ISLAMIC BANKING IN SOUTH AFRICA

1. Purpose

The purpose of this paper is to provide a description of the workings and principles of Islamic banking and finance.

2. Introduction

Islamic Banking refers to a method of banking that is based on Islamic Law (Shari'ah) which prohibits interest-based banking and encourages risk and reward sharing based banking. Islamic Banking is based on four main principles namely, the prohibition of interest, ethics by prohibiting investment in unlawful businesses, transparency, and equitable sharing of risk and reward primarily through the use of profit and loss sharing contracts.

2.1. <u>Basic Principles of Islamic Banking:</u>

- Prohibition of Riba

The word Riba is loosely translated into English as usury or interest. Riba in its simplest form is any excess or premium charged on money loaned. Islamic Law considers the excess or premium charged an unjustifiable increase in capital without consideration.

In terms of Islamic law, money is not a commodity but a medium of exchange and a unit of measurement. Money represents purchasing power and cannot be used to increase such power without any productive activity. Islamic finance advocates creation of wealth through industry and labour via trade and commerce.

- No Risk No Gain

Simply put, in Islamic banking, if there is no exposure to risk, there shall be no entitlement to a gain. This principle provides a clear stance in Islam regarding its recognition of risk for justification of earnings in any economic venture. Indirectly, it also entails that in the absence of exposure to the risk element in business undertakings, one may find oneself in a circumstance that might give rise to interest-based transactions which is condemned and prohibited.

- Prohibition of Gharar

Gharar embodies the notion of ambiguity, contingency in a contract, lack of knowledge or uncertainty. Gharar, in practice, relates to issues such as pricing, delivery, quantity and quality of assets that are transaction-based and could affect the degree or quality of consent of the parties to a contract. Gharar may arise from misrepresentation, mistake, fraud, duress, or terms beyond the knowledge and control of one of the parties to the contract, and give rise to settlement risk. Islamic banking upholds contractual obligations and the disclosure of information as a sacred duty. This is intended to reduce the risk of asymmetric information and moral hazard.

- Prohibition of Maysir

Games of chance, excessive speculation and any zero-sum game which create no additional value to the society are forbidden. Islamic banking is geared towards directing surplus funds to the most productive assets.

- Unlawful Goods and Services

Only those goods and services that do not violate the rules of Islamic Law qualify for investment. Thus, any investment in a business dealing with alcohol, pornography, or gambling is prohibited. The prohibition is extended to the entire value chain including packaging, transportation, warehousing, marketing, and provision of after sale services.

- Justice and Equity

Islamic Law requires that both the bank and the client share in the inherent business risk in an equitable manner. Any transaction leading to injustice or exploitation is prohibited.

- Transparency

  Islamic contracts require rigorous following and transparency to ensure a fair distribution of risk and reward.

3. The History of Islamic Banking in South Africa

The establishment of the first Islamic bank in South Africa was in 1980, named 'Jaame Limited'. but it was later liquidated due to financial difficulties. Another Islamic bank was registered in 1988 but was also liquidated a year later due to poor management and the changing face of South African Politics in 1989. [1]

[1] Vahed & Vawda, 2008, The viability of Islamic finance in a capitalist economy: A South African case study, *Journal of Muslim minority affairs*, Vol. 28 No.3, 453-458.

There are two types of Islamic banking operating models being applied in South Africa: Fully fledged Islamic banks and Islamic banking windows.

