EXCLUSIVE REPORT - Looking for an exit scenario: the ARAB FINANCE HOUSE to be or not to be

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A new chapter in the story of the Lebanese based Arab Finance House Islamic Bank will be in the making next October as the Qatari largely dominated assets institution will be seeking a where about to its losses and its final shareholder identity on the Lebanese market.

Reportedly the bank has been suffering from acute losses following its subscription to different funds prior to the 2008 international financial crisis without getting clearance from the Central Bank of Lebanon nor the Banking Control Commission; Lebanon’s financial sector’s regulating authorities. To date the bank has seen the resignation of three general managers.

More than 4 general directors holding key positions in the bank have been sacked; banking sources confirm also a capital flight from the bank. Different irregularities were also spotted in the bank’s internal auditing book keeping; sources confirmed. The newly appointed General Manager and its deputy handed out their resignation in August due to the Qatari partners relunctancy to find a where about of the Arab Finance House monetary shortfall. Lebanese financial authorities will be looking for an exit strategy to the bank in the coming months to prevent a new distressed bank scenario; banking sources say.

There are 5 banks enjoying an Islamic license and operating under foreign restrictions in Lebanon out of 63 banks statistics show. They are all operating under foreign licenses. Beirut-based Lebanese Islamic Bank

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started offering Shariah-compliant services in 2005 after receiving the first Islamic banking license from the central bank, according to data on its website. Albaraka Banking Group BSC, the biggest publicly traded Islamic lender in Bahrain, Arab Finance House S.A.L. (Islamic Bank) - 70 percent owned by Qatar investment bank - and Blom Development Bank S.A.L. are the other three shariah-compliant banks in the country.

Arab Finance House-Holding Company was founded in Lebanon in 2003 with a capital of 60 million American dollars and a plan to raise that capital to 100 million American dollars within three years. The Company established two banks in Lebanon: the Arab Finance House commercial bank, and the Arab Finance House investment bank; the bank say on its website. Under the decree number 9494 of the Central Bank of Lebanon dated26/12/2006, the two banks merged to become the Arab Finance House SAL(Islamic Bank) holding the number 125 on the list of Banks (commercial register #1002082). The Arab Finance House is an Islamic bank, and subsequently all its investments and products are Shari'a compliant while remaining under the realm of Lebanese banking laws; the statement added.

According to banking sources Arab Finance House was not able to cover its losses from three real estate denominated funds which latest one is expected to mature end of October. Funds under obligation sold to customers amount to Usd 10mln. The first two funds which did not accumulate to Usd 15mln in value were covered last year.

The debacle of the Arab Finance House started as the old management under the patronage of ousted general manager Fuad Matraji bought Qatari three funds in order to boost profits of the bank. The first two were reimbursed from the bank's profits. Worth to be noted that QIB helped other non Lebanese based financial institutions holders of the funds to meet maturity from direct cash injections; but failed to do so in the Lebanese case because of the irregularities of the transactions. Irregularities in the Lebanese operation was mentioned as main reason for failing to do so.

The Arab Finance House real estate holdings in Lebanon are ripe; it owns a Usd 40mln valued headquarter as retail operations were profitable for the last years; enough to raise for investors appetite in the institution. Last year the Central bank of Lebanon opposed the turnover of the bank to a group of Lebanese investors and bankers because of confessional reasons; sources who asked for anonymity say. If Arab Finance House will be allowed to be liquidated; this move will cause a serious blow to the fragile Islamic banking practice in Lebanon.

More than 8 years have elapsed since the ratification of the law pertaining to regulate Islamic banking in Lebanon however this practice is still a rare commodity in the market. Although central bank sources disclosed that they working with a group of local lenders to amend a 2004 law that allowed the establishment of Shariah-compliant banks, the interest for Islamic operations is yet to be seen in a country where more than 60 pct of the population is Muslim. Islamic banks consolidated balance sheet amounts to a shy 1 pct total of Lebanon’s total consolidated balance sheet. Liquidity management in Islamic banks is profitless because of different restrictions in the work of Islamic banking.

