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## **Islamic Banking In Turkey, Indonesia And Pakistan**

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Worldwide, the Islamic finance industry is developing fast. Whilst it makes sense for the Islamic financial institutions to foster growth and to regularly measure themselves against the financial market as a whole, sometimes it is also worthwhile to look around and see what happens in different countries.

It is easy to talk about “market shares” and “deposits”, but what do they really mean? And what can be expected in the near future?

Turkey and Indonesia both are secular republics with a large majority of Muslim population, but Islamic finance developed very different. With a population that approximately holds the middle between both countries; the Islamic Republic of Pakistan is used as an outside comparator. To put all into even more perspective, some data from Malaysia are also included as a benchmark.

### **Turkey**

From the very start in 1985 with Albaraka Türk, the Turkish participation banks (before called Special Finance Houses) were poised to aim at the Turkish market as a whole. Therefore they did not really target the small niche of the “convinced” Muslim population in particular. This of course influenced marketing and product development. Part as a consequence of this strategy (and compared to Indonesia), the Turkish participation banks could have a faster growth and now cover roughly 3.5 % assets of the total Turkish banking industry. One may also note the strong growth of the sector that outperforms the conventional counterpart now for 8 consecutive years.

The loss of Ihlas Finance House (2001 – alleged fraudulent insolvency) meant the loss of 40 % of the deposits held by the sector at that time and the subsequent stampede on the other Special Finance Houses (now participation banks) meant another 35 % loss. Because of their ties to the “real economy”, the Special Finance Houses were not hit by the big financial crisis that hit Turkey in 2001 and they recovered fast. Their deposits now have been taken into the guarantee fund of the banks (to avoid other shock withdrawals) and the sector has acquired bank status.

There is no specific government aid to the sector and no (government or corporate) Islamic bond. There also is no access to the money markets, so we can hardly talk about a level playing field, as compared to conventional banking.

There are no Islamic windows and therefore foreign market players can only enter the market through shareholdings in the existing participation banks (or have to start their own participation bank from scratch).

A Government sukuk issuance could be in the make, so has been rumored for some time now. The talks on the projected Rent (Ijarah) Certificate however move slow, subject to rather inactive local financial markets, cheap conventional international funding and political factors.

A well thought off strategy of decentralization – for instance using techno / tax incentives and privatizations – created upcoming of several bigger conglomerates throughout the country.

## **Indonesia**

With its' first established Bank Muamalat Indonesia (together with Bank Syariah Mandiri still today front runner), the situation differs profoundly in Indonesia. As from the very start, products and marketing were directly aimed at precisely that group of clients of “convinced” Muslim (market share of roughly 1.5 %). Whilst the present impressive government initiatives aim to broaden that base (a potential “floating market” of approx. 75 % of the population would be within reach), Bank Muamalat confirms to adhere as before to their strict policies and client target. It might mean an extra strong growth potential for the other market players.

The need to mobilize internal capital and attract foreign investment, required special measures. Indonesia's Central Bank announced in July 2007 that – subject to full implementation of the “blue print for development of the Indonesian Shari'ah Banking system” - total assets of the Islamic banks (and Islamic business units) are expected to triple by the end of 2008 (growth of approx. USD 6 billion) to reach an overall volume of 5 % on the total Indonesian banking assets. When deposits / loans follow same development, it will be clear that opportunities are at hand (growth potential of approx. USD 5 billion).

Foreign banks are not really visible yet on the Indonesian Islamic finance market. HSBC pioneered as first big international institution with a full dedicated Shari'ah head office in Jakarta - the projected growth potential is enormous: they calculated that roughly 50 % of their clients would be willing to use the products if priced competitive. Recently also Albaraka Group announced the prospect of opening of a branch there.

The first Government Sukuk (plans to raise up to USD 1 billion have been announced) is in the pipeline. Actual issuance could however be postponed till the fourth quarter of 2007 or even the first quarter of 2008, pending parliamentary approval. Indonesia at present already knows corporate Ijarah and Mudharabah Shari'ah Bonds. Access to the money markets has been opened.

Conventional banks that want to participate in the “Islamic pie” need to dedicate 5 % of their assets to such venture. This commitment, together with other incentives, will be responsible for the expected fast growth over the next two years.

## **Pakistan**

From the late 70s onwards, Pakistan has a protracted history of Islamic banking. As from July 1<sup>st</sup>, 1985 all commercial banking in Pak Rupees was made interest free. The sudden conversion (and lack of preparedness) posed difficulties on implementation however. As from 2001 an evolutionary process was then chosen for, in order to nurture acceptability and development in a more structural approach. The first “Islamic bank license” was awarded to Meezan Bank back in 2002 (founded 1997). But as said, Islamic banking has been introduced since the mid 80’s.

