



## SOUL-SEARCHING AFTER THE CRISIS

# Islamic Banking Lessons for the Financial Sector

By ALBERTO RIBERA, VEIT ETZOLD and PHILIPP WACKERBECK

As national governments, central banks and international financial institutions continue to struggle to contain the fallout from the recent financial crisis, a consensus is forming that radical change is needed within the global financial sector to ensure there is no repeat of the events of 2008.

The U.K. government, for example, is contemplating undertaking a complete overhaul of its financial regulations in September 2011, which would require banks to hold more capital and partly separate consumer operations from investment banking.

Even the United States – the birthplace of

many of the toxic real-estate assets, credit default swaps and other derivative instruments that helped to trigger the crisis – appears to be coming round to the need for tougher regulation.

Clearly, serious mistakes have been made and lessons need to be learned. But to whom should governments, regulators and financial bosses turn for inspiration?

Perhaps a good place to start would be to study those banks that have performed best since the crisis – many of which, ironically, were shown to be “underperforming” in 2006, during the heady days of the housing boom, as research by finance professors Andrea Beltratti and René Stulz has revealed.

## Due to constraints placed on them by their faith, Islamic banks did not engage in some of the shady dealing that led to the crisis. Are there lessons for conventional banks?

One area of the banking sector that has consistently outperformed most other banks since the onset of the crisis is Islamic banking. Though still a very small part of the global financial system, Islamic banking has consistently enjoyed double-digit annual growth, even during the worst years of the global downturn.

As many international financial institutions try to strengthen their capital and reduce their risk operations, perhaps they could learn a thing or two from their more prudent Islamic counterparts.

After all, unlike most conventional banks, including many of the traditionally cautious credit unions in the United States and saving banks in Europe, Islamic banks did not participate in the dubious practices that triggered the unravelling of the global financial system.

Due to constraints placed on them by their faith-based values, they did not engage in irresponsible lending, nor did they speculate on the extremely opaque derivatives markets.

While many Western banks are fighting tooth and nail to raise enough capital to meet the Basel III reserve ratio requirements, most Islamic banks are better equipped for the new capital requirements due to their higher equity base.

Admittedly, some of our readers might be taken aback by the suggestion that a banking model that derives much of its influence from a religious faith could possibly have anything to teach secular Western banking, which has dominated global finance for decades.

By no means are we saying that Islamic finance is a cure-all to the world's financial ills. Far from it! Islamic banks face some important challenges of their own – more on these later.

What we are saying, though, is that, as in any business sector, it is worth studying and learning from examples of best practice in order to improve one's own performance.

Take the example of Barclays Bank, one of the world's oldest financial institutions, which has survived over three centuries' worth of financial crises. Founded by the Quakers in 1690, Barclays grew to become the hub of a

wider Quaker banking network based on values of "honesty, integrity and plain dealing." The founding premise was, "Wealth was accumulated slowly and could easily be lost," as the historian Richard Saville explained it.

Islamic banking – like the Quakers' banking network long before it – has been able to shrug off the worst effects of the financial crisis by drawing inspiration from its faith-based values.

In this article, we will explore how such values have shaped some of the unconventional products and services Islamic banks now offer, drawing on extensive, hands-on experience we have gained as consultants on Islamic banking issues. This includes devising market-entry strategies and restructuring Islamic banks, everywhere from Southeast Asia to the Persian Gulf, from Turkey to the United Kingdom, as well as developing Shariah-compliant offerings and Islamic private-banking strategies for European firms.

We will also look at some of the challenges to be overcome if the sector is truly to come of age. After all, compared with its Western counterpart, Islamic banking is still very much in its infancy.

### A Nascent Industry

Although several Islamic financial contracts were in existence during the age of the Prophet Muhammad, Islamic banking is almost wholly an invention of modern times.

The first seeds were sown in Egypt in the 1960s, and by 1976 the country boasted nine banks that neither charged nor paid interest. Their activities, however, were mostly limited to trade and industries in which the banks invested directly or as partners of depositors.

