in 2008 and the UAE central banks cut interest rates, which resulted in conventional banks reducing savings rates. In Dubai Islamic Bank savings accounts paid a profit rate of only 1.75 per cent, but no notice was required for withdrawals, although clients were restricted to one withdrawal per month. This distinguished these accounts from current accounts with unlimited withdrawals permitted provided the account remained in surplus.

Returns to depositors in KFH were significantly lower, with those holding savings accounts paying profits of 2.87 per cent in 2008, with the rate adjusted annually rather than quarterly.¹³ The investment deposits are subject to terms and conditions completely different from those in the Dubai Islamic Bank, clients having instant access to a minor proportion of their funds, but most tied up for a twelve-month period. The *mustamera* (continuous) investment deposits paid 4.3 per cent in 2008, clients having instant access to 10 per cent of their funds; the *al-sedra* (evergreen) deposits paid 3.34 per cent, but clients had instant access to 40 per cent of their funds.

⁹ Al Rajhi Banking and Investment Corporation, *Consolidated Financial Statement*, Riyadh, 2008, p. 3. The Saudi riyal is pegged at SR 1=US\$3.75.

¹⁰ *Ibid.*, p. 22.

¹¹ Dubai Islamic Bank, *Consolidated Financial Statements*, 31 December 2008, p. 43.

¹² www.alislami.ae/en/personalbanking_investmentaccount-profit.htm.

¹³ Kuwait Finance House, *Annual Report 2007*, Section 14: Depositors Accounts.

It is evident that these deposits, although based on the Islamic *mudaraba* concept of forming a partnership to share in profits, have their terms and conditions determined by marketing considerations and liquidity requirements. The *shariah* boards are concerned with the broad principles governing the account contracts, but not with the actual terms and conditions or indeed how the profit levels are determined. Indeed, the Arabic names given to the accounts usually have no religious significance, and have largely been determined by their perceived client appeal or their effectiveness in defining client segments. In short, the Islamic principles governing the accounts provide basic client assurance, but this is deemed to be a necessary rather than a sufficient condition for an effective business model.

ISLAMIC MUTUAL FUNDS

In Saudi Arabia bank clients wanting a return on their savings were from the 1970s encouraged by the National Commercial Bank (NCB) to invest in mutual funds. As the NCB is the largest bank in the GCC, its marketing campaign had considerable success in attracting over a million of its clients to invest in equity-based mutual funds, with the stock held being mostly listed in New York and London, given the infancy of GCC stock markets at that time. The investments were in companies regarded as *shariah* compliant, but until 1999 there was no formal system to determine what companies were *halal* (permissible) and which were *haram* (forbidden). However, investors perceived the dividends and any capital gains as being a justifiable return for risk taking, unlike interest on conventional bank savings accounts.

The first designated *shariah*-compliant mutual fund, the Al Ahli International Trade Fund, was launched by National Commercial Bank in 1987, the designation being justified by the bank appointing a board of *shariah* scholars who were consulted about the fund's investment policy. Rather than investing in equities, the funds were used to finance US dollar-denominated *murabaha* commodities transactions. From inception the return has averaged 3.75 per cent, similar to the performance of a savings account.¹⁴ A range of equity funds were launched in the 1990s, starting with the Al Ahli Global Trading Equity Fund in January 1995, which has provided an average return of 5.83 per

¹⁴ www.alahli.com/pdf/funds/itf1.pdf.

cent since inception.¹⁵ By 2008 the National Commercial Bank was offering twenty-five wholly *shariah*-compliant funds, including Saudi and GCC equity funds and sector funds focused on real estate, small capital companies and health care.

Given the success of National Commercial Bank in marketing the Al Ahli funds, competitors inevitably followed a similar strategy, with Al Rajhi Bank launching a range of *shariah*-compliant funds, with fifteen separate types available by 2008.¹⁶ The Al Ahli funds still account for around 40 per cent of the total market in Saudi Arabia, National Commercial Bank depositors being the main customer base; however, since 2006, with the opening up of the mutual fund market, new specialist entrants have arrived, which has intensified competition. The most notable is Jadwa Investments, which has the backing of Prince Faisal Bin Salman Bin Abdulaziz and leading Saudi businessmen.¹⁷

By 2008, Saudi Arabia had 127 *shariah*-compliant funds, compared with 45 in Kuwait, 29 in Bahrain, 27 in the UAE and 2 in Qatar.¹⁸ Investors have considerable knowledge and experience in dealing with funds in both Saudi Arabia and Kuwait, one selling point being that the fund takes care of *shariah* compliance, since if investments are made directly into stock there may be uncertainty about what companies are acceptable. The Dow Jones and FTSE Islamic indices have financial and sector screens which are now widely adopted in the GCC, not least because leading *shariah* scholars from the region were consulted over what criteria should be used (Wilson 2004).