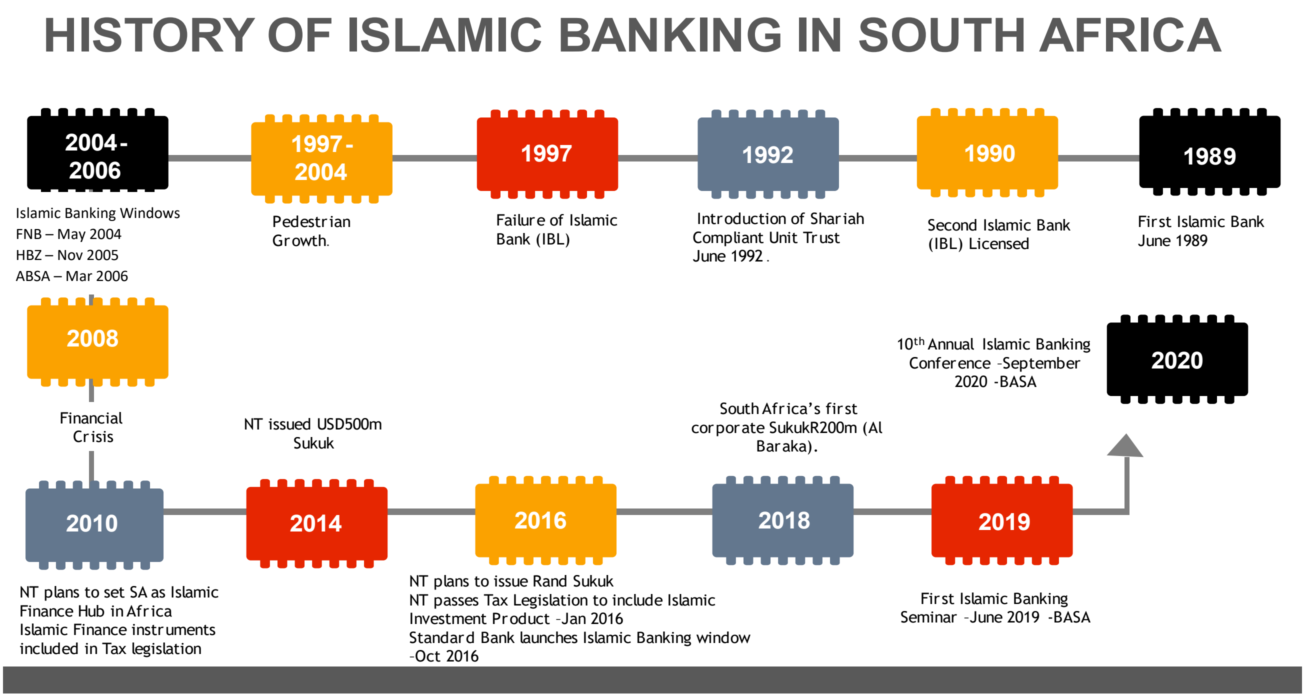
3.1 Fully fledged Islamic Banks in South Africa

A fully fledged Islamic Bank is formed to solely offer Islamic financial services. These banks utilise their own service delivery channels, operating systems, business strategies and policies. An example is Albaraka bank which was established in 1989 became the first bank to successfully offer Shari'ah compliant financial products in South Africa.

3.2 Islamic Banking Windows in South Africa

An Islamic Banking window is formed when a conventional bank establishes a separate ring-fenced division to solely offer Islamic financial services. These divisions are premised on Islamic financial principles and utilise the established infrastructure of the host conventional bank. The conventional banks that offer Islamic windows in South Africa are: First National Bank (est. 2004), HBZ Bank (est. 2005), Absa (est. 2006), Standard Bank (est. 2016).

Figure 1: The History of Islamic Banking in South Africa



Source: The Banking Association South Africa, Islamic Banking Conference 2020

4. Islamic Banking Products

It is important to note that Islamic banking is not only for specific individuals or denominations, anyone can open an investment account and apply for the range of services on offer. Like conventional banks, Islamic banks accepts deposits for savings and transactional purposes.

4.1. Deposits

- ***Mudaraba*** investment accounts

Mudaraba deposits are profit and loss sharing investment instruments. Islamic finance offers savings and time deposits in the form of investment accounts under the system of Mudaraba. The depositors of such accounts share profits with the bank under an agreed-upon formula. The capital loss is borne by the depositor. The bank incurs a loss in terms of operational expenses since it receives no income when it makes a loss on investment.

- ***Wakala*** investment accounts

This is a contract where the depositor grants the bank authority to act on its behalf in a permissible dealing. Wakala deposit accounts give the bank mandate to invest funds on the behalf of the depositors in return for service fees. All profit and loss (minus services fees plus incentives) accrue to depositors.

- ***Qardh Hasan*** current account

Conventional 'cheque' accounts in modern commercial banks are non-interest bearing deposits, and since Islamic banking institutions shun interest rate based dealings, most of them offer such demand deposit accounts. Consistent with the "no risk no gain" principle, the principal amount on these deposits is guaranteed but no return is payable since the depositor is not taking any risk. The bank invests the money at its own account and risk and is therefore entitled to all the profit.

4.2. Advances

Islamic banks also offer Shari'ah asset-based finance through sale, leasing equity and equity-sale hybrid financing instruments.

- ***Mudaraba*** finance (venture capital)

In Mudaraba financing, the bank provides venture capital while the client manages the business and thereby contributes skill and expertise. The bank has no right to interfere in the day-to-day running of the business, but the Mudaraba contract normally contains mutually agreed conditions the client is required to abide by to manage the principle-agent problems arising from asymmetric information.