The first genuine Islamic private commercial bank, the Dubai Islamic Bank, was founded in 1975. Within the space of a few years, Islamic banks could be found in countries as far and wide as Bahrain, Pakistan, the Philippines, Saudi Arabia and Sudan.

Nowadays, there are more than 500 Islamic banking institutions worldwide, and their number is rapidly growing. In the past two years

alone, more than 50 new Islamic finance providers have been founded.

Naturally, many of these institutions are based in Islamic countries, with Iran, Malaysia, Qatar and Saudi Arabia accounting for the bulk of their market share. There is also considerable potential for growth in countries such as Bangladesh, India, Pakistan and Indonesia, whose combined population of Muslims exceeds half a billion people.

Currently the industry's focus is shifting westward, as more and more Islamic banks try to gain a foothold in major European and American markets with large Muslim populations, including Canada, France, the United Kingdom and the United States.

### The Birth Pangs of Islamic Finance

What most sets Islamic finance apart from Western banking is its prohibition of interest. This is not to say, however, that Islamic banks are not geared to profit making.

While the Quran may prohibit usury, it actively encourages both trade and the profit derived from it. Lest we forget, the Prophet Muhammad himself was a merchant, and merchants, traders and entrepreneurs hold positions of high standing within the Muslim community.

All the same, turning a bank that can neither charge nor award interest into a profitable business was clearly an uphill challenge, and one

that may explain why it took so long for Islamic banks to gain traction, even in many Muslim-majority nations.

The early pioneers of the Islamic banking model faced a host of other dilemmas. How to build a strong portfolio of investments when the Islamic religion prohibits participation in many sectors? Or, for that matter, how to develop a corporate governance structure that ensured the bank not only generated profit but also operated in accordance with Islamic principles?

Also, how would they provide a stable source of capital funding for large-scale projects without being able to issue interest-bearing bonds? How could they gain a foothold in non-Muslim countries, where the legal, regulatory and value systems differed so markedly from those in Islamic countries?

Let's examine each of these dilemmas one by one and some of the creative solutions that have been applied to them.

### Where's the Interest?

Try, for one moment, to imagine that you had to set up a bank that is unable to either charge or award interest payments in exchange for its products and services. Your bank must find a means of generating profit for itself as well as attracting customers willing to deposit their savings – even though they stand to earn no interest on their money.

Clearly it is no enviable task. Essentially, the pioneers of Islamic banking had to conceive a whole new banking model – one that provided the same services as secular banks but with a completely different approach.

Their answer was to devise a profit- and loss-sharing system based on joint venture, cost-plus and leasing models.

To illustrate how this approach works, let's consider how it functions in relation to the provision of three standard financial products: mortgages, current and savings accounts, and credit cards.

**MORTGAGES.** In a typical Islamic mortgage transaction, the client and the Islamic bank form a partnership to purchase a property. The capital contributed by the client should be at least 25 percent of the total, and the remaining capital is raised by the bank.

As in the case of many such joint ventures, the bank will sell the good at a higher-than-market price to the debtor, and then retain ownership of the good until the loan is completely paid off. The customer is allowed to use

## EXECUTIVE SUMMARY

**The financial crisis that started** with the demise of Lehman Brothers in 2008 and almost brought the world economy to its knees has prompted many international financial institutions to do some serious soul-searching. As they try to strengthen their capital and reduce their risk operations, whom should governments, regulators and financial bosses turn to for inspiration?

A good place to start would be to study those banks that have performed best since the crisis – many of which, ironically, were shown to be “underperforming” in 2006,

during the heady days of the housing boom. In this sense, Islamic banking is a good test case.

The authors, who all have extensive experience in the Middle East, analyze how faith-based values have shaped some of the unconventional products and services that Islamic banks offer, and they highlight the challenges these banks face as they expand their presence to Western countries.

Might there be useful lessons for conventional banks as they reconceptualize and rebuild their damaged institutions in the wake of the crisis?

What most sets Islamic finance apart from Western banking is its prohibition of interest. This is not to say, however, that Islamic banks are not geared to profit making.

the good – in this case, the house – as long as he or she pays monthly installments to the bank as remuneration.