However, although the funds are *shariah* compliant in the sense that they do not invest in highly leveraged companies or enterprises involved in activities such as pork production, in all other respects they are identical to conventional funds. *Mudaraba* and *musharaka* are regarded as *shariah*-based structures for equity investments, but none of the funds available in the GCC uses these structures, even though they prevailed in Mecca and Medina in the early years of Islam and could arguably be adapted for contemporary use. Much of the product development work on this has been undertaken in Malaysia (Hussain 2008), while the GCC has simply adopted standard Western fund structures.

¹⁵ www.alahli.com/pdf/funds/GTEF1.pdf.

¹⁶ www.alrajhibank.com.sa/reports/Documents/Q4English.pdf.

¹⁷ www.jadwa.com/english/shareholders.php.

¹⁸ Islamic Finance Information Service, Funds Database, London, 2008.

SHARIAH-COMPLIANT CONSUMER CREDIT

A major criticism of conventional banks from an Islamic perspective is that they entice their personal clients into debt by encouraging consumption of unnecessary goods, and thereby promote the worst aspects of capitalism (Chapra 1985). However, in practice in the GCC the Islamic banks have behaved in exactly the same way as conventional banks when providing consumer credit. Indeed, the major Islamic banks in the GCC are unapologetic; their business strategy is to focus on consumer rather than development finance. As the GCC states have become increasingly affluent consumer societies, Islamic banks have responded by offering financing products similar to their interest-based competitors and indeed to those of retail banks in the West. In other words, only the methods of financing are different, not the allocation of funds.

Initially Islamic banks only offered debit cards to their current-account customers, which meant that they could not go into debt, but more recently credit cards have been marketed, as their clients have sought to have more flexibility over their discretionary spending in the shopping malls of the GCC. There can be no interest charges on debit balances with Islamic credit cards, but, as with conventional credit cards, the issuers, in this case Islamic banks, receive a commission from the retailer proportionate to the amount of the transactions in return for a guaranteed payment. Some banks charge an annual fee, but, given the competition from other card issuers, Al Rajhi Bank and Dubai Islamic Bank no longer charge fees.

Indeed, incentives are now given to cardholders, such as a 'buy one main dish and get one free' offer by Dubai Islamic Bank which extends to restaurants throughout the UAE,¹⁹ 4 per cent cashback when the Noor Islamic Bank card, also issued in Dubai, is used for food purchases in selected supermarkets,²⁰ cards with football logos by Al Rajhi Bank designed for sports fans in Saudi Arabia and free shopping vouchers with the Visa Laki ladies' card issued by Al Rajhi Bank.²¹ Gambling is, of course, prohibited in Islam, but KFH has an awards programme for its cardholders offering KD 100,000 in prizes.²² It seems that an Islamic designation for credit cards is no constraint on product

¹⁹ www.alislami.ae/en/personalbanking_card_credit.htm.

²⁰ www.noorbank.com/cb-assets-cards.html.

²¹ www.alrajhibank.com.sa/Individual/Solutions/CreditCards/Pages/cards.aspx.

²² www.kfh.com/english/Promotions/2005/tayseer-p/p2.asp.

development or on what incentives clients are offered, even if some of the incentives would appear to conflict with Islamic teaching and are morally dubious.

Islamic banks, like their conventional competitors, allocate their consumer finance in line with salary. Clients with high incomes are given platinum cards, and those of more modest means classic cards, while middle-income earners receive gold cards. These define the credit limits on the cards, reflecting perceived ability to pay. Often limits are set at high levels for promotional purposes, however, as with the Al-Tayseer Platinum Premier Package offered by KFH, where the credit limit is three times monthly salary and outstanding credit obligations can be deferred for up to twelve months at no additional charge.

Islamic consumer credit also covers car purchases and home equipment and improvements such as new bathrooms, kitchens or furnishings. Car finance involves *murabaha*, the bank purchasing a car on behalf of the client and reselling to the client for deferred payments. Al Rajhi Bank offers up to sixty months to pay through instalments with no down payment required. Applicants must have been employed for at least six months with a minimum monthly income of SR 2,500. Leasing is also possible, with free roadside assistance in case of vehicle breakdowns. Car finance has become highly significant in the GCC, with most buyers no longer paying in cash. Al Rajhi Bank has its own car showrooms at eleven locations throughout Saudi Arabia, while KFH has two new and used car showrooms, as well representatives available at most car distributors in Kuwait who can advise on its financing packages. KFH has established a separate affiliate, KFH Trade, for its car financing business and warranties are offered on all vehicles sold for two years.

REAL-ESTATE FINANCE

The fastest-growing sector in the GCC has been real estate and construction, and Islamic banks are heavily involved in all aspects of real-estate financing, from residential mortgages to the finance of major commercial property developments through *istisna* (project finance). In addition to mortgages for owner-occupied properties there is much buy-to-let activity, as only local nationals can own property in Saudi Arabia and Kuwait, and therefore the large expatriate workforce offers a captive market for landlords. Elsewhere foreigners can now purchase property, but only in designated zones.

KFH has been involved in real-estate finance for over thirty years and produces quarterly reports on the local market in Kuwait containing a detailed analysis of pricing trends.²³ It has a real-estate affiliate which provides *shariah*-compliant mortgages as well as an *ijara* – leasing service that provides an ownership option for clients whose financial circumstances permit.

