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ISLAMIC BANKING IN EMERGING MARKETS
Comparing Opportunities in Turkey and Egypt

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Wien, Juli 2012

Golnaz Miremadi
For my parents

I dedicate this work to my loving parents who are the pillars of my life. Thank you for all the loving support, warmth and valuable guidance you have given me.

I feel blessed and am grateful for my being your daughter.
Acknowledgment

I would like to thank everyone who has supported me during the period of my studies and specially those who have helped me to make this work happen.

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I would also like to thank every member of my family who have always encouraged and motivated me throughout my academic years. Without the support from each of them I wouldn´t have been able to succeed on my academic and professional path.
Abstract

This paper evaluates the relevance of Islamic Banking in modern times. In going so, it focuses on the economic aspects and surveys the available literature including published and working papers, analysis of the financial performance of (central-) banks, other financial institutions and also other relevant publications and comparative reviews of Islamic Banking versus conventional banking. It takes a closer look into areas where improvements could be achieved, especially in emerging markets and finally it focuses on Turkey and Egypt to determine if and how Islamic Banking can be instrumental in uplifting the lives of ordinary people.
Kurzfassung

Preface

With my thesis „Islamic Banking in Emerging Markets – Comparing Opportunities in Turkey and Egypt“, I would like to address all economists, particularly the ones who still find the subject of this paper and its conceptual pillars rather new. In this respect I will explain and emphasize the structures of Islamic laws which influence the daily life of every practicing Muslim. Furthermore it is necessary to explain some basic principles of Islam in general in order to give a better understanding of the Muslims’ perspective which is the guiding requirement for Islamic banking.

By introducing two Islamic emerging markets (Turkey & Egypt) I will explain some possibilities for growth, given by their circumstances.

My goal from this thesis is to show the attractiveness of investing in this market segment especially for their respective local population. Although there are difficulties in the system of Islamic Banking and though the banking system in emerging and developing markets have not yet fully developed relative to the banks in the industrial countries, the potential growth of Islamic Banking system is enormous.
This thesis is divided into two parts. Part one discusses the historical and juridical background of Islam, highlights some major and unique Islamic Banking instruments and also role of business ethics, Corporate Governance and the parallelism with Shariah rules. The second part focuses on Turkey and Egypt, two selected Muslim emerging markets with the purpose of exploring new suggestions for improvement and to serve certain segments with a concrete product proposal.

The paper focuses on the economic aspects of Islamic Banking and as such does not consider analysis of political events.
### Abbreviations

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tr>
<td>AAOIFI</td>
<td>Accounting and Auditing Organization for Islamic Financial Institutions</td>
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<tr>
<td>ATM</td>
<td>Automated Telling Machine</td>
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<tr>
<td>CB</td>
<td>Conventional Banking</td>
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<tr>
<td>CBE</td>
<td>Central Bank of Egypt</td>
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<tr>
<td>CRIS</td>
<td>Credit risk information system</td>
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<td>CRM</td>
<td>Customer relationship management</td>
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<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<td>IB</td>
<td>Islamic Banking</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IFSB</td>
<td>Islamic Financial Services Board</td>
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<tr>
<td>MTP</td>
<td>Medium Term Program</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>SSB</td>
<td>Shariah Supervisory Board</td>
</tr>
<tr>
<td>S&amp;P</td>
<td>Standard &amp; Poor’s</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
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1. Introduction

Recent developments have highlighted the growing relevance of Islamic Banking in today’s world. Against the backdrop of the financial crisis of 2008, it is fast becoming a major theme in the financial world. According to the Standard & Poor’s (S&P) the assets of the top 500 Islamic banks expanded 28.6% to $822 billion in 2009. They estimate that Shariah-compliant assets currently total about $1 trillion worldwide, after a brisk growth during the past decade.\(^1\)

This is a progress in the right direction as it gives the impetus to re-examine what banking truly means. What is the purpose of financial intermediary in our modern lives and should it be all about money?

Modern banking has taken its root in Islamic banking as practiced by merchants during the expansion of Muslim empire. Western merchants became aware of this practice during the crusades and they brought the practice with them into the western world. The two systems diverged when western banking adopted the concept of interest during the renaissance period. Banking in the modern sense of the word can be traced to medieval and early Renaissance Italy, to the rich cities in the north such as...

\(^{1}\) Coughlin, P. (2011), p. 3f
as Florence, Venice and Genoa. With the western dominance, the banking practices employing the concept of interest prevailed for centuries and became the norm in most of the world including the Muslim countries. There were, however, renewed activities in Islamic Banking starting in the 1960’s with the entry of two microfinance banks in Malaysia and Egypt. Afterwards, Islamic principles were applied gradually to trade financing practices and were further formalized and institutionalized, and since then the Islamic finance methods have been adopted in view to all the practical aspects of Islam.

Recent events, most notably the financial crisis of 2008, have rekindled not only Muslim but western businesses interest in Islamic Banking.

A broader concept for the study of the past performance of Islamic Banking should include the political and economical interests of potential investors in Islamic Banking. However, in the following work the political aspect banking investments and investments have not been considered since it would go certainly beyond the scope of this thesis.
2. Islamic Finance and its Development

2.1 The Historical and Juridical aspects of Islam

Islam is today the second largest religion in the world with an estimated number of monotheistic followers of 1.3 to 1.6 billion.

The Muslim population is divided into two major groups:\footnote{Spuler-Stegemann, U. (2007), p. 5f.}

I. The \textit{Sunnis}: the biggest group with 90\% of total population which are further subdivided in some smaller sub-groups

II. The \textit{Shiites}: the remaining 10\% with their own sub-groups.

The above two groups do not differ that much in their main theological aspects. Their difference is more in the concept and foundation of their highest guide’s authority namely about the \textit{Kalif} who is the Sunnis’ highest guide and the \textit{Imam} for the Shiits.

The following five pillars are the foundation of Muslim life and contain injunctions, which every Muslim should observe in his or her life:\footnote{Geilfuß, K. (2009), p. 2 ff.}

1. The declaration („\textit{shahadah}“) about the Unique God:

2. The daily prayers

3. Self-purification through fasting and meditation
4. The religious alms (zakat), which is a certain percentage of one’s annual savings, depending on the income.

5. The pilgrimage (hajj) to Makkah, an obligatory once-in-a-lifetime journey for those who are physically and financially able to undertake.

In addition to the five fundamentals the Islam also has some other maxims which are: The belief in God’s angels, His manifestation in the holy book Quran, the divine provisions, Doomsday and the subsequent life after that.

In general, the daily life of a Muslim is very much influenced by the above-mentioned pillars. The ensuing duties of Muslim individuals are not related only to the five fundamentals, but also in such terms as education, science and social duties. These terms are observed in the Islamic financial and banking concepts which are explained in more detailed in chapter 4.

2.2 Social and Ethical Circumstances of Muslims

Islam is not just a religion per se but it contains a set of the basic principles for all juridical, economic and social decisions for a Muslim country. In an Islamic system the general and daily behavioral norms are based on the Quran, which determines the basis for legal rules and normal framework for the life of practicing Muslims. The Islamic law itself is based on the four elements - Quran, Sunna (prophet’s tradition), Ijma (the judgement among the wise people) and Qiyas (analogy).

The Quran and the Sunna are the first and also the most important sources governing society. The Sunna\(^4\) contains the bequeathed messages and actions from the last prophet Mohammad.

The two other additional sources of reference (Ijma & Qiyas) are considered only if the Quran or Sunna cannot provide answers to the question at hand. They will not be explained more since the discussion will go beyond the scope of this work.

It is necessary in Islam to distinguish between *haram* and *halal*. *Haram* is the notation for everything that is forbidden by Quran, Shariah or Fiqh (jurisprudence, see following chapters). *Halal* stands for everything that is allowed and favored.

All Islamic financial services, including the Islamic Banking system and so every financial product must take the principles of *halal* and *haram* into consideration.

### 2.2.1 Shariah and Fiqh

The two juridical segments which are the most important parts for Islamic Banking are called the Shariah (the ways, the rules) and Fiqh (the jurisprudence). Shariah includes the actual duties of a Muslim, also the Islamic law, though it is not a law in the common meaning. It is more a directional guide, which should lead the people towards God⁵.

Whereas the Shariah is seen as part of the Islamic law, which is based on the “divine revelation”, the Fiqh forms a collection of all law sources. It distinguishes between the relationship towards God (*Fiqh’ibaha*) and the relationship among people (*Fiqh Mu’ammat*)⁶.

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⁵ Geilfuß, K. (2009), p. 5
In order to understand the fundamental on which the Islamic financial system, hence the Islamic Banking, is based, it is necessary to explain the basics of the Shariah laws, which refer to the financial aspects, short but not getting too much involved in the philosophical details of the religion itself.

Like other religions Islam prohibits all kind of cheating on others. This principle counts when dealing with Muslims and non-Muslims alike. However, compared to the other religions the prohibitions of cheating in Islam are defined much stricter.

In the deeper sense it means a certain level of openness has to be established e.g. when selling: the seller has to honestly describe the advantages and the disadvantages of the product he is selling, particularly if they are invisible and leave it up to the to the buyer to accept or reject the deal.

A good example of unethical business practice that would also be considered as cheating according to Quran are ambiguous terms and conditions in credit cards and loans which are not made transparent to clients.

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7 Dahduli, M.S. (2009), p. 17 f.
Furthermore, the principles of gharar (agreement - see chapter 4) prohibit any form of ambiguity - either intentional or unintentional - or uncertainty in business contracts. Based on the principle of gharar the deals, which are, only for the sole gain of one party and to the cost and the disadvantages for the other(s), are strictly forbidden. According to the Shariah one must always consider himself in someone else’s situation and treat his counterpart just the way he would like to be treated. This can also be referred to as the „golden rule“ of acting ethically in any life-situation.

2.3 The recent growth in Islamic finance

The financial principles in Islamic finance have remained basically the same since their developments over 1400 years ago. As Sorenson points out „... the field of Islamic finance grows and globalizes, the relations between Shariah-compliant financial products and conventional financial products deserves more consideration as an area of law on international stage“.

According to Coughlin „... the global growth of Islamic finance stayed strong in 2009, just when the majority of the world’s financial systems found themselves deleveraging amid the capital market dislocation and its spread to economies around the world.“

The financial crisis of 2008 and later also has brought about a concern among many scholars to cite the roots of the crisis in the distance the conventional banking and finance industry has been keeping from ethical principles and from attempting to train the future bank managers with the notion of (divine) stewardship. Emmanuelle Smith directs an important question in an Financial Times article of June 18th, 2012 where he asks “Were “the masters of the universe” ever taught about ethics? And if not, why

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9 Sorenson, B. (2008), p. 647
not?"11 Implying that the current financial crisis is essentially a crisis of moral and ethical issues, and that is why there is an increased interest in alternative financial products, which are based on stricter ethical rules, are more predictable and contain less risk than conventional financial products. "The great corporate and financial scandals of our time can always be traced back to one thing: the failure of the rules, or the moral imperatives, that overrule greed."12

The basis for Islamic finance is not just to embrace the religious beliefs of religious customers only, it is also to emphasize a code of conduct to take care of your counterparts at the same time. Its role is to promote risk sharing together with economic justice instead of a "profit maximization" as the only goal13.

According to Iqbal, “... the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions to enhance equality and fairness for the good of the society as a whole.”14 In general, the Islamic concepts promote risk sharing and entrepreneurship. They discourage speculation, which is believed to be the main reason responsible for the financial market crash in 2008. As Omneya Abdelsalam, the director of the El Shaarani Research Centre for Islamic Business and Finance and the director of the MSc in Islamic Finance at Aston Business School says “Several of the ethical lapses which occurred in the financial sector are prohibited in Islam”15.

Islamic finance is one of today’s fastest growing industries so that more and more players, including conventional banks, want to enter this market.

11 Smith, E. (2012)
15 Smith, E. (2012)
One of the reasons for this development is the growing oil wealth, with demand for suitable investments soaring in the Persian Gulf region\textsuperscript{16}.

Several factors have contributed to the strong growth of Islamic finance, including:
\begin{itemize}
  \item Strong demand in many Islamic countries for Shariah-compliant products;
  \item Progress in strengthening the legal and regulatory framework for Islamic finance;
  \item Growing demand from conventional investors for diversification purposes; and
  \item The capacity of the industry to develop a number of financial instruments that meet most of the needs of corporate and individual investors.
\end{itemize}

Another main reason is the attractiveness of many of the products available to Muslims and non-Muslims as well because of taking the economic justice under consideration.

