

Islamic Banking in the Middle-East and North-Africa (MENA) Region

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Abstract

Islamic finance has now become an important element in the development agenda of the Middle East and North African (MENA) countries. It is also gaining significance in the financial landscape of the region as well as of the individual countries. As a growing business it caters to the financial needs of the people without conflicting with their social and religious values. Despite this reality, little systematic and consistent analysis exists in the literature on the asset and liability structure of Islamic banks in the region and across individual countries. Even lesser is known on what drives Islamic banking growth.

This paper addresses this gap and explores how the structure of the Islamic banking sector has been evolving in the MENA region in recent years, and how it is growing in terms of assets, liabilities, financing and funding structures within the region and across different countries. It also provides an exploratory analysis of relative importance of the various factors responsible for the growth of Islamic banking in the region. The financial crisis provided us with a natural experiment to evaluate the contribution of Islamic banking towards resilience and inclusiveness of financial sector by analyzing the performance of these banks during this period.

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1. Introduction

Islamic finance in the Middle East and North African (MENA) countries has now become an important element in their societies' development agendas and it is also gaining ground in the financial landscape of the region as well as in the individual countries. It is also a growing business as it caters to the financial needs of the people without conflicting with their social and religious values. Despite this reality, little systematic and consistent analysis exists in the literature on the asset and liability structure of Islamic banks in the region and across different countries. Even lesser is known on what drives Islamic banking growth. Except for some sweeping statements that appear in popular press no systematic analysis of the driving factors exist to our knowledge. Similarly, what has been the contribution of Islamic banking to the financial sector in terms of resilience and access are unexplored questions.

This paper explores these issues. In particular it sheds light on how the structure of Islamic banking sector has evolved in the MENA region in recent years. How it is growing in terms of assets, liabilities, financing and funding structures in the region and across different countries. It also provides an exploratory analysis of relative importance of various possible factors responsible for the growth of Islamic banking in the region. The financial crisis provided us with a natural experiment to evaluate the contribution of Islamic banking towards resilience and inclusiveness of financial sector by analyzing the performance of these banks during this period.

The Islamic banks were among the first categories of financial institutions that emerged in Islamic financial services industry. As this industry expanded, and as the conventional financial sector in MENA countries diversified into capital markets and other segments, many other non-banking financial institutions and services also emerged in Islamic finance. Now Islamic financial services industry not only comprises of Islamic banks but also includes investment and mutual funds, project finance companies, and *takāful* institutions. New instruments of financing and capital market products have also emerged. This study however focuses on Islamic banking segment only.

2. Nature and Model of Islamic Banking

Financial intermediation is an important activity for the smooth functioning and growth of the economic sector. Collection of savings from various economic agents

and channeling them for investment is information intensive activity. It requires institutions that on one hand can provide incentives to the savers to pool resources with them and on the other hand specialize in information processing and monitoring to evaluate fund-seekers and their investment opportunities to allocate the funds in the best possible way so as to earn income for themselves. In the conventional banking these two activities of collection of funds and then their disbursement are done on the basis of interest charge. That is, the bank charges an interest amount from the financed party and pays a slightly lesser interest amount to the funding party with the differential interest margin gained for itself.

Interest is prohibited in Islam. Therefore conventional banking is not the right arrangement for financial intermediation in an Islamic economy. Islam also gives a higher role to moral values and promotes justice in all aspects including finance. Hence Islamic economy requires other institutional arrangements that are conducive to the objectives of Islamic law. Banking without interest is one of the hallmarks of Islamic banking system.² In this system, the incentives to the financing institutions for rendering their financing services are provided in the form of sharing in the profits of the financed enterprise; in the form of earning profits by engaging in trade or supplying of the intermediate goods and services to other businesses; and in the form of fee in return for various payments services and investment services etc. On the funding side too, the Islamic banks do not obtain funds on interest based contracts. Rather, they share their profits with their investment account depositors hence providing incentives to the savers to use the banking system. These banks also provide deposit, safekeeping and payments services thus attracting current deposits which do not pay any remuneration to its depositors. In short, Islamic banks do not work simply as pure intermediaries of financial capital but get more involved with the activities of the users of funds. In this sense they are closer to universal banks.

An initial simple model of Islamic banking that was proposed in 1960s was a two tier *muḍārabah* arrangement.³ Whereby the bank collects funds on the basis of agency relationship from savers/depositors and invests them as their agent on the condition that the bank will get a pre-agreed proportion of profit from this investment. This agency agreement in return for a defined proportion of share in profit is called a *muḍārabah* arrangement that the bank has on its funding side with

² Other features of Islamic banking include avoidance of un-necessary uncertainty, attention to moral values and wellbeing of society.

³ Initial full model appears in Siddiqi's book published in 1966 in Urdu language entitled "*Bila Soodi Bankari*". This was translated and published in English as Siddiqi (1986).

the savers/depositors. In order to invest the funds that have been pooled from the savers/depositors and earn a return for them the bank uses a second tier of *muḍārabah* arrangement, this time it is between the bank and the financed party. Whereby, the financed party utilizes the funds in its commercial enterprise and agrees to share with the bank a proportion of the profit. This is the two tier *muḍārabah* model. It has the advantage that liability side fully adjusts to fluctuation in the asset side, bank solvency is not an issue, and a broader level of risk sharing is achieved in the society. Risk sharing at all levels of business enterprise leads to lower levels of premature bankruptcies of business, and rarer event of sudden closure of banks. These characteristics have very positive implications for the financial as well as economic stability.

However, this is not the most practicable model for every situation. For example, it has high informational requirements for calculation and verification of revenues, costs and hence profit or loss. The existence of information asymmetry between the contracting parties gives rise to the problems of moral hazard and adverse selection which may result in no contract if these costs are high. Similarly, there may be informational externalities because of which one party may not be willing to reveal a piece of information that is vital for the agency contract to hold between the two parties. Hence, agency may not remain suitable. A less information intensive contract in such situations is *murābaḥah* contract. Whereby, the bank buys, from spot market and in its own name, the plant or the equipment or the raw material that is needed by the entrepreneur and then sells it to him on deferred payment with a marked up price.

This gave rise to a second model of Islamic banking. In this model, which is more prevalent in practice, the funding side of the bank is on *muḍārabah* (agency contract) with savers/depositors but on the financing side the bank uses both *muḍārabah* (agency contract) and *murābaḥah* (marked up price sale contract) as and when appropriate. Thus this model is applicable for wider set of activities, hence when proportions of both types of financing are high it retains the stability feature and adds accessibility. In addition to *muḍārabah* (profit sharing) and *murābaḥah* (fixed return) contracts, *ijārah* (leasing) and other contracts are also used by Islamic banks on their financing side which further adds to menu of choices and applications. Further details of asset and liability sides of Islamic banks will be discussed in coming sections.

An important point to note in all models of Islamic banking, and also for Islamic finance in general, is that finance is always tied to real economic activity or investment. There is no untied credit that earns a return. Income earning credit

comes into being only by value adding real economic transaction be it in the form of *murābahah* or leasing or other such contracts. This in itself is a source of stability for the overall financial system. Moreover, the profit sharing that takes place between individual bank and savers/depositors works to stabilize the bank, increase its monitoring, and in turn have positive systemic stability implications as well.

2.1. Major Islamic Banking Business Models

The theoretical model of Islamic banking is closer to the universal banking model, whereby the bank is not restricted to the business of extending credit only but it also gets actively involved in trading and owning the shares in other businesses. Given the nature of Islamic finance the strict segregation of banking business into commercial banking and investment banking is not an optimal arrangement. However, due to the existing regulatory setup as well as based on the diverse organizational arrangements of the financial sectors across countries, we find various business models of Islamic banks have emerged. Following are some major business models used in Islamic banking:

1. Retail and Corporate Banking
2. Investment Banking
3. Combination of Commercial and Investment Banking
4. Bank working as Money Changing and Money Transferring Business
5. Investment Company Models
6. Holding Company – holding various financial companies
7. Banks operating mutual funds (i.e., indirect investment companies)
8. Industrial and financial conglomerates
9. Specialized Banks (catering to specific sectors as agriculture only or industry only)

In the MENA region majority of Islamic banks are in private sector. They exist along with the conventional banking and financial institutions with the exception of Iran which classifies all its banks as Islamic and majority of them are state owned. Among the MENA countries, most developed Islamic banking sectors are found in Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates. The nature of funding and operations of Islamic banks are somewhat different from that of conventional banks. In these countries Islamic banks raise depositor funds mainly under three categories:

- (i) Demand Deposits do not give any returns to the depositor and can be withdrawn by the depositor at any time. For these deposits the relationship between the bank and the depositor is that of debtor and creditor. Thus the amounts in this category of deposits are a liability in the accounting books of the bank. Safekeeping and payments facilitation are the primary motives of the individuals and businesses in keeping such accounts with the banks. Thus these deposits are similar to current accounts in conventional banking system.
- (ii) Unrestricted Investment Accounts raise funds which are utilized by the bank in its general investment and financing activities based on their own judgment, and the profits or losses from the overall business of the bank are shared between the bank and the holders of such account. The account holders do not have a voice in instructing the banks on how, where, and for what period to invest. Except that the investment avenues and methods should not be against Shari'ah – a fiduciary responsibility of Islamic banks. Thus the contractual relationship between the bank and the depositor in this account is that of unrestricted *muḍārabah*, with bank acting as *muḍārib*. Moreover, the account holders are also allowed to withdraw their funds any time; however such early withdrawal will reduce the proportion of profit share that they will get. This combination of non-voting equity like features (i.e., sharing in profit and losses by depositors and free hand to bank in investment decisions) with debt like feature (i.e., possibility of withdrawal) makes these accounts like quasi equity. This also gives rise to a corporate governance issue that how to keep investment risk and return preference of the bank aligned to that of the unrestricted account holders.
- (iii) Restricted Investment Accounts (also called special investment accounts) raise funds which are invested by the bank only in the specific projects and sectors pre-agreed between the account holders and the bank. Bank shares in profits from the specific investments with these account holders who are expected to keep the investment account up to the end of its maturity. The contractual relationship between the depositor and the bank is that of restricted *muḍārabah*. Given these features, these accounts are not liabilities of the bank, rather a kind of equity contribution to the bank but with a proviso that the shareholders do not have full voting rights. This last feature gives rise to corporate governance issue of how to protect the interests of the depositors or how to keep the investment and risk preference of the bank and the depositors in alignment with each other. The closest counterparts of such arrangement in conventional finance are

collective investment schemes or the closed end mutual funds. The issues of governance, disclosure and protection that arise therein are also relevant here. The specificity of investment avenues and restriction on premature withdrawal of funds create higher risk for the depositors in restricted investment accounts but such investments can also bring higher returns. Generally the minimum investment requirements in these accounts are higher than that in unrestricted investment accounts and these are offered for wealthy or sophisticated investors.