Housing finance is also a major Islamic financing activity in Saudi Arabia, as although the government-owned Real Estate Development Fund (REDF) provides interest free finance to local nationals, it is inadequately capitalized, and repayments are often deferred or not honoured by its beneficiaries. Consequently although since its inception in the 1970s REDF has provided 443,842 loans,²⁴ as the Saudi population has grown the waiting list for finance has increased, with applicants often having to wait for years for finance, fewer than 10,000 loans a year being approved on average in recent years.

The Islamic banks have aimed to fill this gap, with Al Rajhi Bank offering funds for villas and apartments through a *musharaka* partnership arrangement whereby the client pays at least 10 per cent of the initial purchase price and the bank pays a maximum of 90 per cent. The client pays rent to the bank for the share it owns, but at the same time buys out the bank's share on an instalment basis, usually over a fifteen- to twenty-five-year period. Al Rajhi Bank also offers finance for land purchase and building homes through an *istisna* project finance facility, where the costs of materials supplied and construction are covered and the client repays over a period of up to twenty-five years.²⁵ This differs from a conventional loan, as the bank is financing costs directly on the basis of invoices supplied by the client.

Al Rajhi Bank also provides funding for up to ten years for investors who wish to acquire property for renting to expatriates working in the kingdom. Unlike in the UAE and Bahrain, foreign nationals are not allowed, as already mentioned, to own property in Saudi Arabia, but with over 6 million expatriates working in the kingdom there is a captive market for landlords. In addition it is estimated that fewer than one third of Saudi

²³ KFH, Local Real Estate Report, second quarter 2008, pp. 12–29.

²⁴ Real Estate Development Fund, Annual Report, Riyadh 2008, at www.mof.gov.sa/en/docs/ests/sub_est_dev_fund.htm.

²⁵ www.alrajhibank.com.sa/Individual/Solutions/Realestatefinancing/

nationals own their own home, partly because they have insufficient income to afford to buy. A further handicap has been the absence of a mortgage law, which has hindered the development of a housing market. At present most of the Al Rajhi Bank finance is for newly built properties, not existing housing. A Mortgage Law was finally passed by the Shoura Council in July 2008, but it is unclear how this will affect the housing market (Ghafour 2008). There has at least been no sub-prime crisis in Saudi Arabia, as banks such as Al Rajhi have pursued cautious financing policies. However, there is no evidence that the availability of Islamic finance has helped local citizens to acquire property who would not have acquired it anyway.

Given the construction boom in Dubai, it is not surprising that the largest property finance company, Amlak Finance,²⁶ is based there. Originally an affiliate of Emaar, Dubai's largest construction company, it was floated independently on the Dubai Financial Market in 2004, and has subsequently expanded into Egypt, Jordan and Qatar. Amlak has a *shariah* board and designates itself an Islamic financial institution, but its fees and charging structures are little different to conventional banks, except that it cites an annual profit rather than an interest rate. It is admirably transparent over fee charges, the application fee being AED 6,000 for residents and AED 10,000 for non-residents, the other major upfront charge being a valuation fee. As the annual profit rate charged is 8.5 per cent, the financing is far from cheap and, unlike Al Rajhi Bank, no information is given on the product structures, for example whether the financing involves *murabaha*, *musharaka* or other forms of Islamic financing.

The construction boom in the GCC which Islamic financial institutions have helped to fuel has created temporary employment for millions of expatriate building workers, provided housing for richer expatriates and some locals, and changed the landscapes of the region's cities. It has also resulted in much speculation, with property bought and sold in the UAE, Bahrain and Qatar before it is ever occupied. There is a large amount of empty residential property, and the Islamic finance institutions have been unconcerned about the social impact of their financing or the sustainability of the developments. There is certainly much to criticize, raising questions as to how far the values of those engaged in Islamic finance are different from those in commercial banks.

²⁶ www.amlakfinance.com/html.

The major correction in the property market since 2008, especially in Dubai, has adversely affected Islamic financial institutions as well as their conventional competitors, and Amlak has been merged with Tamweel, another Islamic mortgage company, to establish a larger company with a strengthened capital base.

ISLAMIC INVESTMENT BANKING

There are twelve wholesale banks of significance in the GCC, of which Arcapita, Gulf Finance House and Unicorn Investment Bank²⁷ are the major institutions; however, these are investment companies focused on asset management and venture capital investment around the world rather than investment banks as understood internationally. Arcapita invests itself as a principal, the aim being to sell on its assets to its investor base of around 1,000 clients. Gulf Finance House originates from Kuwait, but its Bahrain activity is substantial, its focus being on infrastructure finance in the Middle East and north Africa. Unicorn Investment Bank is a relative newcomer, founded only in 2004, with a business model similar to Arcapita and Gulf Investment House, but its focus is on the wider Islamic world, including Turkey, Pakistan and Malaysia.