Since 1975, the Islamic finance industry grew from only few hundred thousands of dollars to around hundreds of billions of dollars by 2005\textsuperscript{17}. Due to its tremendous growth Islamic finance became a competitive segment. The system covers (Islamic) banking, capital formation, capital markets and every other type of financial intermediation\textsuperscript{18}.

According to the \textit{International Monetary Fund (IMF)} publication of August 2010, the \textit{International Organization of Securities Commissions (IOSCO)} estimates that more than half of the savings of 1.6 billion world Muslims will be clients in Islamic financial institutions by 2015\textsuperscript{19}.

Specifically the Islamic Banking is not only available in the Arab or Muslim countries but it has reached other markets all around the globe, including the Europe, Asia and the USA. Islamic finance is a very new approach - compared to the

\textsuperscript{16} El Qorchi, M. (2005), p. 1
\textsuperscript{17} Iqbal, M. & Molyneux, P. (2005), p. 1
\textsuperscript{18} Iqbal, Z. (1997), p. 42
\textsuperscript{19} Imam, P. & Kpodar, K. (2010), p. 3
conventional system - the European finance market has adopted its concepts, techniques and actual instruments\textsuperscript{20}. As for today, Islamic Banking has a growth of 10-15\% per year\textsuperscript{21} and this number is still growing. There are more than 300 Islamic Banking institutions over at least 75 countries, including the United States of America, United Kingdom and Switzerland. Additionally there are already more than 250 funds that comply with the principles of Islam. Furthermore countries like Iran, Malaysia, and Saudi Arabia have the biggest Shariah-compliant assets in the market worldwide (see graph 1 below).

\begin{graph}
\centering
\includegraphics[width=\textwidth]{graph1.png}
\caption{Asset Distribution top 500 banks by countries\textsuperscript{22}}
\end{graph}

\textsuperscript{20} Iqbal, Z. (1997), p. 42
\textsuperscript{22} The Banker (2007), p. 3
Although Islamic Banking has been growing rapidly over the last few years, it is still a very small part of the global banking system. Although it dramatically increased from $145 billion in 2002 to $1,033 billion in 2010, Islamic Banking is still less than 1% of total global banking\textsuperscript{23}. This is because the majority of the targeted group of Muslim-clients remain still not reached and not well informed as yet, but also that many investors including Muslims who have access and knowledge about the options given by the Islamic banks may still be too conservative to switch away from conventional banking systems.

The estimated size of the Islamic Banking industry at the global level was close to $820 billion at end of 2008 according to a report released in September 2010 by IMF\textsuperscript{24}. It is necessary to review the historical economic growth of the Muslim developing countries as a spring board for a rapid growth in demand for economical and financial services from the developed nations hence in the financial and banking industry as well.

However, it should be noted that the arch principles of Muslim population (including the need to observe their Shariah rules) has awakened the Muslim population all over the world gradually to the need for the research and development of financing products that would be more appropriate for the needs of the Muslims and also for those who are searching for a more ethical banking system and investments.

A possible approach by individual countries would be to transform the country’s financing sector into a fully Islamic system on political and religious grounds. Such tendencies are more likely to develop first in countries with a predominantly Muslim population. There are some countries such as Malaysia and Bahrain, that have allowed a mix of Islamic and conventional Banking for many years and have

\textsuperscript{23} http://www.arabianmoney.net/islamic-finance/2012/04/18/1tn-islamic-banking-asset-base-is-still-less-than-1-of-global-bank-assets - last access June 2012

\textsuperscript{24} Hasan, M. & Dridi, J. (2010), p. 5f.
managed to use the cross fertilization between the two systems eventually to produce well-diversified international financial hubs\textsuperscript{25}.

\textbf{2.3.1 Economical Consequences of Growth}

The subject themes of ethics in investments and Islamic financing are still being looked at separately at various quarters. The question remains if the two concepts will be eventually merged into yet a new and broader concept or they will remain independent and separate for a good time to come.

Islamic Banking which covers the biggest part of Islamic finance is spreading out of its niche and is becoming an identifiable segment that could serious rival to the conventional sector; it has become a visible alternative not only in the Muslim countries but still not every universal bank has Islamic variations of products to offer. One could even say they might be conservative and not diverse enough. “Islamic banks may become systemically relevant as they grow and increasingly interact with systemically important conventional banks.”\textsuperscript{26}

The pioneers of establishing Islamic financial products have been Bahrain in the Middle East and Malaysia in South-East Asia. These countries have become the leading centers for Islamic Banking.

Today many countries in the Persian Gulf region have followed as seen in graph \textsuperscript{27} below. Iran not only has changed her entire banking system to Islamic finance but has also become the leader of the trend. Countries in the southern Asia and North Africa like Pakistan and Sudan have also made steps forward towards entire change.

\textsuperscript{25} Solé, J. (2007), 13
\textsuperscript{26} Solé, J. (2007), p. 23
\textsuperscript{27} Imam, P. & Kpodar, K. (2010), p. 3
As stated in The Banker report of 2007, Iran has today’s highest level of Shariah-compliant assets, which tops the country ranking with $154.6 billion assets (see graph 1). The financial institutions are 100% Shariah-compliant and have more than double the amount of its nearest competitor, Saudi Arabia with $69.4 billion and Malaysia with $65.1 billion. Though both Saudi Arabia and Malaysia have bigger banking sectors than Iran, but in terms of Shariah-compliant assets they are considerably smaller.

If and when the full potential of Saudi Arabia and Malaysia is utilized in the growth of Shariah-compliant assets, the relative significance of Iran would be lessened, merely because Iran was only an early beginner in the trend while the sheer size of the financial markets in these two countries are by far greater than Iran.

The world-wide trend for Islamic financing is growing particularly in African countries with population of 400 million Muslims\textsuperscript{28} at the same time with the growth

\textsuperscript{28} Moody’s Global Banking (2008)
trend toward in the proportion of Shariah-compliant assets, hence it is expected that the growth in the volume of such assets would be exponential\textsuperscript{29}.

In order to support the development of Islamic Banking to become sustainable in the future the IMF/World Bank developed the *Islamic Financial Services Board* (IFSB) together with the central bank governors from countries like Bahrain, Indonesia, Kuwait. The aim is “to promote regulatory and supervisory practices and uniform prudential standards for Islamic financial institutions. (...) The establishment is a milestone in the recognition of the growing significance of Islamic financial institutions and products globally\textsuperscript{30}.

\textsuperscript{29} The Banker (2007), p. 2
\textsuperscript{30} Sundararajan, V. & Errico, L. (2002), p. 17
3. Relationship between modern Business Ethics and the Islamic Financial Aspect

*What is Ethics?*

According to Dilley „*ethics is the practice of applying ideas of right and wrong to create and uphold codes of behavior that help guide people.*“\(^{31}\) But there is not yet defined a terminology for business ethics since it will always be room for discussion due to different cultural understandings.

Today it is not enough anymore to just offer a banking product. The clients expect to see certain ethical principles to be incorporated into the institutions’ business philosophy. Ethical principles should help develop a stronger relationship to the customers and encourage them for trusting the institutions again after the worst financial crisis since the World War II in the early 1940.

According to a 1999 study\(^ {32}\) the reasons behind ethical codes of practice are markedly different in different cultures, It concluded that 64% of all US ethical codes are dominated by self-interest or “instrumental“ motives while 60% of European codes were dominated by “value“ concerns. “Often, business and ethics are viewed as two separate worlds, Yet, sustainable business, (…), is defined by the ability of companies to do repeat transactions with their customers. Customers need to feel that they are treated fairly and honestly.”\(^ {33}\)

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\(^{33}\) Sullivan, J.D. (2009), p.2
The change of the developments and customers expectations regarding ethical behavior in business is a new challenge, for there is no universally agreed and specific definition on “business ethics“ to emphasize. The public reacts with its own mix of religion, cultural background, race, politics, and prevailing situations at any given time. That is also one of the many reasons for the existence of various interpretations on ethics in business.

In 2009, the Group of 8 wealthiest industrial countries\textsuperscript{34}, which are better known as G8 emphasized the movement towards ethics and recommended “… a set of common principles and standards governing international economic and financial activity is an essential foundation for stable global growth”\textsuperscript{35}

Today almost every reputable company, for instance, Pricewaterhouse Coopers\textsuperscript{36} has its own published Business Code of Ethics to emphasize their aim, improve their public image and enforce ethical behavior in society and the observance of ethics in daily corporate life.

“Ethics and moral norms now set a new benchmark for choosing to “do the right thing” in business practices. Corporate scandals of excessive fraud, greed, dishonesty, and bribery have slowly turned the tide so that today corporate codes of ethics are the norm rather than the exception.”\textsuperscript{37}

As the purchasing power in the Islamic market is increasingly growing, which is the result of various causes, the consumers not only demand established products based on the religious beliefs but also prefer that the whole institution to be based on these principles. As a result they tend to keep a distance from the general global movements and expect adjusted products and facilities to be offered on the basis of their own beliefs and requirements.

\textsuperscript{34} G8 countries: Canada, France, Germany, Italy, Japan, the United Kingdom, Russia and the United States
\textsuperscript{35} Donaldson, T. (2000)
\textsuperscript{36} http://www.pwc.com/gx/en/ethics-business-conduct, access April 2011
\textsuperscript{37} Sullivan, J.D. (2009), p. 10
Western financial institutions have recognized the importance of adopting ethical standards while the Islamic Banking principles offered these standards mostly starting from their inception.

3.1 Corporate Governance and Ethics

Just like business ethics, Corporate Governance is also a relatively new concept in mainstream business, it may be described as a framework by which companies are directed and controlled i.e. for the corporate objectives and the supervision of the performance against these objectives. It covers the two main avenues of behavioral subjects (performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders) as well as normative rules (the rules under which firms are operating—including the legal system, the judicial system, financial markets, and factor (labor) markets).

Corporate Governance has been undergoing immense improvements in the past two decades. Attention is growing to observe how it regimes change over time and how this impacts corporations in different countries. Less evidence is available on the direct links between Corporate Governance and social and environmental performance. Expectedly, the range of Corporate Governance subject matters in developing and emerging markets includes those in industrialized countries because of still-limited development of private financial markets as well as their poor access to financing, concentrated ownership structures, and low institutional ownership.

One of the most positive developments in the past two decades has been the shift of non-financial subjects to mainstream elements of business decision-making. The ongoing development and dissemination of better Corporate Governance practices has been improved along with the ongoing integration of global economics. This

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trend seems to be a never-ending development and source of innovation. It should be realized at the same time that the business environment is now building and scaling up from a much higher standard of ethical values and Corporate Governance rules that were not considered even a decade ago.

A McKinsey survey\(^{39}\) of 200 institutional investors controlling over $2 trillion assets in 116 countries in 2002 revealed investors are ready to accept the additional costs of adopting and employing higher Corporate Governance which are estimated at 12-14% in North America and Western Europe, 20-25% in Asia and Latin America. A second McKinsey survey of the world-class corporate managers has revealed that they would favor developing even more ethical practices and more transparency.

The present achievements so far, have placed anti-corruption, sustainability and business ethics practically on the top of the Corporate Governance agenda. Here is where the anti-corruption policies of Corporate Governance and the Muslims need for the observance of Shariah laws overlap very closely. Although their administration seems to be on the basis of obviously different ideologies and value systems however, both intend to enforce the notion of stewardship in business.

As the developments of Corporate Governance became increasingly complex over time, the member countries\(^ {40}\) of the *Organization for Economic Co-operation and Development (OECD)* found that it in their interest to unify their position towards corporate ethics in the late 1990s. The *OECD Principles of Corporate Governance* (see table 1) were endorsed by the respective Ministers in 1999 and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide\(^ {41}\). These principles, which count in both OECD and non-OECD countries, provide specific guidelines for legislative and regulatory initiatives.

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\(^{40}\) OECD members: Austria, Canada, Germany, France, Island, Italy, Spain, Turkey and 26 other countries

\(^{41}\) OECD Principles of Corporate Governance, OECD (2004)
The outlines of these key standards help the regulators to contribute to practices of good corporate governance that make the financial market stable, to promote investment and economic growth.

