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ISLAMIC FINANCIAL SERVICES INDUTRY: FUTURE CHALLENGES AND OPPORTUNITIES

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I. FOREWORD:

The recent global financial crisis and resulting liquidity crunch has affected all economic sectors, especially those of the developing countries. The shrink in banking services worsened the position of productive units in accessing finance. Banks become even more reluctant to bear traditional risks inherent in all types of economic activities. Doubts about financial soundness of fund providers have also lessened opportunities of real sectors in accessing institutional finance.

These circumstances create the need to know more about other financial alternatives. One of these viable options is Islamic Finance which is growing fast over the last four decades. As a complement or an alternative to conventional finance, some key players in global financial markets have started long time ago Islamic financial services. UBS, Paribus, HSBC as an example have opened Islamic banking windows since mid-80s.

Though the international financial system is in a turmoile, the global expansion of Islamic finance has continued and its development has remained sustainable. Islamic finance has become one of the fast growing financial segements in the international financial system:

Modest estimates indicate that Islamic Finance is recording high growth levels: nearly a US$ 2 trillion in assets and mutual funds, and an annual growth rate of 15-to-20 percent. This implies that Islamic Finance could complement and / or be a feasible alternative to conventional finance.

In addition, some perspectives of Islamic Finance like partnership could make it more attractive to investors as profit and loss are shared. Thus, Islamic finance can offer new perspectives and ways to implement financial transaction for the benefit of economic development.

However, since Islamic finance expands to serve the global community and becomes an integral part of the international financial system, it will certainly be subject to risks and development in the international financial system. Islamic finance is also going to interact with a new environment that will be reshaped by the international regulatory reform being undertaken in the post crisis times. Therefore, the foundations of Islamic financial system need to be strengthened to enhance level of resilience and thriving in the new global financial environment.

II. ISLAMIC FINANCE IS APPROPRIATE FOR DEVELOPMENT

Prohibition of *riba* (interest) is a central thesis in Islamic Finance. It simply implies that money cannot be exchanged for money. Instead, money can be converted into goods and services that can subsequently be sold or leased. Money can also be mobilized and used in a business venture with partners sharing profit and loss generated from this venture.

All transactions in Islamic perspective should be interest-free. Basically, there are three categories of Islamic financial instruments which are used by Islamic financial institutions: (a) **sale-based instruments**, (ii) **lease-based instruments** and, (c) **partnership-based instruments.**

Thus, strength of Islamic finance emanates from its inherent underlying principles: Islamic financial transactions must be accompanied by an underlying productive economic activity that will generate legitimate wealth. In this way, Islamic finance links between financial transactions and real economic sectors. Hence, the Islamic finance is released from excessive exposure to risks associated high leveraging and inprudential risk taking. As a consequence, growth in Islamic financial assets will be matching that of underlying economic activities.

Transactions based on profit-and-risk sharing are encouraged and promoted by the Islamic Finance paradigm. Contracting through *mudarabah* (equity finance) and *musharakah* (joint venture) transaction, Islamic finance promotes participatory finance and active participation in the business. Due to this, Islamic financial institutions are at all times observing viability of the proposed business activity. Supervision and review undertaken at the stage of *Shariah*-compliance review process, minimizes mis-use of the funds provided.

In comparison, conventional finance segregates business risk from underlying funded assets and hence, risk management and wealth creation would move in divergent directions, with diverse consequences for effective risk management. Conventional finance also encourages proliferation of risk through leveraging and thus creating potential instability in financial system.

High degree of transparency and disclosure in contracting is a key element in Islamic financial transactions. Islamic financial institutions are required to undertake due and vigilent review of Project proposals submitted for finance. Market conduct disclosure and customer relationship management form the core principles of Islamic finance. Thus, there are built-in measures of governance and risk management that could contribute in directing Islamic finance to real economic development and avoiding leveraging or speculative activities.

The above-mentioned distinctive features of Islamic finance are in fact core factors in identifying whether a transaction or an Islamic financial institution falls within the parameters of *Shariah*. Islamic financial transactions must always be within Shariah parameters – *Shariah* objectives, which entail that primary objective of Islamic finance should be realization of benefits to the human being. These inherent features of Islamic finance contribute substantally in real socio-economic development of societies.

