The Evolution of Islamic Finance:

Sustaining Global Growth

Islamic Finance should be viewed as part of an evolutionary process in the deepening of the financial services industry. This would require that Islamic financial services should be developed in an efficient, competitive, sound and sustainable manner. In developing countries they must perform the critical function of mobilizing savings and intermediating them for investment to generate growth and alleviate poverty.

I would submit that the Shariah Compliance Characteristics of Islamic Finance, in fact, act as an enabler for achieving this particular goal by as it providing access to a segment of population that has hitherto been outside the domain of formal financial services. This segment, in many developing countries, has also been enjoying living standards below median incomes and consumption. Thus bringing them under the fold of Islamic Financial services offers significant potential in achieving the goals of sustainable and inclusive economic development and social progress. To the extent they participate and benefit from the fruits of economic growth these excluded classes would have little incentives to indulge in creating disorder, violence and terrorism. Therefore the linkage between economic and social exclusion, poverty, vulnerability on one hand and violence, terrorism on the other should not be dismissed lightly and taken seriously.

The Islamic financial services industry has been in existence for more than three decades but has made significant impact only in the last five years so. The attention from the fund managers and investors towards this asset class has only been recent. Sovereign Corporate 'Sukuks' have been issued in the last five years as alternatives to conventional bonds and have been subscribed by a wide investor base. Large international banks have started operating Islamic windows. Mutual Funds have been set up in compliance with Shariah.

According to the latest information available 284 Islamic financial institutions operate in 38 countries and manage about US$200 billion. In addition it is estimated that conventional banks' Islamic Window operations have deposits of another US$200 billion. 250 Shariah - compliant mutual funds are currently managing about US dollars 300 billion in assets. 37 Corporate and sovereign sukuk bonds amounting to about $8 billion have been issued so far. The annual Market Capitalization of the stock meeting the Dow Jones Islamic Market Index criteria in Islamic countries is estimated at US$300 billion.

To provide a snapshot of all the banking and non-banking financial services being offered in Islamic mode it would be fair to summarise that assets with approximately USD800 billion are being managed throughout the World in 2006.The annual average growth of the Islamic financial industry during the past 10 years has been estimated at between 10-15%. If the industry continues to grow at the historical rate it is my sense that the size of the assets would double in next five to seven years.

Muslims may be shifting towards Islamic finance for reasons of their faith but a question arise as to why has Islamic finance started receiving attention from non-Muslims in Europe, USA, Singapore, Hong Kong and elsewhere? I can think of several possible reasons. First, there are around 15 million Muslims residing in non-Islamic countries in Europe, mostly in France, Germany and the UK. Islamic Finance is effectively contributing towards penetration of financial services and inclusion of this particular target group, which previously avoided using existing banking facilities due to their faith. The members of the Islamic community in Europe that was not benefiting from the conventional banking on religious grounds are now participating through this particular mode in conformity with their beliefs. This group naturally provides the scale for the financial services industry to build upon.

Second, there are investors who in their quest for diversifying their portfolios are looking for new asset classes, new instruments and new products with low correlation with existing asset classes or products. Islamic financial products cater to this particular need and have, therefore, become attractive to that investors group. The risk characteristics of Islamic finance are different on the liability side due to unique nature of profit sharing investment accounts and on the asset side IFIs take ownership stakes in the contractual relationships and offer different products and services compared to conventional banks.

Third, there is a growing trend, particularly among the younger population to show unethical or socially irresponsible investment funds and businesses. Islamic Finance does not allow undertaking or financing the anti-social and unethical businesses such as gambling, prostitution, alcoholic liquor, nightclubs and narcotics. Islamic banks are prohibited from opening accounts or provide financing to person institutions involved in such activities. In this respect, it is clearly ahead of the recent surge in ethical finance and socially responsible finance that are becoming quite popular in the Western world. Islamic financial institutions, because of their active involvement and knowledge of the nature of businesses of their clients, are in a better position to detect and prevent the channeling of depositors' money for financing highly risky but equally remunerative anti-social activities. The financing it provides is mostly asset-based, whereby the Islamic bank knows the actual utilization of it funds.

Many funds have emerged that are exclusively devoted to meet the specifications of investments in ethical products or socially responsible services. Islamic Finance conveniently fits into this food chain because of its natural affinity and congruence with its end-use restrictions.

