"ISLAMIC FINANCIAL SERVICES INDUSTRY: THE EUROPEAN CHALLENGES"

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Ladies and Gentlemen,

First and foremost, I wish to commend the Islamic Financial Services Board and the Central Bank of Luxembourg for organizing this Forum and providing me with this opportunity to share my thoughts and experience with this august gathering.

In view of the growing interest in Islamic Finance, it is incumbent upon us to outline the distinguishing features and delineate the unique characteristics that make it attractive to a segment of the consumers and investors all over the world.

What is Islamic Finance? There are at least three characteristics which makes it different from the conventional debt finance. First, it prohibits *riba* or interest, or in other words a fixed and pre-determined rate of return to be paid on the deposits or to be received from the borrowers. The rate of return is variable and determined by the profit and loss that the bank makes during a given period and the returns on assets depend on the particular mode and purpose of financing, i.e. *Murabaha* (trade finance), *Mudaraba* (profit sharing), *Musharaka* (partnership), *Ijara* (leasing), etc.

Second, Islamic Finance does not allow undertaking or financing the anti-social and unethical businesses such as gambling, prostitution, alcoholic liquor, nightclubs and narcotics. These are the main channels used for money laundering, terrorism financing and organized crimes, etc. Islamic banks are prohibited from opening accounts or provide financing to persons or 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

[1] Keynote Address at the Islamic Financial Services Forum organized by the Islamic Financial Services Board and the Central Bank of Luxembourg at Luxembourg on November 8, 2005

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 its funds.

Third, Islamic Finance has to be compliant with the basic percepts of Shari'ah, the legal code of Islam which is based on the principles of justice, fair dealings and harmony through equitable distribution of wealth. Islam is deadly opposed to exploitation of an individual or institution by the other for self-aggrandizement. Riba or usury is considered exploitative by its construct and is therefore prohibited. The equitable distribution dimension of Islamic Finance is therefore an add-on that is clearly absent from the conventional modes of financing.

If we examine these properties of Islamic Finance, it becomes apparent that these will appeal to a large number of individuals and institutions whose set of beliefs and faith conform to these principles. It is not necessary that only the Muslims can subscribe to this particular mode of financing but the fact that it is being widely accepted and adopted in different parts of the world including Europe attests to its intrinsic value and strength.

Ladies and Gentlemen,

The Islamic financial services industry is the fastest growing component of the financial services industry, with an annual rate of growth ranging between 15 to 20 per cent. At least 70 countries all over the world have some or other form of Islamic financial services available in their territorial jurisdictions. It is instructive to note that almost all major multinational banks such as Citigroup, HSBC, BNP Paribas, UBS, Credit Agricole, Standard Chartered, etc. are offering these services.

Why are these services spreading so fast? 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 the existing asset classes or products. Islamic financial products cater to this particular need and have, therefore, become attractive to that investors group.

Third, there is a growing trend, particularly among the younger population to show unethical or socially irresponsible investment funds and businesses. 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 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 pre-occupied 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 funding in order to satisfy themselves about the authenticity and legitimacy of their counterparties. 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.

Ladies and Gentlemen,

Several of us – 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. I am sure the Secretary-General of the IFSB would be in a better position to inform you more about the activities of this Body. 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 which I have also been associated with 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.

Ladies and Gentlemen,

I now turn to the example of Pakistan where we have vigorously introduced Islamic Banking in its true letter and spirit. We considered it totally imprudent to dislocate the entire financial system by directing substitution of the on-going banking by Islamic banking in one-go by a certain given deadline. Instead, we decided that we should provide a level playing field and afford opportunity for Islamic banking to co-exist with conventional banking. We believed that the choice should be left to the individual consumer whether they would like to switch over to Islamic banking or stick with their existing banks. The endeavor of the government and the Central Bank was to ensure that there was no discrimination, preference – overt or convert – policy biases in favour of one system or the other. If, over time, the majority of the consumers decide to opt for Islamic banking, the whole system will naturally be transformed and the end point will be reached.

In our view, it is not the responsibility of the Government or the Central bank to impose their will or dictate choices to the people. We have, therefore, opened up the banking system by allowing: (a) establishment of stand-alone Islamic banks; (b) setting up of subsidiaries of banks for Islamic banking; or (c) setting up of full-fledged Islamic Banking branches of the banks. The initial response has been overwhelming and hundreds of thousands of Pakistanis who had never done any banking in their lives are now asking for more Islamic banks or branches in their areas.

In the very first year, Islamic banking segments have captured 1.6% of the total assets of the banking system and the rate of growth is extremely fast. In the basis of the current trends, we project that the Islamic banks will attain about 10% of the market share in the next few years. The State bank of Pakistan has developed a market-based regulatory framework including a high-powered Shari'ah Board to provide guidance on the Shari'ah compliance aspects of the business and regulations. The Institute of Chartered Accountants of Pakistan (ICAP) has prepared accounting standards for Islamic modes of finance which are being implemented. These standards are based on the AAOIFI Standards and are compatible with the International Accounting Standards. We have developed innovative products such as Islamic Export Refinance Scheme in consultation with the Islamic banking industry for it to remain competitive with other banks.

Despite these positive developments which I have sketched above, I will be 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) <u>Fund Mobilization:</u>

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) <u>Nature of Contracts:</u>

The use of non-conventional contracts to offer products for financial services can create a whole range of issues concerning corporate governance standards, sources of new risks 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 Risk 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' balance sheet. On the asset side, Islamic banks will use contracts such as Ijarah, Murabaha, Istisna'a 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 investment 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 bank nor can be regarded as liabilities of the bank, in the accounting sense of the term. This raises complications for the formula for capital adequacy and for other indicators and measures. How to make the 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 Europe as well as a challenge to the regulators who will be evaluating 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) **Regulatory Challenges:**

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 made 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 costs. (The insurance of third party risks 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.

To conclude, let me say that we have made a modest beginning in several Islamic countries for Islamic Finance to take off. The response so far has been positive and the spill-over effects are being felt in other parts of the world such as in Europe. This gathering is an ample testimony to the interest that is being demonstrated in the Western world. Nevertheless, we should be cognizant of the enormous challenges which we face. However, I am sure that the institutional framework that is being put into place would adequately prepare the growing Islamic financial services industry in meeting these challenges in the future.

Thank you.