Investment banking is arguably more compatible with *shariah* than is retail banking, since much of its income is fee-based rather than accruing from lending and charging interest. During the first oil boom in the 1970s there was little investment banking in the GCC, as governments financed most major projects from their own budgets. In recent years governments and the largely autonomous state-owned companies have sought more sophisticated methods of financing, including syndicated project finance and security issuance, as well as equity finance through initial public offerings, rights issues and convertible stock. These are core investment banking activities, but neither the major conventional banks nor the Islamic banks in the GCC have much expertise or experience in these areas.

Much of the Islamic investment activity in the GCC has involved syndicated financing of projects, with, not surprisingly, Saudi Arabia the most active market followed by the UAE, as table 3 shows. Most of the arrangers of the Islamic syndications have been major international banks such as HSBC, Barclay Capital and Standard Chartered, demonstrating that it is organizational skills and experience that matter most,

²⁷ www.arcapita.com; www.gfh.com; and www.unicorninvestmentbank.com.

Table 3. Syndicated Islamic finance in the GCC, 2000–8

Country	Number of deals	Value of deals US\$ million
Bahrain	30	4,222
Kuwait	15	5,148
Oman	2	345
Qatar	24	4,088
Saudi Arabia	46	28,537
UAE	41	15,655

Source: Islamic Finance Information Service, London, October 2008.

not the knowledge of Islamic finance. The Islamic banks in the GCC are mostly too small to manage major syndications, but some, such as Dubai Islamic Bank and Noor Bank, are acquiring experience as co-arrangers. Of course, if an Islamic bank serves as co-arranger it can provide the *shariah* compliance through its own board, and this is one of the major incentives for the international banks to seek to partner an Islamic bank.

Musharaka partnership is an appropriate structure for syndications, as it involves profit and loss sharing, with profits shared in accordance with contractually agreed ratios between the partners and losses shared in proportion to the subscribed capital (Rosly 2005). The provisions are clear and there is no problem in drawing up legal contracts consistent with *shariah* principles for this type of financing facility (Siddiqi 1985). There have been relatively few *musharaka* syndications, however, the largest being a facility worth US\$1 billion for Emaar Properties, the Dubai developer, in February 2007. Most syndication has involved *murabaha* or *ijara* structures that provide financing at fixed or variable rates comparable to the terms and conditions of conventional finance, rather than the distinctive, but perhaps more risky, *musharaka* structures based on profit and loss sharing.

SUKUK SECURITIES ISSUANCE

The global trend towards using money and capital markets for finance could not initially be replicated for Islamic finance, as the instruments used, such as bills, bonds and notes, were interest-based. Islamic finance appeared to be more suited to a classical banking business model, where deposits covered the funding and there was no attempt at securitizing assets or liabilities to create money and capital market instruments. Securitized Islamic financial instruments were first issued in Pakistan under the

Mudaraba Companies Ordinance of 1981 (Lewis and Algaoud 2001), and in Malaysia securities that were approved as being *shariah* compliant were traded from 1995.²⁸ Although the sale of debt instruments, *bai dayn*, is permitted by the Shafii School of Islamic jurisprudence that prevails in Malaysia and Indonesia, the more conservative *shariah* scholars in the GCC do not allow such trading, on the grounds that the transfer of debt at a price other than its face value can result in *riba*. Furthermore, debt trading severs the relationship between creditors and debtors, resulting in debt being treated impersonally.

As trading in real assets is permissible, *sukuk* securities were developed in Malaysia, which provided the asset backing to financial instruments which would make them more acceptable to GCC investors, although the first *sukuk* of this type, launched in 2000, attracted only domestic investors. The initiative then switched to the Bahrain Monetary Agency, now the Central Bank of Bahrain, which issued the first sovereign *sukuk* based on an *ijara* structure in 2001. The aim was not only to provide a new funding vehicle for the government, but also to build Bahrain's reputation as an Islamic financial market by providing a negotiable liquid asset which could be held by Islamic financial institutions. The initiative proved successful, as Islamic banks eagerly took up the issue, which was worth US\$100 million (Obaidullah 2007). This brought competition, however, from Malaysia, which issued its own sovereign *sukuk* worth US\$600 million in 2002, over half of the capital being subscribed from investors in the GCC, including Islamic banks.

As table 4 shows, Bahrain has subsequently been the most active of GCC countries in terms of numbers of *sukuk* issued, although this is only a small proportion of Malaysia's issuance of 509 *sukuk*, worth US\$65.2 billion. In the GCC the UAE is the leader in terms of the value of *sukuk* issuance, with high-profile *sukuk* such as that issued by DP World in 2006 for US\$3.5 billion to finance its worldwide expansion with the takeover of P&O Ports and an even larger *sukuk* issued by Nakheel, the Dubai-based international property development company. Saudi Arabia is undoubtedly the GCC market with the most potential, however, with three major *sukuk* for the Saudi Arabia

²⁸ Securities Commission of Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, 2nd edn, Kuala Lumpur, 2006, pp. 2–5.

