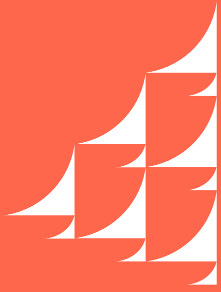

The Arab Gulf States
Institute in Washington
Building bridges of understanding

# Gulf Islamic Finance in a Time of Austerity

Mai Mahmoud

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By Mai Mahmoud

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# Foreword

The Islamic finance sector in the Gulf Arab states has achieved impressive growth over the past decade, drawing upon its own cultural appeal and riding the broader economic expansion. It has tapped underrepresented sources of funding and outperformed the profitability of conventional finance, even while struggling with incompatible regulatory frameworks and underdeveloped investment vehicles. This paper provides an overview of the state of the industry at a time of critical transition, as lower oil prices signal an end to post-2009 economic expansion and an intensification in government efforts to wean themselves off oil dependence.

Austerity will test the maturity of the Islamic finance market, but it may also present some opportunities. Bank assets will diminish and private sector *sukuk* will likely weaken as Gulf governments withdraw assets and slow projects to help balance budgets. Still, Gulf governments may look to the relatively more liquid Islamic financial sector for untapped sources of funds: Sharjah issued a sovereign sukuk in January, Bahrain followed in May, and several other Gulf states – the United Arab Emirates, Qatar, and Kuwait – are in talks.

This paper evaluates these challenges alongside earlier ones that have shaped the development of the young industry. The recommendations highlight the adjustments needed to successfully navigate a new era of diminished government resources and diversification away from oil-led growth.

Kristin Smith Diwan
*Senior Resident Scholar, Arab Gulf States Institute in Washington*

# Executive Summary

Islamic finance has grown in importance in most of the Gulf Cooperation Council countries since 2013. Islamic banks now represent more than 25 percent of the banking system in the GCC, and the region's *sukuk* (sharia-compliant financial securities) market is the second largest in the world after Malaysia. Over the next few years, the growth prospects of Islamic banks in the GCC will depend on how they respond to a period of economic slowdown caused by low oil prices and consequent fiscal deficits. Such economic developments are expected to have a negative impact on Islamic banking through weakening asset quality, liquidity, and profitability. Indeed, customer deposits represent a crucial source of funding for Gulf-based banks, accounting for 70 to 85 percent of the banking system's liabilities. Consequently, local banks are expected to face liquidity pressures as governments dip into their bank deposits to finance budget deficits. Further, the weak infrastructure for liquidity risk management in Islamic banking magnifies such pressures. Thus, recent developments signify the need for structural reforms in the Gulf's financial systems in general, and Islamic finance in particular.

Notwithstanding recent advances in Islamic finance worldwide, there is still room for progress in order to ensure healthy growth and systemic stability. Particularly, the regulatory and supervisory framework for Islamic banking should be harmonized across countries, the process and procedures for issuing sukuk should be standardized, and the infrastructure for liquidity risk management by Islamic banks requires further development. That said, Islamic banks are expected to maintain relatively high levels of growth in the near future given their low base and sizeable market potential. The introduction of financial reforms in the GCC should build on this potential in order to maintain sustainable growth over the long term.

# Introduction

With a total value of assets standing at about $2 trillion in 2015 and double-digit growth over the past decade, the importance of Islamic finance is increasing worldwide.[1] This is especially apparent in Gulf Cooperation Council states, Iran, and Malaysia as a result of growing competition among these countries to become financial reference centers.[2] Remarkably, it is estimated that GCC members account for nearly 72 percent of global Islamic finance assets.[3] Islamic banks represent more than 25 percent of the banking system in the GCC with an asset value of $564 billion,[4] and the region's sukuk (sharia-compliant financial securities) market is the second largest in the world after Malaysia.[5] The future of Islamic banking, like the rest of the finance sector, will depend on weathering the current period of economic slowdown caused by low oil prices and consequent fiscal deficits.