The unrestricted and restricted investment accounts constitute one of the distinguishing funding arrangements between present-day Islamic and conventional banking. The amounts thus raised constitute limited-term, non-voting equity closer to trust funds. The Accounting Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) therefore classifies unrestricted investment accounts as a separate entry between liabilities and owners' equity on the balance sheet of Islamic banks. Whereas it treats restricted investment accounts as separate off-balance sheet item.⁴ Only the banks in jurisdictions which follow AAOIFI standards (Bahrain in MENA) report data in this way. Banks in other countries of MENA region report all deposits on their balance sheet.⁵

The financing operations of these banks comprise of two main types:

- (i) Banking operations (i.e., financing, trading, as well as investments) initiated by the demand of the clients needing finance.
- (ii) Investment operations (i.e., trading, direct and indirect investments) initiated by the bank itself to gain from the available trading and investment opportunities.

Both categories of the operations will increase the profit for the bank as well as for its stake holders, i.e., the shareholders as well as the restricted and unrestricted investment account holders. As can be seen, the above classification of activities is different from the one used in conventional banking i.e., banking book (financing only) and trading book (portfolio only) transactions.

⁴ See Statement of Financial Accounting No. 2 and Financial Accounting Standard No. 1 in AAOIFI (2008) *Accounting, Auditing and Governance Standards for Islamic Financial Institutions 1429H – 2008*.

⁵ To make our empirical analysis consistent across different reporting methods followed in different countries we have treated all kinds of deposits as items on the balance sheet.

For the analysis of Islamic banking data in the MENA region we selected a sample of 30 banks. The sample is well representative of the banking sector in the region, excluding Iran. It consists of those financial institutions that are classified as banks, i.e., those which accept deposits from customers or thus defined by the respective national central banks. These include retail as well as investment banks, but exclude investment companies, mutual funds and the likes. For the detailed balance sheet data we relied on IBIS (Islamic Banks Information System) which has been developed and made available on-line by Islamic Research and Training Institute (IRTI).⁶ Our unit of analysis is average bank in each of the selected countries.

3. Major Items on the Assets Side of the Balance Sheet:

For our data set we relied on IBIS as explained above. In IBIS the major items of assets side of the banks' balance sheet are classified as (i) Cash and its Equivalents, (ii) Financing extended using Islamic Modes of Finance, (iii) Portfolio Investment, and (iv) Total Investment.

The details of the breakdown of each major item are given in Table 1. The item (i), cash and its equivalents is obvious. The difference between items (ii) and (iii) above is that the item (ii) represents output of the bank in extending finance to other businesses, individuals and organizations. Whereas, the item (iii) represents portfolio investments in securities (*ṣukūk* and shares), direct investment in companies, and real estate all that is in the nature of treasury operations and investment holding.

Banks are businesses that cater to the needs of their clients as well as they are the guardians of the wealth of their share holders and of their various account holders. Financing operations are initiated in response to the demands of clients with a view to maximize profits for the bank. The investment operations are primarily bank initiated and utilize the available investment opportunities. Both financing (item ii) and investment (item iii) may involve ownership of the real asset by the bank.

⁶ IBIS Islamic Banks Information System is an online database as well as information and research network that can be accessed from its website <http://www.ibisonline.net>. The database uses published annual reports as primary source of data for individual banks augmented by its own questionnaire survey to present data in consistent way across banks and countries.

Table-1
Assets – Breakdown of Major Items

Major Items	Constituents
i. Cash and Its Equivalents	Cash in vaults Cash with central bank Balances with banks and other institutions Cash equivalents
ii. Financing using Islamic Modes	<i>Al-Qard Al-Hasan</i> <i>Murābahah</i> & deferred sales Leasing and hire purchase <i>Muḍārabah</i> <i>Mushārahah</i> <i>Salam</i> <i>Istiṣnā'</i> Others Less provisions
iii. Portfolio Investment	Investment in companies, funds, shares Investment in bonds, bills, securities Investment in properties & real estate Other investments Less provisions
iv. Total Investments (ii + iii)	Prepaid expenses & other receivables (net)
Total Assets	Fixed assets net of depreciation Other assets (net)

The analysis in this section is based on a sample of 30 Islamic banks (see Table 2) covering 9 countries of the MENA that have significant Islamic financial institutions. The data covers three years 2006, 2007, 2008.

Table-2
Sample Distribution Across Countries

Country	Banks in the Sample
Bahrain	12
Egypt	2
Jordan	2
Kuwait	2
Lebanon	1
Qatar	2
Saudi Arabia	3
UAE	5
Yemen	1
MENA Region	30
SAMPLE YEARS: 2006, 2007, 2008	
The number and identity of banks remain same across years.	

3.1. Highlights of the Asset Size and Growth

The Islamic banking assets in the MENA region have been growing exponentially over the last several years. For example, in 2004 the proportion of Islamic banking assets of the Middle Eastern banks was only about 29 percent of the worldwide Islamic banking assets, which grew to 50 percent of the world wide share in 2008.⁷ Not only the aggregate but the average asset per bank also has increased in the Middle East. Most of this growth was taking place in the GCC countries but recently the non-GCC countries are also witnessing growth of Islamic

⁷ This is based on calculations using IBIS data for the year 2004 and 2008. The data in IBIS is based on published annual reports of the banks. In these annual reports each bank's assets and liabilities are measured as per policy of that bank's regulator which forms the basis of financial reporting by the bank. The general accounting practice is to classify measurement of financial assets into two categories: those that are measured at fair value, those that are measured at amortized cost. The classification is made at the initial recognition of asset and depends on the business model of the financial entity. Debt like instruments or where the objective is only to collect the cash flows are measured at amortized cost. Equity type instruments are measured at fair value.

banking both by coming up of domestically incorporated Islamic banks and also by cross border expansion of GCC based Islamic banks through their subsidiaries.⁸

Key factors behind this high growth have not been fully explored. Increasing demand for Islamic system along with the opportunities for its expression in Islamic finance, successful track record of Islamic banks which increased public's trust in them, and economic growth in the region all may have contributed to the sustained development of Islamic finance over the years. However in the recent past, the outflow of funds from the US banks and financial markets to the Middle East and elsewhere after the hostile and uncertain environment created by the US government policies in the wake of September 11 incident; rising oil prices during 2004 to 2007 resulting in higher investable surplus; and the booming real estate market in many GCC countries during the same period all may have enhanced the growth of financial sector and Islamic banking in the MENA region.⁹

This growth however slightly slowed down in 2008 compared to 2007. For our sample of 30 banks of the MENA region the total assets were 196,569 billion US dollars in 2008. This was only 24 percent higher from the previous year compared to a 34 percent increase in 2007. Analyzing the composition of asset structure, the component of financing in the asset structure of Islamic banks has always been largest proportion followed by that of portfolio investment and cash equivalent components. During 2008, for the overall MENA region these components comprised of 65 percent, 16 percent and 15 percent respectively. Between the period 2006 and 2007 the total assets grew at a rate of 34 percent which slowed down to 24 percent in 2007-2008. The reduction in asset growth rate between the two periods was mainly in two components of asset side, namely portfolio investments and cash equivalents whose growth rates came down substantially. Whereas the financing component of asset side saw a substantial rise in the growth rate from 33 percent a year before to 45 percent in 2007-2008.

Islamic banking sector is not of similar size and scope across MENA countries. Figure 1 shows the asset size distribution for various countries while Table 3 gives asset growth rates from 2006 to 2007 and from 2007 to 2008. The assets have been growing in all countries with the highest growth shown by Qatar of 48 percent and lowest by Egypt of 10 percent. Lebanon with an asset growth of 145 percent is an

⁸ Islamic banks were started in Syria, and forthcoming in Libya, Tunis, and Morocco.

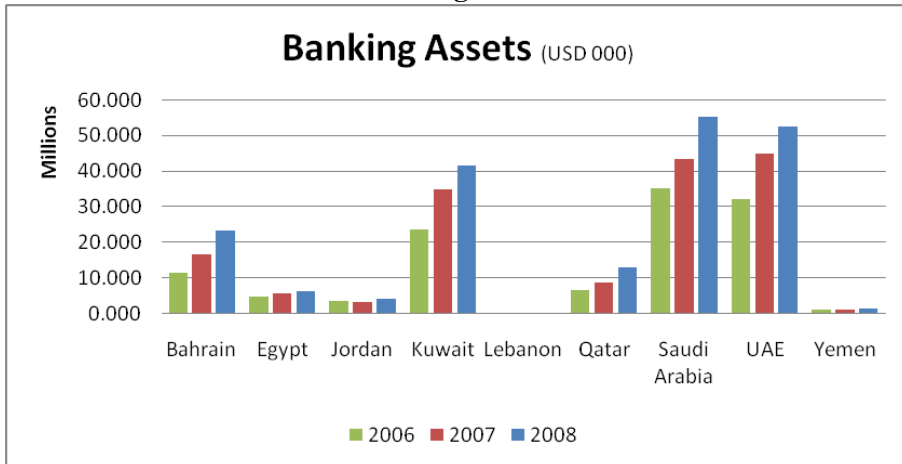
⁹ For example, during the period of 2002 to 2008 the Islamic banking assets experienced an average growth rate of 72 percent per year. This is in contrast to a figure of 56 percent average per annum growth of Islamic banking assets worldwide.

exception as Islamic banks opened in the country only in 2006 and it is starting from a very small base. Saudi Arabia, UAE and Kuwait stand out as giants in terms of aggregate assets of Islamic banks while Egypt, Jordan, Yemen, and Lebanon constitute the lower tail with Qatar and Bahrain in between (see Figure 1).

Table-3
Growth Rates of Assets and Deposits across Countries

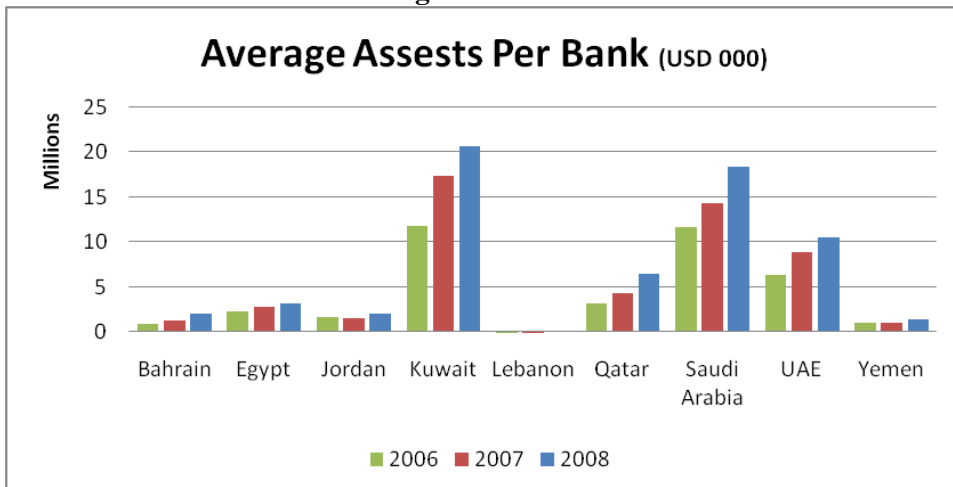
COUNTRY	BANKS IN SAMPLE	ASSETS		CUSTOMER DEPOSITS	
		GROWTH RATE (%)		GROWTH RATE (%)	
		2006-07	2007-08	2006-07	2007-08
Bahrain	12	48.54	39.00	58.33	32.07
Egypt	2	21.27	10.53	22.89	9.54
Jordan	2	(9.30)	25.86	(8.59)	16.34
Kuwait	2	47.04	19.33	51.05	24.94
Lebanon	1	362.09	145.54	(3.02)	21.43
Qatar	2	34.64	47.94	26.63	31.98
Saudi Arabia	3	23.16	27.94	28.65	22.32
UAE	5	40.28	17.07	46.16	19.56
Yemen	1	7.29	20.08	6.13	18.73
MENA Region	30	34.50	24.50	37.47	22.28

Figure-1
Banking Assets



The above chart shows aggregate assets of 30 Islamic banks (our sample) distributed by countries and for each year 2006, 2007 and 2008. The number of sampled banks in each country varies but remains constant across years. The sample distribution is described in Table 2.