Table 4. *Sukuk* securities issuance in the GCC, 2000–8

Country	Number	Value US\$ million
Bahrain	89	4,543
Kuwait	12	2,203
Qatar	5	1,571
Saudi Arabia	15	9,585
UAE	34	26,823

Source: Islamic Finance Information Service, London, October 2008

Basic Industries Corporation, the region's largest petrochemical producer. The Bin Ladin Group, the kingdom's leading construction company, has also raised finance through a *sukuk*, as well as through a *shariah*-compliant syndication based on a *murabaha* structure.

With the increasing issuance of *sukuk* in the GCC, well-known *shariah* scholars, notably Taqi Usmani, have questioned whether the structures adopted for *sukuk* are actually *shariah* compliant. There has been particular concern over *musharaka* and *mudaraba sukuk*, as these contracts are supposed to involve risk sharing without capital guarantees to the investors to justify the profits earned. Once the investors' capital is guaranteed, they become debt- rather than equity-type instruments. Yet five of the Kuwait *sukuk* have had these characteristics, including those for Investment Dar, the *shariah*-compliant investment company, and Dubai Islamic Bank and the Jebel Ali Free Zone in Dubai have used these structures for financing.

The *shariah* board of Bahrain-based AAOIFI, which Taqi Usmani chairs, has tried to clarify the position,²⁹ but the issue remains unresolved. Meanwhile, other centres, notably London, are debating *sukuk* issuance based on a non-controversial *ijara* structure, potentially challenging the GCC centres that aim to be significant *sukuk* markets, although the fallout from the credit crunch and the weakness of sterling have resulted in the UK Treasury postponing any issuance.³⁰

²⁹ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Resolutions on Sukuk*, Bahrain, February 2008, pp. 1–4.

³⁰ HM Treasury, *Government Sterling Sukuk Issuance: A Consultation*, London, November 2007, pp. 3–16; HM Treasury, *Government Sterling Sukuk Issuance: A Response to the Consultation*, London, June 2008, pp. 1–37.

TAKAFUL

In *shariah* conventional insurance is prohibited, as it involves the transfer rather than the sharing of risk, the moral teaching in Islam stressing the sharing of each other's burdens. There are also objections to the uncertainties and ambiguity (*gharar*) in many insurance contracts, where once claims are made the company tries to minimize or refuses to pay compensation by referring to minor clauses in the contract that the policyholder may have misunderstood. More fundamentally, there is the issue of paying a premium for an uncertain benefit, and whether this constitutes *gharar*. With *takaful* the client makes a donation (*tabarru*) for mutual benefit rather than paying a premium for a personal benefit. Hence *gharar* is less likely, as probability theory suggests that where there are large numbers of participants in a scheme, some will almost certainly benefit. A further objection to conventional insurance is that most companies hold a significant portion of their assets in interest-yielding securities. In contrast, *takaful* operators invest in *sukuk*, which pay profits or rent rather than interest (Wilson 2007).

Conventional insurance companies were excluded from Saudi Arabia because of *shariah* concerns, although as insurance was widely available through offshore companies which targeted potential clients in the kingdom, the exclusion was rather meaningless, especially as there was no formal *takaful* provision. Malaysia took the lead in *takaful*, enacting the 1984 Takaful Act; this provided a regulatory framework for Islamic insurance, which soon emerged and prospered. It was only in July 2003 that Saudi Arabia enacted a law for the registration and supervision of co-operative insurance companies (Anthony 2008); hitherto the National Company for Cooperative Insurance (NCCI) had had a monopoly of the local market following its establishment in 1986.³¹

In practice cooperative insurance is not the same as *takaful*, and when NCCI was part-privatized in 2004 through an initial public offering and was floated on the Saudi stock market, it became structurally and operationally similar to a conventional insurance company. NCCI was rebranded as Tawuniya in 2007 as part of a marketing exercise, but it does not have a *shariah* board and its operations are not based on either *mudaraba* or *wakala* (trust agreement) structures which have become the norm for *takaful* elsewhere in the GCC and Malaysia. Bahrain has a better regulatory system for *takaful*, the Central

³¹ http://tawuniya.com.sa/default_E.aspx.

Bank's aim being to make the island a regional hub for it. Bahrain has already attracted eighteen *takaful* operators, including international insurance companies with *takaful* subsidiaries, notably Allianz.³² Most of the independent *takaful* operators in Bahrain are small, however, and cannot insure major commercial risks.

The largest *takaful* and re-*takaful* operator in the world in terms of market capitalization is Salama, the Islamic Arab Insurance Company, which is based in Dubai.³³ It was originally founded in 1979, and, in the absence of a regulatory framework for *takaful* in the UAE, largely set its own agenda. Its income is derived from *wakala* fees and the returns from *shariah*-compliant investments,³⁴ including from *sukuk*; it has a *shariah* board of reputable scholars, including Dr Muhammad Daud Bakr, the well-known Malaysian *shariah* expert. The operational model has proved viable, with a growth rate of over 50 per cent achieved in 2007 (Noor 2008). Salama has opened subsidiaries in Saudi Arabia, where it has already established a branch network, and it has four joint ventures in Tunisia. It is seeking approval in Egypt and Senegal to start *takaful* operations, indicating the breadth of its reach and regional ambitions.

