Shamshad Akhtar: Islamic finance – its sustainability and challenges

Closing keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at Georgetown University, Washington DC, 18 October 2007.

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Introduction

In the closing session for this event on Islamic Finance, I propose to reflect on the growth and trends in Islamic Finance, its size and dimensions and prospects which are now evolving from regional to global scale and impacting the private capital flows. The renewed interest and hype in Islamic Finance is unprecedented. Since it coincides with commercial interest of Western financial institutions to attract flows generated from oil revenues and other savings, there is a degree of skepticism regarding sustainability of interest and trends in Islamic Finance industry within and outside Muslim jurisdictions? Also there are concerns echoed on whether the industry will persevere the competition from the global financial world nurtured by the conventional system backed by strong legal, policy, regulatory and institutional framework.

In my assessment, the Islamic Finance now seems to be a reality and is on its way to be institutionalized, albeit at different levels in different countries, and the Western world is also now selectively and cautiously positioning to invest in this system. There are promising signs that Islamic Finance trends are sustainable. It is entrenched in a well conceptualized Islamic economic system whose mysteries are being unfolded with renewed academic interest in the subject. While undeniably faith driven, the Islamic finance system has great potential to meet the financial gaps and requirements of development and society at large and as such its demand would be robust going beyond religious grounds.

Islamic Finance has to be recognized as a parallel system which will augment and be augmented by the deeper knowledge and experience of the conventional financial system. As such, the key challenge going forward to its growth and sustainability would lie in how it interfaces and benefits from complementing and supplementing the conventional system and how it adapts and conforms to the international regulations and supervision adequately refined in line with the technicalities and nuisances of the Islamic financial instruments and their associated risks. Exploiting properly the unique features of Islamic finance with appropriate adaptability, without compromising Shariah principles, will be critical to the growth and promising future of Islamic industry.

Touching on some of these debates, I propose to first discuss the trends in Islamic Finance, lay the case for sustainability of Islamic Finance and finally discuss some of the key challenges facing the industry which the Islamic financial community at large is now trying to address.

Global and regional growth and trends

Spread across 70 countries, Islamic Finance has grown to almost a $ trillion industry. Despite its growth, given its current size and composition it is still a niche market in the overall global financial industry. Prospect for the industry are quite bright given strong demand for financial services from a large segment of about 1.4 billion Muslim populations and need to channel effectively rising foreign savings and high net worth individuals.

The growth, level, interest and motivation to promote this industry vary across the globe. The growth in Gulf Cooperation Council has been exceptional with Bahrian emerging as a main centre adopting and implementing Islamic banking regulation, being the first central bank to issue Sukuk and establishing centre for Islamic finance education, etc. Iran and Sudan declared sometime back 100% conversion to Islamic banking. Within South East Asia, Malaysia stands out with $31 billion Islamic banking assets, $1.7 billion Takaful industry and has the largest Islamic private debt market which constitutes 45.5% of its total debt market.[1] Other countries in South East Asia have smaller Islamic financial markets and Singapore has positioned itself to offer strong wealth management potential. Within South Asia, Pakistan stands out for its proactive and systematic stance to evolve Islamic finance industry. In all these countries, assets of Islamic banking have grown faster than the overall banking assets and scope and coverage of financial services has been extended to retail and consumer finance, private equity, structured products, insurance and project finance etc.

Distinct from Islamic countries, is the interest of few global financial centers such as London that now provide policy and tax incentives to promote Islamic finance industry to attract funds from high net worth clients. Same motivation seems to have driven global banks such as HSBC, Standard Chartered, Deutsche Bank, Citibank etc. to set up special hubs to structure Islamic finance products.

In reality, while current hype in industry may be partially driven by availability of surpluses generated by oil revenues, Islamic banking is emerging as an alternate financing option that coexists alongside the conventional financial industry. Moving from traditional Islamic products, now the industry is offering consumer financing for residential purposes and structuring financing vehicles for supporting infrastructure and housing finance projects etc. Product innovation is emerging with several different types of hybrid Sukuks and other combination of structures which involve different forms of Musharikas with other products. Notwithstanding these developments, increasing share of equity based credit products, such as Murabaha and Ijara, remain the dominant form of Islamic financing across the Islamic financing institution.

These trends are expected to persist and the industry is set to grow. Standard & Poor Services Rating Agency estimates that industry has potential to grow to $4 trillion over medium term.[2] As highlighted above, the exceptional growth in Islamic Finance, particularly since 2000, which has coincided with growth in oil revenues, has raised questions whether interest in Islamic Finance is one time phenomena? And what the future prospects and sustainability of the industry are?