Figure-2
Average Assets Per Bank



The above chart shows average assets of Islamic banks (in our sample) in each country for each year 2006, 2007 and 2008. That is, aggregate assets of sampled Islamic banks in each country divided by number of banks sampled from that country. The process is repeated for each sample year. The sample distribution is described in Table 2.

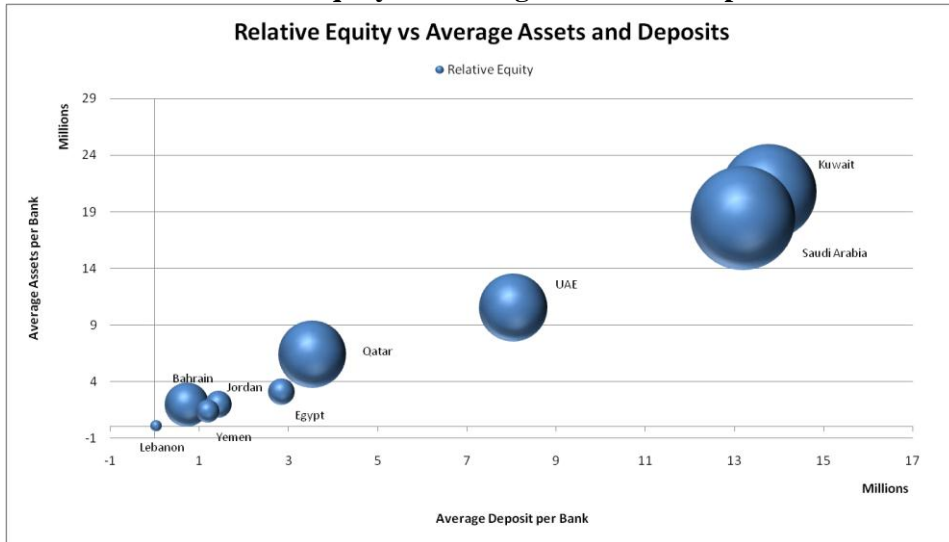
These aggregate figures however do not reveal the average size of Islamic banks and the level of concentration. Figure 2 shows average assets of Islamic banks in each country for each year from 2006 to 2008. It reveals that the average assets have been growing throughout this period in all the sampled countries in the MENA region. It also reveals that the average size of Islamic banks (by asset) have been largest in Kuwait, followed by Saudi Arabia, UAE, Qatar, Egypt, Jordan, Bahrain, Yemen, and Lebanon respectively. In fact the size of Islamic banks in MENA region has been growing for the past many years. In our sample the average asset of Islamic banks in 2008 came out to be USD 6635 million per bank which is nine times larger than the average bank size of USD 727 million in 1996 in the Middle East.¹⁰

Figure 3 shows average asset size (along y-axis) and customer funds per Islamic bank (along x-axis) in millions of US dollars for each of the 9 selected countries for the year 2008. The same figure also shows relative equity per bank (by size of the bubble) in each country compared to the sum of average equity per bank for the entire region.¹¹ It reveals the fact that on the average the banks in Saudi Arabia and Kuwait have larger asset size and larger customer deposit base along with very high equity compared to the banks in rest of the MENA countries making them potentially more stable. It also shows that Bahrain, a country with relatively well developed Islamic financial sector, is in the same league as Jordan and Yemen in terms of average banking assets and deposit base. However, these lower averages for Bahrain are because of more competition and larger number of Islamic banks there than in any other country. Despite this competition, the relative equity of the banks in Bahrain is larger than the banks in Jordan, Yemen and even those of Egypt. The banks in Kuwait and UAE lie in between, in terms of average assets and average deposit base, among the range of 9 countries under consideration with UAE on a higher side than Kuwait. However, in terms of relative equity the banks in these two countries are quite similar having moderately high equity.

¹⁰ The average assets of Islamic banks in the Middle East have been calculated using data from Table-1 and Table-2 of Iqbal et al (1998). The comparison is in terms of nominal US Dollar values.

¹¹ Relative equity per bank for a country = average Islamic bank equity in that country / the sum of average equity in all countries of MENA region.

Figure-3
Relative Equity vs. Average Assets and Deposits



The above chart compares three variables for each country for the year 2008. (i) Along x-axis: Average deposits of Islamic banks (in our sample) in each country. (ii) Along y-axis: Average assets of Islamic banks (in our sample) in each country. (iii) Equity per bank in each country relative to the sum of average equity for all countries in the MENA region (relative equity is represented by the size of the balls in the chart).

3.2. Asset Composition

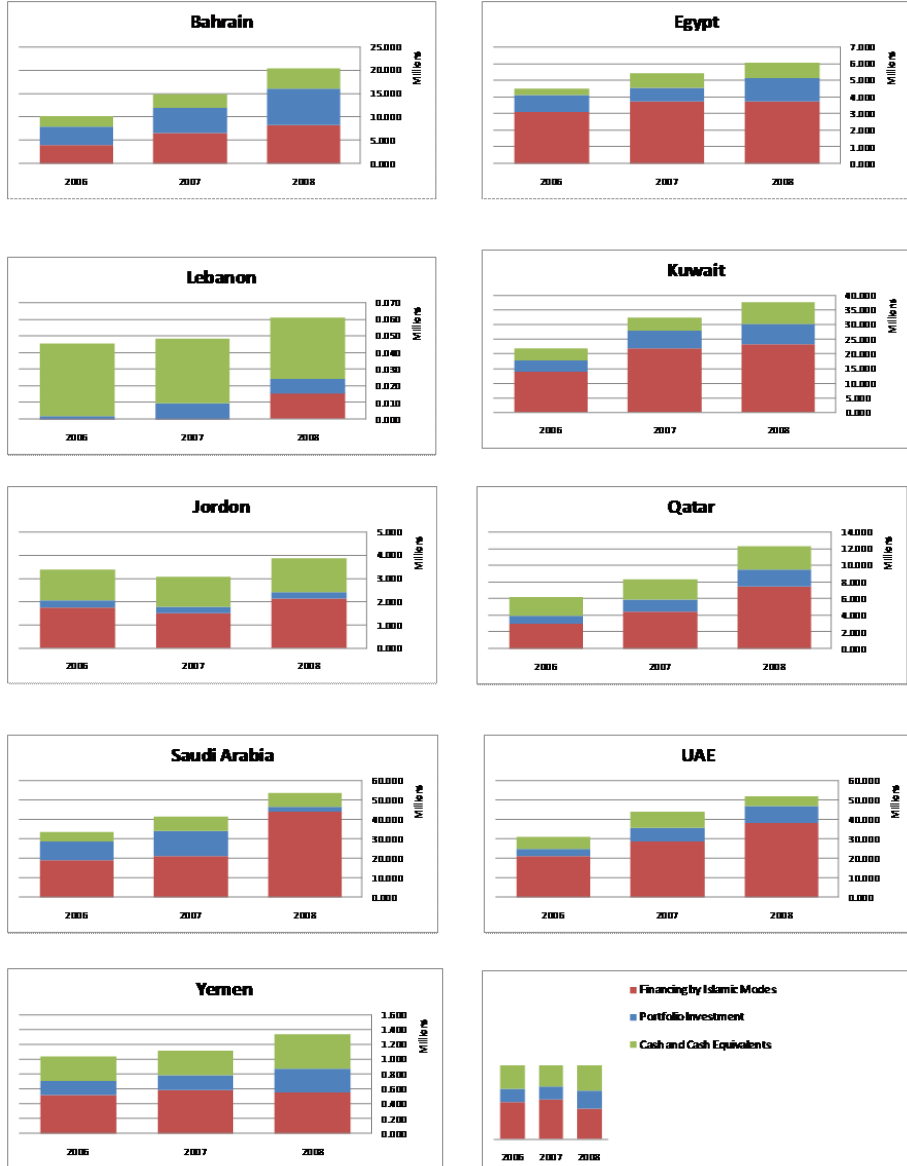
Total assets can be decomposed into the three categories of (i) Cash and its Equivalents; (ii) Financing extended using Islamic Modes of Finance; and (iii) Portfolio Investment which have been described in the earlier section. Figure 4 shows asset composition of Islamic banks (aggregated for each country) by these three categories for each of the nine countries for each year over 2006, 2007, and 2008. Several interesting facts can be gleaned from this figure. First, that in most countries the financing proportion of asset was larger than portfolio investment followed by cash and cash-equivalent assets. Second, while assets increased in all countries the asset composition did not change in similar ways across each country and across each year. Thus the sources and therefore the causes of asset growth were not homogenous across countries. In Saudi Arabia the financing component expanded fast from 2007 to 2008 (showing expansion in credit) while portfolio investment declined significantly. The decline in portfolio investment by banks may be due to subdued financial markets. In UAE, all the three components of assets increased proportionally between 2006 and 2007. However, in 2008 the

financing component of total assets increased faster than portfolio investment while cash and cash-equivalent component in fact declined signifying expansion in credit and strained liquidity situation. Bahrain, Kuwait and Qatar showed proportional growth of all components of assets; however the expansion in total assets in Qatar was much faster. Lebanon is an outlier case in our analysis. As the only Islamic bank there is new, majority of its assets were in liquid form in 2006 which gradually increased and diversified into other asset categories by 2008.

Further analysis of the financing component of assets shows that while a variety of Islamic financing modes are used by the banks and the composition of their use vary across countries, *murābaḥah* financing is the dominant mode used by Islamic banks in all countries of MENA region. In some countries *murābaḥah* constitutes more than 90 percent of financing in others it is just less than 50 percent. On the average, for overall MENA region, the proportion of *murābaḥah* in total financing is 75 percent. Leasing (or hire-purchase) is the second most used mode in Bahrain, Jordan, Kuwait, Lebanon, and Qatar.

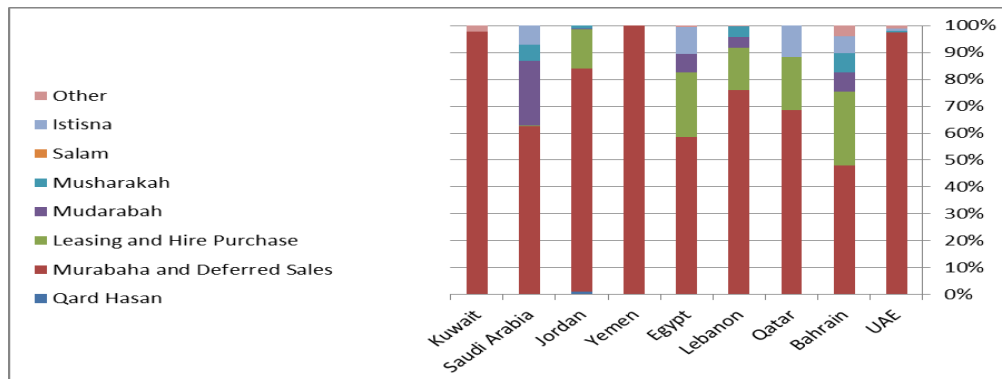
Muḍārabah financing is the second largest mode in Saudi Arabia but of lesser importance in other countries. *Istiṣnā'* is third most used mode in MENA region countries. *Al-Qarḍ Al-Ḥasan* (or zero returns benevolent loan) in any significant amount is used only in Jordan. Figure 5 gives use composition of various modes of financing across different countries for the year 2008.

