Transformation of Qatar Development Bank from Conventional Model to Islamic Banking System

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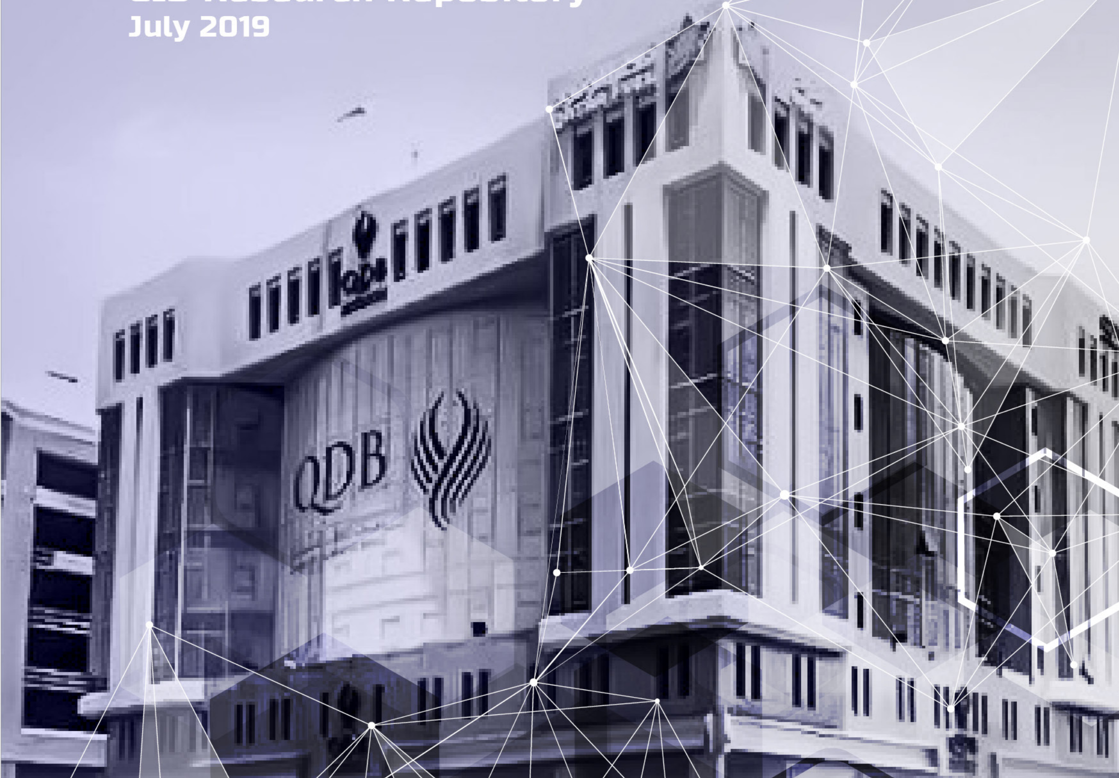

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CIS-Research Division
College of Islamic Studies | Hamad Bin Khalifa University
Doha, Qatar

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Introduction

In February 2011, Qatar Central Bank (QCB) issued a directive which took the banking industry in Qatar by storm. Citing difficulties in monitoring and supervising hybrid banking operations (conventional and Shariah compliant), QCB ordered conventional banks to wind up their Shariah-compliant banking branches. Moody's rating agency stated in the following week that "the loss of Islamic banking is credit-negative for Qatari conventional banks, which derive 10%-15% of their yearly earnings from Islamic banking" (Al Tamimi & Co, 2011). At the time, the Shariah-compliant asset allocation of conventional banks averaged about 10% of their total assets, while full-fledged Shariah-compliant banks in Qatar had assets of around $33 billion, accounting for nearly one-fifth of the total banking assets in the country (The Economist, 2012). Around 16 Shariah-compliant banking branches of six commercial banks – including HSBC, Qatar National Bank, Doha Bank, International Bank of Qatar and Commercial Bank of Qatar – were affected by the order (The Economist, 2012). It was in this environment that Qatar Development Bank (QDB) made the crucial decision to transform itself into a Shariah-compliant bank.

"The environment or the ecosystem when QDB decided to convert to a Shariah-compliant bank was hostile to such conversion. Until then, the banks in Qatar had the option to have Shariah-compliant windows, and the Central Bank then stopped this, after which they were converting the windows to non-Shariah-compliant ones," said Abdulaziz bin Nasser Al-Khalifa, QDB CEO, recalling the industry headwinds the bank confronted after making the bold move.

Once the decision was made, there was no looking back, and the entire QDB team started working dedicatedly to accomplish their mission. Fast forward to June 2019 when this draft was finalized, and 97% of all the bank's assets have been converted to Shariah compliant.