1. Ensuring the Basis for an Effective Corporate Governance Framework
2. The Rights of Shareholders and Key Ownership Functions
3. The Equitable Treatment of Shareholders
4. The Role of Stakeholders in Corporate Governance
5. Disclosure and Transparency
6. The Responsibilities of the Board

Table 1: OECD Principles of Corporate Governance

In terms of “best” practices particularly the Corporate Governance the OECD has been on the forefront. The ethical codes have affected the Corporate Governance in terms of the appointments of high officials such as board members too. In the area where the role of stakeholders are given due consideration for instance, Switzerland has the highest percentage of independent board members with almost 81% of them appointed by the Ethical Investment Research Service.43

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43 Maier, S. (2005), p. 1
3.2 Synergy of Corporate Governance and Shariah Compliance in Islamic Finance

It has been demonstrated in the recent decades that the Islamic Banking products have stayed more stable compared to other financial products in the market. Such Islamic Banking products are based on relatively stricter ethical approach.

The new moves to improve Corporate Governance came about as a result of lack of investors’ confidence, arising mostly from corporate scandals, but the foundation of Islamic Banking is in the moral principles of Quran and related religious texts.

The design of Corporate Governance model in Islamic Banking has its own features and presents distinct characteristics in comparison with the conventional concepts of banking\(^4\).

<table>
<thead>
<tr>
<th>OECD Principles of Corporate Governance</th>
<th>Islamic Banking principles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensuring the Basis for an Effective Corporate Governance Framework</td>
<td>Establishing <em>Accounting and Auditing Organization for Islamic Financial Institutions</em></td>
</tr>
<tr>
<td>The Rights of Shareholders and Key Ownership Functions</td>
<td>Risk sharing</td>
</tr>
<tr>
<td>The Equitable Treatment of Shareholders</td>
<td>Profit and loss sharing</td>
</tr>
<tr>
<td>The Role of Stakeholders in Corporate Governance</td>
<td>Shariah compliance</td>
</tr>
<tr>
<td>Disclosure and Transparency</td>
<td>Prohibition of <em>gharar</em></td>
</tr>
<tr>
<td>The Responsibilities of the Board</td>
<td>Establishment of an additional board <em>“The Shariah Supervisory Board”</em></td>
</tr>
</tbody>
</table>

Table 2: Parallelism of Corporate Governance and Shariah Compliance

\(^4\) Hassan, Z. (2009), p. 287
In order to ensure that all products are Shariah-compliant, the (Islamic) financial products must not only be approved by a conventional Supervisory Board but also by a *Shariah Supervisory Board* (see chapter 4) or its equivalent authority. This additional board has to monitor if the Islamic Shariah is being observed and to certify every financial product as Shariah-compliant. It is an independent expert committee that decides basically whether a product complies with the Shariah rules or not.

The role of Shariah Supervisory Board (SSB) may be summarized as follows:

1. Certifying permissible financial instruments through *fatwas*;
2. Verifying that transactions comply with issued *fatwas*;
3. Calculating and paying of *zakat*;
4. Disposing of non-Shariah compliant earnings; and
5. Advising on the distribution of income and expenses.

By introducing an external institutional infrastructure with AAOIFI (see chapter 6) it has been tried to establish the market solution however so far it is too early to promote an external Shariah compliance. The interpretation of each expert committee varies due to its choice of scholars and committee members. The lack of standard Shariah banking principles may make a 100% compliance sometimes difficult to achieve.

Some detractors who don’t believe in the concept of Islamic finance criticize among other things the role of a Shariah Supervisory Board and doubt the independency of such a committee due the strong influence of politics and almost no transparency. Also the lack of expert knowledge of the religious authorities who have to give the final approval is an eligible reason for doubting the professionalism if it.

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The different interpretation of Shariah and mainly the standard rules of internal auditing may also make it almost impossible to retain the standards they require at least for unforeseen cases.

There is certainly room for improvement on this matter in order Islamic Banking to be considered a real competition for conventional banking. “The lack of uniformity in the interpretation of some Islamic Banking principles makes it possible that similar operations carried out by Islamic financial institutions may be accepted in one country and rejected in another. It may be useful, therefore, to form a common view on a set of key features characterizing financial institutions operating according to Islamic Banking principles to be used as a benchmark against which they may be compared and contrasted with institutions operating in a conventional or interest-based system.”⁴⁶

⁴⁶ Sundararajan, V. & Errico, L. (2002), p. 20
4. The Fundamental Principles of Islamic Banking

The majority of today’s Islamic financial institutions are represented by Islamic banks, which are spread all over the world. Many companies find out that their long-term stability and security depends on an acceptable growth that would keep their investors also safe. The road to growth may mean globalization and that may well be a strategic way that the Islamic finance industry may adopt for its future in order to be more effective and gain new markets. The ultimate aim of strengthening the international financial architecture\(^{47}\) is to analyze the operations of markets in order to develop benchmarks.

Growing awareness of the extent of the possibilities and the growing interest in more efficient alternatives in the financial markets has been contributing to the growth of the industry.

There are two different approaches to develop a modern Islamic financial product or service. The most common way is to identify an existing conventional product, which is on the markets, and modify it according to the Shariah principles of Islam. This would mean to eliminate all the factors that are incompatible to the principles. The name Islamic Banking implies that all practices under this title and heading are supposed to conform to Shariah rules. The other more complicated approach is to develop a complete new product and/ or service that are based on the principles of Shariah which aims social justice, fairness and equitability in financial transactions,

\(^{47}\) IOSCO (2004), p. 1
so to share rewards as well as losses equally, in a way to welcome the spirit of an adequate banking system.

The modern Islamic banks were formed in the early 20th century to implement the ideas within the Muslim community. The first commercial Islamic bank was *Dubai Islamic Bank*[^48], which opened its doors in 1975. Now United Kingdom is one the most successful countries offering various Islamic Banking products. The Islamic Bank of Britain[^49] is today one of the market leaders, the number of their customers grew up 120% in the year 2005 to 2006 to 30814 and the number of accounts by 200% to 51032. Western banks targeting the Muslim population allow them to act in the value system of Islam by e.g. offering interest free accounts.

Shariah financing forbids the payment or acceptance of interest fees for the lending. It also forbids investing in businesses that provide goods or services that is in contradiction to the Islamic prohibition principles and requires all financial transactions to be based on real economic activity; It strictly prohibits investment in sectors such as alcohol and gambling.

According to the Shariah rules there are clear prohibitions for:

1. All forms of interests - *riba*
2. Uncertainty agreements - *gharar*
3. Gambling - *maisir*
4. All forms of *non-halal*

[^49]: http://www.islamic-bank.com/ - access Feb., 2011
Ad 1. Prohibition of riba

Riba literally means “to grow”, “excess” or “expand” however, not every growth that falls under the category of growth is prohibited in Islam in a categoric way\(^{50}\). *Riba* is defined as an increment, which accrues to the owner in an exchange or sale of a commodity, or by virtue of a loan arrangement, without providing equivalent value to the other party\(^{51}\).

In other words, Shariah promotes the equal sharing of risks and benefits so the two parties enjoy the same transparency of information. Thus, for instance, Shariah does not distinguish between production and consumption loans because both contracts are effectively partnerships between borrower and lender.

The *riba* based financing is the analogy of our today’s modern financial transaction model, the interest-bearing loan. In the conventional interest bearing loans known in Shariah laws as *riba qurudh*, the risk to the income of the lender is covered 100% by the client while his share of risks are not defined, guaranteed or shared.

According to the principles of Shariah, the charging of interest is prohibited while at the same time the earning process of the capital money is being encouraged. The view in the Shariah rules is that when the performance of the investment from the capital money has to be considered before any rate of return could be assumed for the lending process.

The today’s conventional financial system is exactly what the Shariah law prohibits. The concept of *quardh-al hasaneh* financing allows for contracts to be signed between the two parties on the basis of social welfare or other reasons for repayment of the principal in addition to some extra amount as long as it is tied to other business gains in the contract. For trading commodities such as wheat, salt the *riba buyu* allow them to be exchanged against their kind with the same weight, volume or other

\(^{50}\) Ahmad, A. U. F (2010), p. 53
\(^{51}\) IOSCO (2004), p. 6f.
measurements. The aim is that there must be equity between the financier and the debtor.

**Ad 2. Prohibition of activities with elements of gharar:**

Under the term *gharar* the elements of uncertainty or deception are defined on paper in a form corresponding to the object of the contract. It applies to doubtful business deals without adequate information or sharing the risk in case of not succeeding. It is similar to asymmetric information in the agency theory; the objective is to minimize possibilities of cheating, going against *halal* practices, misunderstanding and conflicts between contracting parties\(^52\).

Two examples of such causes are defined below:

1. In terms of commercial transactions it refers to either the uncertainty of the goods or price of the goods, or trying to mislead the buyer or prevent him from getting the required price information.

2. Islamic scholars believe that even the conventional insurance is not compatible with the Shariah. Their solution is that the policyholder should agree to pay a certain sum as premium and in return the insurance company should guarantee to pay a certain amount to be decided in the case of occurrence. This certain amount is not fixed and may vary from case to case.

**Ad 3: Prohibition of speculative deals (gambling, betting) *maisir***

The most paramount principle of Shariah for *halal* laws is simply that the accumulation of wealth without effort is prohibited. Shariah would not allow any capital to earn interest without its owner exerting any effort in one form or another. Therefore speculative deals such as foreign currency speculations, many forms of

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\(^{52}\) Imam, P. & Kpodar, K. (2010), p. 4
stock market of hedging instruments between two or more parties with unclear and undefined intention that might lead to accumulation of wealth without any effort from one side is prohibited in the laws of Shariah. Furthermore it is forbidden for any Muslim to have any interaction, participation, investment or finance any business, which is based on a gambling industry such as casinos. Some investors trend to avoid deals in the stock market because of the speculative nature embedded in many such deals.

**Ad 4: Prohibition of the production and sale of goods and services that are against *halal* according to the Shariah rules**

This includes all the goods and services that are counted as immoral entertainment such as prostitution, pornography and consumption of alcoholic beverages and pork meat as well as some other prohibited animals. This includes also all related activities concluding the process, marketing, supplying and selling of the above goods and services.

As companies and global co-operations become increasingly complex, it has become a real challenge to find pure *halal* investments. Some scholars in the finance industry have proposed a way around this, which is acceptable to Shariah. If a percentage of a business deal is involved with some *haram* activities, the other part that is “tainted” should be donated to charity. To give an example for better understanding: if 5% of the business of a company is deemed to be in activities not compatible with the Shariah laws, 5% of the dividend received should be given to charity.\(^{53}\)

\(^{53}\) Imam, P. & Kpodar, K. (2010), p. 4
4.1 Differences between Islamic Banking and Conventional Banking

The major concept of Islamic Banking and finance appears to be *justice and fairness*, which are enforced fundamentally through the prohibition of interest on risk-free money and sharing of risk depending on the end use of project money between the signatories of finance and banking contracts. The instruments of commercial financing have been based on two principles: the profit-and-loss sharing and the markup principles. The principle of profit-and-loss sharing is unanimously accepted in the Islamic legal and economic literatures as the cornerstone of contractual transactions in finance in an Islamic economy. Stakeholders are supposed to share profits and losses. Furthermore, if any activity may bring any unwanted loss or damage on just one side it has to be avoided.

Basically, in Islamic finance the costly temporary use of assets are avoided through a permanent transfer of funds as a source of borrower indebtedness. In the conventional interest-based banking the project owner needs to come up with strong collateral. Therefore, a strong business plan to depict the end use of financing becomes a second priority for the financiers. Governments, companies and individuals tend to borrow money, not only for genuine development plans but also for ambitions other than development such as politics or prestige. Looking at the subject in this light, Islamic financing promotes genuine development plans much stronger than conventional interest-based financing. This analogy clarifies the basic difference between conventional financing and Islamic financing as far as the concept of development is concerned. In its Islamic sense, such financing would therefore address more profoundly the development of humanity, poverty, inequality, ignorance and ethnicity.

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54 Yousef, T. (1996), p. 3
The Fundamental Principles of Islamic Banking

which are typical problems in the developing countries⁵⁶. According to an IMF paper of 2010⁵⁷ the Islamic banks have performed better in terms of stability and losses than the conventional banks during the recent global crisis after 2008 in Europe and the US, i.e. the Islamic banking sector remain relatively calm and prosperous. This sector was able to show stronger resilience and met a high demand for credit. But what are the main differences between conventional banks and Islamic banks that the latter could perform so well?

Generally, Islamic banks have the same role as other conventional banks but they are governed in their operations simply by the religious rules of Shariah. They contribute to information production, with reduced transaction cost and help address the asymmetric information problem. They serve their offers to a wide range of customers, the small savers as well as the big investors. “They [Islamic banks] operate mostly in developing economies where financial markets are characterized by high degrees of imperfect information and rent-seeking behavior”⁵⁸.

