

ISLAMIC BANKING IN KUWAIT : THEORIES, PRACTICES AND INSIGHTS

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ABSTRACT

The broad aim of this paper is to introduce knowledge of Islamic banking theories and practices to banking finance and practitioners in Kuwait, as well as draw some useful insights on Islamic banking in Kuwait. Prohibition of interest, low consumer lending, profit and loss sharing and high real sector investing are primary characteristics of Islamic banks. Islamic banks operate the three conventional deposit accounts. They also engage in investment financing, trade financing, lending, and other financial services. Differences between Islamic and conventional banks lie in prohibition of interest, emphasis on Islamic principles of morality, emphasis on collateral, certainty of deposits and returns, liquidity risk and solvency risk; while similarities between Islamic and conventional banks lie in profit-making objective and nature of banking services. Though there is a dearth of Islamic banks in Kuwait, Islamic banking has become a fast growing concept. The emergence of full-fledged Islamic banks in Kuwait should be expected in the near future.

Keywords: Islamic Banking, liquidity risk and solvency risk

INTRODUCTION

Islamic banking refers to a system of banking that is consistent with Islamic law *Shariah* principles and guided by Islamic economics. The broad aim of this paper is to introduce knowledge of Islamic banking theories and practices to banking and finance scholars and practitioners in Kuwait, as well as draw some useful insights on Islamic banking in Kuwait. Firstly, the Kuwait banking industry is dynamic. The current trend is directed toward the emergence of Islamic banks sometime in the near future to meet the needs of the devout Muslim populace. Strategic foreign investors, eyeing stakes in Kuwait's financial sector, recently requested from the Kuwait International Bank, details of regulations governing operations of Islamic banking in Kuwait (Shady, 2008). Muslim economic bigwigs in Kuwait are also attempting to promote Jaiz Bank Kuwait, a full-fledged Islamic bank (Sunmonu, 2008: 64). For the first time, the Indonesian Bar Association NBA Section on Business Law had a session on Islamic Business Law at its 2008 annual conference. Islamic banking is a banking system that is based on the principles of Islamic law (also known *Shariah*) and guided by Islamic economics. Two basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of the collection and payment of interest. Collecting interest is not permitted under Islamic law. Since this system of banking is grounded in Islamic principles, all the undertakings of the banks follow Islamic morals. Therefore, it could be said that financial transactions within Islamic banking are a culturally distinct form of ethical investing (for example, investments involving alcohol, gambling, pork, etc. are prohibited). The Dubai Islamic Bank has the distinction of being the world's first full-fledged Islamic bank, formed in 1975. The rapid expansion of the Islamic banking segment in Kuwait over the course of the past decade is indicative of the sector's trajectory throughout the Gulf in the same period, not to mention a broad swathe of the rest of the world. According to data from EY, global Islamic banking assets posted yearly growth of 17.6% between 2009 and 2013, and the segment is expected to continue to grow annually at a rate of 19.7% through 2018. As of June 2013, Kuwait-based institutions housed an estimated 6% of global Islamic banking assets, according to IMF data. As of the end of June 2014, banks accounted for more than 84% of all financial system assets in Kuwait, and the country had the third-largest share of Islamic funds in the world, as per IMF data. The last section concludes the paper. Nevertheless, the question as to whether Islamic Banking will make the much expected contribution to investment and growth, process a challenge for banker, researchers and policy makers alike.

LITERATURE REVIEW

Conform to Islamic rules, Islamic banks prohibit, among other things, the payment or receipt of interest. With the rapid increase of Islamic banking during the previous 3 decades, many Muslims refrained from dealing with conventional banks and switched to Islamic banks. According to The Economist (2014), total assets of Islamic financial institutions amount to about \$2 trillion. It also argues that Sharia-compliant Islamic banking assets grew at an annual rate of 17.6% between 2009 and 2013, and will grow by an average of 19.7% a year to 2018. These growth rates are highly significant for a relatively new industry.