An ethical approach is another dimension of Islamic finance that it adds to its unique features of risk-sahring. Ethical approah means greater attention to transactions that are not profit-driven and to segments of the community with scarce resources. The non-profit institutions have been in operation for centuries. This domain of Islamic finance is composed of isntitutions like zakat, sadaqat, waqf and similar philanthropic and social responsibilities, which are considered as important as the profit-motive institutions within Islamic finance. They also enhance the beneficial economic supportive role of Islamic financial institutions and they constitute a kind of safety net arrangements in societies.

As part of their role in economic development, Islamic financial institutions contributed (though modest) in financial inclusiveness by outreaching small productive units through programs of financing Small and Mediun Enterprises and micro-finance.

A number of market studies commissioned by the International Finance Corporation suggest strong demand for Islamic micro-finance products.

Micro-finance practitioners in countries like Afghanistan, Indonesia, Syria and Yemen indicate that conventional micro-finance borrowers tend to shift over once Islamic products become available.

In short, the Islamic Finance model is pretty much appropriate to economic development as in Islamic finance perspective: (a) funds can go only to real Project, real trade and service transactions. Financial assets can therefore grow in balanced proportion to growth in real sector and subsequently reduce excessive leveraging, (b) social and ethical factors are an integral part of investment decision in Islamic finance.

III. PRESENT STATUS OF ISLAMIC FINANCE

As said before, Islamic finance has grown rapidly and become an integral component of the global financial market. Islamic financial institutions have developed from limited institutions perfoming small groups of society into global multi-purpose institutions encompassing banking, insurance and capital markets. The Islamic financial landscape has now been enhanced with more diverse market players providing an extensive range of financial products and services. Consequently, Islamic finance has now emerged as among the fastest growing segments in the international financial service industry.

A number of indicators reveal growing global importance of Islamic finance:

i. Strong asset growth: nearly US Dollars trillion at end of 2013

ii. Strong performance amid the crisis. In 2008, assets of Islamic banks in the GUlf grew by 38% whereas those of conventional banks in the region grew by only 16%.

iii. Potential expansion outside Muslim markets and jurisdictions: this expansion in regions like Europe and the Pacific, was driven by market forces unlike the Middle East where religious considerations are more often predominant in investment decisions.

iv. Fast growth in Islamic securitization: despite a decline in sukuk market during 2008, the market boosted in 2009 and the market is still highly potential.

v. Wide spread of *Takaful* services: *takaful* premiums increased two times and a half within a period of three years (from 1.4 in 2004 to 3.4 US Dollars in 2007).

vi. Strong growth of Islamic mutual funds: within one year, assets of Islamic investment funds grew from USD 267 billion in 2007 to USD 736 billion in 2008.

vii. Resilience of Islamic financial institutions during the crisis: combined market capitalization of top 10 conventional banks delined by 43 % in comparison to decline of 9% in case of top Islamic banks between 2006 and 2009.

IV. PROSPECTIVE FUTURE OF ISLAMIC FINANCE

The recent financial crisis began from the sub-prime market and gradually penetrate through the whole financial system. Of course there are various interpretations of primary causes of this crisis and the subsequent contagion of the global system.

The built-in features of Islamic finance have practically immuned Islamic financial institutions from serious consequences of the recent financial crisis. Nevertheless, the resultant tightening of international liquidity and credit, did have adverse impact on all financial institutions including Islamic ones. With prolonged financial crisis, persistent recession, collapse of prices and drastic erosion of asset values, the performance of Islamic financial institutions was affected negatively, though to a lesser extent.

In the aftermath of this crisis, claims that a financial system based on Islamic principles would be more stable, equitable and efficient, have gained more recognition and attention. It is claimed that in an Islamic financial system, a crisis like the recent one would have been prevented because basic paradigm of Islamic finance:

a. **requires** that all financing is linked to transactions in the real economy (production and trade);

b. **demands** that savers should not be lıke rentıers – expectıng rısk-free fıxed returns for just provıdıng funds. They must behave lıke ınvestors by sharıng the rısk and return of real use of theır savıngs;
c. **does not approve** ınterset-bearıng debt contracts, debt tradıng and speculatıon.

Investıgatıon of the causes of the crısıs concludes that collapse of the fınancıal system could have been prevented ıf all these prıncıples were applıed and rules observed. It means that Islamıc Finance ıs exopected to assume a greater role ın the future global fınancıal market ıf basıc prıncıples are observed and applıed ın the ground.

Now the crıtıcal questıon ıs: to what extent adherence to these standards of Islamıc fınance ıs ensured ın practıce. However, a mere copyıng and slıght changes of conventıonal technıques and products ın Islamıc fınance would certaınly jeopardıze the whole purpose and undermıne the expected role of Islamıc fınance as real alternatıve to conventıonal fınance.