The conventional banks are mainly based on debt and finance, with high risk performance, while the Islamic intermediation is based on sharing the deal with their investors and clients equally. As a result the investment is structured on exchanging assets. Therefore compared to conventional banking, the Islamic banks get much closer to the real economy.

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Table 3 above compares how risk is shared between the two banking systems. In the Islamic banks the investment is almost not connected to any risk of loss, but to a proposed economic activity. Like conventional banking (CB) the Islamic Banking (IB) must deal with market risks and credit issues. IB activities cause problems and risks of liquidity, operational, strategic and other types of risks. Interest rate risks are very limited but access to hedging instruments is almost non-available in Islamic Banking. Given the limited capacity of many IBs to attract Pension and Saving Investments the return on such investments is uncertain. Additionally the infrastructure and the tools for liquidity risk management by IBs are still in its infancy in many jurisdictions. Therefore managing liquidity is a bigger challenge in the IBs. Limited tools for making use of this liquidity prevent Islamic banks from operating at a level playing field with conventional banks although they usually maintain higher type of liquidity buffers to address this risk.

The major differences between the two systems are listed in the table next page:

<table>
<thead>
<tr>
<th>IBs Risk Sharing</th>
<th>CBs Risk Transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sources of funds:</strong> Investors (profit sharing investment account (PSIA) holders) share the risk and return with IBs (Box 1). The return on PSIA is not guaranteed and depends on the bank’s performance.</td>
<td><strong>Sources of funds:</strong> Depositors transfer the risk to the CB, which guarantees a pre-specified return.</td>
</tr>
<tr>
<td><strong>Uses of funds:</strong> IBs share the risk in Mudharabah and Musharakah contracts and conduct sales contracts in most other contracts (see Appendix I for a discussion of the sources and uses of funds for IBs).</td>
<td><strong>Uses of funds:</strong> Borrowers are required to pay interest independent of the return on their project. CBs transfer the risk through securitization or credit default swaps. Financing is debt-based.</td>
</tr>
</tbody>
</table>

Table 3: Risk Sharing / Transfer, executed differently in Islamic Banking vs. Conventional banking
The Fundamental Principles of Islamic Banking

<table>
<thead>
<tr>
<th>Conventional Banks</th>
<th>Islamic Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The functions and operating modes of conventional banks are based on fully business principles.</td>
<td>1. The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah.</td>
</tr>
<tr>
<td>2. The investor is assured of a predetermined rate of interest.</td>
<td>2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).</td>
</tr>
<tr>
<td>3. CB aim at maximizing profit without any restriction.</td>
<td>3. IBs also aim at maximizing profit but subject to Shariah restrictions.</td>
</tr>
<tr>
<td>4. CBs do not deal with zakat.</td>
<td>4. In the modern Islamic Banking system, it has become one of the service-oriented functions of the Islamic banks to be a zakat Collection Centre and they also pay out their zakat.</td>
</tr>
<tr>
<td>5. Lending money and getting it back with compounding interest is the fundamental function of the conventional banks.</td>
<td>5. Participation in partnership business is the fundamental function of the Islamic banks. So they have to understand their customer’s business very well.</td>
</tr>
<tr>
<td>6. It can charge additional money (penalty and compounded interest) in case of defaulters.</td>
<td>6. The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds are given to charity, rebates are given for early settlement at the Bank’s discretion.</td>
</tr>
<tr>
<td>7. CBs become big generally as a result of the interest income it accumulates. Aside from fiduciary and credit-provider functions, it makes no effort to provide clients growth with equity.</td>
<td>7. IBs give due importance to the public interest. Their ultimate aim is to ensure growth with equity.</td>
</tr>
<tr>
<td>8. For interest-based commercial banks, borrowing from the money market is relatively easier.</td>
<td>8. For the Islamic banks, borrowing from commercial banks must be based on a Shariah approved underlying transaction.</td>
</tr>
<tr>
<td>10. The conventional banks give greater emphasis on credit-worthiness of the clients.</td>
<td>10. The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.</td>
</tr>
<tr>
<td>11. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.</td>
<td>11. The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller.</td>
</tr>
<tr>
<td>12. A conventional bank has to guarantee all its deposits.</td>
<td>12. Islamic bank can only guarantee deposits for deposit account, which is based on the principle of al-wadiah, thus the depositors are guaranteed repayment of their funds, however if the account is based on the mudarabah concept, clients have to share in a loss position.</td>
</tr>
</tbody>
</table>

Table 4: Differences between Conventional Banks and Islamic Banks

The Islamic financial system broadly refers to financial market transactions; operations and services that are not based on *riba* (interest on capital) and comply with Islamic rules, principles and codes of practice\(^{60}\). As the industry grew, there were many developments for new Islamic- Shariah compliance rules such as in equity, debt, brokering investment and advisory services, etc. Similar to conventional equity standard products the Shariah equity financing is based on profit sharing but only under the legitimacy of Shariah rules.

The following few products, explained briefly, are the most common products on the market, which are widely used for banking, capital markets and insurance sectors.

a. *Mudharabah* (Profit-sharing or also known as *muqaradah*):

This is an option for someone with a certain capital who wants to invest in a project without getting involved in the management of that investment. His only liabilities would be the amount of his commitment. On the other hand, let us assume there is an entrepreneur who is also responsible for the same project. While the entrepreneur is working and managing the project the capital provider may not claim a fixed profit and a guaranteed return on his/her invested capital. The two parties have to agree on a profit sharing scheme such as a ratio for the event that the project becomes profitable. In case of project failure it should be only the capital provider who loses capital as the entrepreneur may not be held responsible unless for cases of negligence or mishandling.

\(^{60}\) IOSCO (2008), p. 5
The principle of *Mudharabah* can be applied to Islamic Banking operations in 2 ways\(^6\): between a bank (as the entrepreneur) and the capital provider, and between a bank (as capital provider) and the entrepreneur.

1) You supply funds to the bank after agreeing on the terms of the *Mudharabah* arrangement.

2) Bank invests funds in assets or in projects. The bank’s participation ensures an orderly review of the project feasibility and viability according to the rules of Shariah, also in the eyes of an independent third party. The bank provides the entrepreneurial expertise in determining which assets or projects would be profitable. The exposure to the type of asset or project involved lessens the risk for the investor.

3) Business may make profit or incur loss.

4) Profit is shared between you and your bank based on a pre-agreed formula.

5) Any loss will be borne by you as the capital provider.

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\(^6\) Bank Negara Malaysia (2009)
This will reduce the value of the assets/investments and hence, the amount of funds you have supplied to the bank.

b. *Musharakah* (Profit and Loss Sharing)

Almost just like the conventional Joint Ventures the entrepreneur and the investor have to contribute some capital at different stages and agree in advance to share the profit and the loss and the risks together. The input of the capital can be assets, working capital, technical expertise and anything else that provides a business to start.

c. *Murabahah* (Trade with mark up or cost-plus sale)

For short term financing there is a popular market in purchase financing. The buyer has in this case knowledge about the price of the financing object, and agrees with the financier to pay a premium over the price to him. All the costs and profits (mark up) of such financing projects are made open to the customer who would agree to pay the mark up in cash, at once or in installments according to the contract between the two parties.

d. *Ajil* (deferred-payment sale)

This product is almost the same as *murahabah* with the difference that it is used for longer term financing. Here, the seller may withhold the information about his profit margins, which he has embedded in his contract-selling price. The financier agrees to purchase the asset required by the buyer and resell it to the buyer according to their contract.
e. **Bai’al salam** (Advance purchase)

This is a sale and purchase transaction with deferred delivery. The buyer pays in cash at the time of signing the contract but the asset, which is purchased, will be set to be delivered in a future date according to the contract between the two parties.

f. **Istisna’** (Exceptional cases, Purchase order)

*Istisna* is similar to *Bai’al salam* with same variations whereby the seller manufactures or constructs a specific good according to the given needs in the agreement. Normally it covers those goods that should be usually made/manufactured/prepared/customized and may or may not need pre-payment. Payments in that case is flexible and can be agreed between the parties according to their requirements.

g. **Ijarah** (Lease financing)

The leasor leases out an asset or good, normally used in financing consumer goods especially motor vehicles just like in conventional financing, to the client at an agreed rental fee for a pre-determined period. The owner of the asset (the bank) bears all risks associated with ownership. As such the assets that are covered by this type of leasing could be sold as lease contract. A variant of *Ijarah* contract is like Lease-Purchase Agreement whereby each installment would contribute a certain amount to the other buying options of the agreed asset price. As such, it can be used to diversify products so that companies and individuals could have flexible options for their decision-making, negotiations and planning. A big advantage of this option is that it would not add up to the lease’s liability balance sheet as a form of liability.
These are only some of the most common products in Islamic finance. The scholars have found their way to offer products that are needed for retail and corporate applications that are Shariah compliant but in practice it is very difficult to actually produce each of these products. Each product that is spread out in the market needs to be approved by the Shariah board, which turns out sometimes a difficult thing to do. The question of which and what option is indeed according to Shariah laws seems sometimes a subject of interpretation, therefore it may vary from bank to bank.
5. Emerging Markets: Turkey and Egypt

The following chapters discuss what emerging markets in general are, why are Turkey and Egypt selected as particular countries and finally highlighting possibilities for future developments.

The discussions for each of the two countries cover:

a. General overview of the economic conditions of the two countries,

b. A brief discussion of their financial and banking systems and

c. A comparative analysis of Islamic Banking vis-à-vis their total banking sector.

The general overview includes brief discussion of the country’s current economy, banking, and key areas for development. The OECD studies were used for the overview of economic conditions as these compilations provide the most comprehensive information on the subject.

The second part discusses the role of the financial and banking system, a brief background of its economic development, and the current economic conditions. Sources for this part, included information gathered from Turkey’s and Egypt’s central monetary authority’s financial reports as well as publications from reputable international organizations such as IMF, Standards & Poor’s (S&P) and Moody’s.

In the third part, comparative analyses were used to determine how Islamic Banking contributes to total banking. Important key financial indicators were also studied to determine how relevant Islamic bank is in the context of total financial services of the two countries. For this part, bank annual reports were utilized as well as publications
Emerging Markets: Turkey and Egypt

from banking associations, government regulatory agencies and the central banking authorities.

5.1 What are Emerging Markets?

Following the World Bank classifications, there are six main types of countries:

1. Main industrial nations such as the countries of Europe, North America and Japan.
2. Smaller industrial countries such Australia and New Zealand.
3. Countries in transition such as those under the former Comecon.
4. Newly industrialized countries.
5. Less developed countries.
6. Emerging markets, which are countries where there is a great deal of incentive and interest to invest.

The classification for countries is not straightforward since some countries may belong to more than one category at the same time. Even by today there are various definitions on emerging markets due to the dynamic nature of any “emerging” activity. Banks normally use GDP per capita as a measurement for defining the markets but also the concepts of OECD/ non-OECD countries are widely used. Other important classifications criteria are the level of budget deficit, level of inflation, the rate of GDP growth, political status and economic performance, income level by World Bank definition, etc.

Geographically, the term emerging markets usually refer to some countries in Asia, Middle East, Latin America, Central Europe and Africa. Standard & Poor’s currently

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Emerging Markets: Turkey and Egypt

classifies 19 countries as emerging market, whereas Dow Jones counts some 22 countries as “emerging countries”. The distribution of Muslims distribution is shown in the graph below.

Graph 3: Distribution of Muslim population

The defined emerging markets countries have started to grow but have not reached yet a mature stage of development. They differ widely among themselves therefore there is no typical list of criteria among them. They have a significant potential for economic or political instability. Though, on the one hand they have is a high potential for growth, there are still market problems due to high risk factor. The rapid developments and changes in the countries are therefore becoming more and more interesting. In 2005 more than half of the increase of the global GDP were accounted from these markets. It is easy to obtain the necessary market information in these countries and the economics of scale is reached relatively easy along with other interesting factors for investment in these countries.

The two factors of political instability and possible under-developed infrastructure might be negative points for investors.

Advantages and Disadvantages of Emerging Markets may be summarized as follows:

63 Brazil, China, Egypt, India, Russia, Turkey and 13 other countries
64 Besides the S&P defined countries also Argentina, Columbia, South Korea
Advantages of Emerging Markets:\(^{65}\):

- Opportunity for more rapid market expansion: while the majority of the industrial countries experienced some level of recession, developing countries provided for almost three quarters of the increase in world exports.

