Shamshad Akhtar: Islamic finance – growth, competitiveness and sustainability

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the 14th World Islamic Banking Conference, Bahrain, 9-10 December 2007.

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1. Islamic finance has received overwhelming response from across the world as one discovers its ideological and practical richness and relevance. Growth in Islamic finance industry has however triggered a number of debates regarding the challenges this industry faces. These debates essentially revolve around whether Islamic finance is progressing well and is it there to stay? Is Islamic finance going to be a niche market or does it have global appeal? What are key drivers for enhancing the efficiency and competitiveness of Islamic finance industry which would in turn help broaden its appeal and in turn enhance its sustainability? In my brief remarks I will touch on these debates.

2. Despite transitory challenges – typical of a new and emerging industry, my view is that prospects for growth of Islamic finance are promising but rests on building an effective system for Islamic finance.[1] Growing interest has led to rising investments in Islamic finance and resulted in phenomenal growth in Islamic finance businesses. Interest in this discipline has already extended beyond Muslim and Islamic countries to non-Muslim population and jurisdictions and non-Islamic financial institutions. The avoidance of forbidden investments ("haram" products) and interest rates and speculative structures prohibited in Islamic jurisprudence and Islamic finance's emphasis on just and equitable financial system offers distinct appeal for Muslims to be attracted to this option. Appeal of Shariah compliant financing mechanism is also likely to be a powerful tool for enhancing access to development finance and empowering the poor and vulnerable groups, particularly if Islamic banks extend their reach in rural areas which are currently not effectively served by conventional system.

3. Irrespective of religious appeal and affiliations, consumers would be eventually attracted to Islamic finance if it positions itself to offer an efficient and competitive alternate avenue of financial intermediation which caters to all segments of population and economy and services retail and personal banking and project finance. This can happen only if key messages and principles of Islamic finance are flexibly, constructively and innovatively interpreted, its conceptual framework further developed, nurtured and translated effectively into practical applications, and work is launched to better develop interface and linkages between Islamic and conventional finance and unleash the synergies to advantage of global financial development.

Drivers for enhancing efficiency and competitiveness

4. Few key drivers for enhancing efficiency and competitiveness of Islamic Finance include:

(i) Financial engineering and innovation.

(ii) Global financial centers and their regulators support for Islamic finance industry.

(iii) Standard governance and prudential regulation and supervisory guidance which require tweaking regulations to properly identify and assign proper weights for new

[1] *"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.

and different types of risks associated with the special and unique characteristic of Islamic finance business.

(iv) Development and adoption of simple and standard and cost effective legal frameworks for contracts associated with the new and hybrid products.

(v) Flexible and practical application and enforcement of Shariah principles and injunctions and its acceptability by public.

5. Taking up these items, **first it has to be emphasized that financial engineering and innovation is one of the most potent tools of Islamic finance and will be the key driver to attracting global economic and financial player's interest which will be critical for competitiveness and sustainability of Islamic finance**. Increasingly Scholars, academics and practitioners have worked with global banks to offer wide range of wholesale, retail and trade financing banking solutions. For instance:

(i) Vanilla Sukuks are now being compliment by range of hybrid Sukuks: Sukuk –Ijara, Sukuk-Musharaka, Sukuk-Moharba and so and so forth – as per IMF recent study there are today over twenty odd different variants of Sukuk.

(ii) Islamic derivative market now offers Islamic equivalent of interest rate swap/option called profit rate swap/option and Islamic cross currency and FX swap and options. This is appreciable development given that Shariah compliant transaction has to fulfill existence of underlying real assets and generally it does not approve of uncertainty (jahala) and speculation or undue risk taking (Gharar).

(iii) Private equity has already structural compatibility with Islamic financing, although it has to be deployed for Shariah eligible uses.

(iv) Personal banking solutions are now being floated saving and investment account and information technology is used to offer online, ATMs and telephone banking services.

(v) 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.

(vi) In some cases there is move into bancassurance through establishment of associated Takaful institution and appending insurance sweetener is also a wave, though slow to take off.

6. There is scope for deepening financial engineering and innovation and exploiting its edge to promote equity based financing or structure hybrid debt: equity instruments. This will allow Islamic banks to offer richer and multiple options to customer, while allowing banks opportunities for proper fund mobilization and asset diversification. It will allow avenues for proper diversification and integration of financial services and pooling of risks through blending of Islamic and conventional financing to epitomize risk sharing between stakeholders and align rewards to be consistent with the risks.

7. **Second driving factor would be global financial centers and their regulators support for Islamic finance industry.** Currently wave of interest in Islamic finance is fascinating and has helped attract global banks in Asia and Europe to use their skills to augment the application of Islamic finance principles. As expected the approach and level of enthusiasm and pro-activism has varied in Western world. I would like to highlight the emerging approach of United Kingdom which has set on course a conducive and practical approach for development of Islamic finance which I would advocate other developed

jurisdictions can pursue. U.K aims to strike a balance whereby FSA's recent paper[2] highlighted that it has adopted "no obstacle and no favors" policy for Islamic finance. Recognizing its secular framework, U.K has been upfront, practical and candid requiring financial institutions to find mechanisms for conforming to FSA basic regulatory framework, while being open to be accommodative in interpretation of its rules and regulations. To conform to FSA requirements, Islamic financial institutions have to ensure structures evolved are in compliance with FSA requirements. Meanwhile, U.K provides the necessary flexibility and the required relief to its regulation on case to case basis. Equally supportive has been U.K rationalization of multiple taxes applicable in purchase and sale of properties to facilitate Sukuks and Islamic mortgages.