Funds investments

Arab Finance House fund investments were as follows:

Alareen Real Estate Fund

The project consisted of acquiring and developing a land with an area of 245,165 sqm in the suburb of Dahiyat Al Areen located 25 km south of Manama, Kingdom of Bahrain. Al Areen is a luxurious urban mixed-use health and family tourism development spread over an area of 2 million square meters, and is located on an elevated desert plateau in the southern region of the Kingdom of Bahrain. The core components of the development are the Banyan Tree Desert Spa & Resort and “The Lost Paradise of Dilmun” Water Park, In addition to the recently announced Al Waha resort at Al Areen and the Domina Hotel & Resort Al Areen. The project will feature
additional development to be announced shortly varying from residential, commercial, hospitality, recreational, and entertainment facilities, and its location is close to the F1 racing circus. The Global Banking Corporation, the asset manager, declared in July 2008 the closing of subscription in AlAreen Real Estate Fund with an amount of USD 130 million in a record time frame of six weeks.

Al Danat Real Estate Fund

The project consisted of acquiring a parcel of land measuring approximately 500 acres to develop an integrated middle-income township in the area of Hanspur within the boundaries of New Delhi, India with a strategically ideal location adjacent to three fast growing cities namely: Ghaziabad, Greater Noida and Noida. Khaleeji Commercial Bank, the asset manager, and Gulf Finance house, one of the most respected investment banks in the Middle East region in terms of quality and innovation of product offering with credit rating upgraded to BBB+ by Capital Intelligence, have developed tremendous experience in project establishment and management.

Marsa Alseef Real Estate Fund (Issue 1 & 2)

The project will acquire a parcel of land measuring approximately 2,400 acres to develop an integrated high income township in the Al Seef area located few miles away from Manama, Kingdom of Bahrain. The land is in the northern part of Bahrain with a strategic location very close to the Bahrain International Airport and the Saudi causeway. The project is a celebration of maritime lifestyle and one of the most exclusive and innovative waterfront projects in the Kingdom of Bahrain with expectations to become the premier waterfront city in the Arabian Gulf. Global Banking Corporation, one of the leading Islamic banks in the kingdom of Bahrain, is the investment manager, placement agent and financial advisor.

Options

Qatari investors have been reluctant to boost their investments in the Arab Finance House; basically because of the ill performance of the bank. Political tensions in the region as well as the new Gulf nationals travel ban to Lebanon does not make the matter easier; the sources believe.

The main problem in resolving the issue of revitalizing the banks' resources lies today in sharing losses with customers; sources say,

Today Qatar Investment Bank has three options to help solving the ailing bank debacle.

Buy a 30 percent Kuwaiti partnership in the bank and turn the bank to a full Qatari branch to its mother financial institution. However this option has been disregarded for now since the Kuwaiti counterpart has asked for a high market value to let out; sources added. Under this option the Arab Finance House will be run totally by Qatari partners. The Arab Finance House will thus lose its Lebanese banking operation permit and will be muted to foreign branches management regulations.

Manage a sell out of Qatari shares under the supervision of the Central bank of Lebanon will be one of the most favored options for the banks; experts believe. According to the sources the BDL can find potential partners to run the operation as it has already saved banks in similar scenarios.

On the top of all those priorities Qatar Investment Bank need to cover for losses of Usd 10mln in the maturing October fund. On either scenarios the bank needs a serious shake up and an increase of its capital from Usd 30 mln to Usd 100mln according to new requirements of the Banking Control Commission. Qatari investors will have to abide by this regulation if they will opt for continuity of their Lebanese operations.

It is yet to be seen whether Islamic finance is a profitable business in Lebanon. The ministry of Finance failed to propose different amendments to the Islamic banking practice in Lebanon; including real estate tax exemptions; and the facilitation of shares trading. The Central Bank of Lebanon seems reluctant in the time being to introduce new specific measures to liquidity and reserve requirements that will help Islamic lenders to manage their liquidity; sources stated.
Reportedly the Central Bank of Lebanon commissioned the Association of Banks of Lebanon in a May 21 2012 meeting to intervene with Ministry Of Finance officials to amend certain laws which prevent the development of Islamic finance here. The Central Bank governor Mr Salameh reportedly asked the Association to mediate with ministry officials to introduce laws that will help Islamic institutions to profit from the government program of subsidized loans; be exempted from direct taxation on their Murabaha transaction and be exempted from VAT.