Figure-4
Asset Composition of Islamic Banks in Selected Countries



The above chart shows asset composition of Islamic banking sector in nine countries (using the sample of 30 banks) and provides a comparison for the years 2006, 2007 and 2008.

Figure-5
Composition of Financing Modes in Islamic Banking Sectors, 2008



The above chart shows the percentage composition of various modes of financing across different countries for the year 2008.

4. Major Items on the Liability Side of the Balance Sheet

Major items on the liabilities side include (i) customer funds comprising of various kinds of deposits; (ii) funds due to other creditors; and (iii) other liabilities. A definitional breakdown of these items is given in Table 4. A country-wise composition of the major items in 2008 is given in Figure 6. This comparison indicates that in each of these countries the bulk of liabilities comprised of customer funds (or customer deposits).

Further analysis of customer funds is also possible. In an earlier section we have explained how the liability side of Islamic banks is different from conventional banks. There we identified three types of customer accounts: demand deposits that do not pay any return; unrestricted investment accounts, and restricted investment accounts that share in profits. However, Islamic banks in many jurisdictions, except those in the jurisdictions that follow AAOIFI accounting standards, report the data in a manner that does not permit a clear distinction between restricted and unrestricted investment accounts. Nevertheless a distinction is possible between demand deposits, profit sharing short-term *muḍārabah* investment accounts (these are nearer to unrestricted investment accounts) and profit sharing *muḍārabah* savings investment accounts (which are longer term and nearer to restricted investment accounts). The largest portion of customer accounts comprise of short-term *muḍārabah* investment account that is followed by non-remunerative demand deposits. For example, of the total customer funds of USD131.4 billion held in

customer accounts by Islamic banks in the MENA region in 2008, USD41.96 billion (31.9%) were in non-remunerative current and savings accounts (i.e., not sharing in profits); USD 63.35 billion (48.2%) in *muḍārabah* investment accounts; USD8.1 billion (6.2%) in *muḍārabah* savings accounts; and USD17.9 billion (13.6%) in other customer accounts. Figure 7 shows that the first two categories of accounts had been growing fast in the MENA region over the last three years. The customers holding these accounts include individuals and non-financial firms. Banks and financial firms are also among the account holders but they do not generally hold demand deposits. This structure of bank funding assets has profitability as well as stability implications. Due to a large base of non-remunerative deposits the rate of returns on equity and quasi equity increases making Islamic banks attractive to direct investors (i.e., shareholders of the bank) as well as to indirect investors (investment account holders). However, due to callable nature of demand deposits and short-term nature of *muḍārabah* investment account banks' ability to invest in long-term projects is reduced or a maturity mismatch is encountered.

Table-4
Liabilities – Breakdown of Major Items

Major Items	Constituents
Customers' Funds	Current & Savings Accounts NOT Sharing in Profit <i>Muḍārabah</i> Investment Accounts <i>Muḍārabah</i> Savings Accounts Other (customer accounts, etc)
Funds Due To Other Creditors	Due to Banks and other Financial Institutions Due to Subsidiaries and Associated Companies Margins on LCs and Accounts Payable Due to Employees, Contractors and Suppliers
Profit and Other Liabilities	Profit/Dividend Payable Provision for Taxes and <i>Zakāh</i> Other Liabilities, NES
TOTAL LIABILITIES	
Total Shareholders' Equity	
TOTAL LIABILITIES AND EQUITY	

Figure-6
Composition of Liabilities

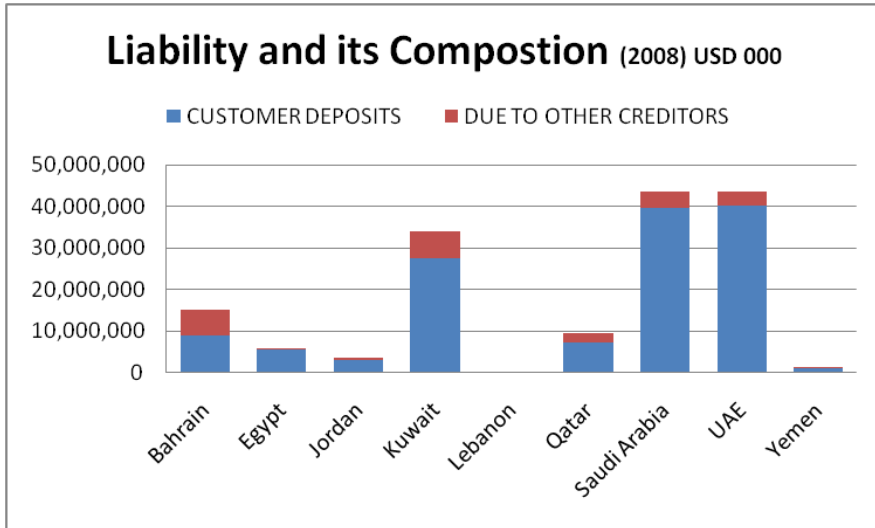
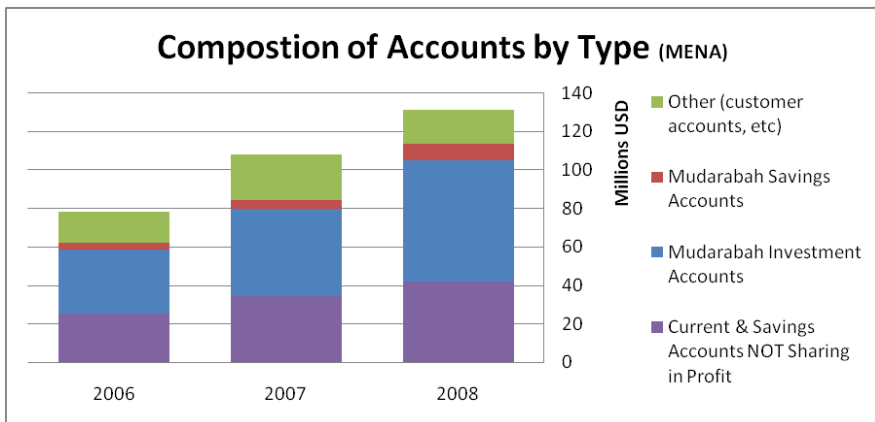


Figure-7
Composition of Accounts by Type



5. Drivers of Islamic Banking

The source of existence and growth of Islamic banking and finance is Islam itself and the extent and willingness of its followers to live according to their faith.¹² This does not imply that a number of other economic and social factors are of no importance, all the other factors have indeed contributed to its growth but they in themselves were not the reason for existence of Islamic finance. At present, Islamic finance is a demand driven industry whose customers are not only from among the Muslim population but in many countries a large number of non-Muslims are also among its customers by choice.¹³ What factors drive the high growth of Islamic banking; and to what extent they can explain the differing levels of its growth among various countries of MENA region are important questions. Answering them can provide help in formulating policies for financial sector growth at national, regional as well as global level. However, a rigorous analysis of these issues will require extensive micro and macro data on social, behavioral, economic, and financial variables which are not currently available. Therefore the analysis in this section on the driving factors behind the growth of Islamic banking in the MENA region is only of preliminary nature.

To set up the framework for analysis we start with several observations. First, it has been observed in the world that the countries where Islamic finance is growing are those that are also witnessing overall development of their financial sectors in general or they already have a developed financial sector. Thus the factors that are important for overall growth of the financial sector may also contribute to the growth of Islamic banking and finance. However, this is not an unqualified statement as there are many distinctive features of Islamic banking that are not possible to come into play under the conventional banking setup, i.e., conventional banking regulations and its supportive institutional architecture, which are based on pure financial intermediation philosophy. Thus, we see that countries where regulatory support exists for Islamic banking (such as in the form of separate licensing and regulatory requirements, avoidance of double taxation, permission

¹² Islam prohibits interest, encourages trade and shuns gambling. It also provides detailed principles of contracts that curtail financial speculation, protect the rights of all parties, and promote social justice.

¹³ It has been documented that a large portion of Islamic banking and finance customers in Malaysia are from ethnic Chinese and Indian population who are not Muslims. Malaysia is multiracial country and both Islamic and conventional banking options are equally available to all. Composition of customer of Islamic financial institutions operating in the West which include non-Muslims as well as the large proportion of Western conventional financial institutions who bought *Shukūk* in the international markets indicates that the demand is not restricted from Muslim customers only.

for the Islamic banks to get involved in trading and direct investment etc.) and where a level playing field is provided, Islamic banking is developing faster. This is our second observation. Third, to make a change in the regulatory environment a strong political will of the government is an important factor. Hence, it is likely that the countries where the governments (or political system) are proactive to make a change towards Islamic finance the Islamic banking will grow faster than in the countries where the government is indifferent to the concept or where it is discouraging it.¹⁴ Fourth, Islamic banking is growing because of its demand by the society. This demand also contributes to influencing the political will. The demand in economic sense is the ability and willingness of the individuals and the corporate firms for utilizing Islamic banking services. The demand for Islamic banking in a country cannot simply be measured by the proportion of Muslim population in total population of that country. Considering MENA region countries for example, each one of these countries have a very high proportion of Muslim population yet differing levels of willingness.

For our analysis of drivers of Islamic finance in the MENA region we combined the second and third factors into one and performed a regression analysis using three factors, namely, general financial sector development, regulatory support and political will, and demand for Islamic finance. We operationalize these with some proxy variables and estimated a parsimonious model given the limited amount of data at hand. This model is used only to find the relative importance of the above three factors for Islamic banking growth in the region, but not in individual countries, by pooling the time-series and the cross-section data.¹⁵

The dependent variable – growth of Islamic banking is measured here by two proxies (i) ratio of assets of average Islamic banks to GDP, and (ii) ratio of deposits of average Islamic banks to GDP. Each one of these variables is taken as the dependent variable, one at a time, in two separate regressions. Here the use of ‘average assets’ and ‘average deposits’ of Islamic banks per country for each year rather than the use of ‘total assets’ and ‘total deposits’ of Islamic banks is to control for differences in sample size (number of banks) across countries. This is divided by GDP to control for country level differences in the GDP.

¹⁴ Recent literature recognizes importance of political will as the real driver of financial sector development to the extent that this is more important than the law because the laws and regulations get implemented through political and social will. See an important article in this direction by Malmendier, Ulrike (2009), ‘Law and Finance “at the Origin”’, *Journal of Economic Literature*, Volume 47, Number 4, December 2009, pp. 1076-1108(33).

¹⁵ We have data on 9 countries of MENA region for 3 years on each of them, this makes a total of 27 data points in the pool.

