SUNGARD AMBIT

ISLAMIC BANKING AND FINANCE:

GROWTH AND CHALLENGES AHEAD

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WHAT IS ISLAMIC BANKING; WHERE DID IT COME FROM AND WHERE IS IT GOING?

With conventional brick and mortar roots going back to the 1960's and Quran teachings dating back nearly 1,500 years, Islamic banking is both an established school of thought and a relatively recent addition to the global financial market. Geographically, its beginnings can be traced back to the Middle East, but the practice has blossomed into a worldwide phenomenon, that includes Malaysia, Indonesia and other parts of Asia. Malaysia is now recognized as an Islamic banking hub for the East while other major financial centers like London, Singapore and Hong Kong are also entering business partnerships with Middle Eastern banking institutions. There are now Islamic financial institutions operating in more than 75 countries worldwide.

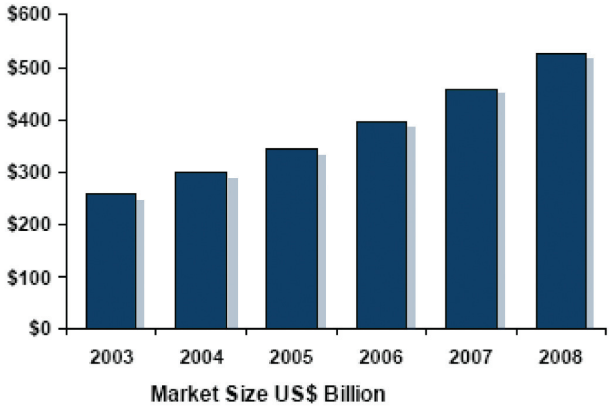
The basic tenets and principles of Islamic banking are built upon the avoidance of Riba, Gharar and the prohibition of impermissible businesses as stated in the Quran. Banking models are built upon the foundation of compliance with Sharia'h (Islamic law). In classical Islamic jurisprudence the definition of Riba was "surplus value without counterpart." Today the popular interpretation of Riba is that it is one and the same with the 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. Any contract undertaken where Gharar exists is null and void. Professor Mustafa Al-Zarqa wrote that "Gharar is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling."

The very first Islamic bank that was collected and formed is the Myt Ghamar Bank in Egypt. Between 1963 and 1971 this institution provided Muslims with a place to deposit their savings safely and in accordance with Sharia'h principles and doctrine. Myt Ghamar Bank was later transformed into Nasser Social Bank and has served to achieve greater social objectives through their banking activities.

The most transcendent and influential move into the mainstream banking arena was the establishment of Dubai Islamic Bank in 1975. Dubai Islamic Bank was the first private Islamic bank designed to achieve maximization of profit on a commercial platform, offering commercial consumer products and banking methods. Launched in the same year was the Islamic Development Bank, who maintained a more expansive agenda of promoting economic prosperity including finance and banking development.

Since that time Islamic banks and institutions have grown at a considerable pace and history has not shown any trends to reveal any slow down. In fact, many trending studies have indicated that the industry should continue to grow at a rapid pace annually over the next few years. According to Arabnews.com, as of January 2008 the Islamic banking industry is set to achieve an estimated 20% growth annually. Management consultants McKinsey & Co have forecasted the sector to reach $1 trillion in assets by 2010.



Projected Growth of the Global Islamic Banking and Finance Industry (2003 - 2008)

Source: Financial Insights & General Council on Islamic Banks

REQUIREMENTS FOR BANKS TO ADOPT AND IMPLEMENT ISLAMIC BANKING STRUCTURES

Sharia'h Compliance

First and foremost, newly formed Islamic banks and conventional banks interested in opening Islamic windows need to maintain Sharia'h-compliance. Banks looking to move into the Islamic banking market first need to appoint a Sharia'h board or a Sharia'h counselor to ensure conformity and minimize Sharia'h risk. These boards and counselors are carefully selected by the hiring body based upon their reputation or experience within a given market. This basic and necessary first step to branch into the Islamic finance world is becoming more difficult as the industry grows - Sharia'h scholars are currently spread too thinly across numerous institutions. Compounding the present difficulty of finding scholars is that there is no standardization of requirements for becoming a Sharia'h scholar. Some estimates are that new Sharia'h scholars will not be prepared for another five years, not nearly fast enough to accommodate the supposed 15%-20% growth rate of the industry. The lack of standardization is also evidenced in the slight variations of Islamic banking worldwide. There are differing opinions of how to apply or interpret Sharia'h law amongst the different banking regions, notably between the Middle East and Malaysia. The Islamic Financial Services Board (IFSB) is an international standard-setting organization. One of their missions is to promote the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding industry principles. Outside of the Middle East, however these standards and principles may not have as strong a hold.