- The developing economies shift toward the private sector: growth in the individual incomes of emerging population will create greater demand for importation of increasingly sophisticated customer products and services.

- Lower levels of competition: Along with increased rates of growth, new markets typically provide a less intense competitive environment than most of the developed international markets. The risk of having other well-established foreign competitors is much less.

- Less expense in reaching potential customers e.g. cheaper advertising costs: in industrial countries there are high costs associated to apply modern technologies and expensive media to gain customers attention in a rather saturated market. In the less sophisticated emerging countries a simple billboard advertisement would raise awareness and attention.

Disadvantages of Emerging Markets:

- Local companies frequently have long-standing political connections that can further complicate market entry by outsiders.

- Political and economic instability may produce high shifts in market.

Before other universal banks enter the market in the emerging economies domestic banks should use the opportunity to expand their branches and products with rapid investments. Many of the financial services and products are poorly available or not available for a small but wealthy and/or better-than-average population, while by

capturing the attention of population the middle class and lower class would develop rapidly.

As far as emerging markets are concerned, the most important success factor in Islamic Banking is the sensitivity of local culture and religion. Banking business needs communications that are received, understood and returned with goodwill on the promise of respecting the Islamic laws (Shariah). In order to stay competitive one has to offer products not only at reasonable prices but also tailor products to meet cultural and in Muslim countries religious customer needs based on their economical circumstances.

5.1.1 The Rationale for Choosing Turkey and Egypt

This study focuses on Turkey and Egypt, two predominantly Muslim countries representing Eurasian and North African regions with rich cultural and mercantile heritage. In terms of Shariah-complaint asset per capita these regions have been developing at relatively slower rate than their counterparts in the Gulf Cooperation Council (GCC) and Asian regions. Egypt and Turkey both are in the Top 10 countries by Shariah-compliant assets, the list includes Brunei, a country with only a quarter of a million Muslim population and United Kingdom where the Muslim minority numbers approximately 1.64 million. Additionally, it would be of significant economic value to promote Islamic Banking in Turkey and Egypt for the following reasons:

(1) Turkey is uniquely positioned in the crossroads Central Asia and Europe. It is also one of the more dynamic Islamic countries in the world outside the Gulf Cooperation Council (GCC) but its growth potential in Islamic Banking has not been fully explored yet. “The greatest potential for Islamic finance in Europe is

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66 Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
undoubtedly in Turkey where Islamic Banking has been established since 1980s although it remains on the fringes of the financial system, accounting for less than five percent of deposits, and where opinion on the merits of Islamic Banking is politicized67. Its nearest neighbors in Europe and Central Asia (Kazakhstan, Azerbaijan, Uzbekistan, Turkmenistan, Kyrgyzstan and Tajikistan) have approximately 38.112 million and 59.395 million Muslim populations68, mostly untapped market for banking products. 

(2) Egypt pioneered Islamic Banking in the modern age but was not able to sustain it. The first modern Islamic bank was established in 1963 in Egypt by adapting some ideas from German Saving Bank. However within the general framework of Shariah rules it started successfully with the principle of rural banking. However in 1967 these operations were taken over by the National Bank of Egypt and were shut down. Three more Islamic banks were established in the 1970s. By 2010, however, only two banks remained.

The fact that Egypt and Turkey have been chosen as a particular countries in this thesis means mainly that the Islamic Banking product proposed in this thesis seems to be easily applicable in these countries. The other countries on the list (see table 5) either had initiated Islamic Banking already (Iran, Malaysia), or had been well serviced by conventional banks, or their GDP per capita are indeed too low to begin with (Pakistan, Bangladesh). In the retail segment, rural and low-income cross sections of emerging markets comprised the bulk of population doing practically without bank services. The main reason for the majority of population doing without bank services may well be that their life style is still backward and old-fashioned, however it seems that a banking system on the basis of interest on money (riba) does not interest the largely religious and traditional society in such countries. While on an individual project basis it may not look profitable at first, substantial income potential could be derived from this segment with their economy of scale.

67 Wilson, R. (2007), p. 18
68 Pew Research Center (2009), p. 27
The Islamic banks and Islamic financing are at a unique position to facilitate economic growth on the basis of Islamic beliefs of the local population in the emerging markets.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Shariah-Compliant Assets SCA (US $ Million)</th>
<th>Population</th>
<th>% Muslim</th>
<th>Muslim Population</th>
<th>GDP Per Capita (US $)</th>
<th>GDP (US$ Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Iran</td>
<td>154,626.28</td>
<td>65,397,521</td>
<td>98.00%</td>
<td>64,089,571</td>
<td>3,435</td>
<td>225</td>
</tr>
<tr>
<td>2</td>
<td>Saudi Arabia</td>
<td>69,379.15</td>
<td>27,601,038</td>
<td>89.00%</td>
<td>24,564,924</td>
<td>13,184</td>
<td>364</td>
</tr>
<tr>
<td>3</td>
<td>Malaysia</td>
<td>65,083.37</td>
<td>24,821,286</td>
<td>60.40%</td>
<td>14,992,057</td>
<td>5,897</td>
<td>146</td>
</tr>
<tr>
<td>4</td>
<td>Kuwait</td>
<td>37,684.47</td>
<td>2,505,559</td>
<td>80.00%</td>
<td>2,004,447</td>
<td>29,081</td>
<td>73</td>
</tr>
<tr>
<td>5</td>
<td>UAE</td>
<td>35,354.36</td>
<td>4,444,011</td>
<td>67.00%</td>
<td>2,977,487</td>
<td>34,842</td>
<td>155</td>
</tr>
<tr>
<td>6</td>
<td>Brunei</td>
<td>31,535.19</td>
<td>374,577</td>
<td>64.00%</td>
<td>239,729</td>
<td>32,501</td>
<td>12</td>
</tr>
<tr>
<td>7</td>
<td>Bahrain</td>
<td>26,251.86</td>
<td>708,573</td>
<td>85.00%</td>
<td>602,287</td>
<td>20,348</td>
<td>14</td>
</tr>
<tr>
<td>8</td>
<td>Pakistan</td>
<td>15,918.21</td>
<td>164,741,924</td>
<td>97.00%</td>
<td>159,799,666</td>
<td>788</td>
<td>130</td>
</tr>
<tr>
<td>9</td>
<td>Lebanon</td>
<td>14,315.82</td>
<td>3,826,018</td>
<td>57.00%</td>
<td>2,180,830</td>
<td>5,833</td>
<td>22</td>
</tr>
<tr>
<td>10</td>
<td>UK</td>
<td>10,420.47</td>
<td>60,776,238</td>
<td>2.70%</td>
<td>1,640,958</td>
<td>41,608</td>
<td>2,529</td>
</tr>
<tr>
<td>11</td>
<td>Turkey</td>
<td>10,065.96</td>
<td>71,158,647</td>
<td>99.00%</td>
<td>70,447,061</td>
<td>5,843</td>
<td>416</td>
</tr>
<tr>
<td>12</td>
<td>Qatar</td>
<td>9,459.71</td>
<td>907,229</td>
<td>77.50%</td>
<td>703,102</td>
<td>54,077</td>
<td>49</td>
</tr>
<tr>
<td>13</td>
<td>Bangladesh</td>
<td>4,331.90</td>
<td>150,448,339</td>
<td>89.00%</td>
<td>133,899,022</td>
<td>458</td>
<td>69</td>
</tr>
<tr>
<td>14</td>
<td>Egypt</td>
<td>3,852.86</td>
<td>80,335,036</td>
<td>92.00%</td>
<td>73,908,233</td>
<td>1,444</td>
<td>116</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>488,279.61</strong></td>
<td><strong>658,045,996</strong></td>
<td></td>
<td></td>
<td><strong>552,049,375</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Table 5: Comparative Shariah Asset vs. Muslim Population in Top Islamic Countries**

Table 5\(^{69}\) shows the range of the main factors influencing the potential Islamic Banking industry in some 14 Muslim countries. The United Kingdom has been

\(^{69}\) Consolidated information from *The Banker (2007)* and *Moody's Global Banking (2008)*
included in this table mainly because its Muslim population have strong ethnic roots in the Asian and African countries, and UK Muslims are believed to be more informed and more active in Islamic Banking, and that is a good reason why the UK is in a pioneering position in IB.

5.2 Turkey

5.2.1 General Overview of Economic Condition

In its 2011 Regional Outlook Report\textsuperscript{70}, OECD noted that Turkey’s economy is more concentrated in small population centers than OECD countries on the average. By the OECD classification the Turkish “TL3” rural territories produced more than half of the national output compared to 38% on the average in OECD countries. Inequality in GDP per capita among Turkey’s larger (urban) “TL2” territories fluctuated from early to mid 1990s but gradually declined to its lowest level in 1999. In 1999-2000 inequality increased again and from 2000-01 it declined. Notwithstanding the decline, Turkey’s level of inequality in GDP remains one of the highest among OECD countries.

OECD identified key challenges for Turkey as two-fold: intra-country disparities across rural and urban areas; and disparity between Turkey vs. EU-member countries. To address these, it recommends that the objectives of regional policy should be effective at the central level, ensure development based on local dynamics and internal potential, increase institutional capacity at the local level and most importantly, ensure development in rural areas.

\textsuperscript{70} OECD Regional Outlook (2011), p. 288-289
It appears that Islamic Banking products and services may well improve development in general and finance in particular if the country moves towards the following\textsuperscript{71}:

- Job creation in the high productivity, modern sector should be fostered through decisive labor market reforms
- Target human capital building and up skilling
- Normalization of policy interest rates should start before the end of 2010
- Budget deficits need to be reduced
- Increase savings
- Improve structure of capital inflow
- Reduce energy dependency

\subsection*{5.2.2 Financial System}

Turkey’s \textit{Medium-Term Program} (MTP) has indicated relatively fast-expected recovery in economic growth and noted that the prevailing fiscal discipline would continue from its 2001-2002 financial crisis. The outlook for its economy is favorable after considering the stability of its financial system, the favorable ratings of credit rating agencies, and also risk premium indicators which are below the pre-crisis levels. Firms and household loans have increased, and along with stimulated demand for consumption, the economy is growing fueled mostly by domestic demand. As a result, there is an increase in the debt ratio of both households and firms. It is critical for Turkey to carefully monitor its short and long-term capital flows as well as current account indicators to sustain its financial stability.

\textsuperscript{71} OECD Economic Surveys: Turkey (2010), p. 10f.
5.2.3 Banking in General and Islamic Banking in Turkey

Turkey suffered one of its worst economic crises in 2001. The crisis was caused in part by the weak and loosely regulated banking sector.

As of 2008, there are a total of 48 banks in Turkey\(^{72}\) classified as follows:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Number Of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Investment Banks</td>
<td>4</td>
</tr>
<tr>
<td>Banks under management of Sustainable Development Innovations Fund (SDIF)</td>
<td>2</td>
</tr>
<tr>
<td>Private Investment Banks</td>
<td>5</td>
</tr>
<tr>
<td>Foreign Investment Banks Established in Turkey</td>
<td>4</td>
</tr>
<tr>
<td>Public Commercial Banks</td>
<td>3</td>
</tr>
<tr>
<td>Private Commercial Banks</td>
<td>10</td>
</tr>
<tr>
<td>Foreign Commercial Banks Established in Turkey</td>
<td>10</td>
</tr>
<tr>
<td>Branches of Foreign Banks Established Outside of Turkey</td>
<td>6</td>
</tr>
<tr>
<td>Participation (Islamic) Banks</td>
<td>4</td>
</tr>
</tbody>
</table>

Table 6: Quantity of different Banks in Turkey

Note: In Turkey, commercial banks are not allowed to have Islamic windows, while Islamic banks are not allowed to accept deposits, and the development and investment banks are not allowed to issue deposit and participation certificates.

\(^{72}\) Banking Regulation and Supervision Agency (2010), p. 16
After the 2001 crisis, the banking sector rebounded with rapid growth for the period 2002-2008. Total assets grew by more than 3 times from $130 billion to $465 billion. This resulted to a bank asset to total GDP ratio increase from 57% to 77%. There were also rapid increase in the number of branches and personnel.

In addition, the risk management systems improved and public supervision became more effective in this period. The positive developments recorded by the banking system in 2002-2008 period have several reasons, including the favorable domestic and international economic situation and the changes in the risk management conception.

Another important reason is the success of the “Banking Restructuring Program”73. Compared to international banks, Turkish banks had very strong financials and profits in previous years. However it became more difficult to observe deposits because the interest rates were falling. It will be still a growth period for the Islamic banks, and they have a major advantage on real sector businesses, but it is necessary for them improve their investment products.