As the bank's share in the partnership decreases, the monthly installments to the bank also decrease. Gradually, the client is able to pay a larger amount for the purchase of shares in the partnership, until the moment the property fully belongs to him or her.

Contrary to conventional Western banking, the bank's profit cannot be made explicit, so there can be no additional penalties for late payment. If default occurs, both the bank and the borrower receive a proportion of the proceeds from the sale of the property based on each party's current equity.

**CURRENT AND SAVINGS ACCOUNTS.** What if somebody wants to deposit his or her savings with an Islamic bank?

In the case of current accounts, the bank receives payments from the customer in trust. The bank can then invest the received funds, such as by extending credit to other customers, for which the permission of the current account holder is necessary. Though the customer receives no interest, some banks do offer some form of compensation or a discount on other banking services.

Savings accounts are a somewhat trickier proposition, since most depositors seek some form of monetary return in exchange for providing the bank with liquid assets. The solution that emerged came, once again, in the form of a dual partnership: If the bank generates profit in its lending business, then that profit is shared in a previously arranged ratio between client and bank.

However, the customer also participates in the bank's entrepreneurial risk – meaning that, unlike in a conventional savings account, the customer's deposit is not guaranteed; in the case of loss, the customer must bear it alone.

Some banks may offer customers additional one-off gifts or payments – known as *hibah* – to draw in customers' savings, providing the banks with the capital necessary to generate profit.

**CREDIT CARDS.** Most Islamic banks offer their customers a form of charge card similar to a standard debit card. The client receives a monthly invoice with all payments accrued from that month. The total amount of the invoice is then debited from the client's current account. Technically, this means that the client receives interest-free credit for his or her monthly expenses.

Crucially, Islamic banks are not allowed to offer so-called revolving credit cards, which offer a line of credit available on demand and can be paid off in increments over a long period of time. Extremely common in the West, such cards tend to attract high interest rates and late-payment charges.

### Profitable and Faithful Investing

Over the past two decades, Islamic banks have come up with their own versions of mutual funds and equity-based funds. Islamic mutual funds are managed on a partnership basis in which one party provides all the funds while the other is solely responsible for the management of the enterprise.

The fund manager receives a share of the profit previously agreed upon with the client. In the event of a loss, both sides of the partnership must bear the cost.

In the case of equity-based funds, the fund manager invests the fund's capital in investments listed on the stock exchange that are in keeping with the Islamic faith. This is no easy feat, as Muslims are prohibited from investing in a number of sectors such as the tobacco industry, weapons and defense, producers and vendors of alcoholic beverages, and the entertainment and media industry, especially anything connected to pornography.

Following the launch of Islamic equity funds in the early '90s, a serious problem became apparent: As most private clients had neither the time nor the inclination to constantly monitor their investments, how could they be sure that their funds were being invested in a manner consistent with their faith?

Interestingly, the solution to this problem came not from the East, but from the West, as

stock indexes in New York and London set out to create credible equity benchmarks for Islamic investors. Dow Jones was the first to pioneer such an index, in 1999, and the Standard & Poor's 500 Shariah and the FTSE Global Islamic Index Series followed soon after.

Today, there are approximately 100 Islamic equity funds whose total assets under management exceed \$5 billion and are growing at an annual rate of between 12 and 15 percent.

### Governance Challenges

Besides providing competitive and profitable financial products and services, Islamic banks must also be seen to adhere to the values and beliefs of the Islamic faith. As such, the issue of corporate governance in Islamic banking is of vital importance.

To ensure that their operations and activities comply with Islamic principles, all Islamic financial institutions must have a Shariah Supervisory Board (SSB).

Members of the Shariah Supervisory Board must navigate two markedly different worlds: the world of finance and the world of religion. Shariah scholars must undertake years of education

and training before they are able to join the board.

Needless to say, such expertise is far from common, and there is a clear need to widen the pool of qualified personnel.

Another major challenge facing Islamic finance is the absence of a clear, worldwide standard for accepted banking practices – a reflection, no doubt, of the broad range of diversity within the Islamic religion itself. As a result, certain products and services are admitted in some regions but prohibited in others.