The Bank shares in the net profit in terms of a pre-agreed profit-sharing ratio and any capital/monetary losses accrue only to the bank. The bank is liable only for capital provided, which means that the client cannot commit the business to any sum that is over and above the capital provided by the Bank.

- ***Murabaha*** (Cost-plus financing)

Murabaha is a sale contract where the cost and the profit margin must be disclosed to the buyer/client. Murabaha is usually called cost plus finance because the bank discloses to the client the acquisition cost of a product/asset and how much profit is adding to the cost. The profit margin is negotiable between the bank and the client. The sale price (cost plus profit) is payable in instalments over an agreed finance term.

For example, a motor vehicle selling at a price of R200,000 may be bought by an Islamic bank and resold to a client at R220,000, to be paid back in monthly instalments over a 2-year period. Instead of interest in a traditional loan, the bank makes a profit with the difference of the purchase value.

- ***Ijarah*** (Lease finance)

The Islamic lease finance product entails the purchase from a supplier and leasing to the client of durable asset required by clients at cost plus over an agreed lease term. In a lease transaction, ownership does not transfer to the client and money is exchanged in lieu of transfer of the right to use an asset or usufruct. At end of the lease term, the asset is either donated or sold to the client depending on provisions of the finance lease contract. The sale price at the end of the lease term is usually a nominal amount. The client has the option to early terminate Ijarah finance through purchase of the asset from the Bank. In such cases, the bank normally sells the asset to the client at present value of the lease contract allowing thereby for the asset ownership to be transferred to the client.

4.3. <u>Other Islamic banking financial instruments</u>

- ***Musharaka*** finance

Under Musharaka finance, both bank and client contribute share capital towards a business undertaking and agree to a profit-sharing ratio. The bank as one of the partners has the right to make strategic decisions and manage the business but not required to do so. Hence, the bank can opt to be a sleeping partner which is normally the case in practice.

The partners share in the net profit in terms of a pre-agreed profit-sharing ratio. Losses are shared in proportion to share capital contribution.

- ***Diminishing Musharaka*** finance

In Diminishing Musharaka, the client acquires the Bank's equity in the enterprise gradually. The value of the bank's equity in the enterprise is divided into units of equal value which are then sold to the clients at cost plus payable in monthly instalments. Profit mark-up is revised with each purchase as agreed between the bank and the client.

The client gradually owns a larger share of the enterprise and, as a result, its share of the capital increases. With this increase in capital, the client will be liable for a larger proportion of any loss.

The client has the option to early terminate the Diminishing Musharaka through acquisition of the Bank's entire equity in the enterprise.

- Foreign exchange

Islamic law has strict principles around currency exchange, and it does not allow for commissions fees on foreign exchange transactions, hence the only source of income for Islamic banks with this type of product is the exchange rate. An Islamic forward exchange contract (FEC) provides businesses with a Shari'ah compliant instrument to hedge their currency risk. Due to volatility and risk of fluctuation in exchange rates of currencies, the businesses involved in international trade preferred to take forward cover on their import and/or export business to avoid losses. Shari'ah does not allow forward sale transactions however, Shari'ah scholars have been permitted to offer forward cover based on promises, in a situation where it is used for the more significant benefit of society and trade.
Islamic Banks intend to offer the facility of forward cover based on a unilateral promise. As per the rules of such transactions, actual sale/purchase would be executed on the specified date or within a specified period in the future at the agreed rate.

- ***Sukuk*** (Islamic bonds)

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity". An important difference between Sukuk and a conventional bond is that the former entitles the holder to a pro rata share of the income generated by the Sukuk asset. A conventional bond, by contrast, entitles the holder to principal plus interest and makes the holder a creditor with a claim against the issuer's asset.

Sukuk are the main instruments in the Islamic capital markets used by corporations and government institutions to raise capital directly from the public. Islamic banks use Sukuk capital instruments to raise economic and regulatory capital.