In conclusıon, to strengthen thıer development role under the current post-crısıs cırcumstances, Islamıc fınancıal ınstıtutıons would have to:

1. Create a robust ınfrastructural local and ınternatıonal ınstıtutıons;

2. expedıte cautıous and effectıve ımplementatıon of *Sharıah* and prudentıal standards and rules;

3. encourage constructıve dıalogue and objectıve dıscussıon of topıcal ıssues of Islamıc fınance, especıally wıth ınternatıonal stakeholders lıke the World Bank and the IMF.

4. The Islamic Financial Services Industry (IFSI) has undergone many stages of development since the foundations of modern Islamic Banking were laid in the sixties. The developments have progressed in a steady fashion starting from straight forward commercial banking in the 70s to development of hedging techniques and hybrid *Sukuk* in recent years. In particular the latest developments of the IFSI have taken Islamic finance to its roots related to providing access to finance for the poor in the form of Islamic microfinance. Its general direction is to provide Comprehensive Human Development which incidentally

is also part of the IDB's vision for development of its member countries.

5. In order to enable the Industry to grow further, we need to take it to the next level i.e. from being simply sustainable to having the requisite enabling environment and then onwards to helping countries develop an attractive and conducive Islamic financial climate.

6. The enabling environment for Islamic finance is a set of conditions, consisting of rules, regulations, policies and the existence of functioning institutions at the macro, meso, and micro levels, which facilitate the growth, sustainability, transparency and overall appeal of the Islamic Financial Services Industry.

7. Furthermore, these set of conditions should also lead to Islamic finance being practiced in the true spirit for which it was intended i.e. providing risk sharing, justice and equity through access to its products for all humanity, thus leading to a state of comprehensive human development.

8. There are a multitude of stakeholders and involved in the creation of the enabling environment; including governments, monetary and fiscal regulatory & supervisory authorities, market participants, well defined and functioning legal system; and a strong will of the government and other stakeholders to foster a true Islamic financial system.

9. The Islamic Financial Services Industry must have a Shariah Governance and Corporate Governance overview to ensure the objective of Islamic finance i.e. comprehensive human development, is met. Further studies, however, need to be carried out to ascertain the relative importance of each of these elements.

10. The Islamic Development Bank has been working towards the provision of various elements of the Industry's enabling environment. We are currently implementing or processing projects in Africa (Senegal, Nigeria and Uganda), Central Asia (Kyrgyzstan, Kazakhstan and Tajikistan), Far East (Indonesia). The current interventions by IDB consist mostly of creating the requisite legal and regulatory framework, subsequent to which, we establish Islamic financial

institutions through equity investment and also provide technical assistance in various forms to develop the institutions.

11. The IDB Group also undertakes research and training through the Islamic Research & Training Institute. We also undertake and participate in Islamic finance awareness creation workshops and seminars around the world.

12. In order to further strengthen the enabling environment the IDB in partnership with other Industry stakeholders has developed several infrastructure institutions such as the Islamic Financial Services Board (IFSB) which has been established as a regulatory and supervisory standard-setting organization for the Industry. The other infrastructure organizations are the Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI), the General Council for Islamic Banks and Financial Institutions (CIBAFI), International Islamic Rating Agency (IIRA) and the International Islamic Center for Reconciliation and Arbitration (IICRA).

13. The Bank has also set up Joint IDB-World Bank Working Group on Islamic finance which is working to strengthen the Industry and a technical assistance sub-account for capacity building has been in operation for more than three years with the International Monetary Fund (IMF).

V. THE ISLAMIC FINANCIAL SYSTEM AND FINANCIAL STABILITY

One of the most important objectives of Islam is to realize greater justice in human society (al-Qur'an 57:25). Justice, however, requires a set of rules or moral values, which everyone accepts and faithfully complies with. The financial system may be able to promote justice if, in addition to being strong and stable, the financier also shares in the risk so as not to shift the entire burden of losses to the entrepreneur.

To fulfill this condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. For this purpose, one of the basic principles of Islamic finance is: "No risk, no gain". This should help introduce greater discipline into the financial system by motivating financial institutions to assess the risks more carefully and to effectively monitor the use of funds by borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the system, and go a long way in reducing excessive lending.