In April 2014 the Commercial Bank of Kuwait (CMBK) received approval from 85% of its shareholders to convert the bank to a full-fledged sharia-compliant lender, making it the most recent financial services provider to begin exploring a possible conversion. Indeed, Ahli United Bank Kuwait (AUB) went through a similar process in 2010. When CMBK completes the transition to sharia compliance – potentially before the end of 2015 – Kuwait's banking sector will be predominantly composed of sharia-compliant institutions. As of the end of 2014 five of the country's 11 banks operated according to sharia principles; the conversion of CMBK will bring that number to six. The sub-theme was 'Islamic Business Law – An Alternative to Development in a Global Economy'. Commercial banks were first introduced into Muslim countries at a time when they were politically and economically at a low ebb, in the late 19th century. Main banks in the home countries of imperial powers established local branches in the capitals of subject countries. These banks catered mainly for the import export requirements of foreign businesses and were generally confined to the capital cities. As a result, the local population remained largely untouched by the evolving banking system at the time.

However, as time went on it became difficult to engage in trade and other activities without making use of the commercial banks. Even then many devout Muslims confined their involvement to transaction activities such as current accounts and money transfers. Borrowing from the banks and depositing their savings with them were strictly avoided in order to keep away from dealing in interest which is prohibited by Islam. As time passed by, governments, businesses and individuals began to freely transact business with the banks, with or without liking it. This state of affairs drew the attention and concern of Muslim intellectuals who felt there was great need to maintain Muslim laws and principles even in the sphere of financial transacting Abdul Gafoor, 2007.

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit- Ghamr in 1963. The bank was very popular and prospered. The experiment lasted until 1967, by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors Siddiqi, 1988. During the 1970s, a number of full-fledged Islamic banks came into existence in North Africa and the Middle East. Dubai Islamic Bank was established in 1975; Faisal Islamic Bank of Sudan was established in 1977; Faisal Islamic Bank of Egypt was established in 1977; and Bahrain Islamic Bank was established in 1979.

In Pakistan, partly because of political interests and the emergence of young Muslim economists, a gradual Islamization of the banking process began in 1979. In the first phase, which ended on 1 January 1985, domestic banks operated both interest-free and interest-based 'windows'. In the second phase of the transformation process, the banking system was geared to operate all transactions on the basis of no interest, the only exceptions being foreign currency deposits, foreign loans and government debts. The gradual pace of transition made it easier for the Pakistani banks to adapt the new system. Islamic banking made its debut in Malaysia in 1983, but not without antecedents. The first Islamic financial institution in Malaysia was the Muslim Pilgrims Savings Corporation set up in 1963 to help people save for performing hajj pilgrimage to Mecca and Medina. In 1969, this body evolved into the Pilgrims Management and Fund Board or the TabungHaji as it is now popularly known.

According to data from the IMF, in recent years Kuwait's Islamic banking industry as a whole posted stronger asset growth than the banking industry average, due mainly to rapid growth in deposits. As of the end of June 2014 more than 60% of total Islamic banking assets in the country were funded by customer deposits, with a significant percentage of the remainder (10-22%, according to IMF data) coming from other financial institutions. At year-end 2013, KFH had 70% market share in the Islamic banking segment and around 26% in the banking sector as a whole in terms of assets, according to a report put out at the end of 2014 by the IMF. AUB was the second-largest Islamic institution, with 14% of sharia-compliant banking assets and 5% of total sector assets. Boubayan Bank, owned by the market leader National Bank of Kuwait, was the third-largest shariacompliant

bank, with 9% of Islamic banking assets and 4% of total assets. Finally, KIB and Warba occupied the fourth and fifth spots, respectively, with 5% and 2% of Islamic banking assets and 2% and 1% of total assets.

Assuming that CMBK retains its current position in the market, and provided that the bank's transition to sharia-compliant status goes smoothly, it will become Kuwait's second-largest Islamic bank. Islamic banks in Kuwait face a range of challenges. Some of these issues are the same as those confronting the conventional sector, including market, credit and operational risks. A reliance on oil revenues in the economy at large and real estate and equity throughout the financial industry is considered a key issue for all banks operating in Kuwait. At the same time, the Islamic segment is prone to a handful of distinctive risks. For example, the sharia-compliant financial sector as a whole lacks depth in Kuwait and to a lesser extent throughout the region, which makes it hard for some Islamic banks to manage liquidity. Sharia provisions require that monetary instruments be linked directly to real economic activity, so that many banks have substantial non-financial holdings across a range of sectors, often in the frame of a conglomerate corporate structure.

