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Financial Services

Islamic Banking Processes and Products

Key Regional Variations

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Introduction

With over two decades of existence, Islamic banks have been extending their reach, in terms of products and services offered as well as geographically. Islamic banks have been making a concerted effort to match the service levels and scale of operations of conventional banks. From defining products to comply with Islamic banking regulations, educating customer, setting-up operational process, today Islamic banks operates and functions on par with conventional banking creating a competitive market in most of the Islamic countries.

Islamic banking is gaining market share at the expense of conventional banking system and is also helping replace the shadow economy. Over the past four years, in which conventional banks have been facing decelerating growth rates, Islamic Banks have recorded an average annual growth rate of 14% during 2010 - 2015, which is 50% more than the growth rate of the overall banking sector in the same period (World Islamic Banking Competitiveness Report FY16 by Ernst & Young).

Penetration and presence of Islamic banking is positively supporting Financial Inclusion in many Islamic countries. With more acceptance and increasing need for banking amongst Islamic population, many countries are promoting financial inclusion through Shari'a compliant financial institutions. Also as young Islamic population getting globally connected and are also concerned about preserving their national and Islamic practices, Islamic banking is getting more traction amongst consumers.

Economic conditions in many Islamic countries coupled with the consistent growth in oil and gas revenues in the Middle East create more viability for Islamic Banking. This in-turn is also creating acceptance of Islamic Banking in high-growth emerging markets and European countries

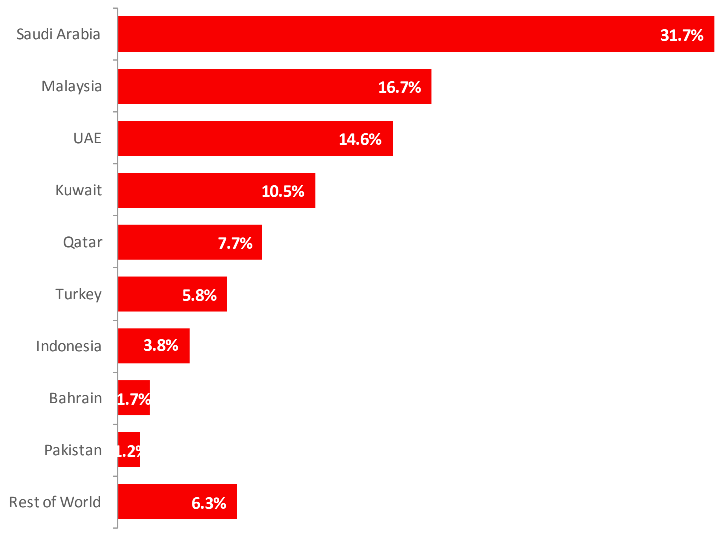
Islamic banking has spread extensively over the years to span multiple geographies. The regions experiencing significant growth are Middle East, South Asia and North Africa, the obvious reason being the larger number of followers of Islam in these regions. However, to bundle these regions together on the basis of the same religion would be an oversimplification. Even within these regions, significant disparities exist between the products and processes of Islamic Banking.

This paper intends to examine these differences across geographical boundaries and the reasons and implications of these differences.

Global Market for Islamic Banking

Islamic banking, beginning from the Middle East, has grown into a worldwide phenomenon with Islamic financial institutions now operating in more than 80 countries worldwide. According to Ersnt and Young's World Islamic Banking Competitiveness Report, FY16, Islamic banking assets with commercial banks globally will grow to US $1.8trillion by 2020 from US $920 billion in 2015.

Market share of Islamic Finance Banking Assets, 2015



Source: Ersnt and Young's World Islamic Banking Competitiveness Report, FY16

The most significant players remain the GCC countries consisting of Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman, which account for the vast majority of Islamic Banking assets. Islamic Banking is also making progress and seeing faster growth in countries such as Malaysia, Indonesia, Turkey and Pakistan.

Recently, new jurisdictions introduced legislative or regulatory enhancement to enable Islamic banking. Libya, Iraq, Tunisia, Kenya and Nigeria are among the countries showing keen interest in opening up to Islamic banking. With the developing economies rising need for alternative investments and financing, and growing Muslim population, the Sub-Saharan Africa region is also showing more potential for Islamic finance. Apart from the region's established market Sudan, Nigeria, Kenya and South Africa are introducing new measures to make way for Islamic financial markets.

