

The Role of Islamic Finance and Banking for Kurdistan in the Next Decade

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Abstract: The Kurdistan Regional Government is recognized as a semiautonomous region in northern Iraq. Although Kurdistan is in the Middle East where the region hosts enormous conflicts and uncertainty, it is differentiated in terms of security, stability and democracy. Kurdistan is in the 51st place in oil production and 58th place in natural gas production however it is 9th place in oil-proved reserves and it is in 11th place in natural gas-proved reserves. These statistics put forth that Kurdistan region has a potential to show a great economic growth. Investment opportunities are going to diffuse in many different fields in the short and medium term. All these facts and expectations show that the banking system especially Islamic finance and banking due to the religious perspective of the Muslim community in Kurdistan is going to play a crucial role in the path of the development of the region like in the early stage of the other developing countries. This paper analyses the short history of Kurdistan's financial system and Islamic banking, current situation, and tries to state challenges and opportunities of Islamic banking and finance in Kurdistan in near future. Since there are very few studies for Kurdistan region this paper will contribute to the literature and future studies.

Keywords: Economic Growth, Financial Development, Islamic Finance, Kurdistan Region

1. Introduction

Islamic financial system is based on a set of rules and laws referred to as Shariah. Shariah is governing economics, political, and cultural aspects of Islamic societies. Shariah originates from the rules dictated by the Quran and its practices and explanations by the Prophet Muhammad (s.a.s) known as Sunnah. We can summarize the basic principles of Islamic financial system as follows:

- Prohibition of Interest: Under Islamic law, any level of interest is prohibited. Islam encourages the making profit but forbids the charging of interest. Quran says that “But Allah has permitted and forbidden usury...” (2:275)
- Prohibition of Uncertainty: The terms and the conditions which of the risk are not clearly understood by all parties to a financial transaction are not allowed.
- Profit-Loss Sharing: Sharing profit or returns from assets are permitted if parties involved in a financial transaction share both the risks. So the business risks must be shared by the lender (seller) and borrower (buyer).
- Ethical Investments: Investments such as alcohol, pornography, gambling, and pork based products are not allowed.

- Money: Money is a very important issue in any of financial system. The status, role, and function of money are not same in conventional finance and in Islamic finance. The philosophy of Islam about money is completely different from the conventional system. The usage of money is limited with its basic purpose in Islamic finance. Money has to be used as a medium of exchange and a measure of value. Money itself cannot be used for the purpose of trade. Money has to be exchanged for money, it can be borrowed but the payment on both sides must be equal. In conventional system, money is a commodity that can be sold or bought. Money can be rented for profit in the conventional system.

In general we can say that Islamic finance contains any financing activities that should not be prohibited by Sharia and these activities must not involve interest (riba) and should avoid uncertainty, risk, and speculation (in Arabic Gharar). Islamic finance does not allow trading in alcoholic beverages, gambling and products that contain pork. Active participation of financial institutions in achieving the purposes and objectives of an Islamic finance is very important issue for Islamic finance. Another important issue in Islamic finance is the financial activities should meet the needs of society and to support socioeconomics justice among the people. Islamic financial products are Musharakah, Mudarabah, Murabahah, Ijarah, Istisna, Takaful, Salam, Sukuk, Muqarada, and Bay Bithamin Ajil (BBA).

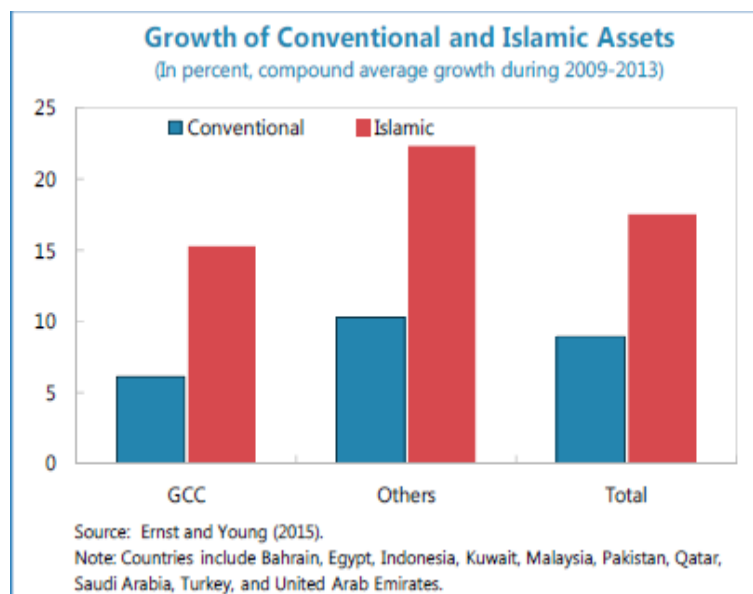


Figure 1: Growth of Conventional and Islamic Assets

Although Islamic finance is getting its popularity in the last two decades it is as old as Islam. From the 7th century trade and business activities were based on Islamic rules in the Islamic world. History of Islamic financing industry in the modern era is very young. According to many authorities in Islamic finance, Islamic financial institutions really took off in the 1960s with the launch of the first Islamic bank in Egypt. When the recent years are observed it can be seen that the size of Islamic finance shows an increasing trend. According to IFSB Industry Stability 2017 Report Islamic financial services' value reached to USD 1.9 trillion despite slowdown in a few years.