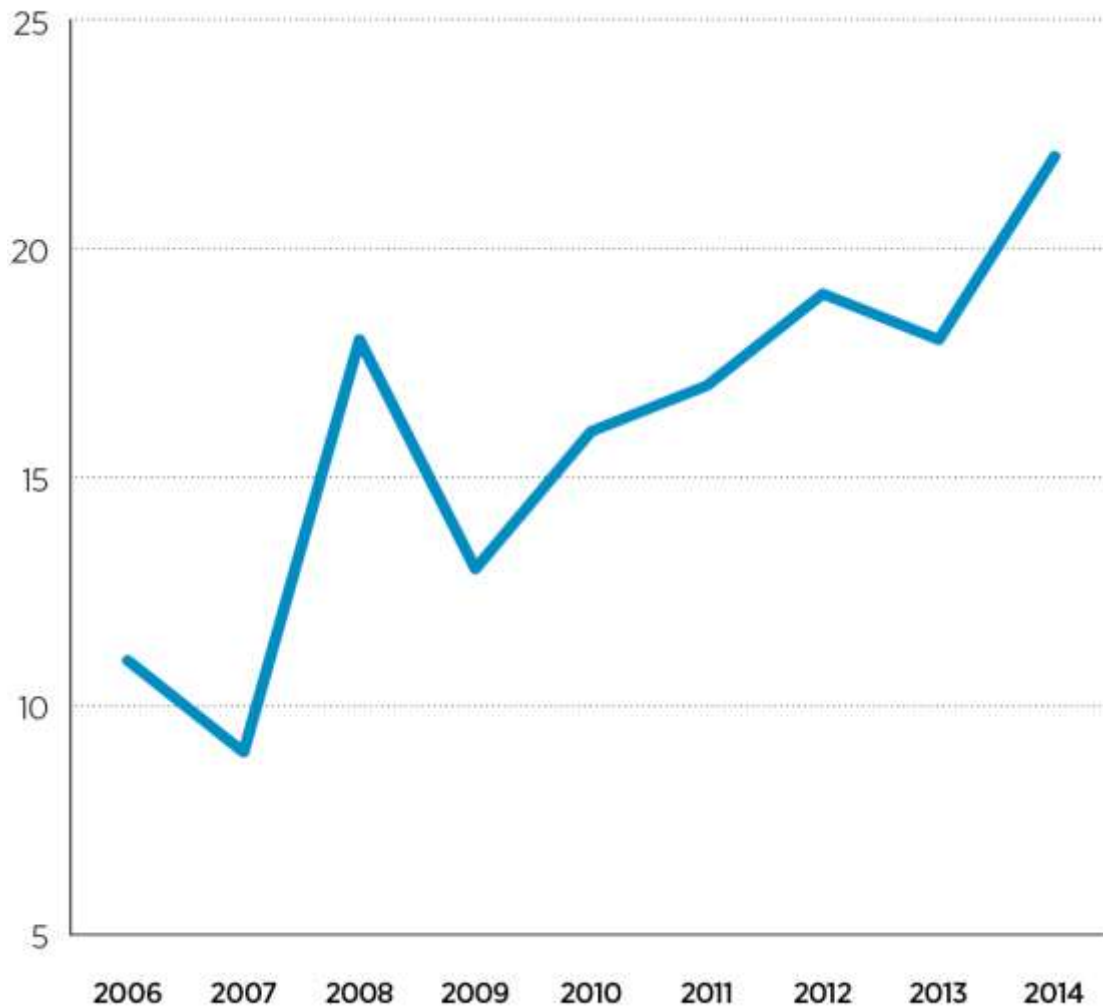
This has the potential to be exposed to risks not faced by conventional banks, which are generally more restricted when it comes to investments in non-financial equity. Additionally, sharia-compliant banks often face risks related to the complexity of their corporate structure and operations, particularly in regard to risk management and, in the case of disputes, resolution. As the IMF pointed out in its mid-2014 report on the sector, KFH "is systemically important with extensive crosssector and cross-border operations, some of which are in offshore centres reputed for lax supervision". Unlike their conventional counterparts, Islamic banks are required to ensure that all of their products and operations adhere to sharia legal provisions, as interpreted by sharia scholars. However, maintaining an independent and qualified board of scholars is expensive and can also potentially entail reputational risk