Islamic Banking is in a very nascent stage in European countries. Turkey, the UK and France, and are considered a low penetration of retail Islamic banking compared to the relatively large number of potential Muslim retail customers. Europe has been able to position itself as a popular destination for Sukūk. Several financial centres in Europe are already on the radar to compete as regional Islamic financial hubs. This positive development is expected to generate greater intensity and activities of Islamic finance in the region.

Islamic Banking Market Drivers

The market for Sharia-compliant financial services will continue to grow, driven by both demand and supply factors. On the demand side, not just retail customers but, increasingly, corporations also want to conduct all financial transactions in accordance with Sharia. The changing demographics of Muslim countries will also drive the demand for Sharia-compliant financial services. Many Muslim countries have young populations, with more than 50 percent of the people under 21, coupled with population growth rates of more than 3 percent per year. Many conventional banks today are also entering the Islamic Banking space due to its inherent characteristic of low exposure to risk. Islamic banking, due to its stringent Sharia compliance norms, can help customers minimize the risks associated with interest based debt financing and easy credit, which plagued conventional banks during the sub-prime mortgage crisis.

The overall economic growth in Muslim countries will drive the growth of Islamic financial services, leading to further growth of Sharia-compliant banking. This is particularly relevant in the oil-rich countries of the Gulf where state-owned enterprises, which tend to strictly adhere to Sharia.

On the supply side, the main driver of growth in Islamic banking is the increasing number of financial services institutions offering Sharia compliant solutions. In addition to the new Islamic banks that are being formed, there is an emerging trend among existing conventional banks to convert their operations to become Sharia compliant. With increasing competition in their home markets, a number of Islamic banks in the Middle East have started to expand globally, with an initial focus on Asia and Africa. This increased competition is leading to new innovative products being offered making Islamic banking more attractive.

Focus on Sustaining the Momentum

Islamic banking system is entering a new era as the markets are getting mature and banks have started focusing on adopting core transformation to sustain and grow business. Islamic banks are also focusing on customers, profitability and efficiency. Some of the major focuses to sustain the momentum are:

Optimize Capital

Capital requirement for Islamic banks is expected to further increase by 25–40% and the pressure for enough liquid assets and stable funding will be significant. 17 major Islamic banks have US$1bn or more in equity and sufficient regulatory capital. This provides for a good platform for organic and acquisitive growth (World Islamic Banking Competitiveness Report 2013-2014 by Ernst & Young).

Efficient utilization of capital will become more critical for sustainable growth. Islamic banks will focus on maximizing returns on each unit of capital invested. A cultural change has to happen through introduction of risk-based performance measurement.

Stress upon impact of Shari'a compliance

Islamic banks have been spending more in terms of money and effort in building operational transformation programs to get better profitability. Islamic banks will have to take initiatives to transform from being a legally Shari'a compliant banking, to demonstrating the impact of Sharia compliant system on customers and economies.

Recently banks have started adopting AAOIFI standards (Accounting and Auditing Organization for Islamic Financial Institutions) which can help financial institutions maximize their comfort with Sharia compliance. AAOIFI standards are officially adopted by a number of central banks and financial authorities on a mandatory basis or as guidance.

Internationalization

Recently, new jurisdictions introduced legislative or regulatory enhancement to enable Islamic banking. Libya, Iraq, Tunisia, Kenya and Nigeria are among the countries showing keen interest in opening up to Islamic banking. Islamic banks should capitalize on this to expand into new markets for getting better economies of scale.

Adopt customer centric approach

Managing customers is the buzzword in the banking industry and this requires developing a 360 - degree view of the requirements and doing it profitably. To achieve this, Islamic banks will have to move away from a product centric mindset to a customer centric model with an integration capability across channels for a seamless service offering.

Comprehensive reforms in risk management

With the fast changing perception on risk management, the need is to adhere to risk practices. Although Islamic banks have successfully weathered the storm of 2008, the regulatory bodies require banks to implement comprehensive reforms in the risk space. The demands from the risk governance bodies start from the strategic planning stage and cover areas of capital and liquidity management, data and IT infrastructure management, security system and reporting requirements. By addressing these demands, Islamic banks can shore up their businesses and counter any possible competition from traditional banks, some of whom are yet to recover from their financial stress.

Tap new customer segments

Islamic banks also have to tap into customer cross-selling opportunities and provide segmented offerings to sustain and be competitive in the market. Increasing average product holding from an industry average of 2.1 to a class-leading 4.9 can increase profitability by 40% from new customers. For some Islamic banks, the impact on ROE could be as high as 5% (Ernst & Young).