Shariah-Compliant Banking Landscape in Qatar in 2011

Shariah-compliant banking had formally started in Qatar in 1983 with the establishment of Qatar Islamic Bank. It was only later, in 2005, that Qatar Central Bank opened the market to conventional banks by authorizing them to offer Shariah-compliant products and services to their clients through separate branches. As the Shariah-compliant banking market's share grew over the 20 years since its formal inception in Qatar, more and more conventional banks started opening dedicated branches to participate in this lucrative segment. By 2011, the share of Shariah-compliant banking in terms of total assets had grown to 20%, with conventional banking players such as Qatar National Bank, HSBC, Doha Bank, Commercial Bank of Qatar and International Bank of Qatar all having opened Shariah-compliant banking windows (Al Tamimi & Co, 2011). Conventional banks' average allocation towards Shariah-compliant products was 10% of their portfolio at the time of the QCB announcement.

Only a few banks in Qatar were given the license to exclusively practice Shariah-compliant banking – the most prominent ones being Qatar Islamic Bank and Masraf Al Rayan Bank. The cumulative assets of these Shariah-compliant banks were about one-fifth of the total banking assets in Qatar, amounting to about $33 billion (The Economist, 2012). Their share of private-sector deposits, however, was higher, at nearly 30% of the total.

In February 2011, QCB notified conventional banks in Qatar which were operating Shariah-compliant banking branches that they would have to refrain from opening new Shariah-compliant banking branches, accepting Shariah-compliant deposits and conducting new Shariah-compliant finance operations. QCB justified this decision on the grounds that the "overlapping nature of non-Shariah-compliant and Shariah-compliant activities of conventional banks" and the "comingling of their activities and services" were leading to supervisory and monetary policy implementation issues and creating impediments for conventional banks to effectively manage bank risks, financial reporting, capital adequacy requirements and financial stability. About 16 Shariah-compliant banking branches of six commercial banks were affected by this QCB directive, either closing, transforming or transferring their Shariah-compliant banking operations by January 1, 2012.

Global Trend of Conversion from Conventional to Shariah Compliant

When deciding to convert, QDB was supported by some encouraging trends in the region and globally. At the end of 2013, still the early days in the conversion story of QDB, the Shariah-compliant finance industry's assets worldwide were estimated to have grown by 18.6% annually to reach $1.8 trillion, according to KFH Research, and this amount was projected to reach $2.1 trillion by 2015 (The Halal Journal team in Finance, 2014). By 2014, Kuwait, for instance, had five Shariah-compliant banks, compared with four conventional banks. Commercial Bank of Kuwait had received the approval of 85% of its shareholders in April 2013 to convert into a Shariah-compliant institution and was ready to follow the footsteps of its country peers, Boubyan Bank and Ahli United Bank Kuwait in switching to Shariah compliance (The Halal Journal team in Finance, 2014). Around the same time, Malaysia's Agro Bank had announced plans to convert to Shariah-compliant banking by 2015 while the country's SME Bank was envisaging a complete conversion by 2018, according to Reuters. Faysal Bank and Summit Bank in Pakistan were working on similar plans to convert their whole banking system into Shariah-compliant banking. Sharjah Islamic Bank, formerly known as National Bank of Sharjah, was established in 1975 in Sharjah, United Arab Emirates. It began converting into a Shariah-compliant bank in March 2001 and completed the process by June 2002, becoming the first case of a completed conversion. Other examples of transformation in the Gulf region to a full-fledged Shariah-compliant bank were the conversion of Aljazerah Bank in Saudi Arabia and that of Bahrain's Ithmaar Bank, which completed its transformation from an investment house to a Shariah-compliant retail bank in 2010.

"This is the first time that a state-owned development bank voluntarily converted from non-Shariah-compliant to Shariah-compliant and we believe that the conversion story of QDB will serve as a reference point and a role model for future conversions," said Al-Khalifa, emphasizing the uniqueness of QDB's conversion. While there had been precedents in the transformation of state-backed national financial institutions due to the legal conversion of a country – in Iran, Pakistan and Sudan, for example, central bank regulations only allowed Islamic system practices – QDB was the first one to do it voluntarily.

Soon after the Islamic revolution of Iran in February 1979, a spree of mergers and nationalization initiatives in the banking sector were executed as part of the broader economic measures passed by the Revolutionary Council. Soon after, the Central Bank of Iran announced the reduction of interest rates on loans and deposits and labelled them as "banking fees." On September 1, 1983, Iran's parliament ratified the interest-free banking bill into law. Thereafter the riba-free Banking Act was imposed on all banks in Iran, which included comprehensive details on permissible activities such as the financial products that could be used and businesses that could be funded.

Sudan is another country which sought to implement a country-wide Islamic financial system. Islamic Cooperative Development Bank was formed as part of these efforts following the declaration of Shariah laws in Sudan in 1983. Subsequently, in 1984, the Civil Transactions Act was issued according to which all usury transactions in the country were prohibited. Pakistan too has a similar history of the state investing significant time and resources to convert the entire banking system to be Shariah compliant.