Risk Management

Both pure Islamic banks and conventional banks operating Islamic banking windows also need to address their risk. Not only do these institutions have to cover the same risks as wholly conventional banks, but Sharia'h banks must cover additional, unique risks, including:

- Commodities and inventory risk (from holding items in inventory either for resale, as terms of a Murabahah contract or with intent to lease under an Ijarah contract)
- Legal and Sharia'h compliance risk (due to an additional set of laws and rules, it

is more likely that Sharia'h compliant banks will enter into additional contractual agreements. In the event something should go awry, the issue may end up being taken to a secular court unfamiliar with Sharia'h law, exposing the bank to risk)
- Equity position risk (from the equity exposures in Mudharabah financing contracts)
- Mark-up risk (since Islamic banks use market rates as opposed to interest to benchmark their product pricing, as a result there is a risk associated with any changes to the benchmark rate)
- Transfer risk (risk transfers are normally done in Sharia'h as Bai'-al Dayn (debt transfer) contracts. Most Middle Eastern banks do not deem these contracts compliant)

Segregation of Funds

It is not permissible for Islamic banks and conventional banks maintaining Islamic windows to allow funds from their conventional banking operations (if they exist) to commingle with Islamic funds per Sharia'h law. Conventional banks operating Islamic windows must maintain a separate balance sheet and financial books and participate strictly in Islamic-compliant investments. Funds intended for Sharia'h-compatible investments should not be mixed with non-Islamic investments in order to maintain the purity of the Islamic transactions and banking practices. Conventional banks with Islamic windows must maintain separate books and publicize that such a practice has been indoctrinated within their institution.

First Steps

These base requirements reveal that a conventional bank looking to break into Islamic banking must do more than simply introduce Islamic banking products to the portfolio or suite of products. The initiation of those financial devices will require scalable, adaptable back- and front-office treasury, cash management and core banking systems. These banks will require cohesive, proven solutions that are capable of providing the necessary levels of transparency to ensure the segregation of funds and to establish a successful Islamic banking segment. To enter the rapidly growing Islamic banking arena, these banks should look to a solution provider that can offer a system that can provide the various banking modules necessary to appease Sharia'h boards and scholars no matter the region.

As noted earlier, another contributing factor to the need for unique and module-based core banking and treasury solutions is the fact that there are currently a number of regulatory frameworks within which Islamic banking is developing. These frameworks and rules can often be contradictory and lead to difficulty in maintaining Sharia'h-compliance. Standardization of Sharia'h-compliant rules on accounting risk management, and corporate governance across the Islamic banking industry is becoming increasingly necessary as there are a number of different conditions to be applied in each region.

- Tawarruq: The sale of an asset with deferred payment. The purchaser then sells the asset to a third party for cash with a price lesser than the deferred price, for the purpose of getting access to cash. Also known as reverse Mudarabah.
- Sukuk: Asset backed bonds, applicable in investment products.
- Mudarabah: Profit-sharing agreement, used for equity financing or equity based mutual funds.
- Musharakah: Equity financing, used for working capital or investment funds.

Some organizations, including the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are reaching out and making an effort to bring regulation to the markets auditing and accounting standards. Solutions providers need to cater to these institutions in different ways; for example in certain regions data needs to be segregated differently, while in another there may only be a need to change terms within an existing solution (terms like "profit sharing" may need to be inserted wherever there is a similarity to interest). To serve as an example of the need for standardization across the financial products themselves, there is a lack of consistency in the accounting methods of numerous Islamic financial institutions resulting in difficulties comparing the results and performance of one Islamic financial institution to another. Speakers at the International Bar Associations "Islamic Finance in the Middle East" conference on January 13, 2008 were nearly unanimous in their assertion that there needs to be some level of consistency applied to Islamic finance laws across the GCC countries which may be of aid in establishing regionally-accepted regulatory standards.

HOT TOPICS AND CURRENT TRENDS IN ISLAMIC BANKING

At a time when the conventional banking sector is facing many challenges related to the credit crunch, (following investments in sub-prime US housing mortgage loans which have since collapsed) there may be even more migration to Islamic financial services in certain countries, and more lessons to be learned for both financial systems. The overall main driver in Islamic banking is Sharia'h compliance, and the need for core banking, risk solutions and treasury systems that can provide it. Islamic banking institutions that operate off of systems that are approved by organizations like the IFSB are able to focus more on what their customers needs are as opposed to constantly confirming compliance.