Common Principles of Islamic Banking

The basic tenets and principles of Islamic banking are built upon the avoidance of Riba, Gharar and the prohibition of impermissible businesses as stated in the Quran. Banking models are built upon the foundation of compliance with Sharia (Islamic law). Riba is generally the same concept of interest, or usury, and is therefore unlawful and forbidden. Instead of Riba, the concept of profit and loss sharing is practiced; essentially the concept of sharing risk, as opposed to transferring it. Gharar is the ambiguity and uncertainty present in a contractual relationship, to the extent that it might provide one of the parties of a contract with an unfair advantage over the other.

Islamic Banking Variations across Geographies

Sharia compliance is at the core of the activities for any bank intending to launch Islamic products. The Sharia compliance is ensured or verified by bank's own Sharia boards with Sharia scholars on them; and/or by Sharia boards of Central banks. However, Sharia scholars are currently spread too thinly across numerous institutions. Compounding the present difficulty of finding scholars is that there is a difference in opinion on Sharia interpretations among Sharia scholars. There are differing opinions of how to apply or interpret Sharia law amongst the different banking regions, notably between the Middle East and Malaysia. Also, currently there are a number of regulatory frameworks within which Islamic banking is developing. These frameworks and rules can often be contradictory and lead to differences in the application compliance.

Islamic Bank Offerings across Geographies

Islamic banks worldwide traditionally offer four categories of financial contracts: Deposits, Lending, Treasury and Trade Finance. The following sections provide a comparative evaluation of Islamic Banking offerings across geographical regions.

Deposits

PRODUCT/PROCESS	MIDDLE EAST	NORTH AFRICA	MALAYSIA	INDONESIA
Savings Account based on: □ Wadiah □ Mudharabah □ Qard	Mudharabah and Qard are standard offerings	Mudharabah and Qard are standard offerings	Wadiah is more popular than Mudharabah	Mudharabah is most popular, followed by Wadiah
Current Account based on: □ Wadiah □ Mudharabah □ Qard	Qard and Mudharabah are standard offerings	Qard and Mudharabah are standard offerings	Only Wadiah is offered to customers	Only Wadiah is offered to customers
Fixed Deposit based on: □ Mudharabah, □ Commodity Murabaha □ Wakalah	All three are popular products, especially within GCC countries	All three are popular products	Mudharabah is the standard offering. Commodity Murabaha and Walakah are gradually becoming more popular	Only Mudharabah is being offered to customers
Recurring Deposits/Saving Plan to increase deposits	Popular scheme offered to customers as a “forced saving plan”	Popular scheme	Slow take-up as Takaful unit-linked plan is more attractive to customers	Popular scheme to encourage saving for Hajj and Education
Structured Products	Products are offered to selected customers	Products are offered to selected customers	Products are offered to selected customers	Not offered to public yet
Profit Distribution	Adopt guideline issued by AAOIFI on Mudharabah-based products	Adopt guideline issued by AAOIFI on Mudharabah-based products	Adopt guideline issued by AAOIFI but more refined and complex	Revenue-based (instead of profit based) but less complex
Liquidity Management	Standard offering when banks promote their cash management services to commercial and corporate customers	Emerging requirements	Same as ME and Africa	Emerging requirements in Indonesian market

Fund Management (Allowing banks to create multiple funds or pools meant for specific target customers)	Very popular arrangement wherein customers can place deposits into various funds based on their risk preferences and expected returns	Popular arrangement wherein customers can place deposits into various funds based on their risk preferences and expected returns	Low demand from customers. However, non-bank financial institutions (NBFI) and developmental banks are using this capability to manage borrowings or “special allocation” received from banks and government agencies	Emerging requirements but take up from customers is low