Qatar Development Bank – Background and History

Qatar Development Bank was founded in 1997 by an Emiri Decree aimed at expanding Qatar's private sector and diversifying its economy. His Highness Sheikh Hamad Bin Khalifa Al Thani, the Father Emir, identified three tasks as crucial to Qatar's development into a modern state. Since its establishment in 1997, QDB has been at the forefront of these efforts and has worked with thousands of Qatari entrepreneurs and enterprises. In 2007, the institution was renamed from Qatar Industrial Development Bank to Qatar Development Bank as it started diversifying its services to sectors other than industry. Those new sectors included healthcare, education, tourism, agriculture, livestock and fisheries. The following year, the company's equity capital contribution was increased from an initial amount of QAR 200 million to QAR 10 billion as it was realized that QDB would need to play a much more significant role in shaping the Qatari business and financing ecosystem. As of June 2018, Qatar Development Bank had about QAR 9.5 billion in assets on its balance sheet, which was supported by total shareholder equity of QAR 9.2 billion.

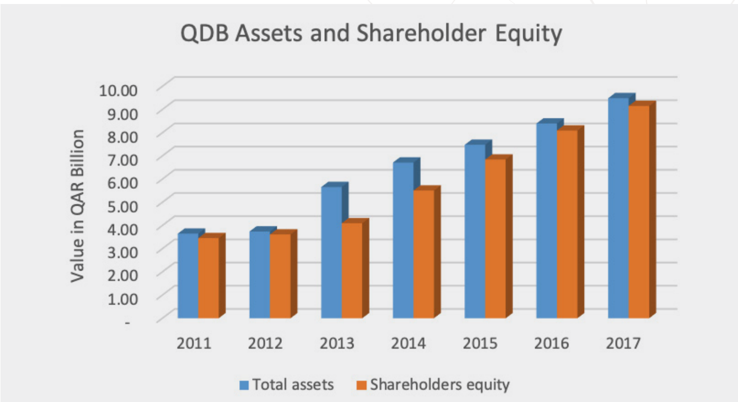

Fig 1: QDB assets and shareholder equity (Source: Data retrieved from Financial Statements of QDB)

The main objective of Qatar Development Bank is to participate in the economic development process of the State of Qatar, by providing the necessary financing for small and medium-size industrial, educational, health, agricultural and tourism projects. The bank also administers the disbursement of the government's land loan scheme as part of its fiduciary activities.

QDB has provided financing along with advisory services and guidance, both for new startups and established companies. Over the years, QDB has built a reputation for itself for its ability to identify promising business opportunities for investments. QDB's focus has been on the growing micro, small and medium-sized enterprises in key sectors, offering them suitable products and services through a single window to comprehensively cater to all their business and growth needs. The bank provides support to small and medium-sized enterprises through methods which include:

- direct and indirect financing of mandated sectors in general, but with a sector-agnostic approach
- providing consultancy and business advisory services in the early stages and throughout the growth of the business
- enhancing technical skills and capability development
- promoting and supporting exports
- providing opportunities for small and medium-sized enterprises domestically and globally
- providing initiatives and services associated with real estate development and housing loans to citizens
- promoting SME ecosystem development

Qatar Development Bank was named the Best Development Bank in the Middle East at the 2014 Banker Middle East Industry awards. More recently, it received the Best SME Loan award during the Arab Banks Awards and Commendations of Excellence 2017 in recognition of the development organization's leading position in creating a series of direct and indirect financial assistance programs for small and medium-sized enterprises.

QDB's Focus on the SME Sector

Qatar has a growing entrepreneurial population and has over the past decade been increasingly serious about diversifying its economy beyond the oil and gas sector to transform itself into an advanced society capable of achieving sustainable development. Qatar National Vision 2030 (QNV 2030), launched by the State of Qatar in October 2008, emphasizes this need for a balance between energy exploitation and economic diversification and promotes the creation of a knowledge-based economy. Qatar's interest in public-private partnerships stems primarily from the planning, technical, implementation and operational expertise that private partners can offer and the beneficial impacts of this expertise on local capabilities and service quality (Ibrahim and Harringan, 2012). SMEs are essential enablers of these aspirations of Qatar to evolve into a more diversified and sustainable economy. This vision was supported by shorter-term plans, including the National Development Strategy (NDS) 2011-2016. This plan paves the way for the country's long-term social and economic goals and emphasizes the need for using public-private partnerships to deliver new services to the population. Recognizing the relatively smaller input of the private sector to Qatar's economy and a further more modest number of private firms outside the oil and gas sector, QDB reoriented its services to serve a more extensive base of SMEs.

As the private-sector arm of the government, QDB is guided by the objectives of QNV 2030 in all its endeavours. In line with this approach, QDB focuses its efforts on developing and empowering local entrepreneurs and innovators and encouraging the creation and growth of small and medium-scale enterprises in Qatar's key industry sectors.

“We always knew that, to chart the type of progressive economic and social path envisioned by our state, we need to be imaginative and proactive in our approach for our future generations. Today, we support our local entrepreneurs, startups and SMEs through both financial and non-financial methods until they can achieve the capacity to sustain themselves,” notes Al-Khalifa.