Malaysia, for instance, has the world's largest Islamic bond market. In effect, Malaysia has its own national Shariah Board, which advises the central Bank Negara in Kuala Lumpur on banking rules and regulations. Malaysia is also known for its more business-friendly interpretations of what sort of practices are allowed than, say, many Persian Gulf countries.

To address this divergence, concerted efforts are being undertaken by a number of international institutions, such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), to establish a global set of standards and codes of conduct.

### ABOUT THE AUTHORS

**Alberto Ribera** is a senior lecturer of Managing People in Organizations at IESE, following a 15-year career with the World Health Organization, the European Commission and other multilateral organizations, in charge of projects in Africa, Southeast Asia and especially in the Middle East. From 1999 to 2003, he was general director of the Euro Arab Management School. He has a Ph.D. in economics from the International University of Catalonia (UIC) and a degree in medicine from the Autonomous University of Barcelona (UAB), and is a trained specialist in social and preventive medicine from Sapienza University of Rome.

**Veit Etzold** is program director and lecturer for executive education at the European

School of Management and Technology, a Berlin business school founded by 25 German corporations in 2002. His fields of interest are marketing and branding of service-based industries and banks. He holds an Executive MBA from IESE and is based in Berlin.

**Philipp Wackerbeck** is a principal at Booz & Company. He is one of Europe's foremost experts on Islamic banking, with extensive experience in consulting for Islamic banks in the Middle East, Europe and Asia. He is leading Booz's global Islamic banking and insurance practice. Together with Michael Gassner, he is the author of *Islamic Finance*, the No. 1 book in Germany on Sharia-compliant banking. He is based in Munich.

### Business and Capital Funding

Bank finance is one of the main sources of capital funding for businesses and large-scale public infrastructure projects around the globe. But how do Islamic banks get around the problem of providing such large-scale finance without being able to issue interest-bearing bonds?

Their solution is to issue what are commonly called sukuk – financial certificates that are similar to conventional notes or bonds and which are often backed by leases or guaranteed by sovereign or regional governments.

While in conventional bonds the bondholder receives predetermined payments of principal and interest from the issuer, the returns on a sukuk bond are explicitly linked to the performance of the physical asset. In other words, profit is shared if and when the asset delivers a profit. The recent refurbishing of the Dubai airport, for example, was financed with a sukuk transaction.

Islamic banks also use a number of innovative approaches in business transactions. For example, they can lend money to companies by issuing floating rate interest loans pegged to the company's individual rate of return. Thus, the bank's profit on the loan is equal to a certain percentage of the company's profit, and once the principal amount of the loan is repaid, the

Recent attempts by Islamic financial institutions to expand their presence to Western countries with large Muslim populations have not come without difficulties.

profit-sharing arrangement is concluded.

Islamic banks have even devised a form of venture capital funding, in which an entrepreneur provides labor while the bank provides the financing, so that both profit and risk are shared. Such participatory arrangements between capital and labor are common in Islamic banking and reflect the Islamic view that the borrower must not bear all the risk or cost of a failure.

### The Challenges of Western Expansion

Recent years have seen increasing attempts by Islamic financial institutions to expand their presence to Western countries with large Muslim populations, including Australia, France, South Africa, the United Kingdom and the United States.

This expansion, however, has not come without difficulties. Any Islamic bank seeking to get established in a Western country must first scale the hurdles of that country's financial regulations – easier said than done, seeing as the regulations were originally designed with secular banks in mind.

The bank must also decide what kind of services to provide and to whom. In the United Kingdom – a traditionally banking-friendly environment and currently the largest Western market for Islamic finance – four of the country's five Islamic banks are focused on investment and corporate banking.

The only Islamic bank in the United Kingdom that offers retail banking services is the Islamic Bank of Britain, founded in 2004. The bank has faced challenging business issues in recent years, largely due to lack of capital and available funding – a problem that appears to have been temporarily relieved by Qatar International Islamic Bank's capital injection in 2010.