Financing

PRODUCT/PROCESS	MIDDLE EAST	NORTH AFRICA	MALAYSIA	INDONESIA
Monetization Products (Cash finance based on Tawarruq and Salam	Salam structure is preferred as Tawarruq is discouraged by scholars	Salam structure is preferred	Very popular scheme based on Tawarruq concept	Both Tawarruq and Salam structures are not approved by scholars
Vehicle Financing (Murabaha and Ijarah)	Standard offering	Standard offering	Standard offering	Standard features, some are managed by multi-finance outfits
House Financing (Murabaha, Ijarah and Diminishing Musharakh)	Only Ijarah and Diminishing Musharakh are popular	Only Ijarah and Diminishing Musharakh are popular	Only Murabaha and Diminishing Musharakh are popular	Only Ijarah and Diminishing Musharakh are popular
Pawn Broking (Al-Rahnu)	Prohibited product	Prohibited product	Popular, as a form of personal financing with gold as collateral	Popular form of financing with gold as collateral
Equipment/Industrial leasing (Operating/Financial) based on Ijarah concept	Operating and financial leases are popular	Operating and financial leases are popular	Mostly financial lease	Mostly financial lease
Plant/Construction financing using Istisnaq and forward Ijarah	Both structures used but forward Ijarah is popular	Forward Ijarah is popular	Istisnaq and forward Ijarah are prevalent	Istisnaq structure is more popular
Project Financing based on Musharakah and Dim Musharakah and Mudharabah	Popular form of financing	Popular form of financing	Banks not keen to offer as deemed too risky	Popular form of financing
Working capital financing based on Tawarruq , Mudharabah or Musharakah	Mudharabah and Musharakah offered but not Tawarruq as it is prohibited	Mudharabah and Musharakah offered but not Tawarruq as it is prohibited	Only Tawarruq is being offered by banks	Mudharabah and Musharakah offered but not Tawarruq as it is prohibited

Syndication origination, processing and support	Basic requirements. Subscription received under Musharakah and other structures	Basic requirements. Subscription received under Musharakah and other structures	Syndication mimics arrangement in conventional using Sharia compliant structures	Basic requirements. Subscription received under Musharakah
Rebate processing	Rebates are given at end of financing or at redemption	Rebates are given at end of financing or at redemption	Rebates are given during or at end of financing	Rebates are given at end of financing or at redemption
Penalty charging	Penalty charged is always given to charity	Penalty charged is always given to charity	Penalty charged is treated as income, and if above a threshold to be given to charity	Penalty charged is treated as income, and if above a threshold to be given to charity
Asset securitization (Selling of financing assets to other parties)	Practice is now emerging	Not Prevalent	This is common practice in Malaysia wherein a government body buys mortgages from banks to enhance liquidity	Requirement is being discussed but is yet to be approved by the Sharia scholars
Rescheduling and restructuring	Complete flexibility required, especially for corporates	Complete flexibility required, especially for corporates	Complete flexibility required, especially for corporates and VVIPs	Less complex requirements than ME, Africa and Malaysia
Collection	External collectors and lawyers are used extensively by banks and they form part of the eco-system and must be monitored closely	External collectors and lawyers are used extensively by banks and they form part of the eco-system and must be monitored closely	Same as ME and Africa	Less complex requirements. Collections are mostly handled by internal collectors

Assets Takeover	Very popular scheme as this helps reduce complexity and to transfer assets to banks' books	Popular scheme as this helps reduce complexity and to transfer assets to banks' books	Same as ME and Africa	Same as ME and Africa
Origination – Retail (Ijarah, Istisna, Mudharabah, Musharakah, Murabaha and Tawarruq)	Advanced requirements to address competitive landscape including Doc Mgmt, Credit Scoring and Credit Control before disbursement	Advanced requirements to address competitive landscape including Doc Mgmt, Credit Scoring and Credit Control before disbursement	Same as ME and Africa	Requirements are still basic. However, future requirements may match that of ME and Africa

Origination – Corporate (Ijarah, Istisna, Mudharabah, Musharakah, Murabaha and Tawarruq)	Advanced origination features for various business requirements like Project finance, Working capital Financing, Term financing including Financial analysis, workflow definition, Doc Mgmt, Credit Scoring and Credit Control before disbursement	Advanced origination features for various business requirements like Project finance, Working capital Financing, Term financing including Financial analysis, workflow definition, Doc Mgmt, Credit Scoring and Credit Control before disbursement	Same as ME and Africa	Requirements are still basic. However, future requirements may match that of ME and Africa

Treasury

PRODUCT/PROCESS	MIDDLE EAST	NORTH AFRICA	MALAYSIA	INDONESIA
Forex	Standard requirements. Forward deals are not allowed	Standard requirements. Forward deals are not allowed	Standard requirements. Forward deals are not allowed	Standard requirements. Forward deals are not allowed
Money Market	Money market is active but products are less complex due to strict rules imposed by the Sharia scholars	Money market is active but products are less complex due to strict rules imposed by the Sharia scholars	Money market is very active and many unique products based on Mudharabah, Commodity Mudharabah and other structures are offered by central banks and government agencies	Standard requirements, very basic instruments based on Mudharabah are offered. Commodity Mudharabah is yet to be offered in the market
Securities	Government papers and Sukuk offered by government and large companies are the typical securities traded	Government papers and Sukuk offered by government and large companies are the typical securities traded	Active market even though players buy for investment rather than trading. Active repo market as well	Only government papers are traded. Very limited Sukuk and other instruments
Derivatives	Very limited derivatives products due to strict ruling by Sharia scholars	Not Yet Available	More advanced than Middle East and Africa. Profit and Currency swap derivatives have been seen in the market	No derivative-based product in the market

