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Islamic Finance for Asia:
Development, Prospects, and Inclusive Growth

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CHAPTER 8

The Way Forward: Key Islamic Finance Challenges and Road Map for Asia

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The way forward for the global Islamic finance industry[1] has to be built upon an edifice where the distinctive and unique characteristics and the fundamentals of Islamic finance are closely set out, understood, and disseminated widely. In this regard, a critical question posed forward is: What makes Islamic finance more stable and resilient against anticipated shocks vis-à-vis conventional banks? Would it be the *Sharīʿah*-compliant financial instruments themselves or the practices and processes of Islamic finance?

Islamic Finance: The Resilience Factors

The Islamic financial system is built-in with principles of *Sharīʿah* that naturally incorporate several factors promoting market discipline, stability, resilience, and overall ethical practices that instill prudence and soundness in transactions. An Islamic banking system promotes a unique underlying relationship between the depositors and shareholders; by use of partnership and risk-sharing contracts such as *Muḍārabah*, deposits structured as special accounts have the propensity to absorb losses as opposed to passing them in entirety to shareholders alone. This enables the capital adequacy ratios of Islamic banks to be at comparatively higher levels than those of conventional banks as the loss-absorbing properties of special investment accounts reduce the burden on the equity capital.

Meanwhile, the *Sharīʿah* prohibition on investments involving exposures to highly risky and uncertain contractual outcomes is an important source of financial stability. As such, Islamic financial institutions are shielded from investments in highly leveraged and toxic assets such as securitized derivatives and other exotic products in conventional finance. During the onset of the global financial crisis, several conventional investment banks were found to be highly leveraged on funds from the money markets and then placing these borrowed funds on risky investments for quick gains. Excessive risk taking is a natural consequence of the asymmetric relationship between appropriation of rewards and incurrence of risks among conventional finance players. In an event of market financial downside, the shareholding risks are limited to their equities and there is an underlying sense of assurance that the government bailout using taxpayer money can save the day. However, if the risky investments pay off, it will result in magnified profits for the shareholders and management of these investment banks.

In Islamic finance, leveraging on borrowed funds from the money markets is not a norm as Islamic banks usually have ample liquidity at their disposal and it is the dearth of productive assets that keeps deposits underdeployed. As a result, Islamic finance follows a course of natural rather than unnatural growth, because it does not permit the existence of invented or contrived money. These factors contribute toward a relatively stronger confidence of depositors in Islamic banks and it is widely regarded that during the peak of the crises, several conventional finance depositors transmitted their funds to Islamic banks for safekeeping. The asset-based and/or asset-backed nature of financial transactions in Islamic finance helps establish a link with the real economic sector and limits risks growing out of proportion beyond the real economy.

Furthermore, Islamic banks did not participate in exotic structuring of securitized assets which deeply affected the major conventional banks. Exotic products such as collateralized debt obligations, which resulted from slicing and dicing various loan portfolios into structured financial assets, would not obtain *Sharīʿah* compliance from the *Sharīʿah* supervisory boards of Islamic banks.

[1] This chapter is based on the panel discussion that took place at the final session of the Conference. The panel was led by two chairpersons: Rajat M. Nag (Former Managing Director General of the Asian Development Bank) and Jaseem Ahmed (Secretary-General of the Islamic Financial Services Board). In addition, the panel consisted of three speakers: Richard Thomas (Chief Representative for Gatehouse Bank in Malaysia), Baljeet Kaur Grewal (Managing Director and Vice Chairman of Kuwait Finance House Research), and Madzlan Mohamad Hussain (Partner at Zaid Ibrahim and Co. in Malaysia)

Overall, it is a combination of *Sharīʿah*-compliant financial instruments as well as practices and processes in compliance with *Sharīʿah* that contributes toward the stability and resilience of Islamic finance.

Risks and Challenges Impacting the Industry

During the first phase of the global financial crisis of 2008–2009, Islamic banks were largely insulated from adversities as they did not carry any contrived products on their books. However, in the second phase, when the broader economy was impacted and disposable household incomes were reduced, real estate prices fell drastically. Real estate was the natural hedge for Islamic banking transactions and as real estate prices went tumbling down, Islamic banks were also adversely affected. However, Islamic banks did not require any taxpayer bailouts as was witnessed in the case of major conventional banks. In some cases, Islamic banks recapitalized themselves through the *Sukūk* market. Islamic financial institutions had relatively higher capital adequacy which provided a better cushion in case they incurred unanticipated losses.

One of the fundamental challenges of the Islamic financial system is the need for a holistic and robust ecosystem including regulations. As the system is still gradually building its resilience, and the regulatory system, standards, infrastructure, and institutions are beginning to evolve, it remains largely untested. The adoption of the regulations and standards by the central banks has been a slow process and confined to only a few countries, even among the large membership of the Islamic Financial Services Board (IFSB). Some IFSB members have stated that the binding constraint is the lack of adequately trained and experienced human capital, rather than anything else.

On the other hand, the Islamic finance industry faces a crucial challenge of balancing between maintaining profitability in a competitive environment and sustaining social responsibility. There is apprehension that any trade-off that strengthens social responsibility may be achieved at the cost of making profits for the shareholders and account holders which still remains the prime raison d'être for the existence of these banks. In contrast, the dilution of social responsibility may deviate from its distinctive and unique feature. The line between following ethical values, which is the core proposition of Islamic finance, and earning adequate returns at the same time in a market that is volatile and that has high credit risks and other business risks is not at all easy and straightforward.

