

## Banking on Islam: A Technology Perspective

By Charlie Hamdan

Modern Islamic banking effectively began in the 1960s but it only came of age in the last decade when banks started to offer sophisticated Islamic products and financing arrangements. Today, Islamic banking technology solutions have matured and there is a concerted effort across the industry to standardize Islamic products. So, with the recent credit crisis throwing the deficiencies in the conventional banking system into sharp relief, Islamic finance has emerged as a viable alternative.

Islamic banking is guided by Shariah principles which include the following:

- The prohibition of riba or interest. Interest in any form is forbidden as it is considered unearned income and therefore unjust. Any risk-free investment or guaranteed income is considered usury.
- Money is not a commodity. Money cannot be traded like a commodity because it has no intrinsic value if not used to buy tangible assets. It is the value of these assets that determines the rate of return.
- The prevalence of justice at any cost. Financiers are not allowed to exploit entrepreneurs in any way.
- Uncertainty, or gharar, of any form is prohibited. So, any contract which involves the element of speculation or gambling is forbidden. For example, futures and options contracts are not permissible as the returns from such investments rely on events that may or may not take place. Both parties have to agree to all terms of a particular contract, and Shariah law forbids transactions where the subject matter or price cannot be fixed in advance.

Today, Islamic finance, growing at a rate of 15% to 20% every year according to industry estimates, spans most of Asia and the Middle East and is beginning to make inroads into the West. For the most part, the industry has remained unaffected by the global financial meltdown. Islamic financial assets are tipped to reach US\$1 trillion over the next few years as customers turn to it as a socially responsible banking alternative.

In recent years, Western countries have started to show interest. For instance, France recently announced that it has eliminated tax obstacles and improved the legal framework for the setting up of Islamic financial institutions in the country. It has been reported that an as-yet unnamed French financial institution will be issuing a EUR1 billion (US\$1.32 billion) Sukuk as early as next month.

The UK is home to five Islamic banks, the only ones in the EU so far, with GBP5.5 billion (US\$8.42 billion) in Sukuk on its stock exchange.

In the US there are 19 Islamic financial institutions providing retail, mortgage and investment services to a potential customer base of around eight million Muslims.

The growth in Islamic finance throughout the world can be attributed to socio-demographic trends, such as:

- The population growth and rising affluence of Muslims worldwide, particularly across Asia.
- Rising discernment among Muslim customers who want to invest and borrow according to Shariah principles while enjoying a full range of banking products and services.

That said, however, Islamic banking has become a potent force for innovation, attracting devotees from outside the Islamic community. Services include a broad range of profit-sharing, safekeeping, leasing, cost-plus financing and joint venture agreements.

Islamic banking may differ from Western-style conventional banking in many respects but the same business, regulatory and technology requirements prevail. Both use similar customer channels and offer what are, functionally at least, the same products.

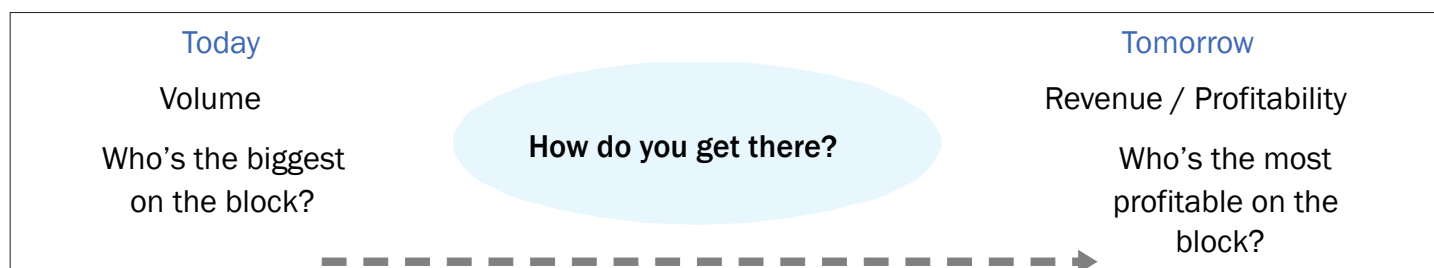
Innovative new technology solutions have enabled banks to meet the increased demand for these services. Now, virtually every product and service offered by conventional financial institutions have a Shariah compliant equivalent, from loans to mutual funds; electronic payment systems to stock indices.