Among the independent variables, the ratio of broad money (M2) to GDP is used to proxy for general financial sector growth. Demand for Islamic finance is measured by GDP per capita multiplied by Islamic finance awareness which is measured by the ratio of number of news items pertaining to Islamic finance to total number of news items on finance in general.¹⁶ The data on the number of news items were gathered using Google News search engine. This method excludes advertisements but relies on news count, not on analysis of the news content.¹⁷ The regulator support is measured by a dummy variable which can take values +1, 0, and -1 to signify the jurisdictions where Islamic finance is actively supported, indifferently looked upon, and discouraged respectively.

¹⁶ To be exact the Islamic finance awareness index was created by calculating following hit-ratio: the Google News was searched for the terms “Islamic finance”, “Islamic banking”, and “Islamic hedging.” The sum total of hits from these three searches were divided by the sum total of hits from the terms “finance”, “banking” and “hedging”. Each of these searches was made restricting the domains by each individual country so as to produce country specific results.

¹⁷ Other methods of measuring awareness can also be devised such as number of books, articles, and features published in a given year within a country; number of teaching and training programs running in a country, etc. However, each of these will have their own limitations. We chose our variables for which data are easy to get, consistent, and which show sufficient variability over our limited period of analysis.

Table-5
Summary of Variables

Variable	Operational Definition of Variable	Explanation
Dependent Variable		
Some proxy for growth of Islamic banking	<p>Either $AAIBtGDP = \text{Assets of average Islamic Bank} / GDP$</p> <p>Or $DAIBtGDP = \text{Deposits of average Islamic Bank} / GDP$</p>	<p>Captures increase in financing and investment operations of Islamic banks.</p> <p>Captures increase in ability of Islamic banks to mobilize funds.</p>
Independent Variables (to find drivers of growth)		
A) Growth of financial sector in general	<p>1. $M2tGDP = \text{Borad Money (M2)} / GDP$</p> <p>2. $CCtGDP = \text{Currency in Circulation} / GDP$</p>	<p>Higher the number higher the level of development of financial sector</p> <p>This highlights the use of cash money in transactions. It is expected to be negatively related to financial sector growth.</p>
B) Demand for Islamic Finance	<p>3. $DIF = (GDP \text{ per CAPITA}) \times (HITRATIO)$, which is the ratio of Islamic finance news to total finance news). Data on news items was collected using Google-news search.</p>	<p>To measure ability and willingness to use Islamic banking services. Expected to be positively related with demand for Islamic Finance.</p>
C) Regulatory Support	<p>4. $RSPW\text{-Dummy} =$ Dummy variable taking values +1, 0, -1 respectively, if the regulatory and government policy stance is supportive, indifferent, and discouraging to Islamic finance.</p>	<p>To measure regulatory support and political will in a subjective way. Higher the number, higher is the perceived support. It can be converted into objective measure by counting the supportive measures. For example, existence of separate regulations for Islamic banking means concerned, thinking, and caring regulator and political will of government to support Islamic finance</p>

The Regression results are reported in Table 6 Panels A and B. The Panel-A shows the relative importance of (the above mentioned) three factors in driving the average assets of Islamic banks in the MENA region controlled for differences in

the GDP across countries. The regression results inform us that regulatory support is the most important factor followed by general financial sector development for expansion of assets of Islamic banks. The constant term is also large signifying that there are some other important factors not captured by our analysis. Interestingly, contrary to expectation the coefficient of the proxy variable to represent demand for Islamic banking is very small and has a negative sign. All three factors and the constant term turn out to be statistically significant. The model as a whole is also statistically significant but suffers from serial correlation as evidenced by the Durbin-Watson statistic. The Panel-B shows the relative importance of the three driving factors behind average deposits of Islamic banks in the MENA region controlled for differences in the GDP across countries. In this case too, the regulatory support was found to be much important followed by the general financial sector development followed by demand variable which was least important and negative. This time the constant term was relatively larger than all coefficients, indicating that some important determining factors are left out. All individual coefficients as well as the overall model are found to be statistically significant.

Table-6
Regression Results – Drivers of Islamic Banking in the MENA Region

Panel-A: Drivers of Assets per Islamic Bank

$$AAIBtGDP = C + b_1 (M2tGDP) + b_2 (DIF) + b_3 (RSPW-Dummy) + e$$

Dependent Variable: AAIBtGDP

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.047991	0.010933	4.389474	0.0002
M2tGDP	0.032346	0.012748	2.537250	0.0184
DIF	-1.10E-05	4.53E-06	-2.418448	0.0239
RSPW-Dummy	0.050239	0.011066	4.539982	0.0001
R-squared	0.618143	Akaike info criterion		-4.298981
Adjusted R-squared	0.568336	Durbin-Watson stat		0.809056
F-statistic	12.41067	Prob(F-statistic)		0.000049

Panel-B: Drivers of Deposits per Islamic Bank

$$DAIBtGDP = C + b_1 (M2tGDP) + b_2 (DIF) + b_3 (RSPW-Dummy) + e$$

Dependent Variable: DAIBtGDP

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.032520	0.008440	3.853034	0.0008
M2tGDP	0.024637	0.009841	2.503397	0.0198
DIF	-8.01E-06	3.50E-06	-2.287970	0.0317
RSPW-Dummy	0.028891	0.008543	3.381949	0.0026
R-squared	0.488184	Akaike info criterion		-4.816570
Adjusted R-squared	0.421425	Durbin-Watson stat		0.737197
F-statistic	7.312664	Prob(F-statistic)		0.001297

We further investigated the anomalous result of very low importance of demand for Islamic finance in explaining Islamic banking growth in the above two regressions. For this purpose we separated the two components of the proxy variable for demand i.e., per capita income and ratio of Islamic finance news items to total financial news items, and included them as independent variables in the regression equations as follows:

$$\text{AIBtGDP} = C + b_1 (\text{M2tGDP}) + b_2 (\text{HITRATIO}) + b_3 (\text{GDP per CAPITA}) + b_4 (\text{RSPW-Dummy}) + e,$$

and

$$\text{DAIBtGDP} = C + b_1 (\text{M2tGDP}) + b_2 (\text{HITRATIO}) + b_3 (\text{GDP per CAPITA}) + b_4 (\text{RSPW-Dummy}) + e.$$

We found a large coefficient for the HITRATIO which was statistically significant at 5 percent level of significance but very small coefficient for GDP per CAPITA which was statistically not significant at 5 percent level of significance. This was true in both regressions (see Table 7 Panel-C and Panel-D). Thus the GDP per capita is not a very good proxy of demand for Islamic finance and hence for Islamic banking growth.¹⁸ This result may be due to skewed income distribution in the countries as well as due to uneven access of the population to Islamic finance.

Another anomaly is in the negative sign of HITRATIO coefficient while it was expected to be positive. The variable HITRATIO gives the proportion of news items mentioning Islamic economics or Islamic finance in total news items pertaining to general finance and economics. The ratio may have become biased during the financial crisis period (the years spanning our sample) because the number of news items on general finance (the denominator) may have been growing faster than number of Islamic finance and economics news (the numerator), thus producing a negative relationship with the growth of Islamic finance.

¹⁸ Per capita GDP is also not a good predictor of conventional banking growth. As a test case we used GDP per capita along with other financial sector development variables to predict conventional deposit corporations' assets in the MENA region and found very small and statistically insignificant coefficient. Similar results are found when we tried to predict conventional deposit corporation liabilities using GDP per capital as an explanatory variable.

Table-7
Regression Results – Refined Model

Panel-C: Drivers of Assets per Islamic Bank

Dependent Variable: AAIBtGDP

Included observations: 27

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.066990	0.016217	4.130950	0.0004
M2tGDP	0.028642	0.013193	2.170941	0.0410
HITRATIO	-0.417916	0.197800	-2.112828	0.0462
GDPperCAPITA	-5.32E-07	3.73E-07	-1.427471	0.1675
RSPW-Dummy	0.053008	0.012226	4.335740	0.0003
R-squared	0.631101	Akaike info criterion		-4.259429
Adjusted R-squared	0.564028	Durbin-Watson stat		0.897109
F-statistic	9.409231	Prob(F-statistic)		0.000137

Panel-D: Drivers of Deposits per Islamic Bank

Dependent Variable: DAIBtGDP

Included observations: 27

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.051240	0.011690	4.383199	0.0002
M2tGDP	0.021872	0.009511	2.299703	0.0313
HITRATIO	-0.409751	0.142588	-2.873669	0.0088
GDPperCAPITA	-3.53E-07	2.69E-07	-1.313213	0.2026
RSPW-Dummy	0.033081	0.008813	3.753563	0.0011
R-squared	0.568854	Akaike info criterion		-4.914015
Adjusted R-squared	0.490464	Durbin-Watson stat		0.933123
F-statistic	7.256707	Prob(F-statistic)		0.000694

6. Performance

Islamic banking in the MENA region has been a fast growing sector. As evidenced by data in Table 3 the assets, deposits, and financing all grew fast in the region during 2006-2007. However, the growth rate tapered off in 2007-2008 period, which may be due to the knock on affect of the financial crisis. Even with this moderation affect the performance of Islamic banking sector had been much

better than conventional banks during that period. The adverse affect of the crisis spilled over to Islamic banks only in 2009.

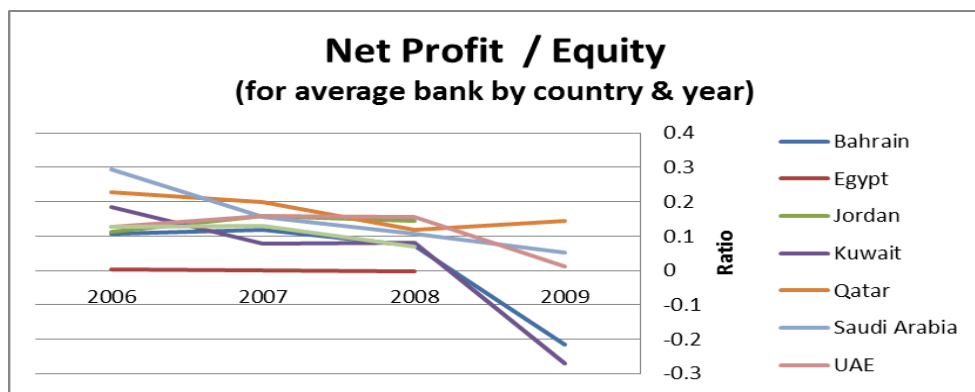
To systematically compare the performance of Islamic banks across countries a methodology is devised in this section whereby we compare the average of key ratios of Islamic banks in one country with the similarly averaged key ratios of Islamic banks in the other countries. This is, as if an average (representative) Islamic bank in one country is compared with the average (representative) Islamic banks in other countries as well as with the average for MENA region. The key ratios selected for analysis are: return to equity, return on assets, asset utilization ratio, and operating income to asset ratio.

The return to equity (ROE) as measured by net profit to total equity varied significantly across Islamic banks in our sample but in general remained high even during the global financial crisis when the conventional banking sector globally was severely affected. For example, for an average Islamic bank in UAE during 2008 the ROE was above 15 percent, highest in the region compared to other countries. During the same year ROE for an average Islamic bank in Bahrain was 7.2 percent, in Egypt about 0.1 percent, Jordan 14.4 percent, Kuwait 8.2 percent, Lebanon negative 9 percent, Qatar 11.9 percent, Saudi Arabia 10.7 percent, and Yemen 7 percent. The figures for Lebanon are an outlier in our sample as the only Islamic bank there came into being in 2006 and it is undergoing a developmental phase. However, the situation changed in the MENA region during 2009 when ROE of Islamic banks declined in most countries.

