Islamic finance lacks government support in some GCC countries

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Given the predominance of Islam as the religion and being closer to Islam's two holiest shrines, it was quite natural for GCC countries to embrace Islamic financing as an alternative to interest-based financing.

Although a late comer compared to Iran and Malaysia, the growth in the Islamic finance industry in the GCC over the past years has been impressive. For example, at the end of 2007, total Sharia-compliant assets worldwide amounted to about $640 billion (Dh2.3 trillion), of which the GCC countries accounted for around 41 per cent.

The impressive growth of Islamic finance in the GCC countries could not be achieved without government support. However, the extent of government support varies considerably across GCC countries.

For example, there is lack of government support for Islamic finance in Oman, while officials in Bahrain and Kuwait have been very supportive. Notably, the government support in Bahrain has helped the country to host 24 Islamic banks and 11 takaful insurance companies, by far the largest Islamic financial institutions in the GCC.

Ironically, on a comparative level, Saudi Arabia's government has been very reluctant to promote Islamic banking in the Kingdom. For example, the Al Rajhi Bank, today the world's largest listed Islamic bank, was not permitted to function until 1987, much later than the launch of Dubai Islamic Bank in 1975, Kuwait Finance House in 1977 and Bahrain Islamic Bank in 1978.

Whereas the central banks in Bahrain and Kuwait have been active in integrating Islamic banks to the broader domestic financial system, the SAMA (Saudi Arabia's central bank) has yet to formally recognise the presence of Islamic finance in the Kingdom.

The actions by GCC governments have resulted in a fragmented financial market. Despite moves towards creating a monetary union and a single GCC currency, there is little regulatory convergence.

However, the lack of government involvement has helped the private bodies in GCC countries to come forward to develop the Islamic financial market. In this respect, the regional Islamic banks took much of the initiative ranging from their establishments to appointing boards of specialists in fiqh muamalat - the branch of Islamic jurisprudence that is concerned with civil contracts.

This private initiative has helped the system of Sharia compliance to become more market driven in the GCC countries, which has resulted in product differentiation and extended customer choice. For instance, the Islamic banks in the GCC states are regarded as 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.

Nevertheless, given the complexity of Sharia-structured financial products, the need for government involvement cannot be ignored. There is a debate in the GCC states concerning the appointment of specialists to Sharia boards. In the absence of national Sharia authorities, the boards of each financial institution are free to appoint their own consultant, causing a lack of standardisation of the fatwa of different Sharia boards.

Consequently, GCC banks were permitted to get the fatwa they want, most notably in the case of sukuk, resulting in a burgeoning growth of Islamic products in the region. Bank clients or investors wanting Sharia compliance have the option to shop around for the least restrictive fatwa.

With the increasing availability of Sharia-structured products in the GCC, some scholars, notably Taqi Usmani (head of Bahrain-based AAOIFI), have questioned whether the structures adopted for sukuk are actually Sharia compliant.

Particular concerns were raised 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. These issues remain unresolved.

In addition to their normal day-to-day operations in, among others, deposit facilities and consumer credits, GCC Islamic banks' involvement in "investment banking" and "sukuk" has generated considerable attention in the media.

Investment banking gained momentum in the GCC largely because it is more compatible with Sharia than with retail banking, since much of investment banks' income is fee-based rather than accruing from lending and charging interest.

However, the nature of investment banking as understood internationally is different in the GCC, where much of the Islamic investment activity has involved syndicated financing of projects.

Nevertheless, lacking organisational skills and experience, most of the arrangers of the Islamic syndications have been major international banks such as HSBC, Barclays Capital and Standard Chartered.

Saudi Arabia has been the most active market in Islamic syndicated financing of projects, followed by the UAE.

Sukuk securities, which provide the asset backing to financial instruments, were developed in Malaysia, and launched in GCC in 2000. Bahrain has taken much initiative to popularise sukuk securities in the GCC states. This has helped Bahrain to emerge as a reputed Islamic financial centre in the Middle East.

Bahrain has been the most active of GCC countries in terms of numbers of sukuk issued, while UAE leads in terms of value of sukuk issuance. The combined value of sukuk issuance in GCC countries is still lower than Malaysia's issuance of 509 sukuk, worth $ 65.2 billion.

Islamic financial institutions have emerged as credible alternative sources of capital in the GCC and other parts of the world. While the impact of the financial crisis has been severe on conventional banks, the impact has been relatively less on Islamic banks.

For example, Abu Dhabi and Qatar Investment Authorities, which hold significant stakes in Barclays, have seen the value of their investments plummet. By contrast, the value of Al Rajhi Bank and Kuwait Finance House investments in retail Islamic banking affiliates in Asia has been much more resilient.

This undoubtedly presents an opportunity for GCC Islamic banks to expand further in retail and investment banking, insurance, fund management and the issuance of and trading of Sharia-compliant securities.

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