GCC FINANCIAL CENTRES

The market for financial services in the GCC is very fragmented and, despite moves towards monetary union and the aspiration to a single GCC currency, there is little regulatory convergence (Saleem 2008). Each state has developed its own regulatory system for banks and other financial institutions, and in the UAE and Qatar the financial centres have their own laws and regulations since they are not regulated by the central banks. The regulatory regimes are not just distinctive in relation to conventional banking and finance, but also with respect to Islamic finance, where there has been no attempt at harmonization. Indeed, there is much competition between GCC financial centres for *shariah*-compliant business, one issue being whether this competition is beneficial or detrimental to the development of Islamic finance and indeed financial services more generally.

³² Central Bank of Bahrain, *The Insurance and Takaful Review*, 23 (August 2008), p. 8.

³³ www.salama.ae/aboutus.asp.

³⁴ Islamic Arab Insurance Co. (Salama) and its Subsidiaries, *Condensed Consolidated Interim Financial Statements*, Dubai, 30 June 2008, p. 9.

THE REGIONAL ROLE OF BAHRAIN IN ISLAMIC FINANCE

Bahrain has functioned as a regional financial centre since 1976, keeping its market open to foreign banks, while Saudi Arabia and Kuwait licensed only majority-locally-owned institutions. Bahrain has more Islamic financial institutions than any other centre, with twenty-four Islamic banks and eleven Islamic *takaful* insurance companies, most of which serve the regional rather than the local market.³⁵ It is very dependent on Saudi business, however, and as the latter opens up its financial sector there are competitive challenges to Bahrain, including in Islamic banking.

The Bahrain Monetary Agency, now renamed the Central Bank of Bahrain, has been very active in promoting Bahrain as an Islamic financial centre. The island has been the headquarters since its foundation in 1991 of AAOIFI, which serves as a standard-setting body for financial reporting.³⁶ Most Islamic financial institutions worldwide are members of AAOIFI and many adhere to its standards, which build on rather than replace the International Financial Reporting Standards (IFRS) used by most conventional banks in Europe and Asia.

Bahrain also hosts the International Islamic Financial Market (IIFM), whose remit is to help Islamic capital and money markets through promoting common trading standards.³⁷ Its work is at an early stage, but it has support from the central banks of Bahrain, Brunei, Indonesia, Malaysia and Sudan, as well as from the Jeddah-based Islamic Development Bank. However, the central banks of other GCC countries are not members, preferring to focus their efforts on their own markets and institutions. The Bahrain-based Liquidity Management Centre³⁸ has also been slow to take off, its aim being to facilitate the placing of surplus funds of Islamic financial institutions in profitable traded instruments. The capital was subscribed by KFH, the Bahrain and Dubai Islamic Banks and the Islamic Development Bank, but they have used international investment banks for much of their own *sukuk* issuance rather than the Liquidity Management Centre. The other major role of the Liquidity Management Centre is to promote secondary-market trading of *sukuk*. Trading volumes have been limited

³⁵ Business Friendly Bahrain, Islamic Financial Services, at www.bahrainifs.com/FSInBahrainIslamicFinance.aspx.

³⁶ www.aaofii.com.

³⁷ www.iifm.net.

³⁸ www.lmcbahrain.com.

however, with eleven buying and selling transactions in 2005, twenty-five in 2006 and only fifteen in 2007.

The Central Bank of Bahrain has a detailed rulebook which governs all financial activity on the island, including Islamic banking. However, there are only two additional specific requirements for Islamic banks: each Islamic bank must have an independent *shariah* supervisory committee, and Islamic banks should adopt the AAOIFI standards for their financial reporting.³⁹

It is debatable how far Bahrain's relative success in attracting Islamic financial institutions is due to a pull factor – the encouragement of the Central Bank of Bahrain – or a push factor – the past unwillingness of its neighbours to grant new licences to Islamic banks and *takaful* insurance operators. There are six Islamic retail banks catering for the local market in Bahrain, including Bahrain Islamic Bank and Shamil Bank, but these are all small financial institutions. Their sustainability in the long term is open to question, especially as Saudi Arabia has opened up its market for financial services since 2005 as a condition of its World Trade Organization membership, although admittedly the nine new entrants, which include Deutsche Bank, BNP Paribas and JPMorgan Chase, have only a limited interest in Islamic finance.

THE QATAR AND DUBAI FINANCIAL ENCLAVES

Unlike Bahrain, Qatar and Dubai have established financial centres in free zones governed by their own laws and regulations which are based on English common law as applied to finance. Both the Qatar Financial Centre and the Dubai International Financial Centre (DIFC) are separate jurisdictions, with disputes not subject to the civil law which applies outside the zones in Qatar and the UAE. Institutions functioning in the free zones are also outside the jurisdiction of the local *shariah* courts, although admittedly *shariah* arbitration is rarely used in banking disputes, the *shariah* court remit being largely confined to disputes within families over matters such as inheritance.