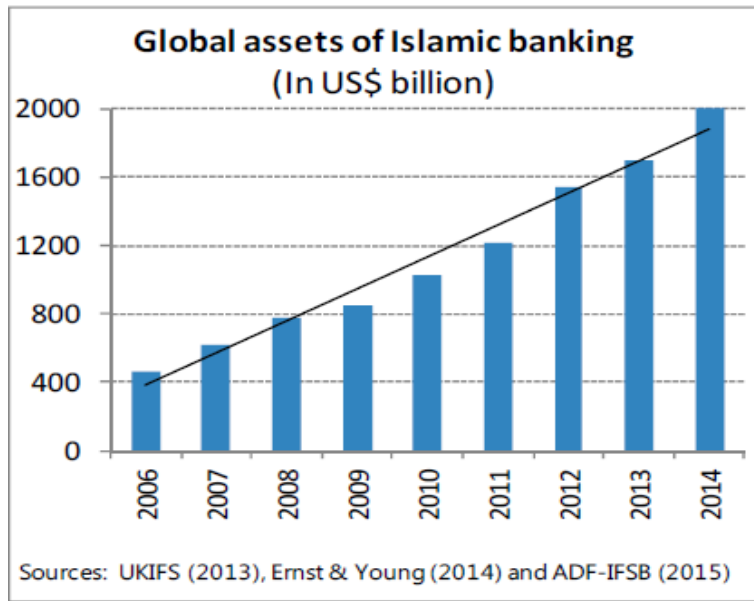


Figure 2: Global Assets of Islamic Banking

Islamic finance is increasing its share in the global economy at a remarkable pace (El Qorchi, 2005). Now Islamic banking is operating more than 75 countries. Islamic finance is becoming more important in the Middle East (Syed, 2012) as well as in the world. The researcher Bashir (2001) studied on the Islamic finance in Middle East to measure the performance of Islamic banking. He argued that profitability of Islamic banking have positive effect increasing in capital and loan ratios. Hamadi and Bassil (2015) also argued that Islamic Banks are more efficient than those conventional ones since they are not based on the interest.

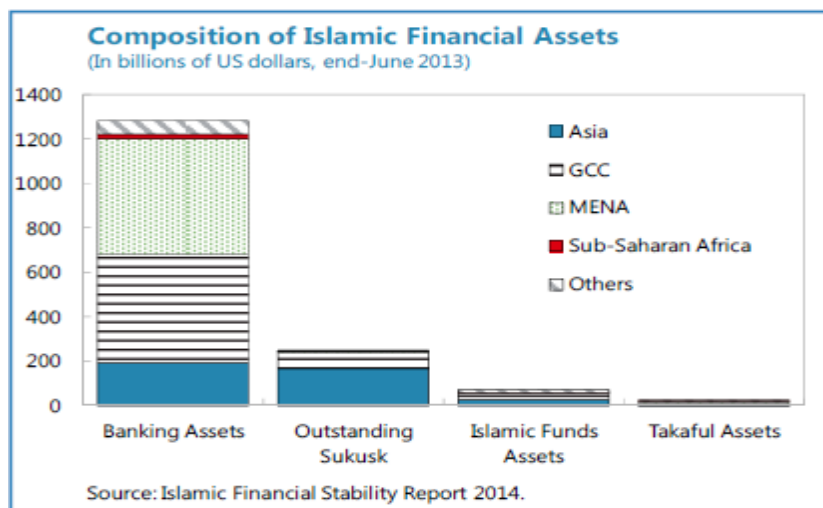


Figure 3: Composition of Islamic Assets

2. Islamic Finance and Banking in Kurdistan Region

The Kurdistan Regional Government is recognized as a semiautonomous region in northern Iraq. Kurdistan showed a great economic, politic, and social modernization in the last decades (Gunter, 2004). Middle East is suffering from conflicts and uncertainty from many years. However Kurdistan Region in terms of security, stability, and democracy is more stable place in the Middle East. Kurdistan has a great importance in the region in geostrategic and natural sources. Kurdistan economy is mostly dependent on the oil. On the other hand, oil and non-oil sectors were tried to be promoted until first half of 2014. The conflicts between central Iraqi government and Kurdistan and the violence caused by ISIS in the region address the new challenges on the Kurdistan Region after the second half of 2014.