Meanwhile, plans are afoot to establish an Islamic bank in Germany. Gaining regulatory approval, however, has proven to be an enormous obstacle, and it remains unclear whether the bank, if given the go-ahead, will focus on investment or retail banking.

What is clear, though, is that Germany, with its four-million strong Muslim community, represents a highly attractive market for Islamic banks.

What's more, both German companies and Middle Eastern investors stand to benefit. Germany's export-driven companies would be able to access new sources of funding from cash-rich Middle Eastern countries, while many Muslim investors would welcome the chance to invest in German manufacturers, whose machinery-based products are not only Sharia-compliant by nature, but are also held in high esteem by many in the Muslim business community.

### East Meets West or West Meets East?

One of the most remarkable aspects of the growth of Islamic banking in the West is that much of it is owed to the efforts of Western banks, many of whom have established independent departments within their corporate structures to cater to the needs of Islamic clients.

Such departments – often referred to as “Islamic windows” – have flourished by offering many of the same products and services that had already been developed by Islamic banks. For example, all Islamic windows have a Shariah Supervisory Board and their operations must, in theory, be ring-fenced from those of their parent organization.

The world's largest Islamic window, HSBC Amanah, was founded in 1998 and has grown so fast that it already accounts for some 10 percent of HSBC's net income. With operations across the Middle East, Asia Pacific and Europe, Amanah has enabled HSBC to leverage its vast global resources to offer Islamic banking services to a major new client group in some of the world's fastest-growing emerging markets, including the Arab states of the Persian Gulf and Malaysia.

Many other international banks have since followed suit, and the number of Islamic windows has mushroomed to over 350 worldwide.

Nevertheless, Islamic windows face a number of challenges, the most important of which

Moves to offer more Western-style banking services face an uphill battle. The theological grounds for Islamic hedge funds, for example, are shaky at best and not Shariah compliant.

is addressing widespread Muslim concerns that their funds may be used by the conventional part of the bank for financial activities prohibited by their religion, such as speculating on derivatives or issuing conventional mortgages.

Naturally, if given the choice, most Muslims would prefer to use the services of genuine Islamic banks. However, due to the relative scarcity of such institutions in developed countries, most Muslim residents in the West are denied such a choice.

To expand their presence in both the East and the West, Islamic banks may have to rethink their models – just as many international banks have diversified their offer to capture a growing market of Muslim customers.

But in doing so, they face two key challenges: opening up their financial services to a broader cross section of society; and diversifying their offer of products and services while taking care not to dilute their unique value proposition.

### Reaching a Broader Clientele

Islamic banks have come under growing criticism for not offering services to poorer social groups. Such accusations gain traction from the fact that more than 60 percent of Muslims live in relatively impoverished Asian countries, the vast majority of whom are deprived of banking services.

Ironically, it is these economically deprived Muslims who are most in need of financial assistance, to help raise their standard of living. Given the growing wave of social unrest across the Middle East and North Africa, and the heavy toll it has already exacted on some financial sectors in the region, Islamic banks would be well advised to start addressing the financial needs of these people.

What's more, it could even work to their benefit. After all, this largely neglected section of Muslim society represents a potentially enormous new market for Islamic banks – a market that institutions in some less developed Muslim countries have already begun to tap, by providing microfinance to growing ranks of micro-entrepreneurs.

However, microfinance institutions (MFIs), such as those pioneered by Muhammad Yunus of Grameen Bank in Bangladesh (where almost 90 percent of the population is Muslim), are generally non-Islamic in nature. While Yunus and other supporters of microfinance argue that the lack of collateral and low levels of interest in microlending are consistent with the Islamic prohibition of usury, most Islamic banks remain unconvinced.

Perhaps what is needed is to devise a microfinance model based on profit and loss sharing rather than the payment of interest. One potential avenue for achieving this would be to offer microcredits via Internet crowd funding, which would help to minimize the bank's administration costs.

For such a microfunding model to work, however, it must be highly standardized and scalable – no easy feat given the divergent nature of most national banking regulations.