This institution’s vision statement is also aligned with these objectives and states that QDB aims to develop and empower Qatari entrepreneurs and innovators to contribute to the diversification of the Qatari economy, through successful small and medium enterprises that can compete in global markets. QDB’s mission is to improve the economic development cycle by providing entrepreneurs and SMEs with a wide range of financial and advisory products under one roof.

QDB deploys a multi-pronged strategy towards promoting the SME sector in Qatar. It starts with arranging consultancy services for entrepreneurs to develop their business idea, followed by the support of legal, incubation and acceleration services to get the business up and running. After that, bookkeeping assistance, financing and audit support are provided so that the entrepreneur can focus on growing the core business operations without having to worry about these ancillary business requirements. Additionally, relevant marketing and promotional support are provided to the SMEs to enable faster growth. To top it all, QDB provides them with opportunities to expand their footprint beyond Qatar through their matchmaking services with importers across the globe.

QDB has been taking several proactive steps with SMEs to increase their access to the institution’s various facilities. Its ultimate objective is to become a “partner of first resort” for all SMEs and their entrepreneurs in Qatar. Schemes such as Jahiz-I and Jahiz-II offer new SMEs in innovative and environmental-friendly industries the opportunity to rent ready-built industrial facilities and other incentives to the entrepreneurs. Programs such as Tasdeer are tasked with promoting and developing SME exports by organizing informative workshops, exhibitions, market studies and training, developing exporter directories and offering relevant advisory services. Al Dhameen is another program sponsored by QDB that provides bank guarantees to registered SMEs seeking finance from local banks. The program helps SMEs obtain financing without a proven credit history, which many entrepreneurs who are primarily in the early stages may lack. QDB also provides direct financing to SMEs for the construction of premises, factories or any required infrastructure. QDB also initiates seed funding products such as ITHMAR through which it aims to create self-sustainable businesses backed by innovative, scalable and sustainable ideas. It also has SME equity programs such as ISTITHMAR through which QDB provides capital to SMEs actively owned and managed by Qatari nationals across industries. SMEs can partner with QDB by selling a stake in their equity at an agreed valuation which they have the option to buy back in the future. The establishment of QBIC, one of the largest mixed-use business incubators in the MENA region, was another important initiative of QDB towards creating a supportive ecosystem in Qatar for startups and innovation. QDB is also working in partnership with universities to develop entrepreneurship curricula whose enrolment cost will be subsidized by QDB.

As an acknowledgement of the tremendous efforts made by QDB in the SME sector, QDB has received several awards in this area, including the Best SME Finance Scheme award in 2013 by Banker Middle East Product Awards, Best SME Loan award in 2014, Best Financing Program for SMEs in the GCC award in 2016 for its Al Dhameen program and Best SME Loan award during the Arab Banks Awards and Commendations of Excellence 2017.

Shariah-Compliant Banking Well Suited for SME Financing

"One of the main reasons why we also wanted to convert or to make this bank more Shariah compliant was that Shariah-compliant financing is more tuned towards SME financing and perfectly suited the existing financing programs such as the startup fund. They have a common fundamental characteristic which involves sharing risk and this contributed favorably in the argument for adoption of Shariah-compliant funding against the conventional counterpart," says Al-Khalifa.

According to Ibrahim et al. (2003), Shariah-compliant financing methods are better suited for satisfying the financing needs of SMEs. The focus in Shariah-compliant financing and investment is on the transaction itself, unlike conventional banking where the creditworthiness of the partner gains more attention. Shariah-compliant finance is primarily based on the principles of profit and loss sharing, and any securities or collaterals demanded are only to protect against fraud or repayment evasion and not against the risk of loss. Trade financing contracts which are generally based on the concept of murabaha contracts, for instance, will ensure that the client uses the funds to purchase the intended products alone, avoiding the use of money for a different purpose, which is a common phenomenon in conventional banking. Khan and Ahmed (2001) argue that the risk of loss to the financier in a murabaha transaction is significantly lower than in a traditional credit transaction due to over-collateralization of the debt.

Customized Approach Towards Transformation

QDB did not adopt any readily available Shariah codes or standards. Instead, it went through the entire process of brainstorming over hundreds of meetings with experts, management and internal Shariah board members to finally develop what can only be called a unique QDB Shariah framework for financial products and services. Recalling the start of efforts towards conversion, Suhaib M. Mohammed, Shariah Controller at QDB, noted, "The seeds of transformation were sown back in 2008 when the housing loan services were designed by Prof. Dr. Ali Muhyeadin Al-Quradaghi to comply with the Shariah requirements. The necessary approvals to set up the Shariah board as per the QCB requirements were taken in 2011, and thereupon efforts were focused on transforming the direct lending products to Shariah-compliant ones." New requests for conventional financing were not entertained beyond this point. At the same time, the existing loan portfolio was gradually converted into Shariah-compliant structures. Each case was considered individually on its merit, and the most optimal route for conversion (or not) was adopted after taking its specific circumstances, risk and return attributes into consideration. The team had to be flexible with the structure to be used in order to minimize hassles and avoid any significant alterations in the risk profile of the loan portfolio. For instance, projects backed by substantial assets were converted into the ijara, ending with the ownership structure which involves a "purchase-and-leaseback" arrangement wherein the client sells his project's assets to QDB and re-leases it under ijara. However, projects with weak asset backing were transformed using the tawarruq transaction. QDB, as a rule, utilizes tawarruq only to address cases that cannot be financed through other Islamic mechanisms. In some other cases, the management had to delay the conversion due to impediments created by their unique circumstances to avoid the risk of unintended and unwarranted consequences. Particularly in the cases of construction project financing where the construction had not been completed yet, the conversion would entail the original contract between the borrower and the construction contractor being cancelled to pave the way for a new deal based on the Shariah-compliant terms between the contractor and QDB. Such an attempted manoeuvre could lead to unnecessary complications to the borrower, including cost escalations or failure to find a contractor to sign the new contract. Hence, in some of these cases, it was deemed practical to await the project completion before initiating the conversion of the loan to a Shariah-compliant one.