5. Differences between Islamic banking and Conventional banking model

Table 1: Main Differences between Islamic banking and Conventional banking model

	CONVENTIONAL BANKING	ISLAMIC BANKING
LIABILITIES Deposits	**Product Type:** Savings Account **Return on Deposit:** Interest income **Risk Type:** Credit risk (Capital & Interest Guaranteed)	**Product Type:** Mudaraba Investment Account **Return on Deposit:** % share of net profit generated by underlying real assets **Risk Type:** Business Risk (Capital & Profit not Guaranteed) --- **Product Type:** Wakala Investment Account **Return on Deposit:** profit generated by underlying real assets net of management fees **Risk Type**: Business Risk (Capital & Profit not Guaranteed)
	Product Type: Current Account **Return on Deposit:** Zero/low Interest Income **Risk Type:** Credit risk (Capital & Interest Guaranteed)	**Product Type:** Current/Qardh Account **Return on Deposit:** Zero/No Income **Risk Type:** Credit risk (Principal Amount Guaranteed)
ASSETS Advances	**Product Type: Loan** **Underlying Asset:** Money **Return on Advance:** Interest Income **Basis For Entitlement:** Time Preference **Risk Type:** Credit Risk (Capital Plus Interest (Guaranteed)	**Product Type:** Murabaha & other Sale-based Finance Products **Underlying Asset:** Real Asset (Trade and Other Assets) **Return on Advance:** Predictable Fixed Profit Income **Basis For Entitlement:** Asset/Business Risk **Risk Type:** Business & Credit Risk (Capital & Profit Guaranteed)

	CONVENTIONAL BANKING	ISLAMIC BANKING
Finance Lease	**Product Type:** Finance Lease **Underlying Asset:** Durable Real Asset **Return on Advance:** Interest Income **Basis For Entitlement:** Time Preference **Risk Type:** Credit Risk (Capital Plus Interest Almost Guaranteed)	**Product Type:** Ijarah Finance Lease **Underlying Asset:** Durable Real Asset **Return on Advance:** Rental Income **Basis For Entitlement**: Asset/Business Risk **Risk Type:** Business & Credit Risk (Rental Income Not Guaranteed)
Investments	**Product Type:** Preference Shares **Underlying Asset:** Commercial Enterprise **Return on Advance:** Dividend Income **Basis For Entitlement**: Time Preference/Credit Risk **Risk Type:** Credit Risk (Capital Plus Dividend Almost Guaranteed)	**Product Type:** Diminishing Musharaka Finance **Underlying Asset:** Commercial Enterprise/ Real Asset **Return on Advance:** Predictable Profit from sale of Units and Rental Income in some financing structures. **Basis For Entitlement**: Business Risk **Risk Type:** Business & Credit Risk (Capital Plus Profit Not Guaranteed)
	Product Type: Venture Capital **Underlying Asset:** Commercial Enterprise **Return on Investment:** % share of net profit generated by underlying real assets. **Basis For Entitlement**: Business Risk **Risk Type:** Business Risk (Capital Plus Profit Not Guaranteed)	**Product Type:** Mudaraba Finance **Underlying Asset:** Commercial Enterprise/ Real Asset **Return on Investment:** % share of net profit generated by underlying real assets. **Basis For Entitlement:** Business Risk **Risk Type:** Business Risk (Capital Plus Profit Not Guaranteed)
	Product Type: Private Equity **Underlying Asset:** Commercial Enterprise **Return on Investment:** % share of net profit generated by underlying real assets. **Basis For Entitlement**: Business Risk **Risk Type:** Business Risk (Capital Plus Profit Not Guaranteed)	**Product Type:** Musharaka Finance **Underlying Asset:** Commercial Enterprise **Return on Investment:** % share of net profit generated by underlying real assets. **Basis For Entitlement:** Business Risk **Risk Type:** Business Risk (Capital Plus Profit Not Guaranteed)

	CONVENTIONAL BANKING	ISLAMIC BANKING
MODEL STABILITY	Unstable- maturity mismatch & interest rate Risk	Generally Stable- return on deposits is a function of returns on underlying assets. Can be susceptible to deposits flight if return on deposits is not competitive. May not generate the expected ROE.
GOVERNANCE STRUCTURE	Corporate Governance	Corporate Governance Shari'ah Governance: Shari'ah Supervisory Board, Shari'ah Advisory & Shari'ah Audit
BANKING SUPERVISION	State Regulatory Bodies	State Regulatory Bodies including Central Shari'ah Supervisory Board (Islamic Countries)

6. Governance Structure

The corporate governance structure of Islamic Banks includes an additional layer consisting of Shari'ah governance framework as illustrated below.

