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Islamic Finance

Evolution and Challenges

Iqbal Ahmad Khan[*]

Abstract

This paper discusses the evolution of Islamic finance, the limits to growth, and its future potential. The first half is concerned with the evolution of the industry, and begins with a discussion of the different stages that various countries are at in their implementation of Islamic finance. The industry as a whole is then tracked across a three-stage timeline consistent of 1970-1980, 1980-2000, and 2000 onward. The second half highlights challenges to the success of Islamic finance: asset management, cooperation/collaboration, consolidation/critical mass, culture/creativity, harmonization of best standards and practices, and authentic presence. If Islamic finance is to meet these challenges successfully in the period after 2000, it must achieve critical mass, with mainstream relevance, in Muslim countries, and have niche status elsewhere.

I. Introduction

I would like to share with you my thoughts on the evolution of Islamic finance, and on the local challenges and global opportunities it faces today. The first half of this paper is concerned with the evolution of the industry. It begins with a discussion of the country spread of Islamic finance: how different nations in the Muslim world have evolved in the period during which they have been focusing on Islamic finance. It then tracks the evolution of Islamic finance as a whole across a continuing timeline. The second half of the paper highlights five key challenges to the success of Islamic finance—leading to the achievement of critical mass with mainstream relevance in the OIC world and a successful niche-product status in the rest of the world. In this regard I will focus particularly on the challenge of asset management, which to me has always been the biggest limiting factor for the growth of this industry. I will also touch upon the challenges of cooperation and collaboration, consolidation and critical mass, culture and creativity, harmonization of best standards and practices, and authentic presence and mainstream relevance.

II. Evolution

A. Country Spread

One way to examine the evolution of Islamic finance is to review the five stages of development the various countries find themselves in today. Stage 1 is the point at which Islamic finance is a concept. This concept is being studied today in countries such as Singapore, China, Uzbekistan, Azerbaijan, and Hong Kong. It is important to keep in mind that many Stage 3 or 4 countries were at Stage 1 25 or 30 years ago. Stage 2 is where we see some high-net-worth individuals and retail investors coming into Islamic finance, and we see a few *takaful* (insurance) or Islamic asset management companies being set up. Countries at this stage include Oman, Algeria, Syria, Lebanon, and the United States. Islamic finance is still a niche product at this point. In moving to Stage 3, we see the actual establishment of Islamic financial institutions in countries that are larger players in Islamic finance. Nations in this stage include Brunei (with the Islamic Bank of Brunei), Indonesia, Morocco, Turkey, Tunisia, Qatar, and Palestine (where there are now three Islamic financial institutions).

By Stage 4, we see that mutual funds are launched and that the industry is seeing a major new shift in its evolution. At this stage we have Malaysia, Kuwait, Bahrain, UAE, Saudi Arabia, and Egypt. What we are witnessing at this point is a broadening and deepening of the Islamic finance market. Islamic finance, as an emerging product and an emerging market, is actually building a critical mass of its own, representing an industry sized at somewhere around US$100 billion and growing at 15% per annum. With

[*] Khan is Managing Director and Head of Global Islamic Finance for HSBC Group in London, England.

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a revenue spread of around 1.9 to 2.0%, this means a revenue size of about US$2 billion. This is clearly an industry in the process of evolution and transition. It is important to note that we still do not have the framework that the industry needs to flourish. Stage 5, at which we see no countries at this time, is the stage in which Islamic finance is provided with such a framework and succeeds as a mainstream reality in OIC countries while maintaining a niche status in the rest of the world.

B. Timeline

If examined on a timeline, there are three distinct stages in the evolution of this industry. The first was from about 1970 to 1980. At this point, the concept of Islamic finance was being translated into reality by a group of pioneering Islamic financial institutions, such as Kuwait Finance House, the Islamic Development Bank, Dallah Albaraka, and Dar Al-Maal Al-Islami. Mostly short-term, trade-related, low value-added, and documentation-related businesses were introduced. Serious industry and macroeconomic impediments prevented the further growth and evolution of Islamic finance at this time.