Front Office	Standard front-office functionalities to facilitate dealers in their trading daily, with good support for all instruments available in the market	Standard front-office functionalities to facilitate dealers in their trading daily, with good support for all instruments available in the market	Same as ME and Africa	Same as ME and Africa
Middle Office	Standard middle office functionalities to ensure dealing risks are minimized and all limits are properly assigned and controlled	Standard middle office functionalities to ensure dealing risks are minimized and all limits are properly assigned and controlled	Same as ME and Africa	Same as ME and Africa
Back Office	Standard back-office functionalities to facilitate completion of deals, sending of notices and swift messages to transacting parties and to handle all accounting entries and reporting	Standard back-office functionalities to facilitate completion of deals, sending of notices and swift messages to transacting parties and to handle all accounting entries and reporting	Same as ME and Africa	Same as ME and Africa

Trade Finance

PRODUCT/PROCESS	MIDDLE EAST	NORTH AFRICA	MALAYSIA	INDONESIA
Complete LC Processing based on Murabaha, Wakalah and Musharakah Concepts	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa
Bills	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa
Guarantees	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa
Complete LC Processing based on Murabaha, Wakalah and Musharakah Concepts	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa

Conclusion

The rapid pace of growth of Muslim population worldwide present a lucrative window of opportunity for Islamic Banking. However, banks need to examine the key location-specific factors while offering Islamic Banking products and develop targeted offerings based on the unique needs of a region.

Annexure: Key concepts in Islamic Banking

Hibah: This is a token given voluntarily by a debtor to a debitor in return for a loan. Hibah usually arises in practice when Islamic banks voluntarily pay their customers a 'gift' on savings account balances, representing a portion of the profit made by using those savings account balances in other activities.

Ijarah: Ijarah means lease, rent or wage. Generally, the Ijarah concept refers to selling the benefit of use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipments such as plant, office automation, motor vehicle for a fixed period and price.

Istisna: In an Istisna sale, the buyer asks the manufacturer to create a specific commodity with material from the manufacturer. The price is fixed after all parties give their consent and agree on all the necessary specifications of the commodity.

Murabaha: Murabaha is a sale with an agreed-upon profit margin.

Mudharabah: In Mudharabah, the customer provides funds to the bank, which then invests the funds into various investment schemes and financing.

Musharakah (Investments): Musharakah means “to share.” In a banking context, it indicates that all profits or losses are shared equally.

Qard: Qard transactions are loans without profit. The borrower is required to repay only the principal amount borrowed but may pay an extra amount as a token of appreciation at the borrower’s absolute discretion. Qard contracts can also be used to support current accounts, in which customers lend the money to the bank. The bank generates profit on this loan and returns the capital and some of the profit it has obtained.

Salam: Salam is a sale in which the seller supplies specific goods to the buyer at a future date in exchange for a price fully paid in advance. It is typically used to finance agriculture. The bank must take delivery of the commodity on maturity and it can enter into a parallel contract of Salam with another party to sell the commodity on the future date. (It is prohibited to sell the commodity to the original party.)

Takaful (Islamic Insurance): Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals.

Tawarruq: Tawarruq is a finance method with which one can raise loan financing through buying installments in a local commodity owned by the bank. Applicants then authorize the bank to sell their share in this commodity, on their behalf, to a third party for cash and then deposit the proceeds into his account.

Sukuks: Sukuks are Islamic bonds that must be linked to an underlying asset. Banks cannot raise funds by issuing generic fixed or floating coupon-bearing bonds. Banks can securitize a stream of cash flows from Ijarahs or Murabahas and then issue Sukuks. The coupon cash flow for these Sukuks can be the cash flow from the underlying Ijarahs or Murabahas, for example.

Wadiah: In Wadiah, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it. The depositor, at the bank's discretion, may be rewarded with Hibah as a form of appreciation for the use of funds by the bank.

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