Figure 8 shows historical data on ROE, as measured by the ratio of net profit to total equity, for the years 2006 to 2008 for eight countries in the sample and up to 2009 for five of them where data was available. The ROE in the MENA region shows a converging pattern from 2006 to 2008 across countries. This may be due to the moderating affect of the financial crisis or it may reflect increasing integration and competition across the countries. However, between 2008 and 2009 a diverging trend is quite apparent with banks performing very differently across countries. Bahrain and Kuwait displayed highly negative ROE. While ROE figures also declined in other countries however they remained positive. On the contrary Islamic banks in Qatar witnessed an increase in ROE. Why the Islamic banking sector performed so differently across various countries during the stressful time in 2009 while they were converging in performance earlier? This is a highly important research question that can shed light on importance of various aspects for stability and growth of Islamic banking which requires a full-fledged research in future. Based on a-priori information, negative ROE in Bahrain can be attributed to

large number of small banks with relatively low capital base that reduce their capacity to diversify as well as lower their capacity to absorb credit losses from soured *murābahah* and *ijārah* transactions. In case of Kuwait the negative ROE, despite high capitalization of banks, may be attributable to lax regulation as well as to the limited domestic investment opportunities that led banks to invest in foreign markets and over exposure to real estate sector. The better performance of UAE in 2009 compared to Bahrain and Kuwait may be due to strong liquidity support provided by the Central Bank of UAE to its banking sector including the Islamic banks during the crisis.

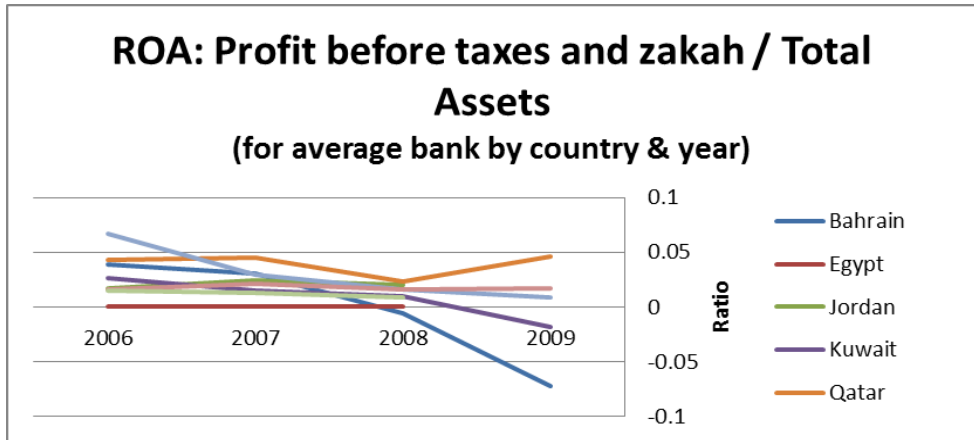
Figure-8
Average Return on Equity for Islamic Banks



The chart shows Return on Equity averaged for all Islamic banks by each country for each year since 2006. Data for Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE goes up to 2009, while it goes only up to 2008 for Egypt, Jordan, and Yemen.

Return on assets (ROA) for average Islamic bank in every country of MENA region had declined in 2008 compared to 2007 but remained in the range of 2.3 percent to -0.06 percent. The trend in ROA had been downwards in most of the countries since 2006 with the exception of Jordan, Qatar and UAE where it had edged up during 2007 before coming down in 2008 (see Figure 9). However, in 2009 ROA declined sharply in most countries but in very divergent ways. The ROA declined to negative 7 percent in Bahrain and negative 2.1 percent in Kuwait. It declined but remained at positive 1.7 percent in UAE and at less than one percent in Saudi Arabia. But it increased to more than 4 percent in Qatar during the same year.

Figure-9
Average Return on Assets for Islamic Banks



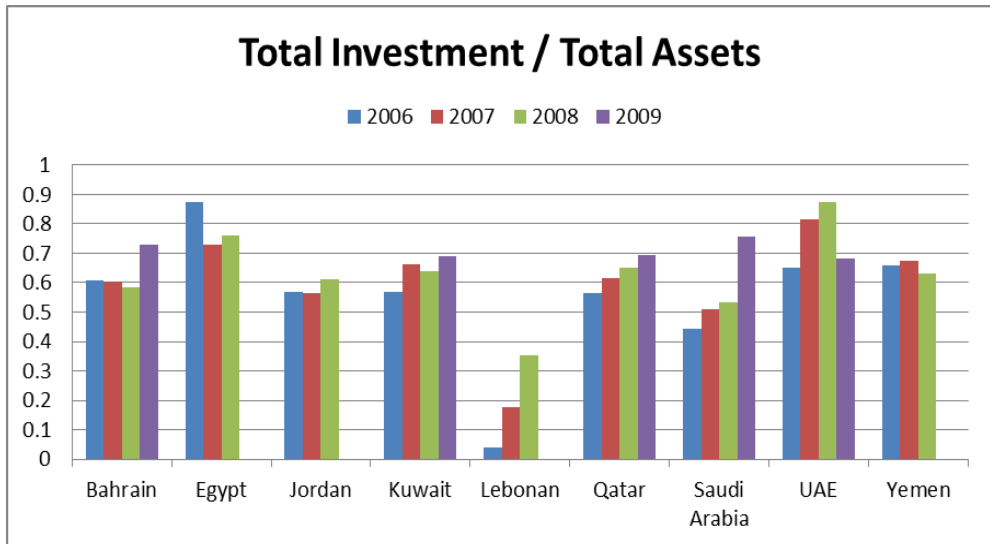
The chart shows Return on Assets (ROA) averaged for all Islamic banks by each country for each year since 2006. Data for Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE goes up to 2009, while it goes only up to 2008 for Egypt, Jordan, and Yemen.

Asset utilization, as defined by the ratio of total investment to total asset, had been high and gradually increasing each year in most of our sampled countries during 2006 to 2008. Figure 10 compares asset utilization for average Islamic banks in different countries and across three years 2006, 2007 and 2008 for the full sample, and also for 2009 for five countries where data is available. The average asset utilization ratio for MENA region had been 62 percent in 2008 with highest being in UAE (87.6 percent) and lowest in Saudi Arabia (53.5 percent) excluding Lebanon. The higher asset utilization ratio is a direct result of the profit sharing nature of the deposit contract between Islamic banks and their depositors (*muḍārabah* based accounts). The *muḍārabah* based deposit accounts make it more imperative for the banks to keep the funds invested in real economic activity in order to generate returns for themselves and their depositors.

The asset utilization ratio still increased in 2009 in most countries however its pattern of growth changed. It increased sharply in Saudi Arabia (75.6 percent) and Bahrain (73 percent) but decreased significantly in the UAE (68 percent). Cautious stance of the Islamic banks in the face of real estate market collapse, their eagerness to increase the proportion of liquid assets and the diminished overall demand for credit all contributed to decline in asset utilization by Islamic banks in

the UAE. Whereas the spike in asset utilization along with an increase in the proportion of liquid assets of banks in Saudi Arabia and Bahrain points to a growing demand for finance and a growing banking sector in the two countries.

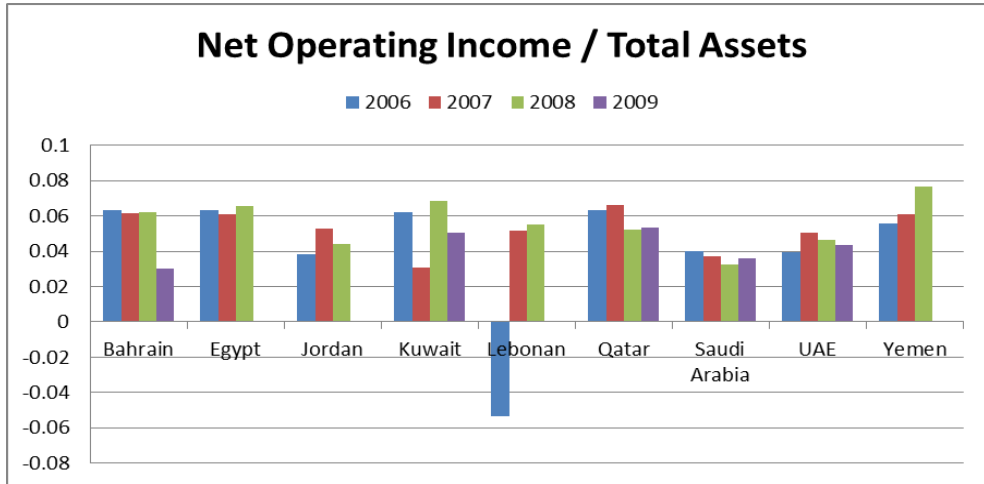
Figure-10
Asset Utilization Ratio



The chart shows Asset Utilization Ratio as defined by Investment/Total Assets averaged for all Islamic banks by each country for each year since 2006. Data for Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE goes up to 2009, while it goes only up to 2008 for Egypt, Jordan, Lebanon, and Yemen.

The ratio of net operating income to total assets for average Islamic bank was quite variable across countries and across time. The data is shown in Figure 11 by country and year from 2006 to 2009. Average Islamic banks in Saudi Arabia stand out to have the lowest operating income to asset ratio throughout the period compared with average banks in other countries of the region. Another striking feature is a sharp decline in this ratio for average Islamic banks in Bahrain in 2009 compared to historical values from previous three years.