Similarly, for loans with low outstanding balances (typically less than QAR 1 million) that were likely to be paid off soon, clients were not keen to go through the entire process of conversion. In some cases, the conversion could not be executed due to Shariah-related factors. For instance, the accrued interest amounts in specific loan portfolios hindered conversion since pure interest amounts cannot be converted to Shariah-compliant accounts according to the laws of Shariah.

Below is an outline of the transformation of the loan portfolio from a conventional to a Shariah-compliant structure. The entire transformation story of QDB can be broadly classified into three stages:

1. Rapid transformation phase from 2010 until 2015, which began with straightforward loan cases and during which about 70% of the entire loan portfolio was converted.
2. Consolidation phase from 2015 to 2017, during which some of the more complex cases were dealt with, raising the total percentage of the portfolio converted to 90.6%.
3. Completion phase, which started in 2018 and continues, at the end of which QDB aims to have a 100% Shariah-compliant loan portfolio.

QDB's Shariah-compliant products were carefully developed, considering that the nature of the projects to be financed would have to be aligned with the QDB-mandated sectors. For example, projects requiring financing for new construction were funded through forward ijara, while a product called "Lease with a promise to sell ending with ownership" was used to address the financing needs of the project machinery/line production. In the case of renovation projects in the healthcare and education sectors, ijara or forward ijara could not be used in most cases since medical centers and school buildings are typically leased to clients and are owned by the government. A separate product, istisna, was developed to address the financing requirements in these cases. Similarly, specialized products were created to cater to the specific client requirements in QDB while adhering to Shariah norms. Bai al-wadee'aa was designed to provide a Shariah-compliant alternative for bill discounting. "Bai al-wadee'aa was a pioneering effort in the Gulf region to address the requirement of bill discounting through a Shariah-compliant model. QDB would purchase the export product from the client at a pre-determined discount price and through wakala (agency contract) authorize the client to sell the product on behalf of QDB to the importer," said Mohamed Ali Al-Jalahma, manager of QDB's Export Trade Finance unit. To support the social programs at QDB, products and services such as qard-al-hassan (zero profit) and minha (grant) were introduced.

While efforts were focused on making the loan portfolio Shariah compliant, there were not significant alterations in the characteristics of the investment portfolio. As seen in the chart below, the majority of the investment portfolio assets continued to be interest-based debt securities. Also, QDB did not engage in sukuk and other Shariah-compliant debt securities that are typically a ubiquitous constituent in investment portfolios of Shariah-compliant financial institutions as can be seen in the following chart. This situation can be explained by taking into consideration the fact that QDB is a development bank sponsored by the state; unlike in the case of SME financing, it has to fulfil specific investment needs stipulated by the country and regulators, and may not have much choice or flexibility in structuring the product.

Another aspect of this conversion, which added to its complexity, is that QDB, apart from financing products and services, also offers insurance products. These insurance products were also converted into Shariah compliance based on the widely accepted takaful concept. Al-Khalifa, stressing the uniqueness of this aspect, mentions, “This is a rare mix of products and services which we provide to our SME business clients – financing as well as insurance, all under one roof and all Shariah compliant.”

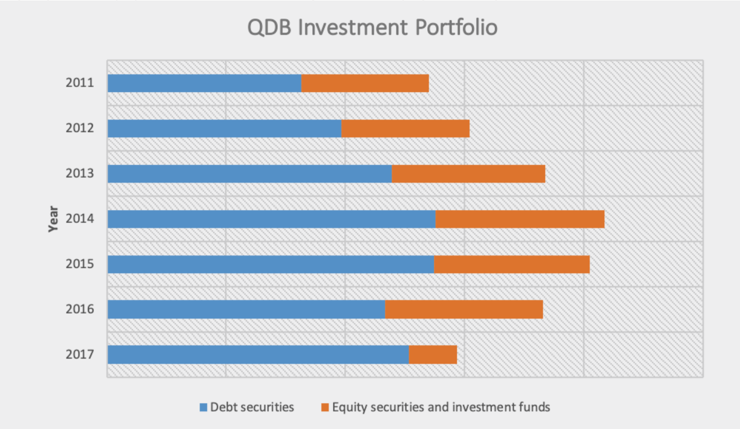

Fig 4: Composition of QDB investment portfolio (Source: Data retrieved from the Financial Statements of QDB)