Islamic banks' liquidity is negatively affected by decreases in government deposits, a main source of funding for Islamic banks. At the same time, the sukuk market is witnessing a decline in sovereign sukuk issuance due to a shift toward conventional bonds in financing budget deficits. This decline in sukuk issuance also affects Islamic banks' liquidity, though indirectly, as sukuk represent one of the few sharia-compliant tools for liquidity risk management available to Islamic banks. Judging from the past, Islamic banks will likely respond to these liquidity risks by upholding large cash buffers. So, liquidity risks shouldn't develop into solvency risks for highly capitalized Islamic banks. However, large cash reserves have a negative impact on Islamic banks' profitability, which tends to put them at a competitive disadvantage relative to their conventional counterparts.

# Islamic Finance and the GCC

Islamic finance refers to financial institutions and instruments that adhere to the rules and principles of Islamic (sharia) law. Specifically, the most prominent principles of Islamic finance are the prohibition of *riba* (usury or interest), *gharar* (excessive uncertainty), and *mysir* (gambling). Instead, Islamic finance is an asset-backed finance in which each transaction has a real economic purpose. Islamic principles necessitate the share of risk and reward among parties without exploitation or duress. Finally, Islamic financial institutions are prohibited from entering a business that is forbidden under Islamic law, such as investing in companies involved with alcohol, tobacco, pornography, or weapons.

The strong linkage between Islamic finance and the real economy is sometimes considered a source of strength for Islamic financial institutions. This is because Islamic principles restrict participating in speculation or contributing to excesses and bubbles. Another advantage of sharia compliance is that Islamic banks can potentially attract a large number of customers

1 "Islamic Finance Outlook: 2016 Edition," *Standard and Poor's*, September 2016.

2 "The IMF and Islamic Finance," *International Monetary Fund*, March 2015.

3 Mumtaz Hussain, Asghar Shahmoradi, and Rima Turk, "An Overview of Islamic Finance," Working Paper no. 15/120, *International Monetary Fund,* June 2, 2015.

4 Ritu Basu, Ananthakrishnan Prasad, and Sergio L. Rodriguez, "Monetary Operations and Islamic Banking in the GCC: Challenges and Options," Working Paper No. 15/234, *International Monetary Fund*, November 9, 2015.

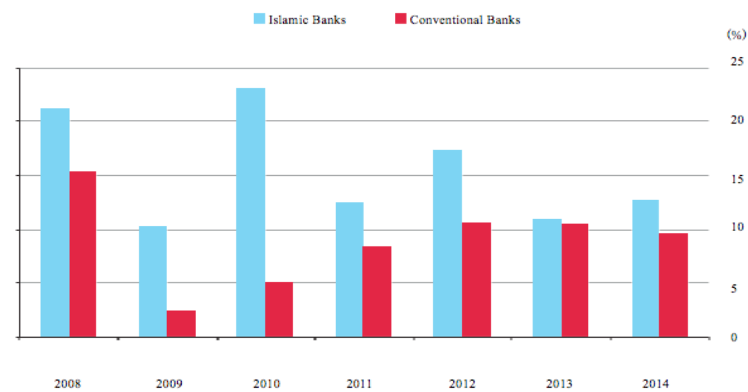
5 "The Global Sukuk Market: The Correction is Here to Stay," *Standard and Poor's*, January 6, 2016.

into the banking system who have previously refrained for religious reasons.[6] Nevertheless, Islamic banks are still vulnerable to economic shocks, particularly in the case of limited portfolio diversification and incompetent liquidity management.

In general, Islamic finance is a relatively new branch of the global financial system. Islamic banks formally entered the GCC market in the mid-1970s, with the first Islamic bank established in the United Arab Emirates in 1975, followed by Kuwait in 1977.[7] By mid-2013, Islamic banking had successfully integrated into most of the GCC countries.[8] In 2014, Gulf-based Islamic banks continued to increase their balance sheet assets at an annual growth rate of 13 percentage points. This is in spite of the recent slowdown in the growth of Islamic banks following a period of an impressive 15 percent growth from 2009-14. In contrast, conventional banks in the region recorded an average growth rate of 9 percent over the same period (see Figure 1).[9]

Over the next few years, the growth prospects of Islamic banks in the GCC will depend on how they respond to a period of economic slowdown caused by low oil prices and consequent fiscal deficits. Such economic developments are expected to have a negative impact on the banking system through weakening asset quality, liquidity, and profitability. This, in turn, signifies the need for structural reforms in the Gulf's financial systems in general, and Islamic finance in particular.