Figure-11
Net Operating Income/Total Assets



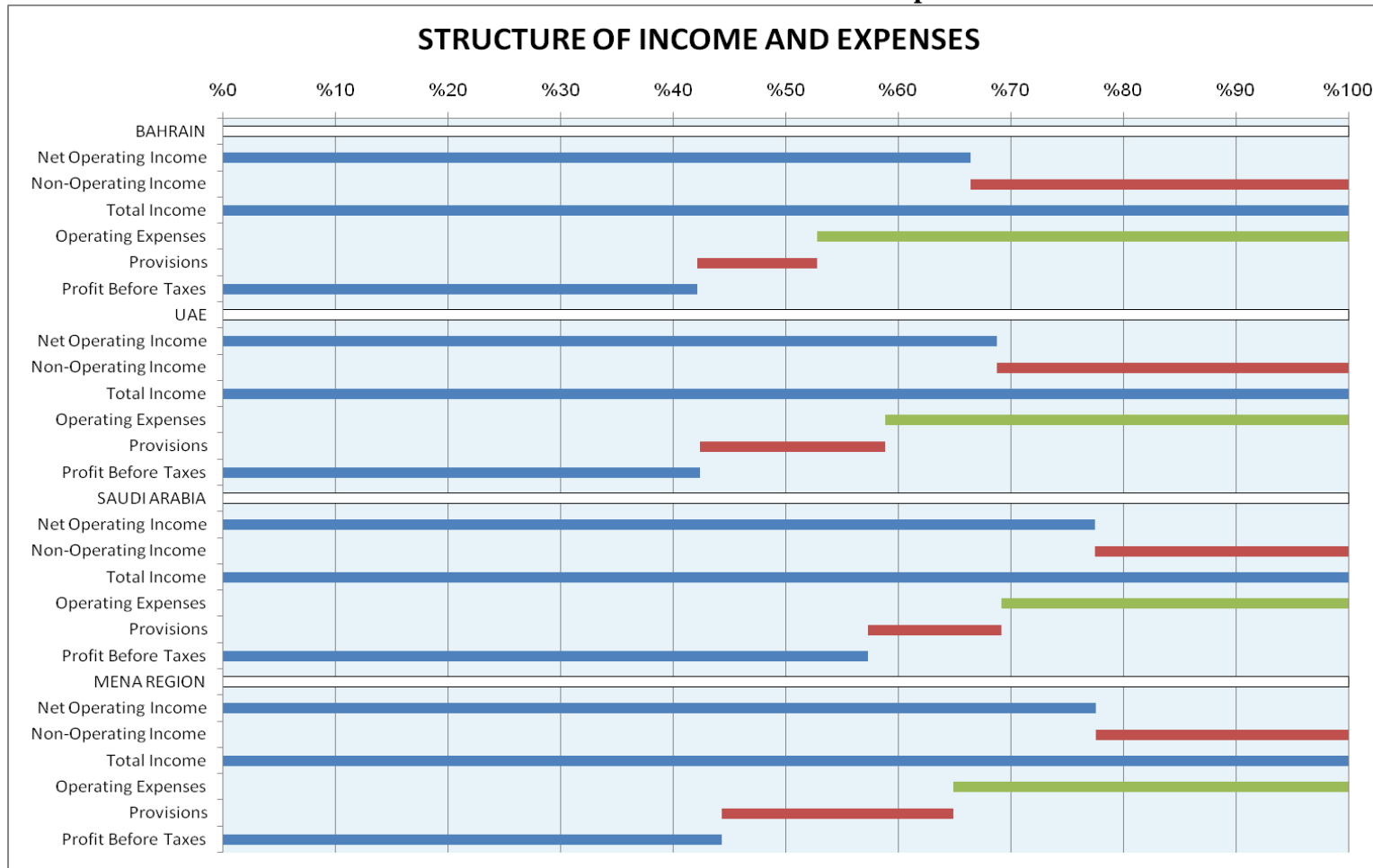
The chart shows ratio of Net Operating Income to Total Assets averaged for all Islamic banks by each country for each year since 2006. Data for Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE goes up to 2009, while it goes only up to 2008 for Egypt, Jordan, Lebanon, and Yemen. Net Operating Income is defined as operating income after paying for the depositors' share.

6.1. Structure of Income and Expenses

Another dimension of performance evaluation is through examining the structure of income and expenses. Figure 12 shows for selected countries the breakdown of total income into operating and non-operating incomes and the breakdown of the total income into its uses: expenses, provisions, and profits before taxes.

The Proportion of net operating income in total income was highest for Saudi Arabia and lowest for Bahrain among the examined countries. The operational expenses as percentage of income were highest in Bahrain and lowest in Saudi Arabia. This may be due to economies of scale resulting from generally larger size Islamic banks in Saudi Arabia as opposed to smaller sized but numerous Islamic banks in Bahrain. As for the provisions, these were the largest percentage of income in UAE and smallest in Bahrain. These structures of income and expenses have implications for profits. The before tax profits as percent of income, on the average, were highest in Saudi Arabia and lowest in UAE.

Figure-12
Structure of Income and Expenses



7. Comparison with Conventional Banks

In the following graphs some comparison of Islamic banks with conventional banks in the region is made. This comparison is based on average Islamic bank vis-à-vis average conventional bank by each sampled country for each year, 2007 and 2008.¹⁹

The first graph (moving clockwise from upper left corner) in the panel Figure 13 shows the returns on assets (ROA) for average Islamic bank against that for average conventional bank in the selected MENA countries for the years 2007 and 2008. The data show that ROA across these two categories of banks are positively correlated. During 2007 the returns on assets (ROA) for average conventional banks were higher than average Islamic banks in four countries, were about equal in two countries, and lower in other two countries. Moreover, there was much diversity in returns on assets among countries in 2007. However, this variation narrowed in 2008 both across countries and between Islamic and conventional banks that they fall tightly around the 45 degree line.

Moving clock-wise, the second graph in the panel compares return on equity (ROE) for average Islamic bank vis-à-vis average conventional bank in each country for the years 2007 and 2008. During 2007 the ROE for averaged Islamic bank was higher than ROE for averaged conventional bank in two out of the nine sampled countries. This number increased to four out of nine countries in 2008. Moreover, the cross country variation in ROE of conventional banking increased in 2008 as compared to 2007 while it decreased for Islamic banking.

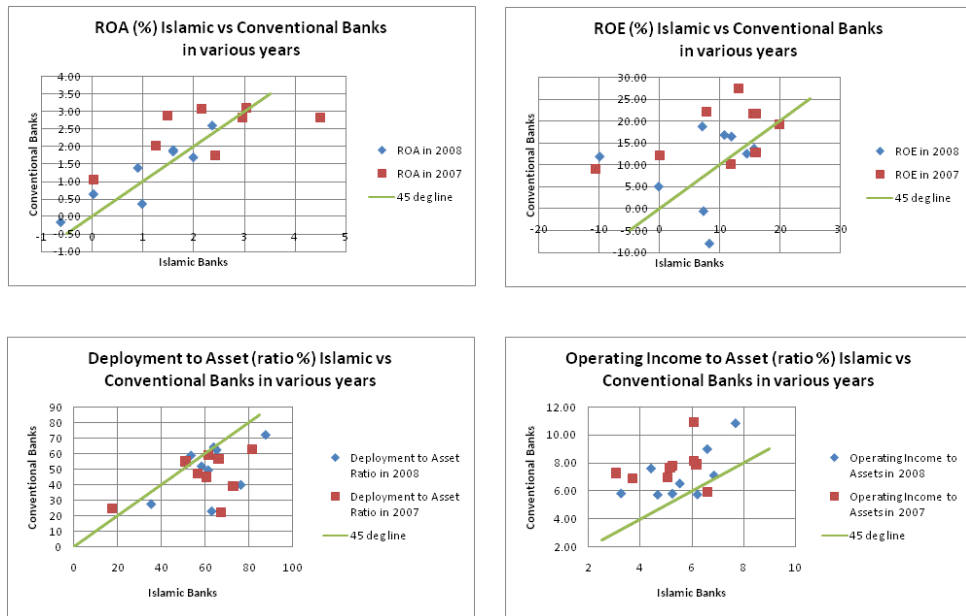
Moving clock-wise, the third graph in the panel compares the ratio of operating income to assets for average Islamic bank vis-à-vis average conventional bank in each country for the years 2007 and 2008. This ratio had been higher for conventional banking as compared to Islamic banking in 2007 and it remained higher in 2008. However, for this ratio, the difference between Islamic and conventional banking narrowed in 2008 as compared to the previous year.

The fourth graph in the panel compares deployment to asset ratio for average Islamic bank vis-à-vis average conventional bank in each country for the years 2007 and 2008. The deployment to asset ratio (which is same as asset utilization

¹⁹ The data for conventional banks in this section are calculated based on the BankScope data for conventional banks for the countries in our sample.

ratio) was considerably higher in Islamic banking than the conventional banking in many countries during 2007 and it remained so in 2008.

Figure 13
Performance Indicators



8. Impact of Crisis

Why Islamic banks remained stable during the early part of the crisis?

To the extent Islamic banks try to emulate the conventional banks in the design of their financing products they expose themselves to similar credit, liquidity and solvency risks leading to similar systemic instability as experienced by conventional banking. The drive towards similarity with conventional banks is less by volition than a result of the current operating and regulatory environment which does not provide all the necessary support and infrastructure institutions that are needed for a well-functioning Islamic banking industry. Greater reliance by Islamic banks on credit type financing (*murābahah* and *ijārah*) at the expense of participatory financing is also a partial consequence of this. These factors translate into financial fragility similar to that of conventional banks.

Focusing on the actual practice rather than the theory and examining the factors that provided stability to the Islamic banks and financial markets during the crisis we find three factors stand out for their stability in the wake of crisis.

First, Islamic banks financing activities are more tied to real economic activities than their conventional counterparts. Though profit and loss sharing modes of *mushārah* and *muḍārah* provide better risk sharing along with maintaining a strong link with the real sector, they are used minimally for various reasons. Most of the financing activity is being done through *murābahah* and *ijārah* modes followed by that through *istiṣnā'* financing. For example, of the total financing activity of Islamic banks in the GCC region, during 2007 *murābahah* comprised of 65.4 percent, *ijārah* 12.78 percent and *istiṣnā'* 3.83 percent.²⁰ In our sample of 30 banks from 9 countries discussed above, *murābahah* constituted more than 90 percent of financing activity in Kuwait, UAE and Yemen; just less than 50 percent in Bahrain; and between 60 to 80 percent in rest of the countries during the year 2008.²¹ On the average, for overall MENA region, the proportion of *murābahah* in total financing was 75 percent during the same year.

Murābahah and *ijārah* transactions require Islamic banks to know the client's purpose and use of finance. These modes also require ownership of the asset by the bank, albeit for shorter duration in case of *murābahah* and longer duration in case of *ijārah* finance. This increases the likelihood (or ensures) that the funds are used for their stated purposes. Thus, it keeps credit tied to real economic activity for each transaction and throughout the tenor of contract. In the conventional bank financing the client is not required to disclose the use of funds as long as the client is believed creditworthy or can post suitable collateral.

Whether this ownership by the bank of the financed asset helps the bank in credit risk mitigation is a different but related issue. To the extent banks own the assets in their names their first lien on collateral is established. The extent they can actually perform foreclosure in the event of default depends on the strength of protection of property rights in the law, efficiency of the legal system and social sensitivities involved impacting the credit risk of Islamic banks.

²⁰ Data from Council of Islamic Banks and Financial Institutions (CIBAFI). 2007. *Islamic Finance in the GCC, CIBAFI Second Report*.

²¹ *Murābahah* as percent of total assets was highest in Saudi Arabia and Bahrain (more than 78 percent) and lowest in Lebanon and Yemen (less than 30 percent) during 2008.

While *ijārah*, *murābaḥah* and *istiṣnāʿ* provide credit, they do so against usufruct, commodity and a future tangible asset. The credit thus created cannot be easily rolled over. Thus these modes keep a tab on ballooning of debt and credit, again maintaining a tie between the financial and the real sectors. Recently the increasing practice of *tawarruq* by some Islamic banks was loosening the tie of finance with real economic activity and contributing to easy rollover of debt. However, the very recent fatwa of OIC Fiqh Academy on the prohibition of organized *tawarruq* is expected to stop its growth.

Second, Islamic banks avoided direct exposure to exotic and toxic financial derivative products. Because of Sharīʿah prohibition against *ribā* and *gharar* the asset portfolio of Islamic banks did not include any CDOs, CMBSs, CDSs and the like which turned out to be highly toxic for conventional banks and amplifying factor for the crisis. These derivative products, initially created in the name of hedging needs became device for highly speculative investments among the conventional financial institutions. In such products fortunes are made or lost on occurrence of trigger events with no time for the institutions to strategize and amend their business strategies. Unavailability of hedging instruments for Islamic financial institutions was used to be cited as a hurdle in the growth of these institutions, but during the crisis this perceived weakness became a strengthening factor for Islamic financial institutions. However, exposure to other investment risks stemming from equity markets, *ṣukūk*, real-estate and ownership stakes in other businesses remain a source of concern when overdone or undertaken purely for speculative gains. Such investments at global level also bring in currency risk into the market risk. However, this is of lesser concern to banks in GCC where the currency is pegged to US dollar than to Islamic banks in the other countries of the MENA region and in other parts of the world.

