FEATURES AND PROSPECTS OF THE ISLAMIC FINANCE DEVELOPMENT IN GCC COUNTRIES

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Abstract: *The system of finance, which activities are regulated by Islamic law - the Sharia, has long ceased to be a new trend in the international financial system. Now, Islamic financial instruments and institutions are represented in many countries all over the world, both in Muslim and non-Muslim countries. Impressive development Islamic financial sector has achieved in the Gulf countries. The oil boom, which served as a new starting point in the economic development of the oil-producing Arab countries, contributed to the establishment and strengthening of the Islamic finance system in these countries. To date, a system of Sharia-compatible finance is one of the ways to diversify the economies of Muslim countries, in particular their financial sector, which is aimed at reducing their dependence on oil revenues.*
The GCC countries account for about 40% of the global volume of Islamic finance assets. Islamic banking in the region occupies 35% of the entire banking system and the regional sukuk market is the second largest in the world after Malaysian market.
The main objective of this article is to review the market of Islamic finance in the GCC countries, as well as to study the main difficulties in their development at the time of a critical transition from the recession in 2009 against a sharp collapse in oil prices and subsequent budget deficits.
The study is based on survey data, and various analytical materials of the GCC countries, as well as data from international organizations and information agencies.
The research examines the main directions in stabilizing the Islamic finance system in the Gulf countries, among which stand out the process of standardization of regulatory and supervisory frameworks in Islamic banking, sukuk issues, and a detailed study of the problem of liquidity risks in Islamic banks.

Key words: *Islamic finance, prospects, Islamic banking, Sukuk, Takaful, GCC*

JEL codes: *G15, G17, N25*

1. Introduction

Along with the traditional economic system, the Islamic finance system coexists, based on ethical-moral principles of distribution of benefits. Its foundations were born at the time of the emergence of Islam as a religion, however, in modern terms, Islamic finance as a full-fledged science was formed only in the XX century. In addition to the religious orientation of this industry, which initially influenced the emergence of ethical finance, due to the need to provide Muslims with suitable financial instruments that do not contradict the Sharia, Islamic finance has also become an alternative source of financing and investment in the modern financial world. For nearly half a century, Islamic finance has been developing and being introduced into the financial system of the countries of the Gulf.

With the development of the oil market in the Arab Gulf countries, the economies of these states have undergone significant changes, in particular in connection with state enrichment through the flow of oil revenues. Through this, the government of these countries has also been given the opportunity to develop an alternative market for religious finance. In the existing literature of the development of Islamic finance in the GCC countries, Wilson (2009) considered the development of the Islamic economy. His research refers to the origins of Islamic finance development by 1975, when the Islamic Bank of Dubai was established, and IFCs began active implementation of Islamic insurance and asset management, compatible with Sharia, through retail and investment banking services.

The oil boom of the second half of the 20th century contributed to the establishment of the Islamic Development Bank in 1975 in Jeddah, Saudi Arabia. The oil boom process in the Gulf countries with the development of Islamic finance in the region. Sharia-based banking assets now constitute a significant part of the overall banking assets of the financial system of the region and currently account for about 35% of total assets in the region. This amount shows that in the GCC countries there are more Islamic banking assets than in other large countries in the regional financial markets. Most of the studies on Islamic finance in the GCC countries were most often based on comparative studies between Islamic and traditional finance (Al-Ajmi et al., 2009; Siraj and Pillai, 2012; Olson and Zoubi, 2008), the impact of Islamic finance on economic growth (Fitti, 2013; Yusof and Bahlous, 2013), and efficiency and productivity (Sakti, 2017), among other aspects. Olson and Zoubi (2008) found Islamic finance to be more profitable, more liquid, better capitalized, and lower risk oriented than conventional banks. These findings were obtained using classification over the period between 2003 and 2010 in the GCC countries. A study written by Olson and Zoubi (2008) revealed that Islamic banks are less efficient than conventional banks but demonstrate good risk management. Their study used 26 financial ratios from Islamic and conventional finance in the GCC countries over the period from 2000 to 2005. In addition to these comparative studies, the literature also discusses the performance of Islamic finance and conventional finance in the GCC countries.