Fourth, in this world where we have all become increasingly cautious and careful about possible risks arising from money-laundering and terrorist financing, Islamic banks by explicitly prohibiting proceeds from activities such as gambling, prostitution, night clubs , drug trafficking provides adequate safeguards. These are the main channels used for money laundering, terrorism financing and organized crimes, etc Islamic financial institutions enjoy a head start in mitigating these risks. Unlike conventional banks which rely on documentary evidence and usually have impersonal, arms-length, passive relationships with the majority of their clients, Islamic banks have more stringent Know-Your-Customer requirements. The reason for this difference is quite commonsensical. Conventional banks rely on a fixed pre-determined return framework and are, therefore less concerned about the character and credibility of their clients. They are often, more preoccupied with the underlying securities and assets. On the other hand, Islamic banks are engaged in a quasi-partnership profit-loss sharing framework and therefore have to know their clients, their businesses, as well as, their sources and uses of finding in order to satisfy themselves about the authenticity and legitimacy of their counterparts. Thus, they would be in a much better position to detect, prevent and disengage quickly from suspicious transactions compared to conventional banks.

In addition to normal audits, Islamic banks have to conduct Shari'ah review of their transactions for ensuring Shari'ah compliance. This review will catch any funds mobilized or used for haram (prohibited) activities. This unique feature of Islamic Finance as possible prevention of money laundering has not yet been widely disseminated and its potential not fully recognized.

The Financial Services Authority of the UK, whom I consider an extremely conservative and competent regulatory agency, after considering all the pros and cons, has finally embraced Islamic banking and issued the first ever licence to the Islamic Bank of Britain which is now operational. Further, they have authorized Islamic investment funds which are a welcome move. In Germany, one of the State Governments has raised funds by issuing an Islamic suck. In the UAE, a number of long term infrastructure projects were financed by Islamic financial institutions as the relative advantages of Islamic modes of finance outweighed the costs in comparison to the conventional modes.

Naturally, if there is so much rapid growth, a question that should arise in everybody's mind is: what is happening on the legal, regulatory, accounting and auditing and governance fronts of Islamic Finance? Are these keeping pace with this growth and are we making sure that the supporting infrastructure are in place to avoid any pitfalls or hazards in the future? This is quite a legitimate concern and I would like to share with you as to what is actually happening on these fronts.

Several of - the Governors of the Central Banks of Islamic countries-worked closely with the International Monetary Fund (IMF) for many years and ultimately formed the Islamic Financial Services Board (IFSB) whose headquarters is in Kuala Lumpur, Malaysia. This Body is working on the development of prudent and transparent standards and codes by introducing new or adapting existing international standards consistent with Shari'ah principles. However, I am satisfied that the work it has initiated through various working groups on Risk management, Capital Adequacy, Corporate Governance, Transparency and Market Discipline, as well as Supervisory Review Process, is proceeding well and we expect the end products to be rigorous and of high quality. This institution, in our view, will economize on scarce expert resources, come up with a consensus view after rigorous debate and research and create uniformity and standardization of Islamic products and services across countries.

The second important body is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which has so far issued over 50 accounting, auditing, governance and Shari'ah standards for Islamic financial institutions. Islamic banking practices are becoming an integral part of the leading accountancy firms of the world - the Big Four - and many other countries and are, thus, being disseminated through their national affiliates and consultancy services. In the last few years, a number of other bodies dealing with different components of the Islamic financial infrastructure have been formed and are beginning to take shape. They are, of course, at different stages of evolution but together they form the necessary complements. The Islamic Development Bank (IDB) must be given credit for taking the lead in establishing the International Islamic Financial Market (IIFM) which is working on the development of liquidity management instruments and markets for Islamic financial institutions and more recently, the International Islamic Rating Agency (IIRA) which will provide credit rating, Shari'ah rating and Corporate Governance Rating to Islamic financial institutions. Dow Jones and Financial Times Islamic Indices have been launched to track the movement of Islamic Funds.

Despite these positive developments which I have sketched above, I will remiss in my duties if I do not put forth the enormous challenges in Islamic Finance and let me tell you there are many.

(a) Fund Mobilization:

The ways in which Islamic banks can and do mobilize funds are all non-conventional and, in some ways, new to the regulators. Several issues and questions arise in the minds of regulators confronted with the task of supervising and regulating Islamic banks. Some methods for mobilizing funds, for example, would require asset-management instead of the conventional concept of fund management. This is an area where the Central Banks do not have either adequate expertise or much knowledge.