Currently there are only 4 Participation (or Islamic) Banks in Turkey:

(1) ALBARAKA TÜRK KATILIM BANKASI A.Ş.;
(2) ASYA KATILIM BANKASI A.Ş.;
(3) KUVEYT TÜRK KATILIM BANKASI A.Ş.; and
(4) TÜRKİYE FİNANS KATILIM BANKASI A.Ş.

These banks’ assets represent only 4% of Turkey’s total assets as shown in the graph next page:

73 The Bank Association of Turkey (2009), p. 5f.
5.2.4 Islamic Banking Performance in Assets and Ability to serve customers

A. Financial Analysis of Asset Performance

Islamic banks have been consistently increasing their share of the banking market as disclosed by the following table. An asset growth analysis has been conducted (in TRY Million):

<table>
<thead>
<tr>
<th>Year</th>
<th>Islamic Banks Assets</th>
<th>% Inc.-IB</th>
<th>Total Banking Assets</th>
<th>% Inc.-CB</th>
<th>% Share Islamic Banks vs. Total Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>2,266</td>
<td></td>
<td>106,549</td>
<td></td>
<td>2.13%</td>
</tr>
<tr>
<td>2001</td>
<td>2,365</td>
<td>4.37%</td>
<td>218,873</td>
<td>105.42%</td>
<td>1.08%</td>
</tr>
<tr>
<td>2002</td>
<td>3,962</td>
<td>67.53%</td>
<td>216,637</td>
<td>-1.02%</td>
<td>1.83%</td>
</tr>
<tr>
<td>2003</td>
<td>5,113</td>
<td>29.05%</td>
<td>254,863</td>
<td>17.65%</td>
<td>2.01%</td>
</tr>
</tbody>
</table>

74 The Bank Association of Turkey (2009), p. 7
75 The Participation Bank Association of Turkey (2010), p. 35
Islamic Banking consistently stands out in performance among banks in Turkey for the period 2000-2010. As a sector, it has out-performed its conventional banking counterparts. If the average annual rate of increase in market share for the past 9 years (post-2001 crisis) remains consistent at the rate of 11.45% for the next 5 years, the IB market share is expected to reach 7.41% by 2015. The average annual growth rate for the past 11 years (2000-2010) has been better than those of the total banking (TB) sector. It is noticeable that in the years of crisis (2001 and 2008), succeeding % increase in the total banking sector showed significant decline. In 2002, there was a decline of 1.02% while in 2009 the % increase was almost only half of the previous year, and was also the least in the years after 2001. In contrast, IB showed phenomenal rate of increase of 67.53% in 2002 while the increase in 2009 was only 5% below the average for the 11-year period. This is an indication that IBs are more resilient than their conventional counterparts, and able to withstand crisis.

<table>
<thead>
<tr>
<th>Year</th>
<th>Islamic Banks</th>
<th>Total Banking</th>
<th>IB Market Share</th>
<th>TB Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>7,299</td>
<td>313,751</td>
<td>23.11%</td>
<td>2.33%</td>
</tr>
<tr>
<td>2005</td>
<td>9,945</td>
<td>406,915</td>
<td>29.69%</td>
<td>2.44%</td>
</tr>
<tr>
<td>2006</td>
<td>13,730</td>
<td>498,587</td>
<td>22.53%</td>
<td>2.75%</td>
</tr>
<tr>
<td>2007</td>
<td>19,435</td>
<td>580,607</td>
<td>16.45%</td>
<td>3.35%</td>
</tr>
<tr>
<td>2008</td>
<td>25,769</td>
<td>731,640</td>
<td>26.01%</td>
<td>3.52%</td>
</tr>
<tr>
<td>2009</td>
<td>33,628</td>
<td>833,968</td>
<td>13.99%</td>
<td>4.03%</td>
</tr>
<tr>
<td>2010</td>
<td>43,423</td>
<td>1,007,031</td>
<td>20.75%</td>
<td>4.31%</td>
</tr>
</tbody>
</table>

Average 35.18% 27.46%

Table 7: Comparative Asset Growth/Market Share - Islamic Banks vs. Total Banking Sector in Turkey
B. Ability to Service Clients by Total Banking Sector (TS) and IBs

<table>
<thead>
<tr>
<th>Indicator</th>
<th>20005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>TS</td>
<td>IB</td>
<td>TS</td>
<td>IB</td>
<td>TS</td>
</tr>
<tr>
<td>Number of Branches</td>
<td>6,568</td>
<td>292</td>
<td>7,302</td>
<td>356</td>
<td>8,122</td>
</tr>
<tr>
<td>Number of Personnel</td>
<td>138,724</td>
<td>5,747</td>
<td>150,966</td>
<td>7,112</td>
<td>167,760</td>
</tr>
</tbody>
</table>

Table 8: Ability to Service Customer, Turkey

With a Muslim population of about 70 million, there are approximately 13-14 branches for every 100,000 people, and 263 bank personnel for every 100,000 people. By way of contrast, France (population: 64 Million) has an average of 61 branches and 594 bank personnel per 100,000 people, or 4 ½ times and more than twice as much branches and bank personnel, respectively. This comparison indicates the potential for the growth in Banking industry in Turkey where more than 50% of the GDP is produced in rural areas (OECD TL3 regions), where banking services are not available sufficiently like in urban areas. It gives an indication of how effectively the banking system is able to serve the population.

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<table>
<thead>
<tr>
<th>Particulars</th>
<th>Turkey</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Branches per 100,000 population</td>
<td>14</td>
<td>61</td>
</tr>
<tr>
<td>No. of Bank Personnel per 100,000 population</td>
<td>263</td>
<td>594</td>
</tr>
</tbody>
</table>

Table 9: Comparative Number of Branches/Personnel per 100,000 population, Turkey vs. France

“Because Islamic banks are excluded from competing with other banks for public sector operations, their impact is better assessed by examining their contribution to private sector operations. (…) They are expected to favor small entrepreneurs who do not have access to credit in the conventional banking system and to extend their links to rural regions that are often cut-off from formal access to urban financial markets.”

(ii) IBs have been increasing their branches at the rate of 18.41% per year, this is almost double the rate of increase in the total banking sector of 9.98%. As of 2009, 5.94% of bank branches in Turkey were IBs, compared with 4.45% in 2006. IB’s share has been increasing steadily.

(iii) IB personnel have been increasing at an annual average rate of 20%, which is more than double the rate of increase for the total banking sector of only 7.42%. Taken together with the increase in number of branches and the significant asset growth, this indicates a growing influence of IB in financial sector and most probably, a growing awareness by the population as well.

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77 Yousef, T. (1996), p. 6
5.3 Egypt

5.3.1 General Overview of Economic Condition

The IMF recommended Egyptian authorities for sound macroeconomic management and economic reforms in 2007. The achievements because of fiscal adjustments privatization in financial sector reform have increased market confidence and boosted investment, thereby helping to sustain economic growth. They noted an increasingly broad-based growth contributing to substantial reduction in unemployment. However the important challenges remain in particular, high budget deficit, low-level financial intermediation and barriers to private sector activity. The slow trickle-down of the benefits of economic growth could weaken public support for the reform effort.

As a result the authorities’ committed to reduce the fiscal deficit to 3 percent of GDP by fiscal year 2010/11. This would contribute greatly to further improve the economy. They also viewed the fiscal adjustment made in 2006 favorably, which included tax administration and public finance management, and the reduction of fuel subsidies such as further reduction of fuel subsidies, provisions for safety nets to protect the less privileged, rationalized social spending, value added tax reform, wage bill containment and the broadening of the tax base. The IMF signified their support in the efforts of the central bank to strengthen monetary policies, and its pragmatic approach in controlling inflation but is still waiting for more reforms. In terms of banking to complete bank recapitalization, enhancing the monitoring of state banks, and undertaking complementary regulatory and judicial reforms is necessary in order to maintain any possible growth. Some of them also called for gradual privatization of state-owned insurance companies in line with the government policy of broadening private sector participation in the financial sector\(^7\).

\(^7\) IMF Country Report No. 07/380 (2007)
5.3.2 Financial System

Egypt implemented financial services reform program in 2004, which involved privatization, restructuring of state-owned banks, strengthening of central bank supervision, reduction of non-performing loans, and bank consolidation. The latter has resulted in the consolidation of 39 banks as of mid-2009 from 57 in 2004.

The reform program was mainly in reaction to the poor access to finance by both individuals and business, compared with Egypt’s peers in the Persian Gulf and other emerging markets. There were limited financial services options and growth in banking was hampered by constraints in regulation, capital control, and inadequate monetary policies.

The reform program, together with Unified Banking Law of 2004 resulted in deep changes over the last few years.

OECD, for its part, has recommended further improvements in the following areas:

(i) a universally applicable law on collaterals;
(ii) privatization and entry of foreign banks to increase competition;
(iii) expansion of the banking sector;
(iv) regulation on related party lending;
(v) reforms in the 4 public sector banks, and
(vi) development of automated credit risk information system (CRIS).

In terms of mortgage products, Egypt banks are still lagging behind their western counterparts. Foreigners cannot yet obtain mortgage for property. Once the new mortgage law is enacted, it is expected to open up the market for the future competition. This will open up the market considerably and create a storm of development and real estate activity in the near future.
Another problem is the very low accessibility of branches and *Automated Telling Machine’s* (ATM) especially in the rural areas. Only 10% of Egypt’s populations have a bank account and even lesser use payment cards. This hampers the general access to financial instruments. Even state-owned banks are mostly concentrated in urban areas.

### 5.3.3 Banking in General and Islamic Banking in Egypt

In their *Doing Business 2007* report, IMF noted important reforms in the banking system that included joint-venture banks and privatization of the fourth-largest state bank. This has resulted into a sounder banking and financial system and has also started modernizing the insurance and capital markets sectors. Egypt’s banking system has undergone major reforms since the 1990s and today it is faced with a liberalized and modernized system, which is supervised and regulated according to internationally, accepted standards.

The banking system comprises 57 state owned commercial banks which include 28 commercial banks, of which 4 are fully state-owned, 26 investment banks (11 joint venture banks and 15 branches of foreign banks), and 3 specialized banks. Although private and joint venture banks are growing, many remain relatively small with few branch networks.

The *Central Bank of Egypt (CBE)* has improved the Egyptian banking systems in the following ways\(^7^9\):

1. Introduction of laws giving more independence to the CBE, and an electronic signature law.
2. Regulation of connected and related party lending.

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\(^7^9\) Nasr, S. (2008), p. 21
3. Management reforms of the four public sector banks, making clear the responsibilities of managers and boards of directors.

4. Development of an automated credit risk information system (CRIS), from which participants would be able to gain online access to clients' credit profiles.

State-owned banks have the most balanced branch network overall, though their presence is still greater in urban than rural areas. Except for state-owned banks, branch and ATM network in Egypt remain low, with ATM coverage estimated at only one-seventh of a typical developing country. Only 10% of the population is estimated to be using a bank account. This lack of banking facility is especially acute in rural areas.

5.3.4 Islamic Banking Performance in Assets and Ability to serve customers

A. Financial Analysis of Asset Performance

There are only currently 2 Islamic banks in Egypt, Faisal Islamic Bank of Egypt and Al Baraka Islamic Bank Egypt (formerly Egyptian Saudi Finance Bank). Al Baraka Bank Egypt was established in 1980 and as of 2010 have 20 branches in the governorates and major cities in Egypt. Faisal Islamic Bank of Egypt, on the other hand, is the first Egyptian Islamic & Commercial Bank, which has officially started operations on 1979.

B. Ability to Serve Customers

Egypt could see an increase in Islamic finance assets grow to as much as $10 billion in the next few years and could expect a market share of Islamic banks increase up to 20% of overall banking. But due to lack of centralized data systems it was not possible to perform an analysis. Based on OECD recommendation there is room for
more dynamic development in banking in general such as providing more complete and updated information and IT-infrastructure. However, judging from the country’s overall strategy, it is expected that any move towards allowing more share for Islamic Banking within the Egyptian Banking sector should be quite welcome by the population.
6. **Egypt’s & Turkey’s Banking Sector Product Analysis**

### 6.1 How Do Islamic Products Differ from Conventional Bank Products?

As a way of avoiding interest, income based on time value of money or *riba*, which is forbidden under Shariah law, Islamic banks have creatively embraced a combination of partnership, profit sharing and leaseback arrangements. While fundamentally based on traditional Islamic Banking, new structures are being created.