DATA

Kuwait's reputation as a centre for sharia-compliant banking dates back to the early 1970s, when Kuwait played a key organising role in establishing what is now known as the Organisation of Islamic Cooperation. Under this body the government of Kuwait organised and hosted a number of international conferences on the topic of sharia-compliant finance throughout the 1970s, in the process paving the way for a host of majority-Muslim nations to invest in their financial sectors during this period. In March 1977 the government introduced Law No. 72, which formally established KFH as a state-owned firm and the sole Islamic bank in the nation at the time and for the subsequent few decades.

As one of the region's flagship sharia-compliant banks, the government gave KFH a considerable amount of regulatory leeway to ensure that it could compete effectively with other new similar institutions in the Gulf and elsewhere. KFH's key competitors during this period included the UAE's Dubai Islamic Bank (DIB), launched in 1975; Bahrain Islamic Bank (BIB), established in 1979; and the Islamic Development Bank (IDB), set up by Saudi Arabia in Jeddah in 1973. KFH and these three other banks had more than 20 years of first-mover advantage in the Gulf – in Kuwait the CBK did not allow any other sharia-compliant institutions to set up shop until the early 2000s. It is perhaps not surprising, then, that KFH, DIB, BIB and IDB continue to account for a considerable percentage of Islamic assets both in the Gulf and around the world. As of end-June 2014, KFH accounted for 70% of total Islamic banking assets and 26% of Kuwait's total banking assets, both conventional and Islamic.

F.1 Kuwait's total government spending

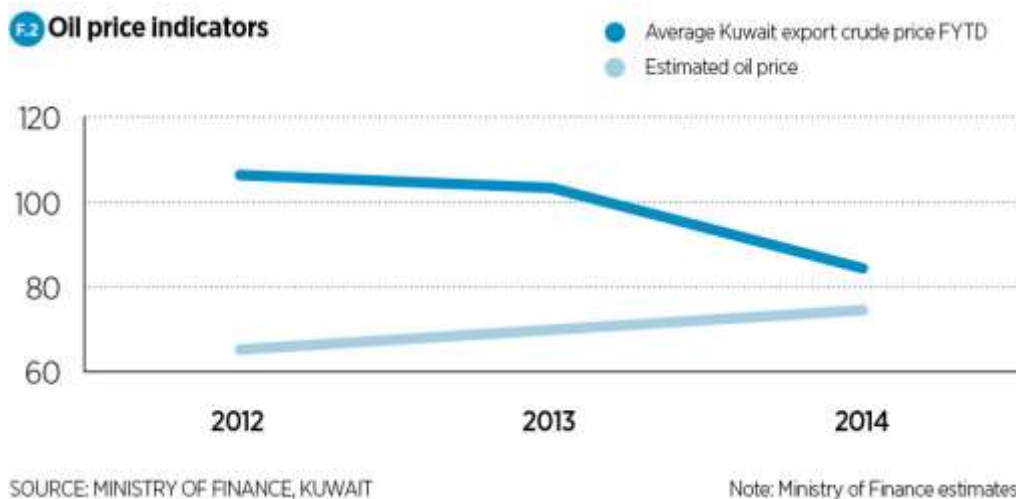


SOURCE: MINISTRY OF FINANCE, KUWAIT

Note: Ministry of Finance estimates

In Kuwait, the sector's history goes back to 1977 with the establishment of KFH Group, Kuwait's largest Islamic bank. For the last three years to end-2013, KFH total assets grew at a compounded annual growth (CAGR) rate of 8.8% to reach KD16.1bn (\$57.2bn). CBK, the state's fifth-largest lender by assets, is following in the footsteps of both Boubyan Bank and Ahli United Bank (AUB) Kuwait in converting from a conventional lender, drawn by the sector's rapidly rising popularity and promising outlook for growth, which continues to outpace that of conventional lenders. According to Reuters, CBK's conversion will increase Islamic banks' market share in Kuwait above an estimated 40%. The move by CBK, to be completed by the end of 2014, will help Kuwait cement its position as a provider of Sharia-compliant products and services.