The entry of large multinational banks with Islamic banking windows into Arab domestic markets is heightening competition. The Financial Services Authority (FSA) stated in a recent article that a move to principles-based regulation will provide the right environment for Islamic finance to flourish in the UK. This international push into the market has resulted in smaller Islamic banks beginning to consolidate, cascading down into a need for smooth transitions that maintain Sharia'h compliance.

Demand for more expertise on Islamic finance is increasing with the sustained growth that the industry is experiencing. As institutions in Malaysia and Indonesia provide benchmarks for that growth, new startup Islamic banks are in need of a core solution that can support a complete set of Sharia'h compliant products (Islamic deposits, lending, and derivatives instruments).

Current issues facing the Islamic banking community include the need for money market instruments that are Sharia'h compliant. There is also an immediate need for short-term money market investments and tools for liquidity management, a space that could benefit immensely from the introduction of new instruments. Most available conventional banking instruments for liquidity management are interest based and therefore not Sharia'h compliant. Until new products or solutions are developed, this is going to severely hinder development of the Islamic inter-bank money market.

Key issues facing Sharia'h compliant banks trying to grow their liquidity management products suite:

- Limited Islamic secondary markets
- Various Sharia'h interpretations
- Small number of participants
- Slow or stagnant development of Islamic financial instruments

Traditionally, Islamic banks have relied on Murabahah for short-term investments and liquidity management; however this leads to an inefficient use of funds due to its low returns. Only now are Muslim scholars learning and devising methods to replicate the conventional inter-bank markets into an Islamic equivalent. The International Islamic Financial Market (IIFM) has been tasked with developing an active secondary market where Sharia'h compliant financial instruments are used in an effort to facilitate liquidity management among Islamic banks.

New sukuk instruments have been introduced recently to the market to aid in liquidity management. Another booming part of the Islamic banking industry, the sukuk market has grown considerably in the last few years (from $8 billion in 2003 to $70 billion in 2007) and is poised to grow at an even more rapid pace in the near future, with projections of $140 billion in three years.

- Murabahah: Cost plus financing, applicable in mortgages, car and corporate loans.
- Bai Inah: A contract which involves the sale and buy back transaction of an asset by a seller. The seller will sell the asset to a buyer on a cash basis then immediately buy back the same asset on a deferred payment basis at a price that is higher (or lower) than the cash price.

SYSTEM SOLUTIONS FOR ISLAMIC FINANCIAL INSTITUTIONS

The solutions that are needed to serve the Islamic banking community and its customer segment are completely unique. The industry is seeking methods to temper its growth with treasury and core banking systems that can handle the unique needs of Islamic banking with regard to its rules and compliance with Sharia'h. Most importantly, the focus is on finding treasury, risk management and core banking solutions that meet the basic requirements and address risks first.

Conventional banks will need to readdress and reevaluate their current systems in order to open Islamic windows and they must streamline their existing operations running disparate legacy departmental applications. An industry experiencing such consistent growth is going to be in need of new solutions capable of consistently and reliably delivering Sharia'h compatible results.

An Islamic core banking system has more stringent requirements than the conventional core system implemented by a conventional bank. Conventional banks opening Islamic windows will require a fair amount of customization; profit-rate parameters must be set according to Sharia'h. It needs to be enhanced and tailored to meet the needs and requirements of Islamic financial products. Such enhancements include:

On the Deposit side, the system has to cater to the different types of deposit products, including; Wadiah, Mudharabah and Musharakah based deposits. It also has to handle profit sharing between the depositors/investors and the bank.

On the Financing side, the system has to cater to the different types of financing contracts including; Murabahah, Musharakah, Ijarah, Salam and others. As an example, the form of financing which is based on a buy/sell transaction requires the system to handle the two-step process (the purchase of the asset by the bank and the sale of it to the customer). It can entail the upfront recording of unearned profit upon transfer from the funding to the financing account. A core banking system has to consider the computation of the selling price, rebates for early termination, grace period, non-capitalization of charges and so on.

For risk management and compliance solutions, both pure Islamic and conventional banks should seek systems offering a centralized view of cash, liquidity and risk across their institutions. Solutions encompassing these traits will lighten the burden and improve decision-making while maximizing returns. A fully featured solution should deliver a scalable framework combining market, credit, stress and scenario-based risk management with Sharia'h and Basel II compliance, in addition to reporting in a single, integrated suite.

As the Islamic banking market continues to grow with no visible end in sight, there currently is and will continue to be a considerable need for core banking, risk management, treasury and other systems that can effectively manage the unique needs of this segment. Pure Islamic banks and conventional banks with Islamic windows will need approved solutions that they can consistently rely on to meet Sharia'h counsel and board approvals, thus allowing their attention to have a greater focus on customer needs and development of new instruments.

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About Ambit

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