The Qatar Financial Centre has a detailed rulebook covering Islamic finance, including criteria for *shariah* supervision.⁴⁰ In Qatar a higher proportion of bank deposits are *shariah* compliant than in any other GCC state, but institutions such as the Qatar

³⁹ Central Bank of Bahrain, *Rulebook, Volume 2: Islamic Banks*, HC-1.3.15 and HC-1.3.16.

⁴⁰ Qatar Financial Centre, *Rulebook on Islamic Finance*, Doha, 2005, pp. 1–22.

Islamic Bank, Masraf Al Rayan and the Qatar International Islamic Bank focus on the domestic market, and despite the international designation of the last-named it is regulated by the Central Bank of Qatar rather than by the financial centre authority. The merits of a division of regulatory responsibilities in a small state such as Qatar can be questioned, and in July 2007 the government recognized this by signalling that it intended to establish a single regulatory authority (Thorp 2008).

The major commercial banks in Qatar have established Islamic affiliates, most notably the Qatar National Bank, which has an Al Islami subsidiary, the Commercial Bank of Qatar, with its Al Safa Islamic Banking subsidiary, and Doha Bank, with its subsidiary Doha Bank Islamic.⁴¹ This increasing competition in a relatively small market is encouraging Qatar's Islamic banks to look overseas for diversification and expansion. The Qatar Islamic Bank owns the London-based European Finance House and the Kuala Lumpur-based Asian Finance Bank. It also has subsidiaries in Lebanon, Bahrain, Yemen and Kazakhstan operating under its own name, and is undertaking feasibility studies of the Turkish, Egyptian and Indonesian markets. Masraf Al Rayan has established a consumer financing operation in Saudi Arabia and is seeking permission to open a branch in Libya, a wholly Muslim country with no Islamic banks to date.

The introduction of a single regulatory system in the UAE is unlikely, as the country is a federation in which each emirate enjoys considerable autonomy, although the Central Bank oversees the entire banking system with the exception of banks registered with the DIFC. The latter has the highest international profile in the region, but Islamic finance is somewhat marginal to its interests. As in Qatar, the major Islamic banks in the UAE are focused on the domestic market; indeed, the Dubai Islamic Bank and the Abu Dhabi Islamic Bank largely concentrate on their home emirates, although they have branch networks throughout the UAE.

The UAE market for Islamic banking has become overcrowded with new entrants, as the National Bank of Sharjah converted to being Sharjah Islamic Bank and in Dubai Noor Islamic Bank was established in 2008, with one quarter of its capital subscribed by the government of Dubai and a further quarter by the ruler himself, Sheikh Mohammed

⁴¹ Oxford Business Group, Islamic Financial Services Overview, *The Report: Qatar*, 2008, pp. 64–6.

bin Rashid Al Maktoum.⁴² Noor means 'light' in Arabic, the aim being to be a high-profile regional force in Islamic finance at the centre of attention. In reality, however, its main focus is on personal finance and credit cards, indicating that it is yet another consumer finance institution, its most distinctive plan to date being to establish a subsidiary in the Maldives through a joint venture.⁴³

Some of the challenges faced by Islamic banking in Dubai became apparent during 2008 through a corruption investigation involving former Dubai Islamic Bank employees in their dealings with Tamweel, a leading local property finance company. Tamweel has seen its share price slashed on the Dubai Financial Market during 2008, with a fall from AED 8.25 in January to AED 2.44 by October. Elsewhere, the global credit crunch and concern over prospects for the real-estate market in Dubai have taken their toll. Amlak, the leading *shariah*-compliant home mortgage company in the UAE, has seen its share value halved, while the share price of Dubai Islamic Bank has fallen from AED 11.2 in October 2007 to AED 4.94 a year later. The wider Islamic financial sector has also been caught up in the share price slump, with Shuaa Capital, a highly respected Islamic investment bank, seeing its price decline from AED 8.22 to AED 3.18. Shuaa reported a loss of AED 371 million for the first half of 2008, compared with a profit of AED 128.6 million for the same period a year earlier.⁴⁴

Competition can, of course, be helpful to financial development, but the emergence of rival centres in the Gulf has fragmented the Islamic finance industry and resulted in the licensing of many, very small institutions which cannot benefit from economies of scale or scope. None of the Islamic banks in the Gulf is in the top 100 world banks in terms of assets, and as a consequence it is the major international banks such as HSBC, Deutsche Bank and Citibank that have moved into Islamic finance to fill the void, especially in investment banking, where capacity and capability are of critical importance. Although HSBC has based much of its Islamic banking operations in Dubai, the other investment banks conduct their Islamic finance business from London, where it is easier to recruit skilled professionals, rather than from the GCC states. The Financial

⁴² Oxford Business Group, *Lighting the Way: Islamic Financial Services Overview, The Report: Dubai*, 2008, pp. 96–7.

⁴³ www.noorbank.com/.

⁴⁴ Data cited from the Dubai Financial Market.