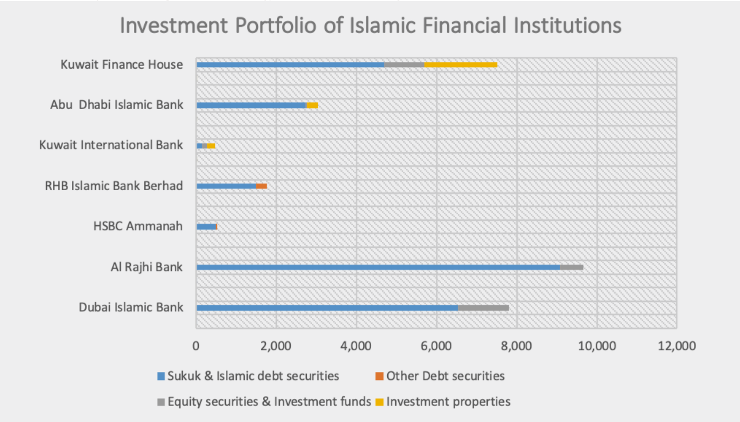

Fig 5: Composition of investment portfolio of Shariah-compliant financial institutions as of 2017 (Source: Data retrieved from the Financial Statements of respective financial institutions)

Enabling Factors for Transformation

The QDB team, led by the CEO, was highly motivated to affect this transformation from a conventional model of banking to a Shariah-compliant one. Al-Khalifa expressed his vision very concisely when he stated, “My goal is that when someone talks about Shariah-compliant finance, Qatar should be a reference point and QDB should be a reference point.” The economic rationale for undergoing this transformation was the opportunity it presented to expand the client base by addressing the financing needs of an untapped (by QDB) segment of the local market which was opposed to non-Shariah-compliant structures. A deeper motivation for them, however, was that they viewed this exercise as a religious act, a means of da’wah – proselytizing and preaching Islamic values and contributing to aligning their country’s economy more with Islamic principles. Al-Jalahma elaborated on this saying, “When we go out to buy food in Qatar, we do not have to worry about or ask whether the food is halal, it is something that we all mostly take for granted. As a Muslim, I would like to see a similar situation in the field of Shariah-compliant finance, especially for those Muslim entrepreneurs in Qatar who would otherwise not have an alternative which conforms to their faith.” The Shariah and Product Development teams played a pivotal role in facilitating this transformation, discussed at length in the following section.

The business model of QDB was another critical enabler facilitating this transformation. As discussed earlier, QDB’s focus was on SME financing, and a Shariah-compliant model of banking was well geared to address this sector effectively. Again, given that QDB is a development bank supported by the government and hence unlike commercial banks, clients are typically not big conglomerates or corporate entities that have strong balance sheets and a lot of choice in selecting the institution to bank with. QDB clients are SMEs who approached QDB to avail of benefits such as lower security requirements and lower profit rates. This factor ensured that even during the transition days, QDB was able to retain almost all its clients. In addition, clients were local businessmen who were mostly Muslims and were either keen or at worst neutral to the idea of Shariah-compliant financing.

Pivotal Role of Shariah Team in Facilitating Transformation

Shariah-compliant banking is based on the Islamic legal system derived from the Islamic jurisprudence (fiqh al-muamalat), which is the part of fiqh dealing with relations between people. It stipulates that all financial practices need to be certified as being "Shariah compliant – not prohibited" with a final verdict given by a Shariah Board.

The composition of QDB's Shariah Advisory and Supervisory Board is as follows:

- Prof. Dr. Ali Muhyeadin Al- Quradaghi – Chairman and Executive Member
- Dr. Sultan Ibrahim Al-Hashemi – Member
- Dr. Nayef Bin Nahar Al-Shamari – Member

Suhaib M. Mohammed is the Senior Internal Shariah Controller.

Elaborating further on the role of the Shariah team, Mohammed explains, "The scope of QDB activities has been significantly affected during the last five years, owing primarily to the additional need to adhere to the Shariah rules. The Shariah team, which comprises the Shariah Board, with the Shariah Controller primarily facilitating all Shariah-related activities, works in close collaboration with QDB's various departments to provide standard practical models and guidance on automating the procedures and standardizing the documents, forms and applications."

Mohammed further adds, “The Shariah team works rigorously to enhance the understanding of Shariah-compliant banking concepts and their practical application among the staff. For instance, the Shariah Controller holds a second-level session meeting before introducing a product and follows it up with a training workshop to discuss and explain the approved product term sheet. It coordinates with the Product Development and Training Departments to then ensure that the necessary knowledge and skills are imparted to all relevant employees. It plays an important role in ensuring that the experts drafting internal documents and procedures are well versed and well equipped with relevant knowledge of Shariah requirements.”