While motivations and driving factors for this industry vary across the world, this round of wave in Islamic finance industry is there to stay there. What lends one confidence is the large investments by financial industry across main hubs in GCC/Middle East/South East and South Asia, within countries and growing foreign ownership and joint ventures across borders, in infrastructure development in this industry through:

(i) issuance of holistic banking licenses or opening of special windows or creation of hubs/dedicated Islamic asset management funds, private equity funds and hedge funds etc. accompanied by Dow Islamic Index to which all such transactions subscribe too are large;

(ii) development of Shariah knowledge and understanding and engagement of Shariah advisors and scholars which together are providing required consensus, guidance and legitimacy to Islamic industry, products and structures; and

(iii) development of Islamic standard setters such as the Islamic Financial Supervisory Board and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Islamic Financial Market (IIFM) etc. by the central banks as well as a range of Multilateral Development Agencies including the Islamic Bank

[1] Malaysia: *Leading Islamic Finance – Price Water House Coopers*; http://www.pwc.com/extweb/indissue.nsf/docid/1d681d874f24fda7ca25720a00158bfd

[2] Standard and Poor: *Islamic Finance Outlook 2006*, http://www2.standardandpoors.com/spf/pdf/media/Islamic_Brochure_2006.pdf

Development. The combined efforts have helped develop and initiate implementation of Islamic prudential regulatory, accounting and auditing frameworks, and inspection and supervision of financial institutions;

All these regional and global efforts are serious long term initiatives which are irreversible though maintaining and building momentum on these fronts would be critical to address the questions of sustainability and challenges facing this industry.

Sustainability and challenges of Islamic finance

Prospects for sustainability of Islamic finance appear promising, but there are associated challenges which need to be concurrently addressed while one exploits and maximizes the opportunities created by this discipline.

First, the sustainability of Islamic finance stems from recognition that Islamic economic and financial architecture has a lot of appeal and depth going beyond Muslim countries. While initially conceived to be solely anchored on Riba free interest rate regime, there is now appreciation that advocacy to move to Islamic business and finance structure – whether on religious or social grounds – is not a “slogan” or mere religious pronunciation or condemnation of Riba but is supported by a complete and deep Islamic ideology. When studied carefully, it has its logic and basis in a comprehensive Islamic economic system which deals with allocation of resources, production and exchange of goods and services and distribution of wealth – all too familiar debates in conventional economic textbooks.

Second, the confidence in sustainability of Islamic economic system emerges from the better understanding that this economic system is a well conceptualized, consistent and integrated framework. More interestingly, it is accompanied by a rich and an elaborate set of tenets which, among others, recognize the right to property supported by elaborate obligations for stakeholders, principles and rules of conduct, a contract system and institutional framework and procedures for enforcement of rules which all together lay the foundation for Islamic business and financial architecture. It is this substantive Islamic ideological and legal framework, governed by Shariah injunctions and principles that have translated into defining the public and private economic and social affairs that eventually help frame the business and financial relations. The core of these relationships is backed by solid principles of contracts, rights and obligations of parties to the contractual arrangements.

Third, the sustainability of this system is reinforced by the business and financial relations that are guided by the logically defined emphasis on the preferred modes of transaction which advocates profit sharing and as such relies on “ex-post” variability rather “than ex ante” fixity in returns and consequently has built in risk sharing as a central element of transactions. Relevance of contracts is at the core of Islamic transactions which define the rules of game for sale and purchase/trade/exchange of goods and services. Financing contracts are than structured around the nature of transaction which could be either in the form of trade financing; asset based financing or different forms of partnerships. Under Islamic finance preference is given to trading of physical assets as well as trading of rights.

Fourth, the confidence in sustainability emerges from the framework of enforcement implicit in Islamic system. The main driver of enforcement of contracts and rules-compliance in Islamic system is ideology and faith which is in turn influenced by Islam’s emphasis on establishing an equitable, ethical, just, and fair socio-economic system. It is this feature which shapes up Islamic finance and also distinguishes it from the conventional finance. Although one can argue that sustainability of interest in Islamic Finance is tied solely to the response of Muslim population to their religious values and beliefs, but it has to be recognized that attraction in this discipline is now widely emerging as there is better understanding of Islamic economics and finance and mechanisms are being found to juxtapose the knowledge of conventional economics and financial engineering.

Fifth, flexibility and innovation to structure different types of financial products which augur well for Islamic Finance's sustainability. What distinguishes Islamic finance is its emphasis on trading of goods and services and its advocacy for profit and risk sharing in businesses supported by a variety of partnership arrangements – this is in sharp contrast to loan based financing in conventional banks. By virtue of these characteristics Islamic finance offers prudent financing options being asset backed or equity based; particularly linkage of assets with financing ensures that transaction is less prone to debt crisis and funds are used for their prescribed purpose minimizing defaults resulting from improper use of borrowed funds. Concurrently it offers promising potential for offering alternate avenues for saving and investment for all segments of population.

Sixth, market surveys confirm that the potential for retail, housing and project finance[3] and innovation emerging in these markets is significant and augurs well for economic and financial services development. Islamic banks have registered double digit growth in retail markets. Penetration has occurred faster where personal banking solutions have been structured well and where information technology is used to offer online, ATMs and telephone banking services. By and large products are structured on murabaha principles where funds are allocated for particular projects or finance an asset (such as home ownership and automobiles) in which depositor shares in the project rather than bank profits and to structure ijara (leasing) with appropriate asset backing and legal structures.