Figure 2: Governance Structure of fully-fledged Islamic Banks

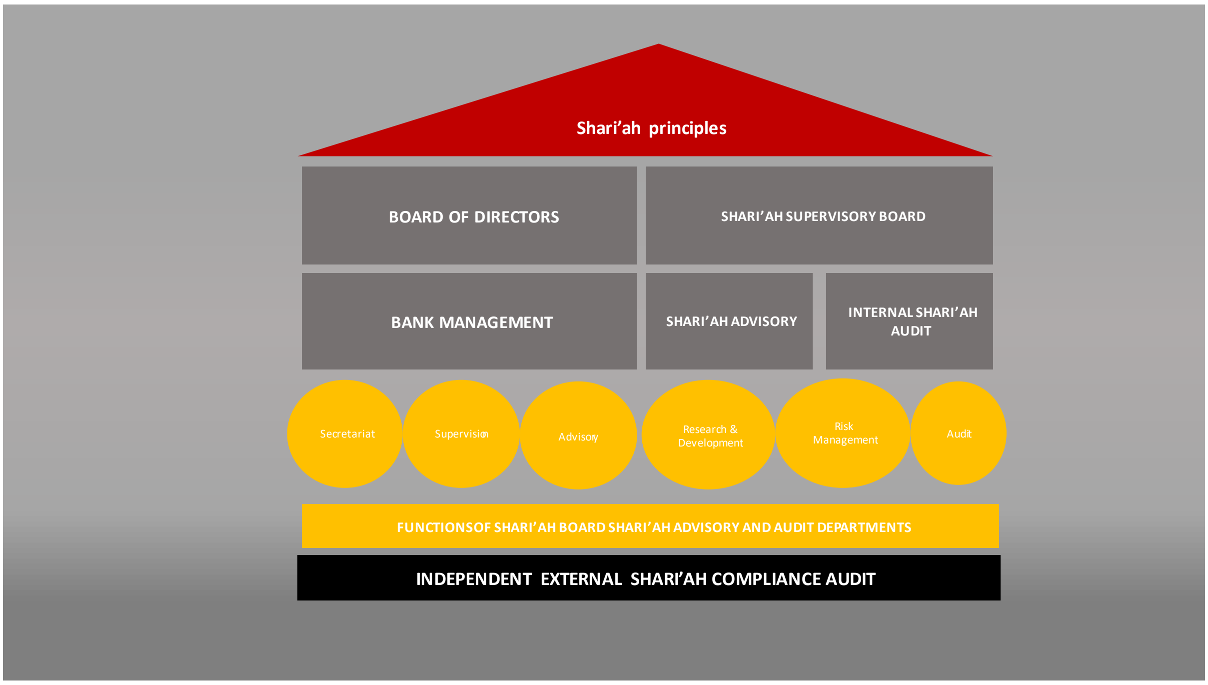
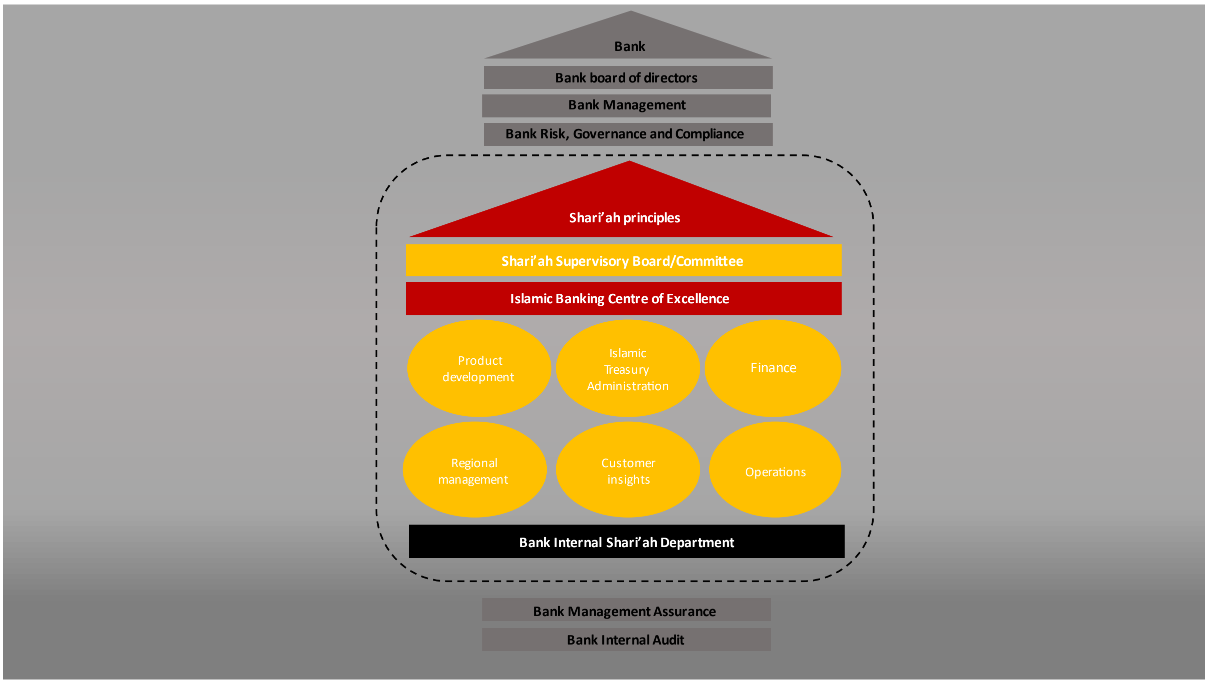