Process Modifications for Adherence to Shariah Standards

The transformation was almost simultaneously accompanied by a parallel process of overhauling and streamlining systems and processes throughout the organization. The latter posed its own set of challenges to the institution since all process flows and systems had to be re-designed while at the same time addressing the variety of hurdles posed by the conversion. This paper, however, focuses on modifications and challenges resulting specifically from the conversion process. As was seen from the process flow charts, there were, predominantly, four areas in the process flow which were more specifically affected by transformation into a Shariah-compliant model of banking:

1. Interactions between the client and relationship manager

One of the main challenges in this exercise was the training of relationship managers to be able to effectively help clients navigate through the revised systems, products and, most importantly, new philosophy of banking. “The relationship managers were given a lot of training. But then, training is one thing and doing it in actual practice is completely different. A lot of us learned as we went along basically. The Shariah Department too had to make a lot of changes and adjustments along the way as new issues were identified. It took over 12 months to get to the level where clients and we got comfortable with the new model," recalled Zaheer Seth, Direct Lending Manager at QDB. These transformation efforts were facilitated by the fact that the majority of QDB clients were Qatari Muslim businessmen who were either actively looking for or at least willing to give favorable consideration to options which comply with requirements of their faith. However, there would still be some reluctance and inertia among certain clients, especially in the early stages. Various incentives were planned to be offered to clients initially to encourage them to opt for Shariah-compliant alternatives. These incentives included offers of reduced rates, lower administration fees and the extension of repayment tenure for project financing. Interestingly, however, QDB was able to convince most of its clients to convert without having to offer them any incentives.

2. Dealing with third parties

Dealing directly with third parties was an additional requirement for some Shariah-compliant products. While this practice gave more control and enabled greater transparency, it also brought with it additional sources of risk, sometimes too high, which would question the feasibility of the product.

3. Credit assessment

Although the process of credit assessment did not change post-conversion, what did change was the nature and amount of risks associated with Shariah-compliant versions of financing products. New risks arose from the fact that the new structures involved direct interactions and contracts with third parties, the ownership of assets and certain Shariah-related restrictions. These had to be fully comprehended and taken into consideration for a comprehensive assessment of risk. Also, Shariah-compliant financing by its very nature is more engaged and requires more diligent monitoring and inspection as part of its requirements. This approach, in some cases, has had positive externalities too, helping to create a more optimal risk-return profile for product financing. The practice of direct payments for the purchase of specific raw materials or machinery minimizes the risk of misappropriation of funds, or personal use, or use in areas other than those specified in the loan application. There was much learning and adaptation in this process along the way. For instance, as Al-Jalahma remarked, “In the initial days, the export products being financed had to undergo a thorough physical inspection for every shipment. Later, however, the Shariah team conveyed that only the products which differ in their nature or specifications from the earlier verified ones need to go through the robust inspection process.”

4. Documentation

Invariably, conversion to a Shariah-compliant product resulted in a very substantial increase in documentation due to the existence of multiple steps and transactions, sometimes with different parties within a single product or service. While creating this documentation for all products was in itself a huge task, explaining it to the relevant staff, training them and finally getting clients accustomed to these new products were significantly more challenging.

In the case of murabaha financing, as part of the risk assessment, the credit inspector inspects goods and obtains the supplier’s signature. In the case of conventional financing, the tracking of work or products was not as diligent. As a result, they were able to identify certain issues and activities among the clients, which remained unidentified until then. Also, there is a step which, at least theoretically, involves dealing directly with a third party – the step in which QDB needs to grant permission to the supplier to release goods or disbursements to the client. In practice, however, the client handles all interactions with the supplier to avoid significant delays or disruptions in the process.

In the case of istisna financing, there are multiple points of direct interaction between QDB and the contractor. The hassles and, more importantly, the associated risks emanating from this arrangement were the primary reasons why istisna became a less favorable choice of financing in QDB.

The underlying concepts and doctrines governing Shariah banking methodology demand that the service charges and administration fees be charged to the client against the actuals. An interesting and positive consequence of this has been that there is a better understanding of the project-specific costs, which led to enhanced decision-making and improved monitoring.

Shariah compliance has also contributed towards mitigation and control of financing risks through the reduction in asset ownership risks, the verification of availability of the subject of financing, and due diligence of the relationship between client and vendor, supplier and contractor. It has also aided in ensuring that the financed asset is used in the intended manner, backed by the appropriate measures for asset maintenance and suitable insurance.

Challenges Faced During Conversion

The challenges faced by QDB during the process of transformation were multifold because the bank had to cater not just to the requirements of Shariah and the expectations of clients and partner institutions, but also to the needs of the regulator (Qatar Central Bank) and the government, whose objective is to ensure that QDB meets the economic aspirations of the state.