The current period of 1980 to 2000 is where we see Islamic finance evolving, gaining momentum as a growth industry, and establishing itself as a niche product. We are seeing the tenures of deals stretching—three-year, five-year, and seven-year deals are now being done—a lot of covenant-based project finance, and Islamic tranches in big-ticket deals (e.g., KFH recently structured a large deal with Citicorp on a large Kuwaiti project). A number of new products are also coming out, there is tremendous improvement in documentation capabilities, and we see more *istisna'*, *bai' salam*, and *ijara* transactions. In this period, equity has opened up as an asset class to us, giving tremendous opportunities for Islamic financial investors. This period is also seeing the gradual liberalization of the economies of the OIC world. The rulebook for capital markets is being written.

In the period of 2000 and beyond, we can look to a focus on infrastructure and venture capital, giving Islamic finance increasing mainstream relevance in the OIC world and a niche-product status in the rest of the world. From stage to stage, this is an industry that is in transition and is evolving along with the markets in which it operates. IDB, at this year's World Bank meetings, announced the creation of the first Islamic countries' infrastructure fund, a US$1.5 billion fund targeted specifically at Islamic countries. This fund will hopefully increase the embedded capital of Muslim countries. In the coming period, we will witness asset securitization, the creation of secondary markets, the mobilization of long-term funds, the creation of new and hybrid instruments, and the achievement of mainstream relevance for this growth industry.

III. CHALLENGES

A. Asset Management

Before it can reach mainstream relevance, however, Islamic finance must overcome a number of challenges. The first and the foremost of these is the challenge of asset management. Good asset management begins with asset allocation and sound ALCO policies. The asset allocation model of Islamic financial institutions should be managed in a dynamic manner, and should be spread across all eligible asset classes. This model should have the ability to switch between different asset classes. The guiding principle for this model should be authentic liquidity management and risk preference for local-currency assets. Local-currency asset portfolios have the benefit of nearness to the risk and therefore better risk-selection opportunities. The foreign-currency component used for cross-border financing should be carefully capped as a percentage of the overall balance sheet. This asset-allocation model should be diversified across risks, sectors, and the yield spectrum.

Asset origination is very important as well. A proactive, market-driven transaction origination strategy should work to originate, underwrite, and distribute Islamically acceptable transactions in line with the asset-allocation model. An Islamic financial institution should review information at both macro and micro levels on the business it potentially wants to finance. These institutions should build stress models and regularly undertake scenario planning on the risks they want to finance.

Asset structuring is likewise of great significance. Asset structures should stay as close as possible to the *Shari'ah* dictates of value-creation potential. These financings should be cash-flow based and not just asset- or covenant-based. It would be worthwhile to check where this potential financing would sit on the balance sheet of the issuers.

As far as asset documentation is concerned, inter-creditor issues need to be looked at very carefully, and Islamic financial institutions should insist on providing as many as possible associated

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services linked to the financing. In asset documentation, the complete opinion of *Shari'ah* scholars, including full legal counsel opinions, should be taken into account. Issues like liquidated damages and other potential inter-creditor items should be clarified early on.

To me, asset monitoring is as important as asset origination or its structuring. It is therefore time to bring asset monitoring forward as a priority frontline function. Islamic financial institutions would be well advised to emphasize asset monitoring as an important career path within their organizations. Their incentive systems and career plans should reflect the policy. In any case, asset monitoring can be a source of valuable fee income.

In the interest of improving the asset quality of Islamic financial institutions, three initial value propositions come to mind. First, the balance sheet of Islamic financial institutions is not there to be tied up, it is there to be turned over. Second, the balance sheet is not there to generate income, it is there to generate customers. Third, Islamic financial institutions are in both the risk and the services business. They should preferably take risks for only those customers who also take their corresponding services. Taken together, these value propositions suggest an asset-management strategy that can lay the foundation of a sound, diversified, and balanced asset portfolio.