Figure 3: Governance Structure of Islamic Window



6.1. <u>Shari'ah Supervisory Board</u>

The main function of the Shari'ah Supervisory Board (SSB) is to provide Shari'ah guidance and directives, certification of products and services offered by the bank. It is also to issue annual Shari'ah compliance reports on the bank's compliance with applicable Shari'ah rules and principles.

The SSB consists of Shari'ah scholars who are experts in the field of Islamic Law in general and have extensive experience dealing with Islamic banking and finance Issues. The SSB is guided by the Shari'ah standards issued by industry bodies such as The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB).

6.2. <u>Shari'ah Advisory</u>

The Shari'ah advisory function is primarily responsible for guiding the implementation of the directives of the Shari'ah Supervisory Board. These directives include providing Shari'ah training to staff, dealing with queries that arise from the day-to-day operations of the Bank, and identification and management of Shari'ah risks.

Shari'ah advisory staff perform research to enhance existing products and operations of the bank, develop new products, and provide guidance on product development from conception to implementation Stage.

6.3. Internal and External Compliance Audit

Shari'ah Audit is the function of reviewing and assessing the activities, policies and procedures, and control systems of the bank to ensure compliance with the Shari'ah guidelines laid down by the SSB for the products and operations being audited. The basic principles and standards upon which the Shari'ah Audit is based are the Shari'ah standards and guidelines prescribed by the SSB and/or industry bodies such as AAOIFI.

6.4 Additional layer of governance in Islamic Banking Windows

The Shari'ah governance structure operates within the framework of the broader bank's governance structures. Shari'ah governance is an additional layer that adds to the controls effective for all banking divisions and subsidiaries. The windows are supported by the bank's / group's risk and control departments such as Internal Audit, Management Assurance, Risk Management, etc.

Islamic windows are also overarched and governed by Shariah principles. Islamic banking windows also have:

- Shariah Supervisory Board (SSB)
- Shariah Advisory
- Internal and External Compliance Audit.

Which perform the same functions as in fully fledged Islamic banks.

7. Numerical Analysis

It is important to note The Banking Association South Africa began collecting Islamic banking Statistics in March 2019, therefore the data used in the compilation of this report starts in March 2019. In 2019, globally, Shari'ah-compliant financial assets were estimated at a worth of $2 trillion.