Services Authority in the United Kingdom has made considerable efforts to accommodate Islamic banking within a conventional regulatory framework, providing a model which regulators in the GCC can in most respects follow (Ainley et al. 2007). However, the UK policy of guaranteeing investment deposits while putting the onus on depositors to ensure *shariah* compliance by voluntarily giving up their right to deposit protection, is unlikely to be acceptable in the GCC.

CONCLUSIONS

It is apparent from this survey that Islamic financial institutions in the GCC are significant sources of capital and are contributing to the development of Islamic finance worldwide, especially in Asia. The GCC is well positioned at the heart of the Muslim world to serve as an Islamic finance hub linking Europe, Asia and Africa, and the spread of subsidiaries of GCC-based Islamic banks illustrates that this is starting to happen.

The popular preference for Islamic banking in the GCC indicates that it is more of a bottom-up than a top-down movement. Al Rajhi Bank in Saudi Arabia has more branches than any other bank in the kingdom, and despite the reluctance to grant it a licence in the 1980s, as discussed earlier, it has become the largest stock-market-listed Islamic bank in the world. Like the Dubai Islamic Bank – the oldest Islamic commercial bank – Al Rajhi has successfully developed a range of deposit and financing products that has attracted millions of clients. The aim of these institutions is to provide as wide a range of facilities as conventional banks, but through *shariah*-compliant products.

Critics of these institutions argue that they are simply imitating conventional banks and focusing on more affluent clients, rather than playing a social role and assisting the poor. They are also accused of encouraging consumer indebtedness through their highly popular vehicle and home finance, but most GCC citizens take cars for granted and want to own the homes they live in, and indeed acquire additional property to rent to expatriates to enhance their current income. The poorest in the GCC are mostly migrant labourers rather than local citizens, and labourers only use banks for remittances.

The most popular Islamic financial products, notably *murabaha* and *ijara*, were pioneered and refined in the GCC, and although investment *mudaraba* deposits were first developed in Jordan, the concept soon spread to Kuwait, Bahrain, Qatar and the UAE. Al Rajhi Bank in Saudi Arabia did not embrace this concept; rather, in Saudi Arabia mutual

funds became the preferred vehicle for those seeking returns on investment. As a result the kingdom was to become the pioneer of *shariah*-compliant funds, and although funds under management have been adversely affected by the global recession and the collapse of share prices, including in the GCC, there remain more funds invested in accordance with *shariah* in Saudi Arabia than anywhere else.

Some governments in the GCC have been very supportive of Islamic finance, notably the government of Bahrain, which has become the major centre for Islamic banking and *takaful*, and Kuwait, which has helpful legislation. Oman has been totally negative and Saudi Arabia surprisingly reluctant, although this has not prevented Islamic banking playing a major role in the kingdom's financial sector. Nevertheless, if SAMA and the Capital Markets Authority were to play a more pro-active role, Saudi Arabia could potentially become the global leader in the Islamic finance industry worldwide, with significant benefits to its economy, not least in terms of employment creation in the King Abdullah Financial District, where, although a grand mosque is included in the plans, there is no mention of Islamic finance in the vision.

As the major international banks have been weakened by the financial crisis of 2008–9, this undoubtedly presents an opportunity for GCC Islamic banks which have been less adversely affected. GCC-based investors in conventional banks, such as Prince Waleed's Kingdom Holdings, which holds 5 per cent of Citibank, and the Abu Dhabi and Qatar Investment Authorities, which hold significant stakes in Barclays, have seen the value of their investments plummet. In contrast, the value of Al Rajhi Bank and KFJH investments in retail Islamic banking affiliates in Asia has been much more resilient. There are already proven synergies between the GCC and its Asian and African neighbours in Islamic finance, and these provide a platform for future developments.

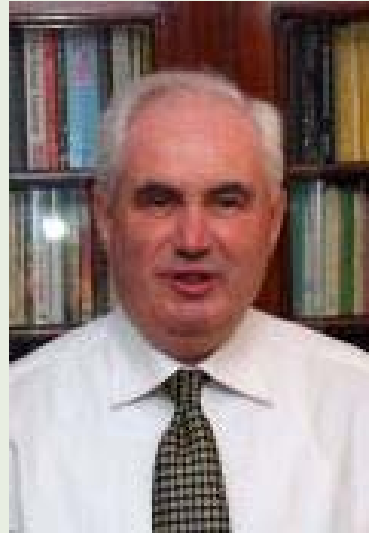
Although the financial crisis has resulted in a large decline in oil prices and has reduced the profitability of all financial institutions in the GCC, including Islamic banks, it may also present opportunities. There has been much questioning of the values underpinning the conventional financial system, and the search for alternatives means that Islamic banks are likely to receive more attention, especially as their *raison d'être* is morality in financial transactions, based on religious teaching. The increasing international respect for Islamic finance is noted in the GCC, and encourages local

acceptance by both governments and bank customers, not least because no Islamic bank has failed in the crisis and required a substantial government bail-out. Furthermore, a global economic recovery is likely to benefit the GCC as oil and gas prices rebound, resulting in fresh liquidity being pumped into Islamic banks to fuel further expansion. Some opportunities may have been missed, but there should be many more to come.

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