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Challenges Facing the Islamic Financial Industry

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ABSTRACT

This paper examines the emergence and relevance of Islamic finance in the 21st century. The development of the Islamic financial industry over twenty years, from stand-alone institutions to a credible financial force that is gaining significant shares of its core markets, testifies to the impressive strides the industry has made. With its core principles in ethical values, and its focus on economic sectors producing real value, Islamic finance has significant relevance to global financial markets. The paper highlights the key obstacles preventing Islamic finance from reaching its full and true potential. These include the lack of regulatory standards specific to Islamic finance, the absence of Islamic capital and money markets, and the shortage of sovereign and top-tier quality issuers. It will touch upon the challenges facing Islamic finance in the years ahead: the emergence of new models, the opportunities afforded Islamic finance by the Internet, and the need for size and scalability in this growing market.

I. INTRODUCTION

One may ask what qualifies an executive from a conventional financial institution to discuss, alongside Islamic bankers, *sharīᶜa* scholars, and Islamic economists, the challenges facing Islamic finance. The author is a practitioner, a banker who represents an industry that has franchises in twenty nations that are members of the Islamic Development Bank (IDB). Conventional banks, through their ordinary business in the IDB area, have observed the impact of the Islamic financial industry on the local client base. Moreover, the HSBC Group's strategic ownership of the British Bank of the Middle East (now rebranded as HSBC Middle East) as well as its presence in other IDB member countries has offered the firm a unique perspective on the development of Islamic finance. The job of a client-focused bank is to serve its clients, and the growing demand for Islamic products is something any bank in the region might seek to satisfy.

Tremendous strides have been made over the last two decades in Bahrain, which has emerged as the international center for the industry, with an impressive number of offshore Islamic investment banks. For a number of years, the Malaysian central bank, Bank Negara, has actively promoted an interest-free banking system alongside its conventional counterpart. This has resulted in advances in all customer segments, particularly the retail and corporate sectors.

In Kuwait, official central bank statistics show the Islamic finance sector to be gaining significant market share, while the central bank of Oman has recently approved the establishment of the country's first Islamic bank. The Saudi Arabian Monetary Agency is now encouraging conventional banks to open Islamic banking windows.

A survey of the scene reveals Islamic financial institutions that now provide investment banking, asset and portfolio management, financial advisory, underwriting, syndication, and private and public placement services. In fact, virtually the entire range of modern financial techniques is being adopted and adapted to suit the principles of Islamic finance. Of notable interest over the last five years has been the development and growth of instruments on the liability side of the balance sheets of Islamic banks and, in particular, the establishment of collective investment schemes. These funds now cover a broad spectrum of investments, including real estate, trade finance, leasing, and commodities. The growth of these funds over the last five years has been a very significant development for the Islamic financial industry.

The opening up to Islamic investors of equities as an asset class, following approval from *sharīᶜa* scholars, has added a new dimension to the industry. A broad pool of Islamic equity funds is now in operation, from plain-vanilla funds to more sophisticated products with particular emphasis, in recent years, on technology and health care. In fact, because of their emphasis on health care and technology, Islamic funds have outperformed the market in recent years, except perhaps in 2000. Certainly, top-tier asset management companies from the Western world are bringing their considerable experience in fund management to the Islamic financial industry, and combining it

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with the *sharīʿa*-structuring expertise of Islamic financial institutions in order to create acceptable and well-performing Islamic equity products.

Asset securitization is another important trend in the Islamic financial sector. Islamic financial institutions have viewed asset securitization as a vehicle to permit extending maturities in transactions while providing liquidity for investors. Securitization products in some Middle Eastern markets, especially for infrastructure projects, are likely to be offered. A particularly interesting transaction that suggests possible applications in the Islamic world was in the United Kingdom, where car leases were securitized into an asset with a maturity of 7 years.

Private equity, too, is emerging as an asset class for Islamic investors. The drive toward enhanced yields and the desire to manage their funds more efficiently has led Islamic investors to seek opportunities in private equity markets in the OECD as well as at home. The IDB's efforts in the recent establishment of a private equity technology fund for the Middle East, through its subsidiary the Islamic Corporation for the Development of the Private Sector (ICD), are to be applauded.

The emergence of the contemporary Islamic financial industry is one of the key developments in modern banking and finance because of the impact it has had on its core markets over a short period of time. The fact that a certain financial system, whose core values and principles are based upon specific religious and ethical precepts, has taken root deserves due recognition.

In an era of global and increasingly complex financial markets, Islamic finance, with its focus toward the real-value-producing areas of the economy and the equitable sharing of risk, has significant relevance to conventional financial markets.

II. Growing Pains, Leading to Maturity

However, it is important to recognize that this is still a growing industry that in many ways has yet to mature. Five areas of innovation, if successful in the next few years, will allow the industry to strengthen.

A. International Islamic Money Market

One of the most obvious needs is the creation and development of Islamic money and capital markets, i.e., short-term and long-term instruments and the ability to trade them. Islamic investors, like other investors, have varying liquidity and maturity preferences, and a money market is necessary in order to uncouple decisions about the maturity of an instrument from decisions about the management of the balance sheet. Most Islamic financial institutions in the Middle East prefer to invest their funds in short-term investments resembling the risk-return profile of conventional money market instruments. Currently, the great majority of such short-term investments is invested in commodity *murāba®a* transactions with creditworthy Western financial institutions. The industry is in dire need of alternative modes of short-term financing that have a range of risk-reward profiles at once compatible with the *sharīʿa*, permitting the development of liquidity, and allowing bankers to apply real balance sheet techniques. The Islamic Development Bank, with the Labuan Offshore Financial Services Authority (Malaysia) and the Bahrain Monetary Agency, are working together to devise an international Islamic money market ("IIMM"). The primary purpose of the IIMM is to provide a platform for participants in the Islamic financial market to issue Islamic money market instruments in primary as well as secondary markets so that a real market yield curve can be constructed. Without an IIMM, the Islamic financial market is likely always to be hindered and fall short of assets.