Islamic finance should, in its ideal form, help raise substantially the share of equity and profit-and-loss sharing (PLS) in businesses. Greater reliance on equity financing has supporters even in mainstream economics. Prof. Henry Simons of the University of Chicago, writing after World War II, argued that the danger of economic instability would be minimized if no resort were made to borrowing, particularly short-term borrowing, and if all investments were held in the form of equity (Simons, 1948, p. 320). Prof. Rogoff of Harvard University, writing more recently, states that in an ideal world equity lending and direct investment would play a much bigger role (Rogoff, 1999, p. 40).

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all the financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable, but should *not* be promoted for nonessential and wasteful consumption and unproductive speculation. For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing (*murabahah, ijarah, salam, istisna* and *sukuk).* It has, however, laid down a number of conditions for the effective operation of these modes. Some of which are:

1. The asset which is being sold or leased must be *real*, and not imaginary or notional;

2. The seller or lessor must own and possess the goods being sold or leased;

3. The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and

4. The debt cannot be sold and thus the risk associated with it must be borne by the lender himself.

A. The first condition will help eliminate a large number of derivatives transactions which involve nothing more than gambling by third parties who aspire to claim compensation for losses which have been actually suffered only by the principal party and not by them.

B. The second condition will help ensure that the seller (or lessor) also shares a part of the risk to be able to get a share in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. This condition also puts a constraint on short sales, thereby removing the possibility of a steep decline in asset prices during a downtown. The *Shari'ah* has, however, made an exception to this rule in the case of *salam* and *istisna* where the goods are not already available in the market and need to be produced or manufactured before delivery. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion.

C. The third and the fourth conditions will not only motivate the creditor to be more cautious in evaluating the credit risk but also prevent an unnecessary explosion in the volume and value of transactions. This will prevent the debt from rising far above the size of the real economy and also release a substantial volume of financial resources for the real rector, thereby helping expand employment and self-employment opportunities and the production of need-fulfilling goods and services. The discipline that Islam wishes to introduce in the financial system may not, however, materialize unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability.

D. Thus we can see that the Islamic financial system is capable of playing a stabilizing role in the world by getting rid of the major weaknesses of the conventional system and, thereby, helping minimize the severity and frequency of financial crises.

E. By requiring the financier to share in the risk, it introduces greater discipline into the system It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses and the buyer wishes to take delivery. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully.

VI. ISLAMIC FINANCE IS EQUITY-BASED MODALITY

Islamic finance is, however, still in its infancy and shares a very small proportion of international finance. It has, thus, a long way to go before it can genuinely start reflecting the ethos of Islamic teachings. The use of equity and PLS is still relatively small while that of debt-creating modes is dominating. This is due to a number of factors, including:

(i) the lack of proper understanding of the ultimate objectives of Islamic finance,

(ii) the non-availability of trained personnel, and the absence of a number of shared or support institutions that are needed to minimize the risks associated with

(iii) secrecy, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations.

(iv) It is, however, expected that the system will gradually gain momentum with the passage of time and effectively play the role of complementing the efforts now being made internationally for promoting the health and stability of the global financial system.

VII. CONCLUDING POLICY POINTS

We can thus see that the Islamic financial system is not something unique and unknown to the world of finance. It only represents an effort to revive some of the sound principles of healthy finance that have been a part of even the conventional system in the past but have become gradually weakened over the last few decades. Therefore, it is indispensable for the conventional system to adopt at least some of the elements of the Islamic system if it is desired to ensure the health and stability of the global financial system in the future. Some of these are:

1) The proportion of equity in total financing needs to be increased and that of debt reduced.
2) Credit needs to be confined primarily to transactions that are related to the real sector so as to ensure that credit expansion moves more or less in step with the growth of the real economy and does not promote destabilizing speculation and gambling

3) Leverage needs to be controlled to ensure that credit does not exceed beyond the ability of the borrower to repay.
4) If it is not desired to prevent the sale of debt in keeping with Islamic teaching, then there should be full transparency about the quality of debt being sold so that the purchaser knows exactly what he is getting into. It would also be desirable to have the right of recourse for the ultimate purchaser of the debt so as to ensure that the lender has incentive to underwrite the debt carefully.
5) While there may be no harm in the use of credit default swaps to provide protection to the lender against default, it needs to be ensured that the swaps do not become instruments for wagering. Their protective role should be confined to the original lender only and should not cover the other purchasers of swaps who wish to wager on the debtor’s default. For this purpose the derivatives market needs to be properly regulated to remove the element of gambling in it.
6) All financial institutions, and not just the commercial banks, need to be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk.

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