Session 6: Panel Discussion on the Way Forward

A Roadmap for Asian opportunities – Key Success factors challenges to venture beyond the region MENA and Europe.

Chairpersons:
Mr. Rajat M. Nag, *Managing Director General, Asian Development Bank*
Mr Jaseem Ahmed*, Secretary General, IFSB*

Speakers:

1. ***Mr. Richard Thomas OBE,*** *Chief Representative, Gatehouse Bank in Malaysia and Senior Advisor to the Board*
2. ***Ms. Baljeet Kaur Grewal****, Managing Director and Vice Chairman KFH Research, Malaysia*
3. ***Mr. Madzlan Mohamad Hussain,*** *Partner, Zaid Ibrahim & Co.*

The Chairpersons opened the panel by opining that the way forward 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. The panel has to address the question:

Is it the financial instruments or the practices and processes of Islamic finance that tend to be more stable against anticipated shocks compared to conventional banks?

The panelists were of the view that there were many factors responsible for this. The unique underlying relationship of the depositors in Islamic finance provides a strong source of stability i.e. the special account holders absorb the shocks as opposed to the shareholders alone. Islamic banks do not encourage and do not have hedging instruments which were at the heart of the previous global crisis. As the banks grow they need more hedging tools and risk management structure tools. The nature of Islamic instruments is such that they do not allow these tools because they magnify and amplify risks as exhibited by the derivatives and other exotic products of conventional finance. But it also raises an equally important issue: what are the hedging tools available in Islamic finance to manage the array of risks? To the extent that these hedging tools do not become the tools of speculation the inherent stability of Islamic Banks will not be impaired. Third, the excessive leveraging in conventional banking proved too detrimental to the system, and the shareholders' equity even in

infrastructure projects kept on diminishing. Excessive risk taking is a natural consequence of asymmetric relationship between appropriation of rewards and incurrence of risks among conventional finance players. With a high leverage ratio of 30 to 40 the downside risk will be taken care of by the tax payers in form of bail out but the benefits of upside will be captured by the shareholders and the management. In Islamic finance, leverage is shunned as they have ample liquidity at their disposal and it is the dearth of productive assets that keeps deposits under deployed. It was surmised that Islamic finance follows a course of natural growth rather than unnatural growth because it does not permit the existence of invented or contrived money. Fourth, the depositors believe that their money is relatively safe at Islamic banks. At the peak of financial crisis there was queuing up by even non-Muslim depositors. It should be recalled that safety, liquidity and relative returns form the essential ingredients of a financial system. Fifth, the asset based and asset backed financial transaction inherent in Islamic finance confines the exposure to that underlying asset. However, it becomes important to assess the quality of asset, rating and liquidity. Sixth, the monitoring mechanism is much stronger as it is not only the Bank management that is involved but also the Shariah Board that ensures that the transaction remains compliant throughout its tenure. Seventh, the originating bank could not slice and dice their loan portfolio, securitize them and sell different tranches off in market. A lot of banks got infected by CLOs and CDOs etc. but these products are not Shariah compliant and therefore did not enter the books of the Islamic banks. Any variants of these structured products will not be allowed by the Shariah boards as it simply leads to risk transfer rather than risk sharing. In Islamic banking the sharing of risk between the bank and borrower reduces the possibility of abrupt insolvency and bankruptcy in case the transaction gets sour. In conventional finance, the risk is borne by the borrower entirely as the bank receives a fixed return irrespective of the fact whether the loan transaction has generated any income or not.

The panel also examined the differentiated impact of the 2008-09 Global Financial Crisis. In the first phase of the crisis, the Islamic banks were insulated as they did not carry any contrived products on their books. But in the second phase, when the broader economy was impacted and disposable household incomes were reduced the prices of real-estate fell drastically. Real estate was the natural hedge

for Islamic banking transactions and as the prices of the real estate went tumbling down the Islamic banks were also adversely affected. However, in not a single case they went for bail out by public sector. In some cases they recapitalized themselves through Sukuk market. Only four Sukuks actually defaulted at the height of the crisis. Islamic financial institutions (IFIs) had relatively higher capital adequacy which provided a better cushion to them in case they had to incur any unanticipated losses. The havoc that almost decimated the banks in the U.S. and Europe left Islamic finance unscathed because of their capital strength and shock absorption capacity. Thus, it should be made clear that in times of financial crisis, the performance of Islamic financial system would like to remain robust and strong. The road map for the future should therefore be based on this Unique Selling Proposition (USP) of Islamic finance and a proper governance framework in which the roles and responsibilities of the Shariah Board and the extent of its autonomy are clearly defined vis a vis other shareholders and management.

