THE FUTURE PROSPECTS OF THE ISLAMIC FINANCIAL SERVICE INDUSTRY

Ishrat Husain

The topic for discussion at this seminar is quite wide-ranging and, therefore, I would like to focus my remarks on six sets of issues that, in my view, will impinge heavily on the success or otherwise of the growth of the Islamic Finance Sector.

We have to agree, at the very outset, on the objective which we are trying to achieve. I agree with Dr. Zeti Aziz that our objective is "to nurture a competitive, dynamic, sustainable Islamic Financial Service Industry as an integral part of Global Financial System".

I believe this objective is attainable. At the national level, particularly in countries with Muslim population, Islamic finance industry will provide opportunities to those who are outside the conventional banking due to their faith and beliefs to join the organized financial sector. This, in turn, will lead to financial deepening in the country and hence contribute towards one of the overall national economic goals, i.e. expansion of financial sector.

At the international level, the investors will have a new asset class available to them, which may not have high correlation with other asset classes and thus help them in diversification of their asset base and minimize their vulnerabilities.

Both these outcomes are based on the assumption that the Islamic finance has equivalence in terms of certainty, predictability, liquidity and profitability (risk-adjusted returns)

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as the conventional finance. As we speak, I am afraid that we have a long way to go before this equivalence can be achieved. Let me spell out the reasons behind this assertion and also attempt to show the way forward.

- 1) IFSI has to safeguard and maximize the <u>interests of major stakeholders</u> so that there is growth in market share of Islamic financial service industry from the existing insignificant level. There are four major stakeholders in this industry – three are common to both conventional and Islamic but there is one additional stakeholder in case of Islamic finance i.e. the Shariah scholars who have to be satisfied that the products are compatible with Shariah precepts and principles. Not only that there is an additional stakeholder, the nature of relationship between Islamic finance service provider and other stakeholders is also quite different.
 - <u>Customers</u> Relationship is varied, complex and multiple. The relationship ranges from that of a buyer and seller (murabaha); transferor and transferee; lessor and lessee (ijara); guarantor and guarantee; depositor and custodian; partner and partner (musharika); investor and working manager (mudaraba). In conventional banking there are only two forms of relationships i.e. borrower or depositor.
 - <u>Shareholders and Investors</u> Risk premium in IFSI is relatively high while riskmitigation, risk allocation and risk transfer techniques are not that well developed; unless risk adjusted returns are equalized across the two market segments, the IFSI growth will remain stunted. Absence of hedging products places the Islamic products at a relative disadvantage as far as risk mitigation is concerned.

- <u>**Regulators**</u> Standards and codes, Principles of Corporate Governance, internal controls, disclosure and transparency have to be separated and made distinct from conventional banking to reflect the peculiar characteristics of IFSI. Some progress has been made but still there are a lot of knotty issues to be settled.
- <u>Shariah Compliance</u> There are conflicting pronouncements and continuing debate as to what is and what is not permissible under Shariah. These controversies in the interpretation of Shariah precepts among scholars from different fiqahs create a lot of uncertainties among the potential investors who then shy away from taking a plunge in the Islamic products keeping the overall size of the market small.
- 2) Legal Framework: The legal framework provides confidence to stakeholders that their rights and obligations will be enforced by the courts if and when a situation arises in the future. But in case of Islamic finance industry there is both ambiguity and lack of predictability about the enforceability of contracts under the Islamic Banking. For example, there is a dual judiciary system in Pakistan. Jurisdiction of Courts is unclear whether Civil or Shariah Courts will take cognizance and decide. Dispute resolution mechanisms such as mediation, conciliation and arbitration are not binding under the existing legal system and practices although litigation is not the preferred mode of dispute resolution in Islam. Judges lack training in banking and Shariah. Lawyers are not trained in Islamic banking and finance. Case law and precedents from one system such as English law are not binding. Enforcement mechanisms are found wanting.

- 3) <u>Accounting, Auditing, Taxation and Information Support Systems</u> have to evolve over time. Infrastructure for Islamic Financial Institutions (IFIs) is still underdeveloped and will take time and efforts. To that extent conventional banks will have an edge over the IFIs, AAOFI and IFSB are the right vehicles and must accelerate and disseminate their work. Tax differentials do erode the competitive edge of IFIs and will amplify the divergence. These differentials will have to be removed to provide equal tax treatment to both segments of the market, i.e. IFIs and conventional.
- 4) Product Innovation and Development should move ahead to keep pace and provide alternative options that are at least as attractive as conventional products with the additional stipulation that these products should be Shariah compliant. Standardization, harmonization and application of Shariah compliant products based on some general principles should be promoted. A menu approach whereby the markets can develop and documents new Shariah compliant products rather than await for ex-ante approvals of Shariah Boards in each single case will enhance the response capacity of Islamic financial markets and enable them to compete with conventional products. At present the transaction costs of Shariah compliant products are higher relative to the traditional products and have to be reduced by adopting this menu approach.
- 5) <u>Human Skill Development</u> Selection, training retention and continuous capacity upgradation of the managers and staff of IFIs are essential for the success of the Islamic financial system. Islamic financial industry has to make strategic investment in all these areas as hiring and merely re-labeling conventional bankers as Islamic bankers is not going to work in the long term. Managers and leaders in this industry are badly missing and unless

we can identify, find and empower them the rest of food chain in human skills development will have important missing links. Dogmas, strongly held opinions and narrow-minded beliefs in some rigid doctrines of the religion should not be allowed to dominate the field. Open minded, pragmatic and innovative men and women committed to the growth of Islamic financial industry should be encouraged and drawn into this profession.

6) Finally, <u>inculcation of Islamic values of integrity</u>, ethics, truthfulness, justice, compassion and absence of exploitation among the Ummah will provide the glue and adhesive that will make this stick in the long run. If the practice of values move in one direction and the financial system evolves in the other, the foundation of the system will get weakened over time and it will not be able to withstand the tremors and vibrations created by exogenous shocks.

Conclusion:

The Islamic financial services industry, despite its remarkable growth during the last few years, is still in its infancy and needs careful nurturing and development to make a perceptible impact in the global financial markets. The creation of institutions such as IFSB, AAOFI, IIFM, etc. has given rise to expectations that the constraints and impediments facing this industry will be tackled in a systematic and informed manner. The six difficult challenges facing the industry identified in this paper should be given priority attention by the national regulators, governments, market participants, judiciary, institutions of higher bodies formed recently. The thrust of the future seminars and conferences should shift from generalized discussions to focused discourse on each of these six topics so that some headway can be made and progress monitored and measured in the achievement of the objective agreed by us at this seminar.