Figure 4: Islamic Banking Market

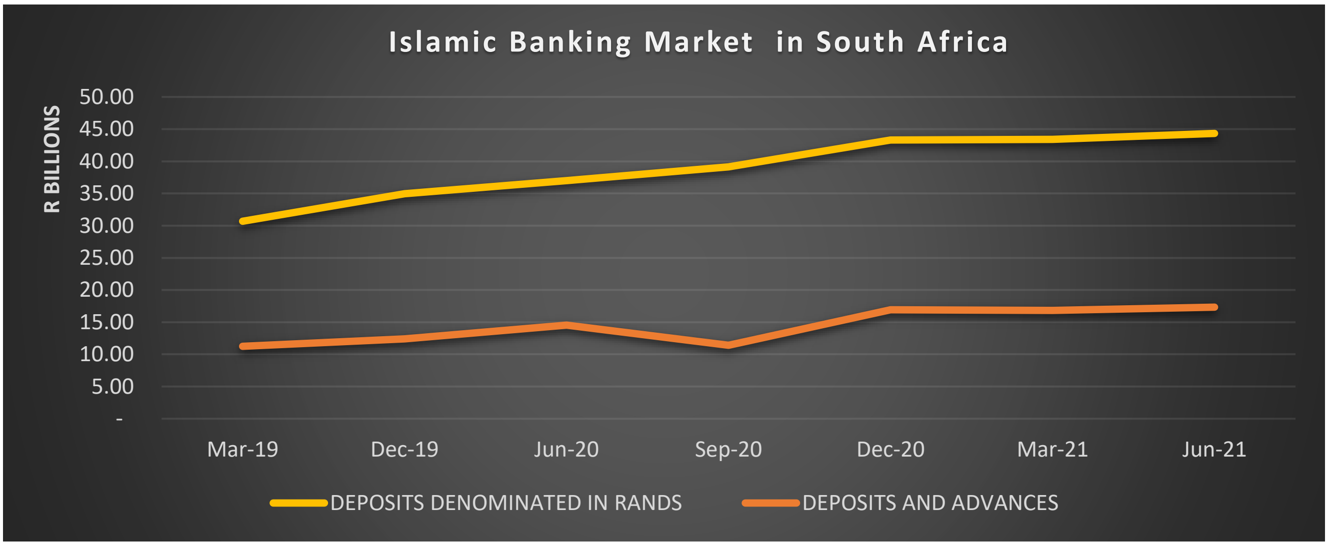
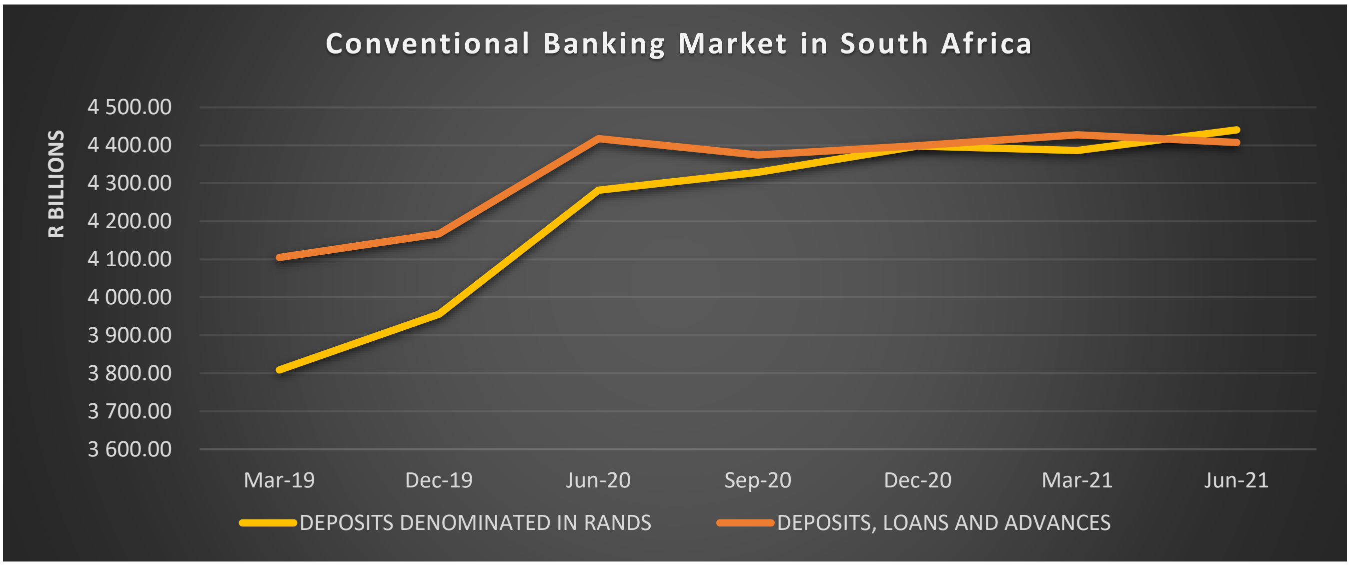


Figure 5: Conventional Banking Market



In South Africa, total Islamic banking assets are 0.16%[2] of the total assets of the banking industry as at March 2021. As illustrated in Figure 4, from March 2019 until March 2021 Islamic banking deposits