Although there is still no international consensus as to which products comply strictly to Shariah, owing to some differences in interpretation, international religious bodies, such as the International *Fiqh Academy of the Rabitah* (World Muslim Congress) and the *Accounting and Auditing Organization for Islamic Financial Institutions* (AAOIFI), have been set up to provide guidelines for each bank’s own Shariah Supervisory Board in order to align the various interpretations and set standardized product concepts. This is extremely important in order to be comparable in the own market but also to compare with conventional banking products. The analogue is necessary for better understanding which measures have to be taken to improve and gain market share.

As for product innovation, it is presently concentrated in the Persian Gulf states of the Middle East and Malaysia.
The table below highlights essential Islamic bank products, its counterpart conventional products (or the nearest product in terms of similarity), and their key differences, aside from the fact that no interest is accrued on Islamic bank products, are as follows:

<table>
<thead>
<tr>
<th>Islamic Bank Product[^80]</th>
<th>Conventional Counterpart</th>
<th>Bank Product</th>
<th>Key Difference/s</th>
</tr>
</thead>
<tbody>
<tr>
<td>MUSHARAKAH [unlike a traditional creditor, the financier will also share in any losses]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MUDARABAH [A special kind of partnership similar to Musharakah except for: (1) only one party invests; (2) Investor does not participate in the management of the business; (3) Only the investor incurs any loss, provided due diligence was provided for by the managing partner]</td>
<td>• Loan facilities such as project financing and import financing. • Liability-side products, including deposits, investments</td>
<td></td>
<td>• Essentially a business partnership • Distribution of Profit or Loss agreed at the time of contract</td>
</tr>
<tr>
<td>MURABAHA [sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit thereon. Thus, Murabahah is not a loan given on interest; it is a sale of a commodity for cash/deferred price.]</td>
<td>Credit line, overdraft facility</td>
<td></td>
<td>• Essentially a sale of commodity for cash/deferred price • Bank is the third party in a sale contract • Bank ownership of the commodity sold</td>
</tr>
</tbody>
</table>

| SALAM [the seller undertakes to supply specific goods to the buyer at a definite future date in exchange.] | Forward Sale, Chattel Mortgage, Import/Export Financing, Agricultural Loan | • Requires that the quantity and quality of the commodity sold to be exactly specified  
• The bank can sell the commodity to a buyer in a parallel Salam contract |
| --- | --- | --- |
| ISTISNA’ [Similar to Salam except for: (1) covers only goods to be manufactured; (2) payment may be made later, and even in installments; (3) time of delivery is not specified; and (4) manufacturer can unilaterally cancel the contract.] | Home loan, project finance, build, operate & transfer (BOT) projects | • Specifically limited to goods to be manufactured  
• Time of delivery not specified  
• No spot payment and payment may be made on instalments |
| IJARAH [Similar to Istisna’ except for: (1) material is provided by the customer and the manufacturer uses only his labor and skill; and (2) purchaser’s right of rejection only exists if the goods do not conform to the specifications.] | Leasing | • Lessor assumes the full risk of the corpus of the leased asset |
| IJARAH WA IQTINA [In lieu of outright sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent.] | Leasing with purchase option | • Assigning of the lease (without assigning the ownership in the leased asset) for a monetary consideration is not permissible |

Table 10: Traditional Islamic Banking Products compared with conventional banking products

Note that for deposits as well as other liabilities-type of products, *Musharakah* or *Mudarabah* also serves as financial instrument, either as (a) participation (or equity) in setting up the bank like any other company by joint investment and the participants will be called the "shareholders"; or (b) as participation by opening their account in fixed deposit and savings account and participants will be called the "account holders" (these will not be the actual owner or shareholders of the bank - rather partners in profit only, meaning that they will have a contract of *Mudarabah*).
6.1.1 Market Segmentation

Market segmentation may be described briefly as a process that identifies a target segment of the company, determine the traits of the segment, identifies the segment needs and determines how these needs are satisfied vis-à-vis the company’s product offerings, and adapts the marketing mix according to the segment's needs in order to sell the right products and thereby increase the profitability of the company.

Segmentation is the first step in the so-called STP process (the other two being: targeting and positioning). “Marketers are increasingly segmenting markets and identifying attractive segments (i.e. what to focus on and why?), in order to identify new product opportunities, develop suitable positioning and communication strategies (i.e. what message to communicate), and effectively allocate resources to key marketing activities (i.e. how much should we spend and where?)”81:

![Graph 5: STP Process](http://www.oup.com/uk/orc/bin/9780199290437/baines_ch06.pdf)

However, it has been noted that far from being homogenous, “markets are fragmenting rapidly and we are moving towards a time when the only relevant segment is the individual customer. Taking a genuinely customer oriented view on marketing changes many of the fundamental marketing assumptions and thus

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81 [http://www.oup.com/uk/orc/bin/9780199290437/baines_ch06.pdf](http://www.oup.com/uk/orc/bin/9780199290437/baines_ch06.pdf) - last access Feb. 2011
marketing in itself changes." This would entail double challenge for Islamic banks in coming up with new products - ensuring all products are consistent with the requirements of Shariah as well as keeping attuned with the needs of the modern Muslims. Islamic banking faces the double challenge of remaining true to tradition yet must also be flexible enough to be abreast with an ever evolving world. These challenges, it must hurdle to achieve a two-fold objective of establishing and maintaining/improving customer relationships, typical of any conventional business.

It is always crucial to know one's customers. As mentioned above, continued fragmentation boils down to a paradigm where the only significant segment is the individual customer. This leads to more complex, multi-dimensional market segmentations, which involves variety of conditions including life cycle stages, lifestyle habits and more individualized traits.

The Islamic Banking segmentations are categorized as followed:

<table>
<thead>
<tr>
<th>Group</th>
<th>Description</th>
<th>Possible communication strategies to retain/attract the segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Religious Conviction</td>
<td>A group that is strongly guided by religious dictates, labelled as the “religious conviction group”</td>
<td>Emphasize Shariah compliance, role of the Shariah Supervisory Board (SSB) in the organization</td>
</tr>
<tr>
<td>Ethical Observant</td>
<td>A group that may not be particularly aware or careful of religious dictates but consciously tries to uphold moral values, identified as the “ethical observant group” and,</td>
<td>Inasmuch as this is the better educated segment, focus should be Shariah credibility as well as on technological advancement/innovation and the comparable returns of IB vs. CB counterpart</td>
</tr>
<tr>
<td>Economic Rationality</td>
<td>The last group, which is indifferent to both religious and moral dictates and is intent on deciding matters solely from the perspective of personal financial gain (or economic rationalism), is described as the “economic rationality group”</td>
<td>Emphasize inherently risk-mitigating features of Islamic Banking (e.g., requirement for an underlying asset on all transactions)</td>
</tr>
</tbody>
</table>

Table 11: Islamic Banking Segmentation

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Table 11 serves as a guide in developing a broad marketing segmentation strategy. It should always be noted that many consumers view Islamic banks just like any other conventional bank; thus, the service quality and products and services offered should be comparable with those offered by the commercial banks, or else they would lose their customers.

### 6.2 Gap Analysis on Product Innovation in Islamic Banking

Banks traditionally classify their product into three broad categories: liabilities (deposits), assets (loans) and services (safety deposit boxes, remittance, foreign exchange, and others). Islamic Banking has their own counter-products, and other products uniquely of their own. While core product development would be most welcome in Islamic business/corporate banking (*sukuk*, liquidity and cash management facilities), incremental product innovations are essentially missing in retail Islamic Banking. Incremental product innovation focuses on improvements and changes to existing products to enhance their value for existing markets and customers.

A gap analysis of product offering by 13 banks listed as Global Finance’s 2010 Best Islamic Banks per country. 8 representative banks from the Middle East and 5 South Asian banks were included in the analysis:
GAP ANALYSIS: Global Finance Best Islamic Banks (per country)

<table>
<thead>
<tr>
<th>PRODUCTS / BANKS</th>
<th>Jordan Islamic Bank (Jordan)</th>
<th>Bahrain Islamic Bank (Bahrain)</th>
<th>Saudi Arabian Islamic Bank of Egypt (Egypt)</th>
<th>Kowari Finance House (Kuwait)</th>
<th>Qatar Islamic Bank (Qatar)</th>
<th>Al Salam Bank (Sudan)</th>
<th>Dubai Islamic Bank (UAE)</th>
<th>Turkise Finans (Turkey)</th>
<th>Bank Marmara (Syria, Indonesia)</th>
<th>Islami Bank Bangladesh Limited (Bangladesh)</th>
<th>Bank Islam Darussalam (Brunei)</th>
<th>CIMB ISLAMIC BANK (Malaysia)</th>
<th>Mercantile Bank (Pakistan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional Retail Banking Products</td>
<td></td>
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<tr>
<td><strong>DEPOSITS</strong></td>
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<tr>
<td>Muamalat/ Savings Account</td>
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<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
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<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
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<tr>
<td>Wadiah/ Current Account</td>
<td>×</td>
<td>×</td>
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<td>×</td>
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<tr>
<td>Muamalat/ Time Deposit</td>
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<tr>
<td>Savings Account with Reward</td>
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<td>Cards</td>
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<tr>
<td>Electronic Services</td>
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<tr>
<td>Remittance</td>
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<td>×</td>
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<tr>
<td>Safe Deposit Boxes</td>
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<td>×</td>
<td>×</td>
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<tr>
<td>Takaful/Insurance</td>
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<td>FINANCING</td>
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<td>Trading</td>
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<tr>
<td>Murabahah</td>
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<tr>
<td>Salam</td>
<td>×</td>
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<tr>
<td>Revenue Sharing</td>
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</tr>
</tbody>
</table>
Table 12: Segments based products

Foregoing are traditional banking products but in terms of incremental product innovation, the only products available are for the following market segments:
Table 13: Increment innovations: improvement on existing retail products

Regionally, banks from south Asia indicated more tendencies toward incremental product innovation. When it comes to targeting a market segment for a bank product, Bank Islam Brunei Darrusalam (Brunei) and CIMB ISLAMIC BANK (Malaysia) are most conspicuously innovative. Both these banks target actively three segments in particular: children’s, teens, and elderly. Additionally, Bank Islam Brunei Darrusalam offers educational loan and an savings accounts for those planning a Haj pilgrimage. Mezaan Bank of Pakistan is the only south Asian bank offering a product specifically for women.

For mid-eastern banks, product innovation is primarily focused on children/teen segments. Only 2 banks showed noticeable product innovation, Kuwait Finance House, which targets Children, Teens, Women, Men and Premium Account segments, and Bahrain Islamic Bank, which targets both Children and Teen segments. The rest of the Middle Eastern banks included in the study have traditional products in their limited offerings.

Another deficiency noted in the portfolio of products is the lack of insurance (takaful), and this evident in both regions. It may be that insurance products are not yet fully integrated with banking services for Islamic banks unlike conventional banks where ban assurance products have been already successfully integrated for more than a decade. Among all the banks included in the analysis, only the Indonesian bank, Muamalat Syaria is offering a takaful product.

A traditional savings account with a reward feature is only being offered by Bahrain Islamic Bank and Turkiye Finans.
Focus on customers: product offering in annual report

Banks need to include customer updates and product offering sections in their annual report. These must also be featured prominently in their website as well as in all their marketing communication. For the more comprehensive reports to stakeholders, such as the annual report, aside from the usual financial information, which would be of interests to owners, investors and regulatory authorities, updates on customers (initiatives on customer satisfaction, customer loyalty programs) and products (new products, innovations, delivery channels) should form the annual report.

How do the banks included in this study fared in these areas?

<table>
<thead>
<tr>
<th>Banks</th>
<th>With Update on Customers?</th>
<th>With Update on Products?</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALBARAKA TÜRK</td>
<td>×</td>
<td>×</td>
<td></td>
</tr>
<tr>
<td>ASYA KATILIM</td>
<td>-</td>
<td>-</td>
<td>Although, it is explicitly stated: “The Bank was established in accordance with the principles of interest-free banking and with emphasis on product development based on this idea.”</td>
</tr>
<tr>
<td>KUVEYT TÜRK</td>
<td>×</td>
<td>×</td>
<td></td>
</tr>
<tr>
<td>TÜRKİYE FİNANS</td>
<td>×</td>
<td>×</td>
<td></td>
</tr>
<tr>
<td>Faisal Islamic Bank Egypt</td>
<td>-</td>
<td>-</td>
<td>Mentioned only in a passing expression of gratitude to customers in the third page of the introduction.</td>
</tr>
<tr>
<td>Albaraka Islamic Bank Egypt</td>
<td>-</td>
<td>-</td>
<td>Products were only mentioned because of the increase in general expense as a result of a publicity campaign.</td>
</tr>
</tbody>
</table>

Table 14: Update on customers and products in Annual Report

One Turkish and the two Egyptian banks failed to mention any customer satisfaction and product initiatives in their annual report.
Though the majority of the population would not even understand the detailed explanation of such in a banking report since it might be to sophisticated but nevertheless in order to set a minimum standard, to be professionally and comparable with other national and international market leaders, it is necessary.