2. Islamic finance services in GCC countries

The GCC countries control around 40% of all Islamic financial assets in the world. However, the successful performance of the GCC countries in financial assets and institutions is not reflected in the sector of education on Islamic economics and finance. It is important to state that, particularly since the Arab Spring, GCC countries have attempted to invest in Islamic finance through state investment, such as their own sovereign wealth fund, in order to develop their domestic economies.

Over the past ten years, the GCC region has registered a compound annual growth rate of Islamic Finance segment of more than 17%. This compares with just 10% for the rest of the MENA region and 8,7% for Asia. High oil prices in period of 2000s before 2014 year, an elevated proportion of high-net-worth individuals and rapid economic growth go some way to explaining this. Between 2008 and 2009 alone, the region’s total assets jumped from $262bn to $353bn, while the rest of the Islamic finance world reeled from the effects of the financial crisis. Even as this wider growth story unfolded, the Islamic finance market was not immune from various global and regional pressures. In the 2015 ranking, the total assets of the industry fell for the first time – by 8.48% – as a number of key currencies reduced in value against the US dollar.

The largest area in Islamic finance is banking. To date, in the total volume of world assets of Islamic finance, which is more than $2 trillion, the share of Islamic banking accounts for about $1.5 trillion.

Modern Islamic banking originated with the establishment of the Dubai Islamic Bank in 1975. Among the pioneers in Islamic banking, both in the world and in particular in the countries of the Gulf, one can single out the largest bank in the entire Arab world – The National Commercial Bank of Saudi Arabia. The bank was formed in 1953, and since 1979, financial services compatible with the Sharia began to appear among its financial instruments. At the moment, more than half of all the assets of this bank fall under the concept of "Islamic", 80% of all its financial operations – compatible with the requirements of the Sharia.

Founded in 1957, the Saudi Al Rajhi Banking & Investment Corporation is a large Islamic bank and, together with Kuwait Finance House, are the two largest, and among the oldest, Islamic lenders in the world. They had total assets of about $ 90 billion and $ 56 billion respectively. Bank Al Jazira is recognized as one of the leading Sharia compliant fast growing financial institutions in Saudi Arabia, client-driven and service-oriented Saudi Financial Group which provides individuals, businesses and institutions with innovative Sharia compliant financial services through professional and dedicated staff.

Islamic banks receive rather high marks of their financial activity from rating agencies. Among Islamic banks in the Gulf there are a large number of highly reliable banks, whose ratings do not fall below the "A" class credit rating. The table below shows the most reliable and financially sustainable Islamic banks in the region.

Table 1 shows that all GCC countries are owners of large and reliable Islamic banks. The above-mentioned largest Islamic bank Al Rajhi lost several stages in its credit position – at the end of 2013, his total score in credit ratings was 18 points with A+ ratings and now it has only 13 points and has A- ratings.

Over the past few years, at low oil prices, the Islamic banking has also felt the consequences of this strike on the economy of oil-producing countries, as well as the sphere of traditional banking. According to Shakeel Adli, the head of Islamic finance at CMS Dubai, Islamic banks need to develop in their niche by participating in small projects where they would have less competition and more opportunities to apply ethical finance norms (www1).

Tab. 1 Credit ratings of Islamic banks in the GCC region, 2017

Name of Bank Group	Country	Ratings			Total score	Assets ($ bn)
		Fitch	Moody's	S&P		
Al Hilal Bank	UAE	A+	A1	-	17	11.8
Kuwait Finance House	Kuwait	A+	A1	A-	16	54
Qatar Islamic Bank	Qatar	A+	A1	A-	16	38.4
Abu Dhabi Islamic Bank	UAE	A+	A2	-	15.5	33.2
Barwa Bank	Qatar	A+	A2	-	15.5	12.6
Ahli United Bank	Kuwait	A+	A2	-	15.5	12
Qatar International Islamic Bank	Qatar	A+	A2	-	15.5	11.7
Boubyan Bank	Kuwait	A+	A3	-	14	11.3
Al Rajhi Bank	Saudi Arabia	A-	A1	BBB+	13	90
Dubai Islamic Bank	UAE	A	Baa1	-	11	47.6
Warba Bank	Kuwait	A+	Baa2	-	11	3.6
Sharjah Islamic Bank	UAE	BBB+	A3	BBB+	10	9.1
Bank Al Jazira	Saudi Arabia	BBB+	Baa1	-	8	17.6