Most note worthy is the present Islamic Banking Policy (December 2001), under which Islamic banking is promoted parallel to conventional banking. Implementation of AAOIFI and IFSB standards is on the way. Besides a Draft for the new Government Securities Bill, Draft Risk Management and Draft Shari’ah Compliance guidelines have been published.

A growth of % 40 per annum is being expected and a % 15 market share is targeted.

Next to the fully fledged Islamic banks, the conventional banks can opt to open up Islamic banks subsidiaries or even dedicated “stand alone Islamic banking branches”. A vast concentration of the Islamic banking to the big cities (Karachi and Lahore) can be noticed. There is government and corporate sukuk in the market.

In 2007 ABN AMRO opened an Islamic branch, Emirates Global Islamic Bank has started a dedicated Islamic commercial bank and QATAR Islamic bank has confirmed plans to setup a Shari’ah compliant banking unit soon. Citibank was another big foreign entry.

## **Malaysia**

Starting off in 1983 with Bank Islam Malaysia Berhad, separate Islamic legislation and banking regulations exist side-by-side with those for the conventional banking system.

In order to create an efficient, progressive and comprehensive Islamic financial system, Bank Negara Malaysia recognized the need to, i.e.:

- Attract a large number of global players;
- Develop a broad variety of instruments; and
- Install a comprehensive financial infrastructure.

A large variety of Islamic financial products and services (more than 100) are at present offered by the banks using various Islamic concepts such as Mudharabah, Musharakah, Murabahah, Bai' Bithaman Ajil (Bai' Muajjal), Ijarah, Qard, Istisna' and Ijarah Thumma Bai'.. next to the existence of the Islamic Interbank Money Market.

Probably subject to pressure from the Dubai DIFC, Malaysia recently opened up regulations to allow sukuk issuance in foreign currency and competes with Singapore (and recently also Hong Kong decided to enter the race) to be the prime Islamic finance hub in the Asian region.

## **Observations**

First of all, it has to be noted that real entrance of foreign investment in Turkey, Indonesia and Pakistan still bounces on inadequate tax regimes.

Though it is difficult to distract far going conclusions from the table hereunder, at first sight, it is clear that both Malaysia and Turkey share the following characteristics: relative big concentration of the population in bigger cities, lower portion of population working in agriculture and a lower weight of that sector in the overall economy. The GDP per capita (calculated in relative purchase power – not in hard dollars) in those countries also is 2 upto 4 times higher then in the other two countries.

Also in Indonesia and Pakistan there is a remarkable concentration of the Islamic banking sector around the big cities.

In Indonesia and Pakistan, the agriculture sector appear to attract socially very important, but statistically for the total economy less important “rural Islamic banks” (targeting micro finance). There is no such sector in Turkey.

Neither the percentage of Muslim population (Indonesia, Turkey, Pakistan), nor the zeal of the Government to promote Islamic banking (Indonesia, Pakistan) appears to be a determinant for success so far.

The marketing strategy of the Indonesian Islamic banks proved to be successful for the loyal but small niche of the “convinced” Muslim population, but did not succeed to appeal to the “public at large.

The Turkish participation banks on their side are severely handicapped (no sukuk, no money markets, relative few products, no government incentives and no Islamic windows) but expanded thanks to a more neutral banking approach (more focused upon the financial advantages and with slight emphasis to ethical merits).

Looking at the mix of relevant measures that are applicable to the different countries, he following guidelines appear to be clear:

- dedicate sufficient means to Islamic rural banking / micro finance for the agricultural areas
- create a good level playing field for the Islamic banks to compete with the conventional banks (for instance access to the sukuk and the money markets), without however any specific need to give them prime conditions (challenge makes competitive, superfluous benefits make lazy and distort the market)
- open up the markets for international institutions (it attracts financial power and innovation)
- install possibilities for all financial institutions to create Islamic windows and / or branches (better product awareness and overall acceptance of the Islamic banking also benefits to the dedicated Islamic banks)
- have the conventional banks that want access to the market commit right from the start sufficient means (the need to dedicate assets to the activity enhances growth in the market)
- promote diversification of products offered to the public (diversity is one of the handicaps of Islamic finance vis-à-vis the very mature conventional counterpart)

- try to spread wealth out of the existing bigger cities to smaller cities and do not focus on the existing metro poles
- try create sufficient liquid financial markets and stock exchanges, if needed through strategic alliances
- give sufficient attention to international accounting standards, (corporate) governance, transparency and accountability
- build strong prudential controls
- give bank status and deposit protection
- without losing sight on the underlying principals, focus on market competition, quality of products and pricing thereof

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### **How to read the table**

The table shows that Turkey has about the same market penetration but has approx. 6 times as much assets ... tied in the Islamic finance industry as compared to Pakistan. It also has twice as much POS. When you see that the population of Pakistan is about twice as big, the gap even gets bigger.