Third, large amount of liquidity. Islamic banks in general have kept a larger proportion of their assets in liquid form than their conventional counterparts. The high liquidity existed for two reasons: (1) Given that there is no lender of last resort (LOLR) facility available to Islamic banks, and given that they do not have access to market liquidity in the form of interbank market therefore high liquidity was maintained purposefully by Islamic banks for risk management purpose. (2) Excess liquidity prevailed also due to lack of interest-free short-term investment opportunities as real economic investments require some gestation period. In some parts of the world such as the GCC region the liquidity position of Islamic banks had been quite high. For example, the ratio of liquid assets to total assets was 21.14

percent for Islamic banks in the GCC during 2007.²² Moreover, the Islamic commercial banks in the GCC region enjoy a large liquidity buffer in the form of high reliance on retail depositor base, a large part of these deposits consist of non-remunerative current accounts. While Islamic investment banks are exposed to whole sale funding and private funds.

Why did Islamic banks and financial institutions start getting affected at a later stage of the crisis?

Figure 14 summarizes the different channels through which Islamic banks are getting affected by the crisis. As the global financial crisis became a global economic crisis it has started to affect Islamic banks and financial institutions in an indirect manner. The business model of many Islamic banks that relied on *murābahah* financing and predominantly invested only in the real estate sector and in the previously growing equity markets is now facing higher risks.

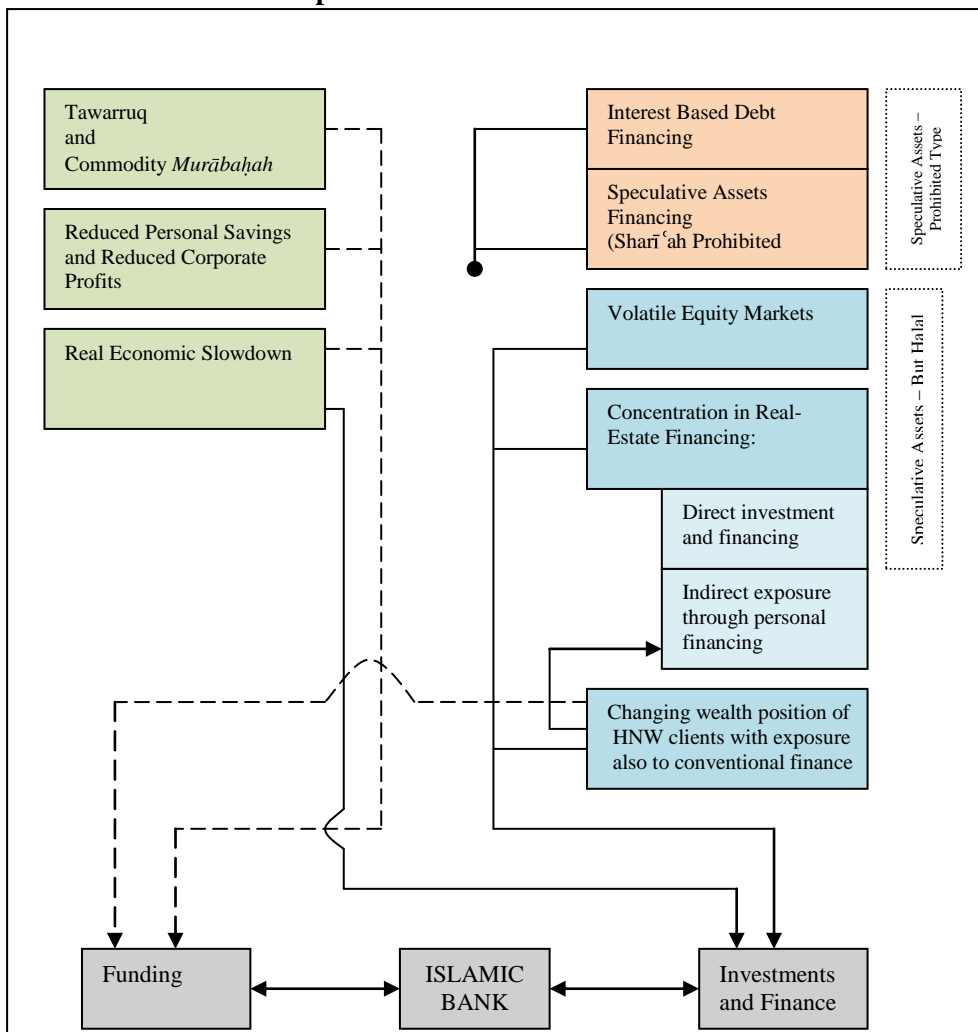
The financial crisis has triggered a chain reaction whereby the slowdown in the real economies of the developed countries has started to affect economic growth and investment activities in export driven economies of the developing countries through decreased trade in goods and services as well as through the declining commodity prices including that of oil. The economic downturn is not only affecting the investment and financing activities of financial institutions including those of Islamic banks, it is also decreasing the funding of these banks through reduced personal savings and declining corporate profits. It may be noted that most of the Islamic banking industry comprises of commercial banks whose major funding source are retail deposits, investment banking constitutes only a small portion of the industry.

Islamic banks in some regions may face risk on their financing and investment side of the balance sheet due to the crisis induced volatility of equity markets where these banks have large positions. Down-turn in the real estate markets where these banks have large direct and indirect exposures is also another source of risk. Similarly, the changing wealth position of their high net worth (HNW) clients who also hold financial exposure in the hard hit conventional financial sector of the West and therefore are now putting aside any investment plans is also a factor. The

²² Data from CIBAFI. 2007. *Islamic Finance in the GCC, CIBAFI Second Report*. Liquid assets are defined here as cash and cash equivalent assets. Beck et al. (2010) also ascribe the better performance of Islamic banks during the recent crisis to their higher liquidity reserves and larger capital to asset ratio.

relative importance of each of these factors varies by the region. For example, the banks in the GCC region and particularly in UAE are more exposed to real estate market risk, followed by risk of international equity markets. For the banks in Asia their investments in domestic and international equity markets are a source of concern as equity markets are showing higher volatility. In some of the countries the existing fiscal imbalance which has widened after the crisis is also a factor in the increased volatility of the markets.

Figure-14
Channels of Impact of Financial Crisis on Islamic Banks



9. Conclusions

This paper analyzed the state of Islamic banking in the Middle East and North Africa (MENA) region. It explored the major Islamic banking models that are in practice along with the explanation and analysis of major balance sheet items on the asset and the liability sides of these banks. The paper also modeled and analyzed the key drivers of Islamic banking along with an assessment of their relative importance; evaluated the performance of Islamic banking and compared it with the conventional banking in the region; and lastly it evaluated the affect of financial crisis on Islamic banks along with an explanation of possible channels of its impact. Throughout the paper, the analysis is coined in terms of average Islamic bank within each country while utilizing a sample of 30 banks across 9 selected countries of the region.

The study finds that the Islamic banking sector has been growing in the region. This was true before, during and even after the crisis. The rate of deposit growth was slightly faster than the asset growth before the crisis which reversed in the post crisis period. Moreover, the size and growth of assets have varied considerably among the countries. Bahrain is more known center for Islamic banking in the region with largest number of Islamic banks, however, in terms of assets per bank, Kuwait and Saudi Arabia have on the average large size Islamic banks followed by UAE, Qatar and other countries. In terms of shareholders' equity also banks in Saudi Arabia and Kuwait have highest equity per bank followed by UAE, Qatar, Bahrain, and other countries.

On the asset side, financing constitutes major portion of assets followed by portfolio investment. This is true for the region as a whole as well as for average bank in most of the individual countries. However, during 2008 the growth in financing activity was very rapid in UAE along with a decline in the proportion of portfolio investment and a decline in the level of cash and cash equivalents. Within the financing category, *murābaḥah* has been the dominant mode of financing in many countries (ranging from a maximum of 90 percent to a minimum of 50 percent of financing) followed by *ijārah*. On the average 75 percent of financing activity in the MENA region during 2008 was based on *murābaḥah*.

On the liability side customer deposits (in the form of unrestricted and restricted investment accounts as well as current accounts) are the major source of funds followed by funds due to other creditors such as financial institutions. The composition of customer funds is however changing with time with rise in the

share of current and savings accounts that are not based on *muḍārabah* and hence do not share in profit. The changing structure of bank funding assets will have profitability as well as stability implications in future.

The paper also investigates the factors that drive the growth of Islamic banking and the extent they can explain the differing growth of Islamic banking among the countries of the region. We used proxy variables to reflect three factors: (i) general growth of conventional financial sector, (ii) regulatory support and political will of the government for Islamic banking, and (iii) demand for Islamic finance. We found that while the overall growth of conventional financial sector is an important determinant of growth of Islamic banking, implying there are some common factors that are important in the growth of both the conventional and Islamic finance. It is the strong regulatory support and political will that stands out even higher than demand for Islamic finance for the growth of Islamic banking in the MENA region. We have used very simple econometric models in this analysis while there is room for more refinement and extensive research in this area.

We also evaluated the performance of average Islamic banks across countries as well as in comparison with average conventional banks in those countries by using return to equity (ROE), return on assets (ROA), asset utilization ratio, and net operating income to assets ratio. In the past, the ROE and ROA in general had remained high and differed significantly across countries of the region. Between 2006 and 2008 there appeared to be a declining but converging trend in ROE, as well as in ROA, among these countries. However, after the crisis both ratios changed in considerably different ways among the countries. This may be a reflection of the differences in institutional and economic conditions among these countries resulting in different behaviors of Islamic banking under financial stress. In comparison with conventional banking the ROA in Islamic banking was similar to their conventional counterpart in the respective countries. However, the ROE was lower in case of Islamic banking compared to the conventional banking reflecting higher capitalization and lower leverage of Islamic banks.

Asset utilization in Islamic banking was generally higher than in conventional banking. The *muḍārabah* based deposit accounts make it more important for the Islamic banks to keep funds invested to generate returns for themselves and for their depositors in order to stay competitive. However, the ratios of operating income to asset for average Islamic banks were lower across the countries in comparison with conventional banks and these significantly varied across countries and across time. There is also evidence of economies of scale in countries with

larger size Islamic banks resulting in lower average cost and hence higher proportion of net operating income to total income.

The Islamic banking sector has demonstrated more resilience against the financial crisis mainly due to avoidance of interest. The requirement to abstain from interest made their financing activities more tied to real economy and also required them to avoid exposure to toxic financial derivatives. The commercial risk associated with Islamic banking activities and the non-availability of lender of last resort facility to these banks also forced them to hold liquid assets in greater proportion than their conventional counterparts. All these factors helped them during the crisis. The impact of the crisis came to these banks late and indirectly through slowdown in the real economy. Some banks were affected due to their asset concentration in real estate sector. However, there was no case of failure of Islamic bank in the region.

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