Source: Global Finance Report, Fitch Ratings (Fitch, 2017).

Along with banking, in the Gulf countries there are also spheres of Islamic capital and Islamic insurance - takaful. Their volume is not as significant as Islamic banking, but they occupy a stable position in the Islamic finance system. The Islamic capital market consists of the Islamic stock market, Islamic investment funds and the sukuk market. The rapid expansion and increasing popularity of ICM can be checked from the increasing number of Islamic Indexes and ICMs. Dow Jones Islamic Market Index, MSCI Global Islamic Index, Standard & Poor's Shariah Index, FTSE Shariah Global Equity Index etc. are some of the globally popular ones. Among the stock exchanges in the GCC countries, there are two largest ones, on which Islamic stock indexes and other instruments are listed: NASDAQ Dubai and Tadawul (the Saudi Arabian stock exchange).

The total volume of Islamic funds in 2015 amounted to 60.2 billion dollars, in quantitative terms - more than a thousand funds. At the same time, the share of Saudi Arabia in the global expression is 18% of the total number of Islamic funds, losing first place in this indicator of Malaysia.

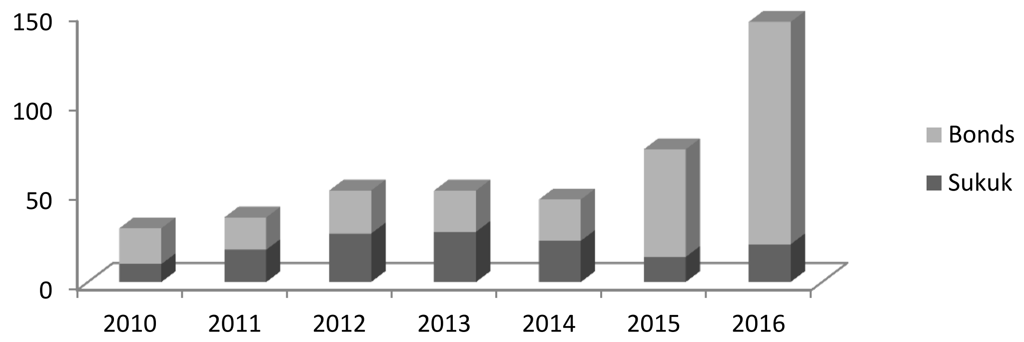
In the Middle East, the Liquidity Management House (LMC), established in 2002 in Bahrain as a joint stock company with an investment Islamic banking license, is aimed at facilitating short- and medium-term investment in accordance with the principles of Sharia. In 2004 LMC launched the Short-term Investment Sukuk Program. The primary sukuk emissions may include sukuk-murabaha, salyam and istisna, mudaraba and musharaka plus investment certificates, ijara, etc. LMC applies sukuk schemes for both debt obligations and in the event of a share issue. LMC is engaged in structuring Islamic investment funds, as well as structuring and coordinating the provision of funding. LMC shareholders are the financial institutions of Bahrain Islamic Bank, Dubai Islamic Bank, Liquidity Management House and Islamic Development Bank in equal shares.

Sukuk is perhaps the most successful Islamic financial instrument on the capital market which also confirms its widespread use. More and more jurisdictions, including non-Muslim countries, most of the EU countries, use Islamic bonds as a means of attracting liquidity, as well as diversifying the debt portfolio.

In the Gulf countries in recent periods there have been significant sovereign issues which are primarily due to the need to address financial problems caused by low oil prices.