8. ***Third critical driver of Islamic finance is the efforts being launched by central banks to reach understanding on banking regulation and supervision.*** Broad understanding has now evolved that financial institution have to conform to standard financial regulation and supervision requirements applicable to conventional banks. There has been steady progress to improvise and modify regulatory framework to recognize the safeguards required for risks associated with Islamic banking solution and the required capital treatment for special and unique characteristics of Islamic finance business. The differences in the assets and liability structure in Islamic finance and the complexities associated with different Islamic products, however, tend to alter the risk perception associated with this financial system.

9. As such, work of IFSB and industry continues to be critical to evolve better understanding of different risks and how to cushion for such risks. Ensuring harmonization and consistent adoption, application and implementation of these evolving standards for Islamic finance and products will be a challenge but absolutely required to avoid regulatory arbitrage by industry and certain Islamic jurisdictions. Potential for such distortions will be inevitable as Islamic prudential regulatory and capital adequacy standards require more guidance and awareness. Furthermore, in line with the spirit of Bank International Settlement subscribed regulatory standards, IFSB standards are also for voluntary, rather than compulsory compliance. While this would result in differences in timing of adoption of such standards by Islamic industry, it is expected that with growing awareness market and investors will be factoring in differences in compliance in their choice of institutions.

10. ***Fourth critical driver of Islamic finance would be development and adoption of simple and standard legal frameworks.*** Contracts are at the core of Islamic transactions which define the rules for sale and purchase/trade/exchange of goods and services. Contracts are 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 and with the growing hybrid products the demands for legal documentation has multiplied and is adding to the cost of transaction. Certainty of contract is another important element under Islamic contract law. The body of Islamic Contract Law while rich and supportive of participant's right in transaction is onerous, complex and prone to different interpretations and rulings. Equally challenging are questions of enforceability of terms and conditions and lack of ability of courts to arbitrate litigation in case of dispute on contracts.

11. ***Fifth, it has to be recognized that Islamic finance is in its evolutionary stage and its sustainability would depend critically on regulators work with Islamic Scholars to reach flexible and shared, if not unified, understandings on principle elements at international level, despite differences in faiths and disciplines.*** There are number of faiths and disciplines across Muslim jurisdictions (for e.g. Syria and Pakistan are

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[2] Financial Services Authority: *Islamic Finance in the UK: Regulation and Challenges.* Micheal Ainley, Ali. Mashayekhi, Robert Hicks, Arshadur Rahman and Ali Ravalia. November 2007.

predominantly Hanafi school, Bahrain, Dubai and Abu Dhabi pursues Maliki school, Saudi Arabia and Qatar relies on Hanbali school). Rather than pursue harmonized views, each faith developing its own applications adds to the cost of transaction, introduces doubts on viability of Islamic finance given the split opinions, and confuses the public that basically relies on Scholars endorsement of products and business. These differences along with different interpretations of Shariah Scholars at the Boards or as advisors within the banks, if significant, further carry the risk of Sharia arbitrage which carries complications for regulators. Reaching consensus and shared/harmonized guidance among Scholars of different beliefs and faiths and evolving more unified institutional mechanism for adoption of common Shariah standards and ensuring proper enforcement through effective internal controls for their compliance would let the industry grow and compete on level playing field. Flexible and simpler interpretation of the basic tenets at the level of Scholars would enhance public acceptability.

12. Finally, keeping these macro considerations aside, Islamic banks being late starters do face a real challenge of competing with a well established conventional industry. Furthermore, full-fledged Islamic banks as per their licensing requirements have to confine themselves to Islamic businesses and products, while conventional banks with Islamic windows have inherent advantage as they can compete more aggressively offering both conventional and Islamic businesses. Different approaches to licensing are debated to have implications for competitiveness of industry whereby there is an argument put forward that in interest of fostering healthier competitions banks should be allowed to choose what they offer without imposition of licensing policy constraints.[3] To propel Islamic industry allowing dedicated Islamic banks is a well accepted course as long as regulators do not shield or provide preferential treatment to these institutions but creates a level playing field in regulatory and supervisory oversight.

Next stage of development

13. Competitiveness of Islamic finance in future would depend on how Government and regulators perceive and nurture future development of Islamic finance and address the issues highlighted above and develop institutional, regulatory and supervisory frameworks and their effective enforcement. In the next stage of Islamic finance development, there is need for more substantive work on Islamic finance in the areas of:

(i) Standardization of contracts and documentation which would reduce transaction costs and risks of litigation.

(ii) Development of dispute resolution mechanism for Sharia compliance matters as regulators will not be in a position to resolve these.

(iii) Proper implementation of evolving guidance of regulatory standards for special features of Islamic without comprising international standards to which both Islamic and conventional banks are to be subject too.

(iv) Development of more interfaces between regulators – so far there seems to have been more systematic alliance between central banks to coordinate standard setting and its compliance. There is however need for better coordination between bank and non bank regulators and also for later to launch more initiatives to nurture nonbank Islamic sector.

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[3] The McKinsey Qaurterly: Rethinking Regulation for Islamic Banking. Nasr-Eddine Benaissa, Xavier Jopart, and Ozgur Tanrikulu. 2007.