Figure 1: Asset Growth of GCC Banks: Islamic Banks Versus Conventional Banks 2008-14




"Islamic Finance Outlook: 2016 Edition," *Standard and Poor*, September 2016

6 Masood Ahmed, "Getting Islamic Finance to Fulfill its Promise," *Asharq Al-Awsat*, May 20, 2015.

7 These are Dubai Islamic Bank and Kuwait Finance House. See Mumtaz Hussain, Asghar Shahmoradi, and Rima Turk, "An Overview of Islamic Finance," Working Paper no. 15/120, *International Monetary Fund*, June 2, 2015.

8 This is the case in all GCC countries except for Oman. See Mumtaz Hussain, Asghar Shahmoradi, and Rima Turk, "An Overview of Islamic Finance," Working Paper no. 15/120, *International Monetary Fund*, June 2, 2015.

9 "Islamic Finance Outlook: 2016 Edition," *Standard and Poor's*, September 2016.

## Resilience of Islamic Banks

The resilience of Islamic banks was tested, arguably for the first time, during the global financial crisis of 2008-09. Contrary to the wide assertion that Islamic finance was immune to the crisis, a number of studies confirm that Islamic banks were subject to "second-round effects."[10] In 2009, the global economic downturn was reflected in the performance of Islamic banks in the form of low profitability, which in some cases fell to levels substantially lower than those of conventional banks in the same country.[11] The main reasons behind this low profitability were found to be excessive cash reserves and high exposure to the real estate sector.

*Gulf-based Islamic banks are under pressure again as a result of low oil prices, widening budget deficits, and rising costs of funding in the GCC.*

Gulf-based Islamic banks are under pressure again as a result of low oil prices, widening budget deficits, and rising costs of funding in the GCC. Islamic banks in the region tend to rely on deposit funding, particularly from governments and government-related entities, which makes them vulnerable to increasing withdrawals as governments run down deposits to fund budget deficits.[12] Moreover, in some countries, such as Saudi Arabia, the government has been putting pressure on domestic banks to finance public debt. This was the Saudi government's response to rising costs of international borrowing caused by the recent wave of downgrades to the kingdom's credit rating.[13] All in all, these events suggest that the capacity of Gulf governments to support local banks is not guaranteed, especially if governments do not take serious steps toward necessary structural reforms.

## Required Reforms in Islamic Banking

Developing the financial sector has been a policy priority in many Gulf countries over the past decade. However, much needs to be done in order to adjust to new economic realities, which imply that the current model of oil-financed economic growth might not be viable in the near future. For instance, the banking sector in the GCC records the lowest level of competition in the world according to World Bank statistics, and is highly dependent on government spending.[14] Thus, GCC governments need to develop new institutional frameworks in order to increase competition, improve efficiency, and ensure systemic stability.

10 For example, Ayah El Said and Rachel Ziemba, "Stress-testing Islamic Finance," *Roubini Global Economics*, May 10, 2009; Maher Hassan and Jemma Dridi, "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study," Working Paper no. 10/201, *International Monetary Fund,* September 1, 2010; and Mohamed H. Rashwan, "How Did Listed Islamic and Traditional Banks Performed: Pre and Post the 2008 Financial Crisis?" *Journal of Applied Finance Banking 2*, no. 2 (2012): 149-175.

11 Maher Hassan and Jemma Dridi, "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study," Working Paper No. 10/201, *International Monetary Fund*, September 1, 2010.