Current market conditions have created a good landscape for new bond issuances, with the GCC sukuk market issuing more than $30 billion in sovereign and corporate bonds in 2017 year. In 2016, a total of $21billion bonds were issued; this figure is up by 74% on 2015 when issuances amounted only to $12.6 billion. Figure 1 shows that despite the growth of sukuk emissions in the GCC, the emission of traditional bonds also increased significantly. The decision on whether sovereigns issue bonds or sukuk is driven such as the target investor and funding base, whether there is an existing sukuk structure and Islamic finance strategy, and the needs and size of the Islamic finance industry, because Islamic banks cannot invest in traditional bonds. Outside core markets, issuance prospects are limited due to a lack of standardisation, which makes structuring sukuk a more complex and time-consuming process than a traditional bond. The recent sovereign bond issues from the GCC region should also help create a capital market pricing benchmark and lower bank liquidity could reduce the pricing gap between capital market funding and the bank loans on which GCC corporates have traditionally relied. The biggest remaining roadblocks to corporate issuance are the development of debt-management expertise and a change in the corporate culture to increase financial and management transparency.

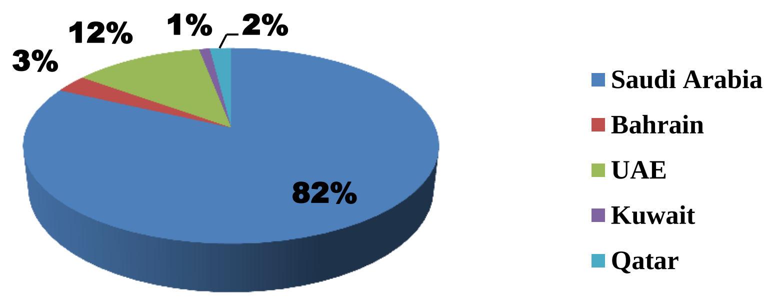
Fig. 1 Sukuk and bond issuance in GCC countries 2010-2016 years, $bn



Source: Standard&Poor's (S&P, 2016)

There are a large number of insurance and takaful companies in operation of GCC countries but the number of conventional companies is significantly higher. The GCC countries along with Malaysia are the key markets for the development of Islamic insurance. However, it is worth to separate the takaful market in Saudi Arabia. Its peculiarity is that it occupies the entire sphere of insurance in the country, i.e. the entire insurance sector in Saudi Arabia is compatible with Sharia law. In 2015 the volume of takaful in Saudi Arabia was $10 billion and about 30 takaful companies operate. Saudi Arabia accounts for up to 82% of the total volume of takaful in the region. This indicator significantly surpasses the volume of Islamic insurance in the rest of the Gulf countries, which can be seen on figure 2. In the UAE it is about $1 billion, in Kuwait, Qatar, Oman and Bahrain $132 million, $329 million, $101 million and $167 million respectively. The number of takaful companies in the Gulf countries, not including Saudi Arabia, is 39, of which 13 are from Kuwait, 12 to the UAE.

Fig. 2 The distribution of takaful in GCC countries, 2015

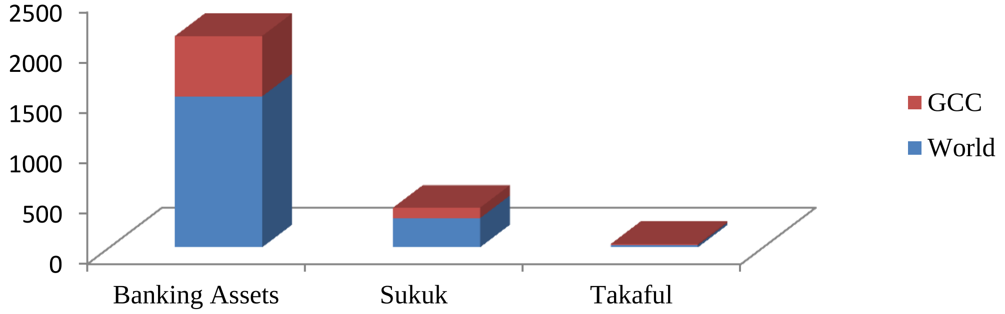


Source: Islamic Financial Services Board (www2)

In all countries, in different proportions, the common takaful over the family takaful extends. And in Saudi Arabia the total takaful accounts for up to 97% of the total insurance market which indicates a very low representation on the life takaful market.