6.3 SWOT Analysis

A recap of the foregoing discussion of retail Islamic Banking in the emerging markets of Turkey and Egypt disclosed areas of strength, weakness, opportunity and threat as follows:

### Turkey

<table>
<thead>
<tr>
<th>Strength</th>
<th>Weakness</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Renewed confidence in Islamic Banking as it has been generally unaffected by the 2008 financial crisis</td>
<td>• Lower ROE vs. total banking sector</td>
</tr>
<tr>
<td>• Steadily increasing market share</td>
<td>• Low-level of financial literacy among the target populace</td>
</tr>
<tr>
<td></td>
<td>• Very low incremental product innovation</td>
</tr>
<tr>
<td></td>
<td>• Low branch and ATM penetration</td>
</tr>
<tr>
<td></td>
<td>• Weak network of international correspondences</td>
</tr>
<tr>
<td><strong>Opportunity</strong></td>
<td><strong>Threat</strong></td>
</tr>
<tr>
<td>• Increasing number of customer looking for alternative channels for their financial needs</td>
<td>• Multi-national banks and large local banks opening an Islamic Banking window or subsidiary</td>
</tr>
<tr>
<td>• Population of more than 70 million people</td>
<td>• Conventional banks offering better returns</td>
</tr>
<tr>
<td>• Increasing usage of alternative distribution channels especially the internet</td>
<td>• Competition from non-bank financial intermediaries</td>
</tr>
<tr>
<td>• Pending entry into the EU</td>
<td></td>
</tr>
<tr>
<td>• Possible expansion to untapped markets of Muslim-majority Central Asia (e.g. Kazakhstan, Turkmenistan, Uzbekistan)</td>
<td></td>
</tr>
<tr>
<td>• Growing acceptance by non-Muslims</td>
<td></td>
</tr>
</tbody>
</table>

Table 15: SWOT Analysis of Islamic Banks in Turkey

Note: The information is based on financial information from the Central Bank’s and individual Islamic banks and trade associate journals.
A pilot incremental product innovation should capitalize on the opportunity of a sizable portion of the population looking for alternative to conventional banks. The threat of multi-national banks is mitigated by the ongoing financial crisis in Europe, and the general mistrust of financial institutions. To promote acceptance, it would be always imperative to stress the safe and ethical nature of Islamic banking, qualities which are foremost in the minds of prudent customers. The primary underlying message in banking proposition should be a personal ‘offer to be a partner in growth’ not to offer of an efficient but impersonal service. Moreover, incremental product innovations should be simple and easy to understand, and over time, with the increase ease of usage, other add-on features may be introduced. A portion of marketing communication budget should also be allocated for basic customer banking literacy. With the population growing more technologically savvy and better informed, incremental product innovation maybe introduced such as smart phone banking and other technologically driven services which are increasingly popular with all layers of society regardless of income or literacy.

**Egypt**

<table>
<thead>
<tr>
<th><strong>Strength</strong></th>
<th><strong>Weakness</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Pioneer of Islamic Banking</td>
<td>• Relatively weak regulatory environment</td>
</tr>
<tr>
<td>• Renewed confidence in Islamic Banking as it has been generally unaffected by the 2008 financial crisis</td>
<td>• Lower ROA, ROE and CAR compared with total banking sector</td>
</tr>
<tr>
<td>• Low customer take-up of products</td>
<td>• Low customer take-up of products</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Opportunity</strong></th>
<th><strong>Threat</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Population of more than 80 million</td>
<td>• Volatile political situation</td>
</tr>
<tr>
<td>• Renewed optimism brought by the recent change in political landscape</td>
<td></td>
</tr>
</tbody>
</table>

Table 16: SWOT Analysis of Islamic Banks in Egypt

As the pioneer of modern Islamic Banking, their inability to sustain the momentum of this important milestone should be an important message for Egyptian Islamic
bankers. An in-depth analysis of the history of Islamic Banking in Egypt may be a perquisite before a bank can re-position itself as an Islamic bank. Awareness must first be engendered, that Islamic Banking still exists in Egypt and it has always been the most viable financial intermediary for a faithful Muslim. An incremental product development may also complement this, but in a smaller scale. The renewed confidence in Islamic Banking may also be used as a motivation to encourage conventional bank customers to try Islamic banking. Perceived shortcomings such as low returns should be addressed, and new branding approaches should be considered. These may include branding Islamic Banking as ethical, religious duty for the faithful and prudent way of doing business, against the backdrop of financial scandals.

6.4 Possible Product to offer based on SWOT & GAP Analysis

At this point of their development, it may not be viable to offer sophisticated products based on complex market segmentation studies. The infrastructure to support this kind of product such as an efficiently working customer relationship management (CRM) system and data warehousing system may not be fully implemented yet. Given their sophistication, it might take more time for the Shariah committee of a specific Islamic Banking to consider such products. Therefore an intermediate product or incremental innovation would be more advisable.

In coming up with a product concept, factors to consider should include the moral aspect of such an offering as well as some of the findings from other researches in Islamic Banking:

1. Islamic finance is a complete moral model that is concerned with the well being of the human race beside shareholder wealth maximization\(^{83}\).

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2. The number of banks and investment companies created specifically for women has skyrocketed across the Middle East. Estimated to control around $246 billion of the region's wealth, women in the Middle East are regarded today by international banks as financial powerhouses.\(^{84}\)

3. The greatest potential for Islamic finance in Europe is undoubtedly in Turkey where Islamic Banking has been established since 1980s although it remains on the fringes of the financial system, accounting for less than five percent of deposits, and opinion on its merits are politicized.\(^{85}\)

4. Small IBs are financially stronger than large IBs possibly because it becomes significantly more complex for an IB to manage its credit risk monitoring system as it becomes bigger.\(^{86}\)

5. AT Kearney’s “Islamic finance: what leaders do differently?” observed:\(^{87}\)
   
   a) Marketing strategies are geared towards building up a reputation – both as a financial services provider and as an Islamic company – as well as developing positive brand image
   
   b) Besides customer focus, leaders put particular emphasis on product innovation, product design and quality as well as product standardization
   
   c) Leaders are also more focused than their counterparts, concentrating on a few customer segments only.
   
   d) Islamic banks are relatively weak with ATM and branch network
   
   e) Islamic banks should understand customer’s preferences with respect to Shariah compliance versus superior returns and services.
   
   f) Emphasis should be on turnaround time and customer experience as Islamic financial companies compete on differentiation rather than price.

---

87 AT Kearney’s (2006), p. 3f.
**Possible Product Proposal:**

Based on the foregoing analyses: a bank product exclusively for Muslim women is proposed.

The product’s unique selling proposition should provide for:

- *Simplicity* (as many of the target market may be novice in banking);
- *Privacy* (a separate room or section of the bank to discuss their transactions);
- *Convenience* (it should not be too time consuming as women have to care of a lot more household requirements);
- *Security* (a research conducted in the UK revealed that only a tiny proportion of women banking customers prefer products that bear high-risk but promise possible high-performance; a majority were willing to accept lower returns in exchange for low to no risk, a preference not commonly stated by men)\(^{88}\).

**Product Concept Presentation**

Membership to this product club should be allowable for three groups:

- **Group 1:** Young women, educated, independent, own money earners, higher standard expectations
  - Additionally banking products, cross selling skills, alternative products
  - more sophisticated financial instruments (like other ethical investment): certain percentage of the interest goes to a charity, orphans, community.

- **Group 2:** Young women, non-educated, independent (own little money, less expectations etc)

• **Group 3**: Housewives, not a net earner, uneducated but own little savings and spending with interests etc.

Product Working Name: “*Exclusively for you*”

Brief Description: A bank account exclusively for women, that offers the following benefits:

1. Low initial deposit and maintaining balance
2. Privacy of conducting banking transaction in a separate room or cubicle with a female bank employee
3. All-in-one account that offers auto-debit options for regularly recurring household expenses (e.g., card bills, utility bills, rent, children school education)
4. *Takaful* protection in case of widowhood, divorce or loss of employment by the account holder or spouse
5. Educational savings option for children (account holder may specify what amount she wants to periodically deposit for this purpose)
6. Retirement savings option (account holder may specify what amount she wants to periodically deposit for this purpose)
7. Discount card on selected shops, groceries, magazines
8. Rewards including raffle for house and lot, educational plan
9. Charitable option (the account holder may set aside part of funds for donation to charities)

The bank product should initially target upper-middle class and upper-class Turkish and Egyptian women. As its working name suggest, the product will provide exclusivity to its clientele. It will be for women only. Aside from basic banking
needs, it should also address their needs for simplicity, privacy, convenience and security.

At this stage, it will be an incremental innovation, with further product enhancement to be introduced as it gains wider acceptance and further product expansion that would cover other women segments (lower-middle to middle class). It is proposed to send flyers to schools and women support organizations. Some community centers may need a bank branch to be opened in their vicinity at suitable daily hours. Future work should concentrate on the experience of the women exclusive banking product to establish similar clubs for the labor force, landowners, young entrepreneurs, etc.
7. Conclusion

Some observers argue that, Islamic Banking, with its strict ethical guidelines, can be an alternative to conventional banking. Their main argument is that what a better and well regulated system of Corporate Governance is trying to enforce as far as its anti-corruption regulations are concerned are almost entirely and already embedded in the Shariah regulations, particularly in the eyes of the practicing Muslim client base. Islamic Banking has been developing in many of Western countries, in Asia and Africa. This trend is posed to continue for a foreseeable future. A full integration of Islamic financing and Banking into the prevailing conventional banking system seems to be forthcoming. A bank’s size is not a reliable indicator of its stability or of its social responsiveness, and this has been proven to catastrophic effect by the latest economic crisis of 2008. While big financial institutions tethered on the brink of collapse, Islamic banks have remained consistently robust and mainly unaffected by the crisis. In the aftermath of the crisis, the potential for Islamic Banking has grown exponentially and it would be wise for banking professionals to consider this option more seriously.

Although Islamic Banking is very solid in terms of stability and ethical responsibility, certain limitations hinder its further expansion. First limitation at the present time is the lack of a standard interpretation of Quranic laws when applied to banking. This limitation applies to the banking industry itself as well as their training institutes. There is no acceptable formal body that promulgates uniform and mutually accepted standards across countries and regions. Each bank has its own Shariah Supervisory Board with its own set of expert-members. Fortunately there are no serious threats of
interpretation conflicts in the foreseeable future. Also Islamic Banks’ limited access institutions to hedging instruments, which may accumulate risks in a closed circle of institutions, would require continuous innovative work by the regulators until this relative deficiency is reduced to an acceptable minimum. Another limitation is the lack of effective customer communication. While it is true that Islamic Banking is a more personal kind of banking than conventional banking in the sense that most of its products could be actually construed as a business partnership between the bank and the client, a review of the annual reports of Islamic banks in Turkey and Egypt revealed a deficiency of useful customer information that would present a more personal face of Islamic Banking.

The absence of product innovation is another limitation. Turkey and Egypt are two predominantly Muslim countries where the potential of Islamic Banking is enormous. The SWOT analysis of the two countries highlighted renewed confidence in Islamic Banking as their main strength, and the main weakness turned out to be the lack of infrastructure (limited branches and ATMs), with opportunities coming from the significant population currently not availing any bank products, with possible threats arising from international competition. Satisfied customers should insulate an Islamic bank from conventional competitors, and this can be achieved by offering products that addresses their unique needs, which for a typical observing Muslim would include compliance with Shariah, security, and a sense of pride and confidence in their identity and their banking behaviours. A review of existing Islamic Banking products revealed significant gaps in their product offerings targeting the women segment. This segment presents enormous potential, and this the segment where incremental innovation may be implemented.

The Muslim population in general, is under-served by conventional banks. Product innovation is practically non-existent except for a few wealthy countries in the Persian Gulf region and Malaysia. Some of these incremental innovations would only require re-packaging of traditional Islamic Banking products with add-on benefits for its targeted segment. A prerequisite for this of course, is that the bank should know about the market segment it wants to serve.
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