### Diversification, But at What Cost?

Recent years have seen moves by some banks to offer more Western-style banking services, in an effort to capture greater market share and offer a broader range of services to their customers.

In 2010, the Bahrain-based International Islamic Financial Market and New York-based International Swaps and Derivatives Association established global standards for Islamic derivatives such as profit-rate and currency swaps – a move that came partly in response to growing calls for Islamic equivalents of Western hedge funds from wealthy Muslims seeking to hedge their risk.

However, as Reuters reported in 2009, Islamic hedge funds may well face an uphill battle, for two reasons.

First, Islamic banking products tend to be more expensive to administer, due to Sharia board expenses and the extra monitoring of products. As a result, Islamic hedge funds would probably be uncompetitive.

Second, the theological grounds for Islamic hedge funds are shaky, at best. As one senior an-

alyst recently told the *Financial Times*, “It is difficult to distance hedge funds from speculation (which, as a form of gambling, is banned under Islamic law), and while many scholars accept the need for risk management, the financial tools applied are often the same.”

Also, many hedge funds use leverage to buy shares, which they normally do by using a conventional credit line from the money market. This would not be Shariah compliant.

Short selling, another (in)famous practice of hedge funds, means selling something the seller does not own – which is also not allowed according to Shariah law.

Attempts to eliminate risk, such as by securitizing liabilities, are still seen by many Muslim scholars as promoting an unjust system of social relations whereby creditors are guaranteed returns while debtors are burdened with the risks. Such practices are, in theory, forbidden in the legalistic structure of Islamic finance.

According to Islamic scholar and economist Khurshid Ahmad, “Islam wants the economy, its major monetary and business dealings, to move from a debt-based relationship to an equity-based and stake-taking economy.”

Considering that the continued securitization of debt and growth of derivatives instruments – once described by billionaire investor Warren Buffet as “weapons of mass destruction” – disproportionately contributes to global growth, there is a clear need for a return to sound global financial management.

Scholars of the Islamic faith are far from alone in their criticism of current financial practices. In his 2009 encyclical, *Caritas in Veritate* (*Charity in Truth*), Pope Benedict XVI warned of the “damaging effects on the real economy of badly managed and largely speculative financial dealing.”

The Pope is particularly critical of financial speculation “that yields to the temptation of seeking only short-term profit, without regard for the long-term sustainability of the enterprise (or) its benefit to the real economy.”

### The Way Ahead

As Charles McDaniel of Baylor University argues in a recent paper on the subject, the increasing role of faith-based investment within the general category of “socially responsible investing” appears to be “reenergizing the practice of theological economics and may have the potential to moderate some of the abuses we recently have witnessed.”

Some Christian investment funds have even

followed the example of Islamic banking in offering alternative investments to investors who want to be consistent with their values. For example, April 2010 saw the launch of the Stoxx Europe Christian Index, which avoids investment in firms associated with pornography, munitions and gambling, for example.

By offering a financial model in which both risk and return are shared more equitably between creditor and debtor, and which has, until now, avoided many of the riskier “innovations” of modern finance, Islamic banking has the potential to enjoy continued growth in the coming years.

However, as illustrated by the 2009 Dubai crisis, which resulted from a temporary default on payments of Dubai World’s \$59 billion debt, Islamic banking is far from immune to financial crisis.

Ultimately, the continued success of the sector hinges on two crucial factors: How it shapes and is shaped by secular banking practices, and its ability to overcome the substantial ambiguities within its own constituent parts.

Efforts need to be made to enact common banking regulations that encompass all Islamic banking practices. Some important steps have been made in that direction, but the obstacles against such wide-ranging reform are immense, particularly given the disunity in the Islamic world.

Islamic banking may not be the remedy to all future crises. Yet it is well worth keeping a close eye on the sector – especially as Western bankers and economists struggle to prevent a repeat of the events that started with the demise of Lehman Brothers in 2008 and almost brought the world economy to its knees. □

### ■ TO KNOW MORE

- Ribera, A., V. Etzold and P. Wackerbeck. “Islamic Banking: Dawn of a New Era.” IESE Technical Note (January 2011).