Thus, according to figure 3, it can be seen that at the end of 2015, the Islamic banking sector in the GCC countries accounted for about 40% of the global volume of Islamic banking assets, whose value is about $1.5 trillion. The sukuk market is about 35% of the world market, and the Gulf countries accounted for $104 billion of sukuk. The cost of Islamic insurance was about $11 billion, which is also a significant part of the global volume of takaful – about 50%.

Fig. 3 Islamic Finance Segments (US$ bn)



Source: Islamic Financial Services Board (www2)

Thus, it can be concluded that Islamic finance in the GCC countries represents a significant share of the global volume which indicates the paramount importance of this region as the main center for the promotion and development of Islamic finance.

3. Discussion

The events of recent years, in particular, the decline in oil prices, the general world economic and political instability, insurgencies in the Arab region – all this to some extent affects the economy of the Gulf countries, in particular in the sphere of finance. One of the main directions of the economic policy of the governments of these countries is the diversification of the economy, its release from dependence on oil and gas revenues, or at least a reduction in this dependence. Diversification of the financial system also include the development of the Islamic finance sector.

As it was mentioned above, the sphere of Islamic financial services occupies about 35% in aggregate from the financial sector of the region. The global financial crisis which hit financial sectors in all directions had relatively little impact on the Islamic finance sector. This is due to the specifics of Islamic finance, in which the main specificity is their based on real assets, the lack of a credit system, as well as a managed system of risks and the absence of excessive types of financial speculation.

The economic policy of the GCC states, due to the budget deficit caused by a significant decline in oil prices, is currently aimed exclusively at developing those industries that have not been sufficiently integrated into the main revenue streams of the state. In addition to Islamic finance, they include the sphere of entertainment, tourism, health, and another spheres of the public sector.

One of the most comprehensive and ambitious projects to diversify the oil-dependent economy of the Gulf countries was the withdrawal of the Saudi Vision 2030.

The Saudi Government laid out plans to modernise, diversify and globalise its economy under its Vision 2030 plan, implementing a series of wide-ranging reforms designed to open the kingdom to foreign investors, reduce its reliance on oil exports and bring it in line with the world's most powerful emerging economies.

Gulf-based Islamic banks are under pressure again as a result of low oil prices, widening budget deficits, and rising costs of funding in the GCC. Islamic banks in the region tend to rely on deposit funding, particularly from governments and government-related entities, which makes them vulnerable to increasing withdrawals as governments run down deposits to fund budget deficits.

Among the main difficulties in the development of Islamic finance in the region is also an insufficiently developed system of regulatory regulation of Islamic financial institutions.

Regulatory reforms in different jurisdictions need to be harmonized in order to facilitate cross-border transactions in Islamic banking. Notably, coordination of regulations would make it easier for highly capitalized Islamic banks in the GCC to increase their geographic outreach, and tap into underserviced markets with large Muslim populations in South Asia, Africa, and a number of the CIS countries.

Over the next few years, the growth prospects of Islamic banks in the GCC will depend on how they respond to a period of economic slowdown caused by low oil prices and consequent fiscal deficits. Such economic developments are expected to have a negative impact on the banking system through weakening asset quality, liquidity, and profitability. This, in turn, signifies the need for structural reforms in the Gulf's financial systems in general, and Islamic finance in particular.

Notwithstanding increasing economic challenges, Islamic finance still has room for growth and development. Indeed, Islamic banks are projected to continue to grow faster than conventional banks for the foreseeable future given their low base, sizeable market potential, and high demand among Muslim populations.

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