Islamic banks perform the same function as conventional banks – they attract financial resources from individuals and institutions and invest these funds in businesses that need external finance to support their activities. However, they share the profit or loss of the business activities and do not rely on interest payments from the borrowers. Another significant source of revenue for Islamic banks is fee income.

There are two types of Islamic banking institutions:

- The “purely” Islamic bank which only offers Islamic products and services.
- Islamic windows set up by conventional banks.

Most banks today deploy core banking systems to support their business processes and increase operational efficiencies. This requires enterprise-wide planning, commitment and resources. This is more complex in the case of Islamic windows where conventional core *continued...*



## Banking on Islam: A Technology Perspective (continued)

banking systems are tweaked to support Islamic banking activities. In these cases, the banks are required to maintain separate entity books for customers and reporting.

Islamic banks are always seeking to innovate and come up with new products and services in personal finance, wealth management, cards, insurance and corporate financing. This requires core banking solutions that allow banks to build new products rapidly and well ahead of their competition.

An Islamic banking solution must provide financial institutions with the following capabilities:

- Cover all lines of business such as investments, financing, payments, cards, treasury management, trade finance and anti-money laundering services.
- Provide customers with a consistent experience across multiple channels and total visibility to the bank's sales and servicing agents, enabling "anywhere anytime" banking.
- Provide banks with a single view of the customer's activities across lines of business and access channels while providing customers with a single view of the bank's products and services.
- Provide enterprise-wide information relating to regulatory reporting, risk management and bank-wide reporting.
- Have a profit distribution engine which provides flexibility in pool definition, profit-sharing schemes, revenue reserves allocation and distribution, alongside the ability to perform "what if" scenarios prior to the distribution of profits.
- Comply with Shariah law, AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) accounting standards and international accounting standards (IAS), among others.

The implementation of an Islamic core banking solution must transform information technology into an enabler of business by providing an agile platform to achieve corporate objectives. It often forms an integral part of a business transformation program addressing key banking issues such as:

- Increased market share (unique positioning) – Historical data and worldwide experience would seem to suggest that Islamic finance institutions can quickly attain market share through pricing their products more aggressively, providing superior service quality, ensuring consistent, well-designed product integration and having cheaper infrastructure to support the processing of transactions.
- Configurability/speed to market – A "state of the art" core banking solution should allow the firms to effectively process the desired products and services while allowing for the introduction of additional functions or even new products and services.
- Reduced TCO (total cost of ownership) – When companies simplify their technology and operations, the superior performance and cost savings would result in a significant reduction in TCO.
- Centralized customer information and risk management – Islamic banking solutions should be customer-centric, managing relationships with any given customer, including family affiliations and prospects, and it should support comprehensive company structures.
- Connectivity and integration – Islamic banking solutions need to be flexible and agile enough to integrate with other systems in multiple ways.

Despite its proven resilience in the face of financial storms, there are a few challenges facing the Islamic finance sector. These include:

- Sociographic mix in many countries with a financial ecosystem ranging from purely Islamic to Islamic-conventional hybrids to the conventional banking environment.
- Liquidity crunch in key sectors, such as real estate.
- Lack of a comprehensive risk management approach.
- The proliferation of accounting standards – there are some 60 AAOIFI accounting, auditing, governance and Shariah standards.
- The need to embrace international standards such as IAS 39 and IFRS (International Financial Reporting Standard) 2 and concepts such as "fair value", and modify existing AAOIFI standards correspondingly.
- The need for different countries to put in place the appropriate local regulatory framework to address Islamic banking, especially in areas such as tax treatments.
- Shortage of scholars – there are an estimated 50 to 60 scholars in the world qualified to advise banks operating internationally under Islamic law and some Shariah experts feel that it may take more than a decade to train a new generation of scholars.
- Shortage of skilled resources in Islamic banking – 85% of those working in the more than 300,000 Islamic banks all over the world require more education and training.

Banks, regulators, scholars, standards bodies as well as solutions and service providers need to come together to figure out how to sustain the accelerated growth of Islamic banking worldwide.

Finding the right technology solution would facilitate this growth. Players can take what has worked in conventional banking, while avoiding the pitfalls, to come up with a sophisticated technology solution for Islamic banking. ☺

  
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