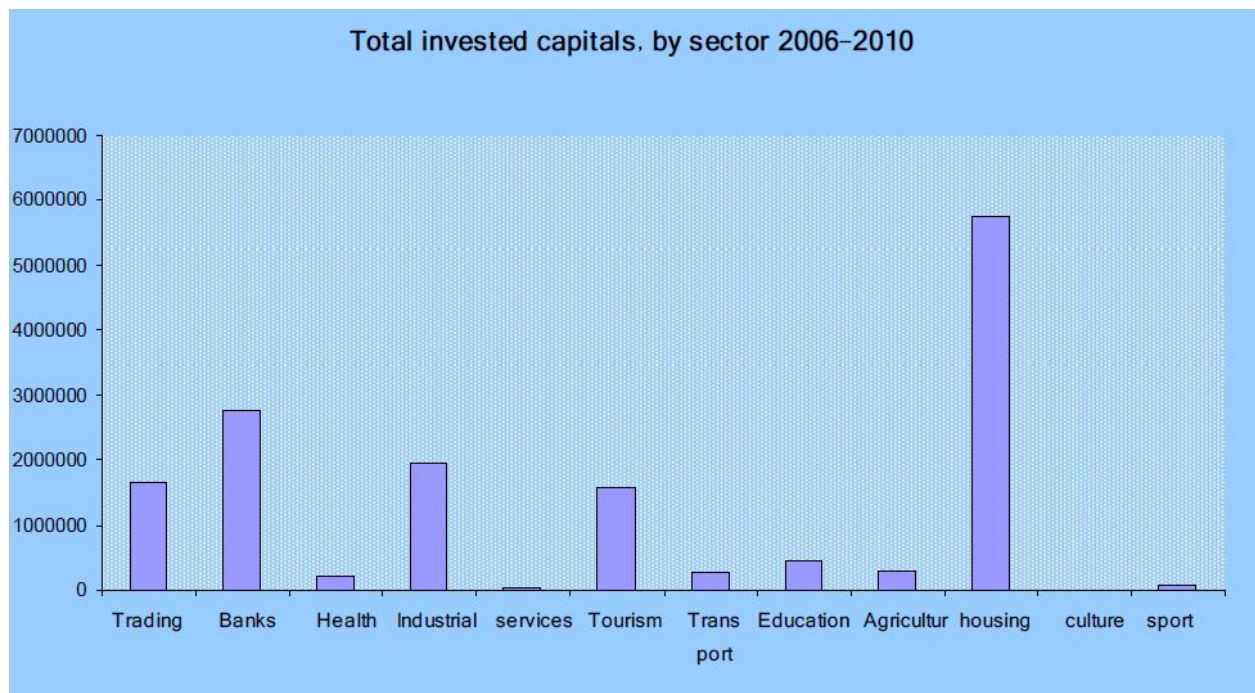


Figure 4: Total Invested Capital by Sectors between 2006 and 2010

Source: Regional Development Strategy for Kurdistan Region 2012-2016

According to World Bank report in 2016, Kurdistan Region has weak financial system and this report also states the fact that most of the transactions in Kurdistan Region depends on the cash-economy. The preference is the cash in most of the transactions especially among the small-medium enterprises. This report states another fact about the number of banks in Kurdistan and their functions. As a number there are plenty of banks and their branches in the region however banking sector is not developed. The banks are not providing capital to the private sector to support development. Real sector most of the time cannot find the loans that needed for investments from the banking sector. After second half of 2014 banks started to face liquidity problems which of course affect their core functions to engage the economy.

Table 1: List of Top Conventional and Islamic Banks in Kurdistan Region

- Emerald Bank
- Erbil Bank of Investment and Finance
- Kurdistan International Bank for Investment and Development-Islamic Bank
- Cihan Bank for Islamic Investment and Finance-Islamic Bank
- Al-Baraka Turk Katilim A.S-Islamic Bank
- Lebanon's Byblos Bank
- Intercontinental Bank of Lebanon Bank of Beirut and Arab Countries
- Vakif Bank-Erbil
- Isbank-Erbil

Source: <http://www.irfad.org/>

Another problem in banking sector is related to the private banking. Private Banks in Kurdistan do not have access liquidity as state banks. Salaries and payments for services are not done through banks therefore private banks cannot evaluate salary history to provide the loan for individuals. This also affects the individuals to access financing for their expenditures.

The problems that Islamic Banks have are also similar to conventional ones. Furthermore one of the major problems for both Islamic and conventional banks is the attitudes of the individuals. The majority of the individuals in Kurdistan distrust the banks. After the crisis starting from 2014 banks started to have problems cash shortages. Most of the private banks restricted their customers from withdrawing cash. This experience forces economy to cash-based economy.

3. Conclusion

Kurdistan Region has a great potential due to geostrategic importance and its rich natural sources. However dependency on oil is the biggest risk for their economy. Financial system is vital for private sector development. Kurdistan Region only can achieve a well-developed economy by financing small-medium entrepreneurships (SMEs). Islamic banks will definitely play a crucial role to provide required fund for investments. Kurdistan government most probably performs new regulations to change the high demand for cash in the transactions. Mistrust in the banking sector for conventional and Islamic banks seem the major issue. If the salary and service payments are done by through banks and government gives guarantees for some amount of money deposited by individuals in the banks then poorly developed banking system will change dramatically. Due to the religious attitude Islamic banks will have more chance to attract funds from individuals when Kurdistan Region has strong financial system.

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