Islamic housing finance for acquisition and other purposes has evolved to be a natural and promising market to cater for huge home financing demand in Muslim countries. This market is gaining momentum following some interesting facilitation/incentives offered by some countries: for instance US has facilitated Islamic lease-to-own relationship by allowing bank to take title to property and in the UK Bank of England abolished double stamp duty on Islamic mortgages, ijarah and murabaha transactions, and rationalized of legal service fees and risk weightage etc. and Australia and Canada allowed adoption of declining balance partnership concepts to facilitate structuring Diminishing Musharaka contract etc.

In some jurisdictions momentum for tapping retail market has been accelerated by partial or full conversion of conventional to Islamic banks such as Saudi Arabia – challenges of which cannot be underestimated as it involves converting the loan book to Shariah compliant modes of product. Stand alone Islamic banks have a challenging task of competing with the conventional players who have an edge of longevity and customer loyalty and economies of scale. High level of customer service, offering full product range, introducing a level of transparency in transactions, devising unsecured personal loan products (a wave emerging with adoption of tawarruq product), introducing Shariah compliant credit cards, handling properly the unfunded businesses and improving efficiencies are some of responses to challenge of competition.

Large scale business opportunities however lie in exploiting project finance. Successful application and integration of Islamic instruments with the conventional financing has helped in this area while facilitating closure of large and complex multisource financing deals. Project financing, backed by asset and equity and structured using combination of Ijara, Istisna,, Sukuk and Musharika etc. has offered opportunities for risk diversification, avenues for resource mobilization and revenue sharing and performance of services between contractual parties. These deals have illustrated how conventional and Islamic financing can blend and coexist under common legal and regulatory arrangements.

Finally, more than conventional finance, Islamic finance emphasizes just and equitable financial system. Among others, Islamic finance offers a financial inclusive option to Muslim

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3 *Islamic Finance: The Way Ahead – Filed under: East Asia/Pacific, Middle East, Economics, Religion.* February 10, 2007.

who have excluded themselves from financial services in absence of riba free services.[4] Since a number of Muslim countries suffer from low financial services penetration, bringing in the appeal of Shariah compliant financing mechanism could turn out to be a powerful tool for enhancing access to development finance and empowering the poor and vulnerable groups.

It is important to recognize that Islamic finance confines itself to largely socially and development projects and institutions are not permitted to invest in prohibited or socially undesirable investments. Emphasis on ethical issues and rigorous self-regulation in terms of Shariah supervision ensures fair play and justice and offers superior consumer protection model. Furthermore it induces higher financial discipline and places stringent ethical standards for all stakeholders that offers a strong and unique model of governance.

Conclusion

In conclusion, encouraging developments and trends in Islamic Finance lend confidence that this industry has taken off. However, there are varying motivation and driving factors for the development of this industry ranging from religious fervor to the opportunities that exist in Islamic finance for broadening and deepening the process of financial intermediation which augurs well for financial innovation and engineering, enhancing the financial services penetration in national jurisdictions and for cross border capital flows. While the size of Islamic financial industry is still quite small as a proportion of the total world's financial assets, the current growth trends and the investments in infrastructure in development of its Islamic Finance networks and its regulatory and supervisory systems, lend confidence that this industry has promising potential.

Prospects for this industry appear comforting because of variety of factors – most significant being the strengths of Islamic ideology and economic system which offer a complete framework for the Islamic finance industry. Islamic financial system lays down rules of conduct and contractual arrangements, and offers feasible financing structure which emphasize trade and equity financing that together will help the much needed financial diversification in Islamic countries.

Islamic finance also has potential to blend economic and social objectives and address the ethical aspects of financing effectively. As such it is generally more acceptable in populations with moderate to strong inclinations toward managing their financial relationships in line with their beliefs. This can thus help in poverty alleviation through inclusion of a larger proportion of population into the banking system giving them access to credit and mobilizing their savings effectively.

The emerging solutions and application to structure Islamic finance innovatively have helped cater for all types of markets and financing requirements ranging from retail to project and home financing to equity funds and products and insurance. Industry effort to benchmark pricing and apply legal, regulatory service standards at par with conventional products and standards has also helped encouraged confidence in the system.

Going forward, the sustainability of Islamic Finance would rest in how the international community builds on the momentum achieved thus far. This would require

(i) Further deepening the efforts to enhance the legal and regulatory framework of Islamic finance consistent with the international practices.

(ii) Continued strive to conform and align the structures and products in line with the Shariah principles would help Muslim population's motivation to turn to this

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4 *See "Building an effective Islamic financial system." Dr*. Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Global Islamic Financial Governor's: Financial Regulators Forum in Islamic Finance, Kuala Lumpur, 27 March 2007.

alternative mechanism of financing, while attracting others to product and risk management and mitigation innovation and additional option that this window offers.

(iii) Recognizing that Islamic finance has perpetuated and changed the dynamics of cross border private capital flow, this industry has great potential to augment the process of globalization and financial integration, but this requires more cooperation and vigilance on the part of home and host regulators.

(iv) Launching aggressive efforts to implement the evolving Islamic financial regulatory and supervisory standards and capturing the different types of risks associated with Islamic finance, while launching consumer protection frameworks.

(v) Promoting more financial diversification by encouraging financial innovation and Islamic capital market development.