Another risk identified from past practices is that of poor quality in Islamic financial institutions' management. People entrusted with the task of managing these institutions have come mainly from a background of conventional finance and failed to appreciate the peculiar set of complexities involved in Islamic finance. This inadequacy of a trained and uniquely focused managerial pool and human talent across the industry remains an obstacle to its growth.

The other challenge is to have strong and supportive governance systems at the level of individual institutions. Islamic banks have to ensure they instill confidence and nurture trust among their stakeholders by adopting best governance practices that incorporate features enjoined under *Sharīʿah*. Any deviations, scams, scandals, or shortcuts will put the industry a step back. Accordingly, the incentive structures and compensation packages should be designed in a way that avoids the pitfalls of conventional financial institutions (i.e., excessive bonus payments based on inflated indicators). Bonuses should be payable when the actual results from the investments financed by the banks become available and not when the quarterly or annual profits at aggregate levels are announced.

A prominent risk from a business perspective is the comparatively higher transaction cost of Islamic finance because of the additional requirement of

Sharīʿah compliance. When every transaction is held up because it has to be reviewed and endorsed by the *Sharīʿah* board, an element of uncertainty is added. If the edicts and opinions of *Sharīʿah* boards were standardized and could be made available for ready reference, the structuring of transactions would not take up many resources, be it time or human. The manufacturing and marketing of preapproved *Sharīʿah*-compliant products on a large scale will mitigate this risk. Transaction costs can be reduced if the probability of predefault and postdefault events is minimized by careful screening and forceful monitoring under Islamic finance modes.

Meanwhile, the issue of liquidity availability for Islamic banks has been a long-standing concern affecting the industry. Unlike conventional banks, which have recourse to an active interbank money market, Islamic banks do not enjoy such a facility. The absence of liquidity management instruments puts Islamic banks at a serious disadvantage relative to their competitors in the market.

Finally, promotion of awareness about Islamic finance and financial literacy are critically important but have been neglected so far. There is no clearly defined responsibility as to who is going to carry out this function. In some countries, it has been a state-led approach for promoting Islamic finance; in others, it has been left to market forces through a demand-led approach to develop the system. Although there may be no uniform answer to this issue and each country will have to customize in relation to its own circumstances, governments or central banks have to take the lead by putting in place credible legislative, institutional, and regulatory structures. Market players, the media, educational institutions, and chambers of commerce and industry have to play an equally important role. Overall, the future road map for Islamic finance should be based on its unique selling proposition and on a proper governance framework in which the roles and responsibilities of the *Sharīʿah* board and the extent of its autonomy are clearly defined vis-à-vis other shareholders and management.

Moving Forward: A Road Map for Asia

In the next 10 years, Asia has an $8 trillion investment gap that needs to be financed. This is an investment gap which may not be funded by conventional finance alone. On the contrary, the asset-backed nature of Islamic finance provides a better match for infrastructure projects. There are tremendous opportunities for Asia to expand the Islamic finance industry in order to support the fast growing economies of the region. Islamic finance is able to support many strategic areas such as financial inclusion, infrastructure investment needs, and insurance penetration as well as further attract funds to flow into the region. Asian markets are home to a large Muslim population, which facilitates a ready market for the introduction and distribution of *Sharīʿah*-compliant products and services, particularly for retail banking and *Takāful*. The progress that Asian countries have made represents more opportunities for the region to benefit from this rapidly growing *Sharīʿah*-compliant industry.

Asia is a pivotal part of both the global economy and the Islamic financial system, operating as a driving force of world economic growth. At present, the Islamic financial landscape in Asia is dominated by the Islamic banking and *Sukūk* sectors, which have driven Asia's robust growth trajectory in recent years, accounting for a combined value of over $390 billion or 21.7% of global Islamic financial assets as at the end of 2013. Islamic asset management remains a nascent but budding industry in Asia which has seen steady growth following the financial crisis. The *Takāful* industry accounts for less than 1.0% of regional Islamic financial assets, despite a significant growth in the number of *Takāful* operators, highlighting considerable potential growth for the future.

The Islamic finance road map for Asia needs to start by making a realistic assessment and taking stock of the needs and requirements of the various markets.

It will then be feasible to match different Islamic financial solutions with the requirements of the market. Some of these solutions have already been tried in advanced Islamic economies and can be modified and adapted. In other cases, solutions have to be found by engaging the various stakeholders in these countries. The road map should be a constellation of developing policy, having an enabling environment, developing the laws, strengthening the regulatory framework, and making progress in capacity building.

Some countries in Asia have progressed well in terms of developing their Islamic finance industry because of the promotional support by the central banks. For example in Malaysia, Bank Negara Malaysia played a pioneering role in guiding and steering the process of development of Islamic finance. The progress is impressive and Islamic finance represents more than 25.0% of the country's banking assets and nearly 57.0% of its capital market. Individual countries need to assess the structures and maturities of their financial markets when designing and delivering appropriate Islamic finance regulations. If successful ecosystems from other countries are introduced in a market without testing or investigation, the adaptation may not always be successful.

To end, Islamic finance has the potential to be an alternative to the existing financial system, but it still faces many challenges and risks that have to be managed and mitigated first.

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