These parameters have helped KIB to achieve growth in profits and greater stability across the board. In 2015, KIB adopted a new and comprehensive transformation strategy, which it has been implementing. This strategy is aimed at improving the bank's performance indicators, not to mention the quality of the products and services on offer to customers.



There are already five other Kuwaiti Islamic banks; Kuwait Finance House (KFH), Boubyan Bank, Al Ahli United Bank, Kuwait International Bank, and Warba Bank, which was established in 2010. This compares with four conventional banks. Kuwait's Islamic banking assets grew by 8.7% during the first nine months of 2013, reaching KD22.5bn (\$79.7bn), while Islamic financing grew by 11.2% to hit KD13.5bn (\$47.8bn) during the same period, reported in *The Banker* in April. This exceeded the growth rates in the overall banking sector, which saw a 7.1% growth in assets and a 7.5% growth in loans between January and September.

This move toward Islamic banking follows a broader regional and indeed global trend. Islamic finance industry's assets worldwide are estimated to have grown 18.6% annually to reach \$1.8trn at the end of 2013, according to KFH Research, which projects that total Islamic financial assets will reach \$2.1trn globally by 2015. The Sharia compliant sector has expanded rapidly within Southeast Asia and the Gulf Cooperation Council (GCC), whose assets accounts for more than a third of the worldwide total according to KFH. Other banks in this region are also looking to make the switch to Islamic banking. Malaysia's Agro Bank plans to convert to Islamic banking by 2015 while the country's SME Bank is planning a full conversion by 2018 according to Reuters. In Pakistan, Faysal Bank and Summit Bank are mulling similar plans.

METHODOLOGY

Due to the Islamic prohibition of interest and in compliance with injunctions on permissible trade contracts, the savings and investment contracts offered by Islamic banks have a different risk profile than those of conventional banks. This gives rise to a number of regulatory issues pertaining to capital adequacy and liquidity requirements. Operational issues also arise as Islamic banks are limited in their choice of risk and liquidity management tools such as derivatives, options and bonds. All these issues are theoretically examined and various performance indicators of two Islamic banks are also examined to compare them with traditional banks that practice mark up pricing.

RESULTS

Owing to high government spending and a dramatic fall in oil prices, fiscal reforms have become all the more important in controlling and optimising the spending and minimising the government's subsidies to maintain a sustainable economy. The Kuwait Government, therefore, has recently started work on serious fiscal reforms. The last two years have seen a string of serious efforts on the right track, including: the study of a corporate and value added tax (expected to increase revenues by 1.3 percent – 2.1 percent of GDP); subsidy reform (for example lifting subsidies on diesel and aviation fuel, reconsideration of treatment abroad, travel and other allowances of government employees, cash transfer to lower income households and the reconsideration of gasoline and electricity subsidies); the discussion in parliament of a promising wage bill reform initiative to enhance government control and standardise the public sector's wage structure; side-by-side with initiatives to enhance public private sector partnership and SME support initiatives.

For Kuwait, while higher oil prices have resulted in a hike in government spending for the long term, historical evidence shows that in the short term (24 months or less) spending is not necessarily affected by oil prices. For example, in the fiscal year of 1998 to 1999, prices reached 85 percent of the fiscal break-even price, yet the government ran a deficit equivalent to 15 percent of GDP, all while expenditure remained unchanged. In general, a short-term deficit can be easily funded, and the Kuwaiti Government has more than KWD 5bn (\$16.5bn)

on deposit with local banks and one of the largest financial reserves in the region, at nearly 300 percent of GDP (\$550bn). The government also has a low debt ratio, at less than seven percent of GDP, and a stable credit rating, which offers scope for borrowing both locally and internationally. Sources at the bank do not foresee that the current low oil price will have a negative impact on the state's economy in the long run, as Kuwait's sizeable reserves help overcome the crisis in the short run. Kuwait International Bank sees the drop in oil prices as an opportunity to expedite the implementation of fiscal reform, in order to mitigate pressures on government budget and diversify the sources of income.