12 Simeon Kerr, "Gulf States Endure Oil Price Slump," *Financial Times*, December 22, 2015.

13 Nicolas Parasie, "Saudi Arabia Seeks Up to $8 Billion Loan," *The Wall Street Journal*, March 9, 2016.

14 Pietro Calice, Nadir Mohamed, and Rolf Behrndt, "Improving the Quality of Financial Intermediation in the Gulf Cooperation Council (GCC) Countries," GCC Engagement Note no. 2, *World Bank*, June 1, 2016.

Improving the competitiveness of Islamic banks should be addressed at the macrolevel of regulatory intervention as well as the microlevel of bank management. For example, Islamic banks confront undue commercial pressure when the interest rates offered by conventional banks exceed the return on Islamic banks' assets. Such exposure to a variant of interest rate risk could be minimized through Islamic banks' efforts to differentiate their products from those of conventional banks. Islamic banks should also target the niche pool of customers who give high value to sharia compliance, and are willing to pay a slightly higher price for innovative Islamic finance instruments.[15] A niche market strategy can increase competition among Islamic banks while being inclusive enough to appeal to non-Muslims who value the ethical features of Islamic finance.

*Regulatory reforms in different jurisdictions need to be harmonized in order to facilitate cross-border transactions in Islamic banking.*

Furthermore, in order to enhance transnational development of Islamic banking, it is pivotal that it has an internationally accepted legal, regulatory, and supervisory framework. Various initiatives have been taken in this regard, including the establishment of the Islamic Financial Services Board in Malaysia in 2002. However, IFSB standards and guidelines are not binding to Islamic banks in several countries.[16] Regulatory reforms in different jurisdictions need to be harmonized in order to facilitate cross-border transactions in Islamic banking. Notably, coordination of regulations would make it easier for highly capitalized Islamic banks in the GCC to increase their geographic outreach, and tap into underserviced markets with large Muslim populations in South Asia, Africa, and a number of the former Soviet republics. [17]

Another major deterrent facing Islamic banks is the underdeveloped infrastructure for liquidity risk management. This, in turn, raises the costs of Islamic banks' arrangements to meet banking regulations for capital adequacy requirements due to the dearth of sharia-compliant high quality liquid assets.[18] In addition, Islamic banks are restricted from entering conventional interbank lending through repurchase agreement (repo) facilities, or short-term lending, for example, since such arrangements usually include interest-bearing assets. As a result, Islamic banks are forced to have large liquidity buffers, which negatively affect their profitability and put them at a disadvantage relative to conventional banks.

15 See Cyril Garbois, Cyril Gourp, Alexander Von Pock, and Mukund Bhatnagar, "The Future of Islamic Banking," *ATKearney*, 2012; Mohamed Ariff, "Islamic Banking in Malaysia: Industry at Crossroads," *The Global University of Islamic Finance*, June 24, 2014.

16 For example, IFSB guiding principles on the needed adjustments to the Basel Committee capital requirements when applied to Islamic banks have been disregarded in a number of countries including the UAE, Britain, and Turkey. See Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song, "Regulation and Supervision of Islamic Banks," Working Paper No. 14/219, *International Monetary Fund*, December 12, 2014; Inwon Song and Carel Oosthuizen, "Islamic Banking Regulation and Supervision: Survey Results and Challenges," Working Paper no. 14/220, *International Monetary Fund*, December 12, 2014.

17 Linda Yueh, "Islamic Banking: Growing Fast But Can it Be More Than a Niche Market?" *BBC*, July 18, 2014.

18 Ritu Basu, Ananthakrishnan Prasad, and Sergio L. Rodriguez, "Monetary Operations and Islamic Banking in the GCC: Challenges and Options," Working Paper no. 15/234, *International Monetary Fund*, November 9, 2015.