Issuing Islamic denominated debt instruments directed to the public sector financing needs will have certainly helped Islamic institutions to invest their liquidity. Lebanon, which is a regular issuer of non-Islamic bonds doesn’t plan to issue sukuk, especially if the transaction has to be backed by assets, as it will require a law that allows the state to pledge public assets.

It was not until 2004 that Islamic banks were given authorization to operate in Lebanon. Under a law - law number 575 dated February 11, 2004, and supplemented by two circulars dated August 30, 2004 - the Central Bank of Lebanon set the regulatory framework for Islamic banking in Lebanon.

AFH or Islamic banking to be or not to be?

Aside from the Arab Finance House debacle experts believe that Lebanese political authorities need to push harder for a ratification of different laws that hinges on islamic banking practice in Lebanon. It is true that the banking sector has accumulated buffers but is facing an increasingly challenging environment. Thanks to prudent management and conservative regulation, banks report capital above the regulatory minimum, high liquidity buffers, low levels of nonperforming loans and stable profits. However, the recent expansion cannot be left to conventional banking alone as more international banks are exposed to the heightened risks from the regional turmoil.

Further conventional banks stability is tied up to an economy which is becoming more resilient in recent years thanks to a marked reduction in the government debt-to-GDP ratio and a build-up of large foreign reserves. Islamic banks are suffering from higher risks in the market than their peers. Most income of banks is drawn out of subscribing to the government issued treasury bills; a source of net interest income they cannot afford the luxury to abide with.

Also banks have to comply with new solvency regulation of Basle III and decisively, comply with requirements, restore their profit-generation capacity, and potentially revisit the way they do business in the future. The minimum Tier 1 capital requirement will increase from 4 per cent to 6 per cent under Basel III. These new requirements will also be phased in by 1 January 2015, with the phase-in period beginning on 1 January 2013. The minimum total capital requirement remains at 8 per cent under Basel III.

Cross Border expansion

Given local market exiguity, Islamic banks cannot as their peers embark on cross-border expansion which was a wise move in terms of market risk diversification and which proved to be a profitable enterprise in more cases than not.

However, one may regrettably have to wonder now about the magnitude of the impact of the regional turmoil not only on the revenues from off shore operations but on the soundness of the loan portfolios themselves, especially in the absence of sufficient transparency regarding the nature and the quality of the upstream scrutiny process applied to these loans and transactions.

Credits Subsidies

Islamic banks also fall short of benefitting from a subsidized interest rate on their credits. The subsidized interest rate is funded by the Lebanese Treasury and managed by the Central Bank; it favors industry, tourism, agriculture, craft industry and high technology. The loan amount: varies between LBP 50 million abd LBP 15 billion. The subsidized interest rate is calculated as 7pct %on the first share of LBP 5 billion and 5pct %on the remaining amount. The subsidy stretches over a period of 7 years and has a grace period from 6 to 24 months interest rate in LBP with a maximum for the 2 years Treasury bills at + 1% Repayment modes should not exceed
a maximum of 15% of the capital during the first 2 years. There is no refunding for such subsidies neither funding for working capital nor funding for equity participation or funding for working capital requirements or funding for debt restructuring plan; As the project has to be executed in Lebanon. Islamic banks also suffer from the lack of proper real estate collateral. Since they are considered as foreign enterprises they have to be included as a part of a 10pct foreign ownership quota of real estate permitted to foreigners.

Maan Barazy

Certified Shari’a Adviser and Auditor (CSAA- AAOIFI Certified) - MA Islamic Comparative Jurisprudence - BS International Economics

Managing Partner And CEO of Data and Investment Consult-Lebanon - The Centre For Islamic Finance - Consultant Researcher and Lecturer