Doing so will push forward the wheel of economic development and maintain a sustainable economy in the long run. Looking at the country's biggest challenges to date, one can't help but consider the issue of diversification, the realisation of growth at sustainable levels and the optimisation of government spending. Answers to these challenges could emerge as a result of the oil price slide; that is the necessity of a prompt fiscal reform and the improvement of the development plan's implementation. In other words, these challenges, together with falling oil prices, have created an accommodating environment for fiscal reform, leaving the Kuwaiti economy to improve in the medium and long term, particularly when considering the giant financial buffers capable of shielding the country from crisis in the short run. According to Kuwait International Bank, the repercussions of falling oil prices have not thrown great pressure on the local economy up until now. Though the real estate sector and KSE indicators were down slightly in 2015, the corporate sector is still realising broad-based gains and the deposits and credit levels continue to exhibit healthy growth, all supported by stable and continuous government spending, a robust consumer sector, and the relentless efforts of the Central Bank of Kuwait in adopting macro prudential policies. These parameters have helped Kuwait International Bank to achieve growth in profits and greater stability across the board. In 2015, Kuwait International Bank adopted a new and comprehensive transformation strategy, which it has been implementing. This strategy is aimed at improving the bank's performance indicators, not to mention the quality of the products and services on offer to customers.

FINDINGS/ DISCUSSION

The balance sheets and various performance indicators show that there is evidence that Islamic banks in Kuwait tend to engage in little long-term project financing. However, on the plus side these banks have shown good performance with respect to the returns on their assets and equity and have also demonstrated better risk management and maintained adequate liquidity.

In Kuwait, the sector's history goes back to 1977 with the establishment of KFH Group, Kuwait's largest Islamic bank. For the last three years to end-2013, KFH total assets grew at a compounded annual growth (CAGR) rate of 8.8% to reach KD16.1bn (\$57.2bn). CBK, the state's fifth-largest lender by assets, is following in the footsteps of both Boubayan Bank and Ahli United Bank (AUB) Kuwait in converting from a conventional lender, drawn by the sector's rapidly rising popularity and promising outlook for growth, which continues to outpace that of conventional lenders. According to Reuters, CBK's conversion will increase Islamic banks' market share in Kuwait above an estimated 40%. AUB Kuwait, (formerly known as the Bank of Kuwait and the Middle East) posted a record \$579.4m in net profit in 2013, a 72.6% increase over 2012's \$335.7m, which Deputy CEO Ahmed Zulficar attributed to the switch to Islamic Banking: "Since the bank's conversion to Islamic banking, our performance has improved". Islamic finance expert Blake Goud, who writes for the Thomson Reuters Islamic Finance Gateway, noted that AUB had no debt when it switched to Islamic banking in 2010, which was beneficial due to the fact that less instruments had to be converted from conventional to sharia-compliant.

CONCLUSION & RECOMMENDATION

The emphasis on the liquidity risk has recently become a very prominent issue particularly in the aftermath of the recent global financial crisis. This paper has attempted to investigate the key feature of Islamic finance in relation to liquidity risk and the techniques used in managing it. It can be comprehended from the preceding discussion that Islamic banks have unique features in relation to liquidity risk management. Therefore, Islamic banks aim to mitigate their liquidity risk by practising and adhering to Shari'ah concepts such as cooperation between all the business partners through the sharing of the risks and mutual responsibilities of running the business. Accordingly, Islamic banks are obliged to have in place effective techniques, procedures and highly industrialized liquidity risk-management practices via appointment of a sufficiently qualified BOD, senior management and other personnel. Efficient accessibility to adequate financial instruments is also significant for Islamic banks to meet their liquidity needs in a timely manner. Based on the achieved empirical results, in order to ease liquidity risk exposure in the Islamic banking sector, innovative approaches are essential in terms of the engineering of new financial instruments and the development of comprehensive regulations and policies.

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