B. Cooperation and Collaboration

For Islamic finance to succeed and grow further, it is also important to move toward collectivism rather than individualism. Islamic financial institutions will have to talk to each other, for we clearly need more collaboration and cooperation within the sector. This requires partnering with asset managers and private banks that have proven track records and a demonstrable commitment to Islamic finance. This relationship should be used to do more research and development and encourage new product creation.

I would like to pay a tribute to the Islamic Development Bank for its continued leadership in this regard, particularly for its creation of the Islamic Banks' Portfolio, Unit Investment Fund, and the IDB Infrastructure Fund. However, more needs to be done. For instance, IDB should seriously consider creating a fund that would take significant equity stakes in Islamic financial institutions. IDB could potentially also float an Islamic Financial Institutions' *mudaraba*. Such an approach could lay the foundation for greater consolidation and the achievement of critical mass in this sector.

We have all heard about the problems of fragmentation in this industry. There is an urgent need to achieve consolidation. Merger within the Islamic finance industry is not a matter of choice, it is a matter of necessity. But merger has to be based on synergy, economies of scale, and compatibility. Mergers within the industry are the only way to achieve critical mass in an increasingly competitive and rather turbulent world economy.

Critical mass is the ability of Islamic financial institutions to go out and bid for business of any size in any of their focus markets. It needs to be built across products, people, systems, management, and earning power.

C. Culture and Creativity

The drive to achieve critical mass should be closely linked to the building of culture and creativity. Islamic finance is different from conventional finance, and that has to be reflected in its culture. This culture is critical because it is possible to replicate the tangibles, but we cannot replicate the intangibles. Culture should be nurtured, and it needs time.

Islamic financial institutions will have to rigorously ensure that they have a highly professional corporate culture. This requires a credit culture in which line management takes independent decisions after doing its own diligent and rigorous analysis. It also means a customer-driven orientation, a service-driven culture, and profit performance as a value.

We also need to have strong shared values based on clearly articulated mission statements and statements of strategic intent. Strong and consistent leadership based on the heritage and tradition of Islamic commerce is needed to head this effort—leadership that understands the past and the present and has a vision of the future of their own institutions as well as of the Islamic world at large. Finally, we need more innovation through *ijtihad*, *ijma'*, and *qiyas* under the guidance of *Shari'ah* scholars.

D. Harmonization of Standards

The harmonization of best standards and practices is the next challenge at hand. The Accounting and Auditing Organization for Islamic Financial Institutions as well as central banking authorities like the Bahrain Monetary Agency, the UAE Central Bank, and the Kuwaiti Central Bank are already playing a

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very important role in ensuring high accounting and auditing standards and setting up new fiduciary standard benchmarks for Islamic financial institutions. The law firms associated with these institutions are also working to help with the appropriate documentation, and the *Shari'ah* scholars are likewise working on *Shari'ah* standards. In all these efforts, we need to be rigorous with each other in order to set up new standards for benchmarking and rating Islamic financial institutions. Similarly, we need risk management that is both independent and vigilant.

E. Authentic Presence

Finally, we need to have an authentic presence. Authentic presence requires an authentic commitment to *Shari'ah* in its totality. It can be achieved through a code of ethics, a self-regulatory mechanism that many Islamic financial institutions today follow. A *Shari'ah*-allegiance statement is also desirable in this regard, as is the commitment to recruit and retain the best. Investing in training and career development is imperative: people are the key to the future of this industry.

IV. CONCLUSION

The future of Islamic finance depends on how it works toward achieving mainstream relevance by increasing the embedded capital of OIC member countries, by participating in more infrastructure and merchant banking activities, and by servicing the need of its customers in the rest of the world. The future is not some place where we are going, but one that we are all creating with our clients, with our *Shari'ah* scholars, with our shareholders, with our regulators, and with our team members. The future will be built on our heritage and traditions. The task of giving mainstream relevance to Islamic finance will bless both the makers and its destination.

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