On the other hand, the overall GDP of Turkey is more then 3 times as big and the same applies to the PPP (purchase power parity) per head. Also notice the dominance of agriculture (both turnover and labor force) in Pakistan and the lack of bigger cities.

With a market penetration that is half that one of Turkey talking in hard USD, the Indonesian Islamic finance still is close to 3.5 times as small as Turkey with only half the POS. The population of Indonesia being 3 times as big, the scale distorts even more.

In spite of the bigger population, the overall GDP of Turkey still is 10 % higher then that one of Indonesia and the PPP per head knows a multiplication of more then 2. Indonesia also lacks the big cities (38 on 231 million people compared to 24 on 74 million people for Turkey) and there also is a larger dependence on agriculture.

Malaysia has by far the best POS coverage of all. The GDP in PPP per capita even exceeds Turkey with 20 %. The comparative GDP (divided by population) is 10 % higher then Turkey. Malaysia has moved away from agriculture and has compared to the population of Turkey twice as much big cities.

	<b>MALAYSIA</b> Islamic banks and Islamic banking scheme participants		<b>TURKEY</b> participation banks		<b>INDONESIA</b> Islamic banks and business units		<b>PAKISTAN</b> Islamic Banks – Subsidiaries – Stand alone Branches	
	Malaysia MYR millions	Malaysia USD millions	Turkey YTL Millions	Turkey USD millions	Indonesia IDR millions	Indonesia USD millions	Pakistan PKR millions	Pakistan USD millions
<b>Assets</b>	117,448	34,543	16,773	12,902	29,899,604	3,267	135,641	2,231
<b>Deposits</b>	86,216	25,357	12,927	9,944	23,231,781	2,538	93,068	1,531
<b>Loans</b>	69,820	20,535	13,809	10,622	23,687,378	2,388	70,761	1,164
<b>Islamic banks</b>	11		4		3		6	
<b>First License Islamic Bank</b>	Bank Islam Malaysia Berhad (1983)		Albaraka Türk (1985)		Muamalat Indonesia (1994)		Meezan Bank (1997 - 2002)	
<b>Offices - Branches</b>	+ 2000 <b>Islamic banks and Islamic banking scheme participants</b>		378 <b>only participation banks</b>		188 <b>both Islamic banks and Islamic business units</b>		173 <b>both Islamic banks and Islamic branches of conventional banks</b>	
<b>Potential market*</b>	26.6 million Muslim 60 %		74.3 million Muslim 97 %		231.8 million Muslim 85%		161.1 million Muslim 96 %	
<b>Cities more than 100.000**</b>	40		67		82		50	
<b>Cities more than 250.000**</b>	16		24		38		20	
<b>Surface</b>	329,847 Km <sup>2</sup>		783,562 Km <sup>2</sup>		1.919,440 Km <sup>2</sup>		880,940 Km <sup>2</sup>	
<b>Market share assets</b>			3.25 %		1.7 %		3,2 %	
<b>GDP overall (USD – nominal - billion)</b>	156.087 billion		403.5 billion		364.5 billion		126.8 billion	
<b>GDP per capita (PPP - USD)</b>	11,374		9,085.6		4,021		2,2575	
<b>Economic sectors***</b>	agriculture: 8.3% industry: 48.1% services: 43.6%		agriculture: 11.2% industry: 29.4% services: 59.4%		agriculture: 13.1% industry: 46% services: 41%		agriculture: 22% industry: 26% services: 52%	
<b>Labor force - sectors***</b>	agriculture: 13% industry: 36% services: 51%		agriculture: 35.9% industry: 22.8% services: 41.2%		agriculture: 43.3% industry: 18% services: 38.7%		agriculture: 42% industry: 20% services: 38%	
<b>Literacy***</b>	88.7 %		87.4 %		90.4 %		49.9 %	
<b>S&amp;P/Moody's/Fitch country rating</b>	A- stable/A3 positive/A- stable		BB- stable/Ba3 stable/BB-stable		BB- stable/B1 positive/BB-positive		B+ stable/B1 stable/-	
* economist.com (2006) ** Rough estimates *** indexmundi.com	Data BNM – June 2006 USD 1 = 3.40 MYR		Data TKBB – 2q 2007 USD 1 = 1.3 YTL		Data BI – July 2007 USD 1 = 9150 IDR		Data SBP – Mar 2007 USD 1 = 60.80 PKR	
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