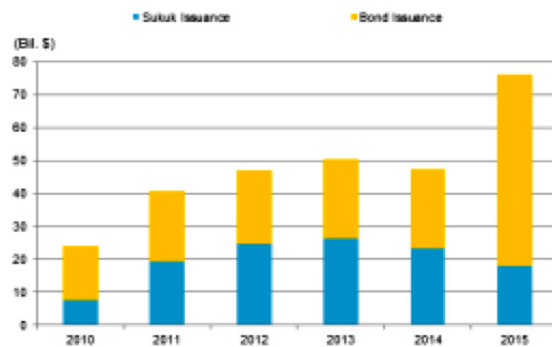
The establishment of the International Islamic Liquidity Management Corporation in 2010, with the objective of issuing sharia-compliant financial instruments, is a positive step forward, although, this is still a work in progress.[19] Monetary and regulatory authorities in the GCC should further develop the sukuk market, as well as sharia-compliant money markets, in order to ensure that the infrastructure for liquidity management does not disfavor Islamic banks.

## Sukuk Market

Simply put, sukuk are sharia-compliant financial securities that combine bond- and stock-like features. One definition of sukuk is "a trust or ownership certificate with proportional or undivided interest in a project or an asset, and carrying the right to a proportionate share of cash flows [or revenue]." Hence, sukuk are similar to bonds in that they have a specific maturity date and often a regular stream of income, while at the same time they present ownership claims with no guaranteed returns.

Over the past decade, the international sukuk market has grown twentyfold reaching a market size of $270 billion by the end of 2013.[20] Primary sukuk issuance is dominated by sovereign and quasi-sovereign issuers in Malaysia, Saudi Arabia, Qatar, and the UAE. However, Malaysia's share of sukuk issuance has been gradually declining, particularly after the Central Bank of Malaysia withdrew from issuing sukuk in 2015.[21] Consequently, GCC countries are picking up their market share due to an increase in semisovereign and corporate issues, while sovereign issues in the GCC have been declining recently.

Figure 2: Sukuk Versus Bond Issuance in the GCC 2010-15




"The Global Sukuk Market: The Correction Is Here to Stay," *Standard and Poor's*, January 6, 2016.

The influence of recent economic events on the sukuk market is twofold. On the one hand, lower oil prices have triggered some GCC countries to reduce investment spending financed by sovereign sukuk issuance and/or shift toward conventional routes of finance. In fact, sukuk issuance in the GCC alone dropped by 22 percent in 2015, while conventional issuance increased by 140 percent over the same period (see Figure 2). On the other hand, the lifting of sanctions on the Iranian economy is likely to spur issuance if Iran turns to the sukuk market to finance infrastructure investments.

19 IILM was established in Malaysia by the joint effort of central banks, monetary authorities, and multilateral organizations. See Patrick Imam and Kangni Kpodar, "Is Islamic Banking Good for Growth?" Working Paper No. 15/ 81, *International Monetary Fund*, April 28, 2015.

20 Mumtaz Hussain, Asghar Shahmoradi, and Rima Turk, "An Overview of Islamic Finance," Working Paper No. 15/120, *International Monetary Fund*, June 2, 2015.

21 "The Global Sukuk Market: The Correction is Here to Stay," *Standard and Poor's*, January 6, 2016.

In both scenarios, the complexity of sukuk issuance and lack of standardization are major hindrances to market growth. This challenge is being tackled by the Accounting and Auditing Organization for Islamic Financial Institutions and the International Islamic Financial Market[22] as well as the International Monetary Fund. Whereas, the AAOIFI and IIFM are working on the standardization of sukuk issuance and legal documentation, the IMF is working with GCC governments to increase issuance of sukuk and incorporate them in their debt management strategies. Thus, there is positive progress toward accelerated growth, potentially over the medium term.

# Conclusion

Notwithstanding increasing economic challenges, Islamic finance still has room for growth and development. Indeed, Islamic banks are projected to continue to grow faster than conventional banks for the foreseeable future given their low base, sizeable market potential, and high demand among Muslim populations. Recent initiatives for harmonizing Islamic bank regulations, developing the infrastructure for Islamic banks' liquidity management, and standardizing the process and procedures for sukuk issuance are all steps in the right direction.

22 AAOIFI and IIFM are international standard-setting institutions for Islamic finance. Both organizations are based in Bahrain.