Despite the extraordinary nature of the task, the QDB team managed to execute the entire transformation within a few years. But this process was not without its share of miscalculations and misjudgments. The team was, however, quick to realize the bottlenecks and errors in the process and took timely actions to address them effectively. Consider, for example, the case of letters of credit for raw material financing requirements of businesses which were based on the murabaha structure. The processes and documentation requirements tended to be complex in the early days, which led to reluctance among clients and significant time delays. At times, these resulted in business losses among clients. "Unlike purchasing machinery which can wait for a few days, buying raw material is a very time-sensitive requirement and any delay might have adverse effects on the factory production. Switching to a Shariah-compliant structure subjected clients to a new product which was a lot more cumbersome in terms of processes and documentation and this is where we faced the maximum heat and pressure initially," noted Zaheer Seth. This problem was remedied by significantly reducing the paperwork requirements, automating certain aspects in the process and reducing the turnaround time of financing requests from nearly five days to three days. The reduced turnaround time is nevertheless on the higher end when compared to the industry benchmark. This is due to the fact that the QDB is a state-owned development institution and, unlike private banks, has to deal with several layers of approvals for each transaction.

Of course, all of this did involve certain missteps as well as trial and error. Alterations were made in product design and in some cases, the entire product was replaced to ensure a more balanced risk-return profile. A textbook example of this was the case of istisna financing. As can be seen in the figure below, istisna was the dominant product in the portfolio of QDB's Shariah-compliant financial assets until 2013. It was later realized that the risk of moral hazard is too high in istisna since it was QDB and not the client who would be responsible to the contractor (third party). This drove QDB to adopt a new structure, forward ijara, which became among the most prominent financing products in QDB along with murabaha. "The risk was too high in istisna, and there was a moral hazard since QDB is the party responsible to the third party while the client is responsible only to QDB," said Zaheer Seth explaining the decision. "The principle of lending and risk assessment, whether it is conventional banking or Shariah compliant, is pretty much the same. We did not understand the gravity of the additional risk until we went into the product, and this, basically, was a lesson for QDB."

Similarly, another product which was shelved due to its complexities in execution was the bay al salam. Al-Jalahma explained this, saying, "Every time we tried to execute bay al salam for export financing, the clients started struggling with the product which they found unsuitable. As a product, it was always available, but was never successfully used for any client."

The need for insurance of financed assets became an issue of much greater significance for QDB after the conversion, considering that in some of the new financing structures, QDB would be the owner of assets until the client made payment. The insurance would still need to be purchased and maintained by the client according to stipulated rules, which created another source of risk for QDB due to the agency effects arising from this arrangement. While it was not possible to eradicate this risk entirely, the management was able to mitigate it by taking cognizance of its existence and acting more proactively from the project initiation stage.

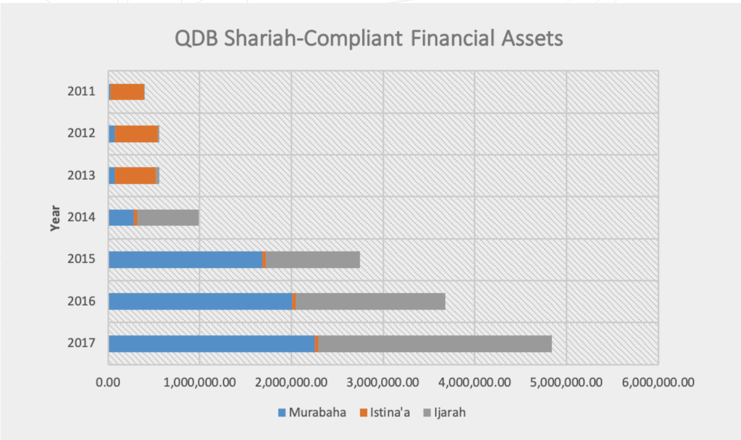

Fig 10: Composition of QDB Shariah-compliant financial assets (Source: Data retrieved from the Financial Statements of QDB)

Conclusion

The case study of the transformation of QDB was unique from several perspectives. The conversion to a Shariah-compliant bank was executed in an environment in which conventional banks were closing their Shariah-compliant operations following a directive issued by the regulatory authority. Globally, however, there were a few encouraging precedents. As a development bank, however, QDB had minimal precedents for its transformation. The challenge of conversion was accentuated because it was carried out with a simultaneous revamp of entire systems and processes in the institution – a mammoth task in itself. Given the unique circumstances of the case, a customized approach was adopted by the management with guidance from the Shariah team, giving due consideration to overall developmental goals, target priority sectors and the nature of existing products and services.

Given that the institution's focus was on SME financing, Shariah-compliant banking was well suited to serve the business model, and this was a significant factor in decision-making. The primary aspiration for conversion, however, was faith motivated. The management had a strong desire to create a Shariah-compliant institution aligned with the principles of Islam. Relevant experience, a skilled and committed workforce, and a strong willingness to change were among the critical determinants for the successful conversion of QDB. The transformation of QDB also sent a very positive signal to its clients, whose trust in the values and ethos of QDB grew stronger. It affirmed their belief that QDB is not just an institution that gives money and is concerned with repayment, but is one that genuinely cares about the well-being of its clients, their faith and their business growth, has aligned interests and is a consistent companion in good times as well as in the tumultuous and challenging periods of their business cycles.

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