The panel then turned to the risks and challenges facing the incipient Islamic Financial Services Industry (IFSI). As the system is hardly 10 years old and the regulatory system, standards, infrastructure, institutions are beginning to evolve, it remains untested and untried. 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 IFSB. Some members felt that the binding constraint that is not allowing speed to pick up is the availability of adequately trained and experienced human capital rather than anything else. It was felt that the legislation, standards, supervision etc. can be put in place if we had the right human capital to drive it. One of the risks identified by the panel members is the act of balancing between maintaining profitability in a competitive environment and sustaining social responsibility. There is an apprehension that any tradeoff 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’ etre for the existence of these banks. On the other hand, the dilution of social responsibility may deviate from its distinctive and unique feature. It is a tough call to follow. The line of 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, has high credit risks and other business risks is not at all easy and straight forward. Another risk identified from the

past practices was that of the poor quality of managing Islamic Financial institutions. People entrusted with the task of managing these institutions came mainly from the background of the conventional finance. They did not understand the peculiar set of complexities involved and therefore failed to come up to the expectations. This inadequacy of trained and uniquely focused managerial pool and human talent across the industry remains an obstacle to its growth.

The other challenge is to have a strong and supportive governance system at the level of the individual institution. Egypt in the 1970s went through a major governance failure and corruption in the banking system which had a long run negative reputational risk. The banking system hasn't yet fully recovered from the loss of trust and faith. So the Islamic banks have to make sure that they instill confidence and nurture trust among their stake holders by adopting best governance practices that incorporate the features enjoined under Islamic Finance. Any deviations or scams or scandals or shortcuts will put the industry back and strike a heavy blow to its future expansion.

Third, the incentive structure particularly the compensation packages should be designed in a way that the pitfalls of conventional financial institutions i.e. excessive bonus payments based on inflated indicators are avoided. Bonuses should be payable when the actual results from the investments financed by the banks become available not when the quarterly or annual profits at aggregate level are announced.

Fourth, the transaction costs in Islamic finance are very high compared to the conventional finance because of the additional requirement of Shariah compliance. If the edicts and opinions of Shariah Boards were standardized and could be available for ready references then the structuring of transaction would not take either that much time or human resources. When every transaction is held up because it has to be reviewed and endorsed by the Shariah Board, an element of uncertainty is added. The manufacturing and marketing of pre-approved Shariah Compliant products on a large scale will mitigate this risk. These costs can be reduced if the probability of pre default and post default events is minimized by careful screening and forceful monitoring under Islamic finance modes.

Fifth, the issue of liquidity availability for Islamic banks needs to be tackled. Unlike conventional banks which have recourse to an active interbank money market the Islamic banks do not enjoy such a facility. Deposit Insurance is also not available to them not is it clear the Central Bank is the lender of last resort for them. The absence of liquidity management instruments, deposit insurance and lender of last resort puts Islamic banks at a serious disadvantage relative to their competitors in the market.

Sixth, 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 the state led approach for promoting Islamic Finance and in others it has been left to market forces or Demand led approach to develop the system. Although it was felt that there is no uniform answer to this question 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, chambers of commerce and industry have to play an equally important role. Islamic finance is a powerful vehicle for Financial Inclusion but this aspect has not been highlighted so far.

Seventh, Asia has an $8 trillion investment gap that needs to be financed during the next 10 years. This is a huge gap which cannot be filled in by the conventional finance only. The asset backed nature of Islamic financing provide a better match for infrastructure projects than traditional lenders. Islamic Sukuk is more suitable for infrastructure financing and can be a good source of mobilizing funds by the kind of investors who would like higher but stable returns over an extended period of time. Other areas where Islamic Finance can play a vital role is Microfinance targeted at those living below the poverty line.

There was a consensus that the road map for Asia would have to start by making a realistic assessment and stock taking of the needs and requirements of the various markets. It will then be feasible to match different solutions with the problems faced by them. Some of these solutions have already been tried in advanced Islamic economies and can be modified and adapted. In other cases the solutions have to

be found by engaging the various stakeholders in those countries. The road map should be constellation of policy development , enabling environment, developing the laws, strengthening the regulatory framework, and making progress in capacity building.

The panel then turned its attention to the multi-speed movement of Islamic financial industry in Asia and elsewhere. Some countries have moved ahead because of the promotional support by the Central banks, the emergence of legal and regulatory environment, the infrastructure and institutions. In other jurisdiction, the progress is slow as the State or the Central Bank does not intervene or play an active leadership role. Markets for Islamic financial products in those cases in absence of any guidance or future plans would be developed in fits and starts. The panel referred to the example of Malaysia where Bank Negara played a pioneering role in guiding and steering the process of development of IFSI. The results are obvious and the progress is impressive. The outcome is that 25% of banking assets and 75% of capital market are now under Islamic modes of financing. State intervention does not necessarily mean financial subsidies. Other countries have adopted a reactive or Demand-driven approach where the superiority of Islamic finance as an alternative to conventional finance will tilt the balance. Bangladesh which has followed a Demand driven approach has also reached 25% of banking assets. If it is cheaper and less time consuming to borrow from the competing conventional banks there will be very little room for demand expansion for Islamic products. Even in such countries the need for a long term strategy cannot be ruled out. The least it will do is to point out the destination and direction in which Islamic finance will be moving.

The structure of financial markets should also be taken into account when designing and delivering the Islamic finance products. If the real economy consists predominantly of the SMEs then a tailor made product catering to their needs at competitive pricing has to be introduced to make any inroads. If products that have made profits in other countries are introduced in that market without testing or investigation and adaptation there is likely be a major setback to the nascent industry.

In the end, the panelists believed that Islamic Finance has potential as an alternative to the existing financial system but it still faces many challenges and risks that have to be managed and mitigated first.