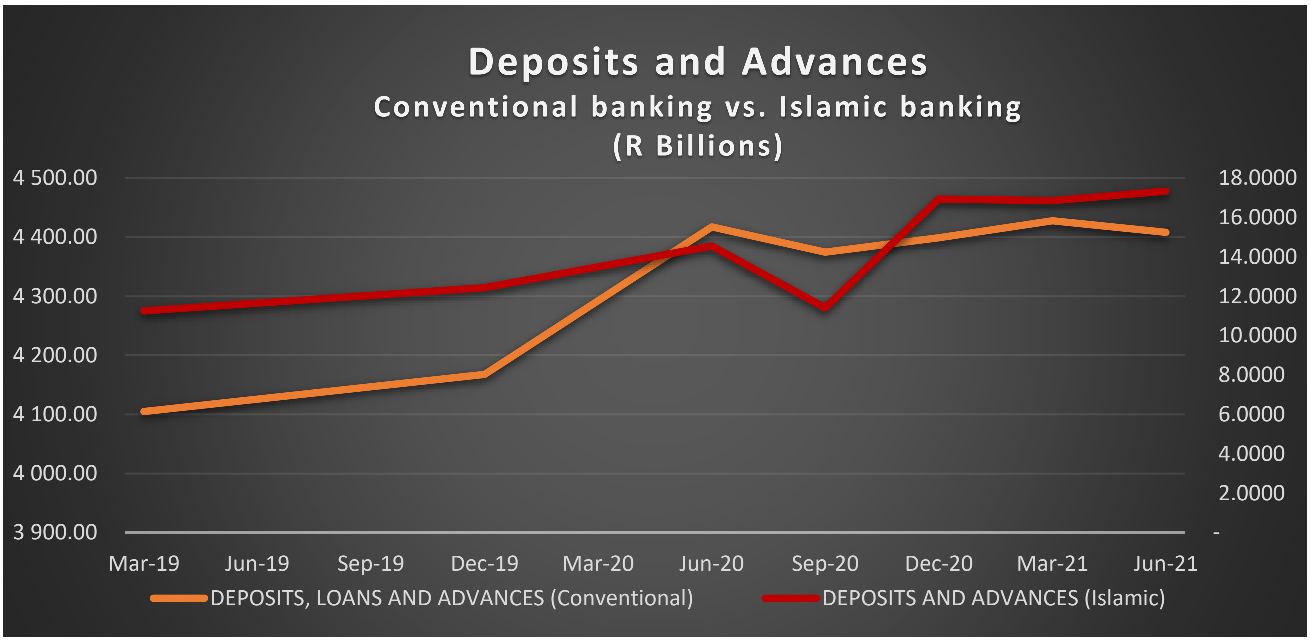
[2] As at March 2021, participating banks account for 92% of total Islamic banking assets in South Africa.

grew by 41.51% contrasted by the 15.16% growth in conventional banking deposits in South Africa, as illustrated in Figure 5. The growth rate of Islamic banking deposits exceeds the growth rate of conventional deposits by almost 30%, for the two-year period. In June 2021, Islamic deposits grew by 2 % and conventional deposits grew by 1.2%.

Figure 4 and Figure 5 further illustrate that Islamic advances grew by 49.71% from March 2019 to March 2021, whilst commercial banking loans and advances grew by 7.86%. There was a large increase in the growth rate of loans and advances from December 2019 to June 2020 in conventional banking, this could have been a result of the bespoke assistance provided by banks to their customers via the Covid-19 Loan Guarantee Scheme which provided loans to eligible businesses to assist them during the COVID-19 pandemic. Funds borrowed from this scheme was done through the assistance of the banking sector. Similarly, there was an increase in the growth rate of Islamic advances from December 2019 to June 2020, possibly as a result of the three-month payment extension on existing loans due to COVID-19. The Islamic banking market did not utilise the temporary relief provisions which were implemented based on concerns as to how the capital would be replenished once the relief was withdrawn. From June 2020 to September 2020 Islamic advances decreased by 21.61%[3]. From September 2020 through to December 2020 the Islamic advances grew by 48%[4], and then declined by 0.51% at March 2021, and increased again by approximately 3% in June 2021. Similarly, loans and advances in the conventional banking market also decreased in growth from June 2020 to September 2020 but by smaller ratio of 0.97%. Loans and advances further decreased by 0.5% in June 2021. This could have been the effects of the loan guarantee scheme as after June most banks reduced the amount of capital contributed to the loan guarantee scheme.

[3] As at September 2020, 4 out 5 banks submitted Islamic banking data
[4] Percentage could be skewed as 5 out 5 banks submitted Islamic banking data as at December 2020

Figure 6: Deposits, loans, and advances: Conventional Banking vs. Islamic banking



The large growth rate of deposits and advances in the Islamic banking market has fuelled significant investment in Shari'ah product development. Islamic banks in South Africa now offer a wide array of investing, financing, protection, and transacting products, which, despite being distinct, compare favourably with conventional bank offerings. As illustrated in figure 6, it seems that the trend of deposits and advances are less volatile in the Islamic banking market than that of conventional banking. According to some authors the prohibition of interest and speculative behaviour in Islamic finance inherently translates to Islamic banking products being robust and less volatile however as illustrated in Figure 6, there is a sharp decline in the growth rate of deposits and advances from June 2020 to September 2020. It would be interesting to further interrogate the reason behind this sharp decline and investigate the unique risks faced by the Islamic banking market as a result of the business model used in Islamic finance.

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