B. Need for Legislative Reforms

The drivers of the IIMM will have to persuade governments in some countries to reform laws and regulations that are unhelpful to Islamic finance. For example, *ijāra* (leasing) transactions cannot be structured Islamically in some nations that enforce restrictive land ownership laws. While conventional financiers can provide conventional loans and take charges over a property, Islamic financiers cannot provide financing via *ijāra* due to their inability to own land on a cross-border basis during the *ijāra* period. In some countries, Islamic financial institutions are unable to offer *ijāra* financing for indigenous property because under existing land laws the institutions are not considered to be local. Furthermore, the taxation regime in countries such as Egypt, Malaysia, and Turkey imposes strict withholding taxes on all cross-border leasing. Inasmuch as *ijāra* is the most suitable mode of financing for long-term facilities (those longer than two years), the restrictions due to existing laws have seriously impeded the development of long-term Islamic finance. These laws were often enacted before the birth of contemporary Islamic finance and thus did not consider its requirements. Reform of these laws is essential to the successful development of an Islamic capital market as well as an Islamic money market.

C. Harmonization of *Sharīᶜa* Standards

The successful development of a primary market for international Islamic money market instruments hinges upon the harmonization of *sharīᶜa* standards. It would be desirable to inhabit a world in which the pronouncements of a respected authority in a recognized center would freely be accepted throughout the market. The path to that state involves intensive dialogue among the various centers for Islamic finance and a move toward gradual harmonization, taking into account the subtleties of Islamic jurisprudence.

D. Need for Quality Issuers

Any successful primary market also requires quality issuers to establish benchmark issues. It would be good to see sovereigns, multilateral and public-sector development institutions, and top-tier corporations issuing into the market on an Islamic basis in order to establish benchmark levels of risk-reward-maturity profiles. The more this happens, the broader and more liquid the market will become, attracting even more investors as part of a snowball effect. Islamic financial paper could thus potentially offer an alternative source of funding as well as a wider investor-base for issuers. In order to attract conventional investors, Islamic issues will need to be rated by the established rating agencies. This means that the rating agencies must be educated about the subtleties of Islamic finance as well as about the risks involved. If required, a different rating grade for Islamic issues must be developed.

E. Market Making

The development of a secondary market for Islamic money and capital market instruments also calls for financial institutions with market-making abilities. Market-making expertise in the conventional market resides mostly in London and New York. It is a highly technical activity that depends on technical knowledge as well as on experience, but that can only be learned on the job. The Islamic financial industry faces the task of building market-making expertise within the various institutions that participate in the market. This can be achieved by training, recruiting, and inviting the participation of institutions that have the needed market-making expertise. The more that happens, the more primary issuers will be enticed, and the more investors will come forward, rounding out a virtuous circle promising rapid growth. In the beginning, most international Islamic money market instruments would be denominated in U.S. dollars, requiring market makers with sufficient expertise in that currency.

F. Issues to be Addressed Going Forward

The advent of the Internet and the e-commerce revolution is affecting all major industries. The financial services market is at the center of these changes, with the Internet already having a profound effect on the delivery of banking and financial services. The Internet in its early stages has affected some sectors of financial services, such as securities and brokerage, more directly than others, such as insurance. Nevertheless, the Internet promises to alter the way that customers perceive value and the way that value is delivered.

The Internet offers the Islamic financial market the opportunity to expand its global reach and target customers who previously were unreachable, in the Muslim world as well as in the significant Muslim communities in the Western world. This will help aggregate demand for *sharīᶜa*-based products and services to an economically viable scale.

A number of Internet initiatives in Islamic finance have emerged recently. iHilal.com, IslamiQ.com, and Islamic Investors Online, among others, are all vying for this untapped market segment. Three thoughts headline how banking and financial entities should respond to the challenge:

1. E-commerce is not about glitzy Web sites and storefronts, and it is not about fancy interactive screen technology. If it is only that, it will fail.
2. An effective e-commerce financial offering is about richness, in terms of a sound product offering. In the end, clients are not fools. They want to know that there is real value-added to the service, and the Internet easily allows them to shop around for competitive products, breaking down monopoly profits.
3. E-commerce is not the stand-alone delivery of financial services. As the Internet matures, it will become clear that any e-commerce venture should serve as one of many modes of interaction between suppliers and consumers. Ventures that will succeed will be those that successfully dovetail their e-commerce capabilities with their ordinary services. While it is not clear who the winners and losers will be when things settle down, the Internet unquestionably provides the customer with new opportunities and presents financial institutions with challenges to which they must respond.

III. CONCLUSION

While Islamic finance has promise, much remains to be done. Its progress resembles that of the climber of a high mountain. The climber looks down and realizes that he has come a long way, then looks up and knows that a long ascent beckons. It is an exciting time and place to be for those in this growing industry as it moves toward the next stage of its evolution.