Competition or Co-operation?

SHARIAH-COMPLIANT *vs* SHARIAH BASED

Islamic Finance Institutions

By Natalie Schoon

On July 9 of this year, the Bank of London and The Middle East Plc (BLME) was launched in the City of London. BLME is the second wholly Shariah-compliant investment bank authorised and regulated by the Financial Services Authority (FSA). This brings the number of fully Islamic banks in London to three, with the total number of financial institutions offering Islamic financial services in the UK at 24.

Although a young segment of the financial industry, Islamic finance has gone through an exceptional growth period. Over the past 10 years, the industry has grown at a rate of 15 percent to 20 percent per year. This level of growth is expected to continue for the coming years and by far exceeds the rate of growth in conventional finance. The increase in wealth resulting from the rise in oil prices and the subsequent requirements for investments in oil-producing countries is a large contributor to the expansion of the Islamic finance industry. Coupled with relatively high returns, this attracts banks and investors alike.

Islamic financial products are not only offered by fully Shariah-compliant banks, but also by conventional banks employing specific distribution channels: Islamic windows and Islamic branches. The issue that arises is whether Islamic financial products offered by a conventional bank are equally acceptable to Muslims as those offered by fully compliant Islamic financial institutions. There is, after all, a difference in the level of Shariah compliance of conventional and Islamic banks.

Shariah Compliant

In order for a financial product to be Shariah compliant, it needs to satisfy, at a minimum, the criteria of Shariah law regarding the avoidance of Riba, Maysir and Gharar. Once these are satisfied and the bank obtains Shariah supervisory board approval, the product or structure can be marketed as Shariah compliant. As far as conventional banks are concerned, this is where Shariah compliance stops. It does not constrain the bank from employing non-Islamically raised funds to invest in Islamic structures.

Shariah Based

A fully Shariah-compliant or Shariah-based bank takes the compliance with Shariah law a step further. Not only do individual products have to meet all the requirements, but all operations within the bank are required to be compliant with Shariah law. This extends to contracts with suppliers, rental contracts and labour contracts. The bank is completely set up to work in line with the ethical framework of Shariah, which makes it more likely to be able to structure all products to meet the requirements. In addition, there is no co-mingling of conventional and Islamically raised funds, since all funds are raised in line with Shariah requirements.

Does it Make a Difference?

The decision any investor, depositor, Sukuk issuer or other client of a bank will have to make is related to the trade-off between the level of Shariah compliance and the reputation and historic track record of the bank.

Is Bigger Better?

A large conventional bank with a proven track record will provide a relatively higher degree of certainty than a newly established Islamic bank. In addition, large conventional banks have the advantage of the backing of a big balance sheet and structuring capabilities that are well beyond the potential of Islamic banks, at least at the moment. This becomes immediately clear when comparing the total assets of the largest

Natalie Schoon is Head of Product Development at Bank of London and The Middle East Plc (BLME), a stand-alone, wholesale, Shariah-compliant bank based in the City of London. Natalie has been working for international financial organisations since the start of her career. She holds a PhD in Residual Income Models and the Valuation of Conventional and Islamic Banks. Natalie began her career in Islamic finance in the mid-1990s while working in Bahrain, Kuwait and Dubai. The views represented in this article are those of the author and do not necessarily represent those of BLME.

At the end of 2006, the largest Islamic bank (Al Rajhi) had total assets of $28.1 billion. The likes of HSBC, Barclays and Citi, on the other hand, each had a total asset base close to $2 trillion at the end of December 2006. As a result, it is much easier for conventional banks to underwrite large Sukuk issues and to structure sizeable project finance structures than it is for Islamic banks.

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As a result, it is much easier for conventional banks to underwrite large Sukuk issues and to structure sizeable project finance structures than it is for Islamic banks. Between June 2006 and June 2007, five of the 10 biggest Sukuk arrangers were conventional banks. Issuers choose conventional banks for their proven track record, their ability to raise large sums of money and, most importantly, their competitive pricing.

However, conventional banks provide Islamic finance as part of a broader range of financial products, and although the individual offerings are Shariah-compliant and the distribution channel is different from other financial products, a conventional bank is likely to co-mingle funds raised in an Islamic manner with conventionally raised funds. In addition, conventional banks can hedge positions using innovative financial products which are often not allowed in Islamic banks, given the speculative nature of the majority of hedging products.

Good Things Come in Small Packages

A small, relatively young Islamic bank does not have a long track record and can hence be seen by investors and depositors as carrying a higher risk. Although some comfort can be found in the fact that the bank is regulated, conventional banks are regulated in the same way. As a result of the smaller balance sheet size, Islamic banks are not currently in a position to underwrite large Islamic finance transactions unless they eare part of a syndication effort, and even then, some transactions are out of their scope due to large exposure regulations and size limitations.

On the other hand, a Shariah-based bank operates completely within the remit of the ethical framework defined by Shariah law, something that could be of significant interest for Muslims. A fully Islamic bank will not only be audited internally and externally, but will also be subject to a review by the Shariah supervisory board as an independent third party to ensure ongoing Shariah compliance for the whole of the business. An Islamic window or branch of a conventional bank does not necessarily go through this type of ex-post compliance audit, and in any case does not have to report the results in its annual report.

A Place at the Table

There is a strong call in the market to form an Islamic megabank, but given the size of the individual Islamic banks, this appears to be a long way off.

Although the number of Islamic banks is growing exponentially, their balance sheet size on a consolidated basis is not even remotely close to the size of any of the large conventional banks on their own. Thus, the two types of players operate in different market segments; which actually makes them very complementary. In the end, there is a place for both Shariah-compliant and Shariah-based banks. By working closely together, they can achieve high market penetration and work on reaching the full potential of the market. •