(b) Nature of Contracts:

The use of non-conventional contract to offer products for financial services can create a whole range of issues concerning corporate governance standards, sources of new risk and how to manage them, as well as how to make Islamic banks conform to the market discipline already created for conventional banks. For example Risks profiles of some financial products may be quite distinct and do not seem to have been addressed by Basel II. The new dimensions of risk emerge on both assets as well as liabilities sides of Islamic banks' balances sheet. On asset side, Islamic banks will use contracts such as Ijarah, Murabaha, Istisna's and Salam which have more complex implications towards risk management than that of products on the asset side of the conventional banks' balance sheet. On the liabilities side, Islamic banks will be offering profit-sharing investments accounts to the depositors. These depositors are assumed to share the profits and losses of the bank, but neither fall into the category of the capital of the sense of the term. This raises complications for the formula for capital accounts of Islamic banks to conform to the banking laws of Europe without violating Shari'ah provisions will be a challenge for the lawyers of Islamic banks intending to provide financial services in the proposals for establishing such banks in Europe. This question is already being examined by lawyers of Islamic banks and regulators in Europe as exemplified by the U.K. The outcome will benefit the rest of Europe.

(c) Reaulatorv Challenaes:

The regulatory challenges have three main dimensions, as highlighted by the Managing Director of the Financial Services Authority of the US when he spoke at a recent conference in the Middle East:

i. Protection of consumers of Islamic Banks;

ii. Transparency (including issues relating to corporate governance); and

iii. Professional competition (in different and distinctive aspects of Islamic banking, in addition to competence in the conventional aspects of banking.

Regulators will need to look at profit-sharing investment accounts from the investors' protection point of view and not merely from the depositors' protection point of view, as in the case of commercial banking. The application of Islamic modes of financing require Islamic banks to assume at some stage of the ownership of the underlying asset, though in some cases it may be effective only for an extremely short period (such as in the case of Murabaha-based financing). The ownership of the asset, for whatever period it is assumed, involves bearing the risks associated with the ownership. These risks, of course, can be insured but that will involve additional cost. (The insurance of third party risk could be quite expensive). Firstly, this is an issue of efficiency in providing an alternative product. Secondly, this is also a question of who will pay for this additional cost. If the depositors have to pay for it, it will have implications on the rate of return of their deposits. There will, therefore, be an issue of transparency about all costs and their implication on return for the depositors of the bank and costs to the clients seeking finances from the bank.

I now address the question that is uppermost in the minds of many of you. How can Islamic financial services industry grow and sustain itself in the future? In my assessment there are many challenges that it has to confront but at least six of them are highly pertinent.

First is the development of the range of products and services the IFSI can offer to its clients, retain them and attract other clients in a dynamic, ever changing business environment. Innovation should remain the hallmark of this evolutionary process but the expert resources for designing and delivering shariah compliant innovative products are in short supply. Unless this constraint is eased the possibility of Islamic finance taking off will remain subdued.

Second, is the strength and soundness of the Islamic financial institutions (IFIs) that are able to compete with other providers of financial services and are able to cater to the entire suite of their customers' financial needs in a cost effective manner. Technological advancement and financial liberalization have enhanced the opportunities but also placed greater premium on managing risks. Islamic finance has some additional risks that are inherent in the system and these have to be managed along with other known risks of the financial system.

Third, the cross border and international financial markets are a good source of diversification and liquidity while at the same time taking the domestic institutions to the efficient frontiers of production. However, as the returns to depositors and investors in IFSI are uncertain and not known in advance this creates an uneven level playing field for IFIs operating in the international financial markets. The issue of uncertainty is being tackled at present indirectly through striking ex post equivalence in the rates of return but this is still unsatisfactory from the perspective of many international market players.

Fourth, increased attention has to be paid by the regulators and supervisors in ensuring that the norms governing the Islamic financial sub system do not diverge from the basic principles of system wide financial stability and integrity and its practices are in conformity and consistent with those of the system as a whole. The core differentiator of Islamic financial system i.e. self regulation and effective monitoring of the use and sources of funds and deployment of assets in ethically and socially responsible investments by the financial institutions themselves should not lull the regulatory and supervisory authorities in a false sense of complacency. They have to remain ever vigilant and watchful in not only safeguarding the interests of the depositors but the genuine use of the funds according to the Shariah precepts. Strengthening of Shariah audit within the regulatory and supervisory agencies should deserve priority.

Fifth, most countries are facing immense shortages of human resources in their IFSI. The binding constraint in Pakistan, for example, in the rapid expansion of Islamic finance is neither the asset or deposit base but the inadequacy of properly qualified and trained personnel who are competent in banking but also well conversant with the knowledge and application of Shariah. This combination of skills is rare to find and more concerted efforts will have to be made in nurturing and developing this particular skill set.

Finally, the legal and judicial systems in many countries have not yet been tested. It is my impression from casual empiricism that these systems have not adjusted to capture the unique characteristics of the contracts under the Islamic finance, built the capacity to adjudicate the disputes and built up a body of precedents and case law that can guide the lawyers and judges in advising and interpreting the legislation governing IFSI. These gaps ands weaknesses in the legal framework, taxation structure and the judicial system have to be identified in each country according to their own context and filled in.