

# **Islamic Finance**

## *Opportunities and Challenges in a New Global Environment*

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### **ABSTRACT**

The opportunity for the growth of Islamic finance is immense in light of the fact that the ten largest Muslim countries have a combined GDP of \$1.2 trillion. This potential, however, can only be realized by overcoming challenges such as fragmentation of the industry, differences in the interpretation of the law, the need for regulation, globalization of the industry, and promoting an appreciation for Islamic financial products. The requirements for growth are consistent treatment of issues under law, the development and enforcement of standards, transparency in dealings, liquidity in the market, and professionalism in the interactions of Islamic institutions.

### **I. INTRODUCTION**

In the current climate of globalization and economic interdependence, the study of Islamic finance can be broken into the opportunity, the current challenges, and the requirements for future growth. Islamic finance's appeal to all people lies in their need to conduct financial transactions in accordance with ethical and religious requirements. In the past, the target market for Islamic banks was limited to those with strong Islamic beliefs. Today, Islamic banks are catering to a larger variety of clients by offering more creative and competitive products. Islamic banks now have total capital of more than US\$7 billion, assets of more than US\$137 billion and deposits of more than US\$100 billion.

Citibank, for example, sees increased demand for Islamic finance across all of its market segments: retail, high net worth, corporate, industrial, institutional and government. Furthermore, the opportunity is not limited to countries traditionally considered part of the Islamic world. The Islamic market itself is immense. According to the World Bank, the 10 largest Islamic countries have a population of nearly 800 million and a GDP of US\$1.2 trillion. Another additional 100 million Muslims live in non-Islamic countries.

In the traditional markets, the initial source of wealth was largely from oil. Subsequent investments in infrastructure and technology over the past 30 years have multiplied the original wealth and thereby increased the demand for sophisticated financial services. The potential can only be realized by overcoming five key challenges.

### **II. CHALLENGES FACING ISLAMIC BANKING**

#### **A. Fragmentation**

While promising, the market is not fully developed. Islamic banking does not represent the core banking or financial system of any major Islamic country. It is still viewed as a niche product or an option but not as a holistic and all encompassing financial system that can cover all aspects of today's requirements. This prevalence of this view in the Islamic world is partly responsible for the fragmentation in the Islamic banking industry. Fragmentation results in institutions with limited earnings capacity, inadequate ability to hold assets and a relatively limited equity cushion to absorb shocks and losses.

#### **B. Interpretation**

At the core of Islamic banking lies a strict adherence to ethical banking practices. However, the differences in interpreting the lawful and the prohibited create redundancies that significantly raise the cost and substantially extend the time to execute broad market transactions.

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### **C. Regulation**

Every major developed market has a strong regulatory structure and strong standardized accounting and reporting. The traditional Islamic banking markets are not as developed. Regulatory oversight and standardized procedures promote investor confidence expand the market opportunity and lower costs.

### **D. Globalization**

It is a mistake to treat Islamic finance as a regional market opportunity. The world economy is changing and forces of globalization no longer constrain the demand for these services to a handful of countries. Besides, Islamic financial products are based on principles that can and do have a much broader appeal. For all of these reasons, we must act accordingly and prepare to meet this growing need on a global, not merely regional, stage.

### **E. Appreciation**

Several years ago, very few people understood Islamic finance. While awareness is increasing, we still suffer from gaps in knowledge. However, in some countries Islamic finance is neither understood nor appreciated.

## **III. THE PATH TO GROWTH**

Given these challenges, how can the industry grow? Evolving into a sophisticated global business is predicated on five basic requirements:

### **A. Consistency**

Consistent treatment of economic issues under law is the sine qua non of investor confidence and market growth. Consistency in evaluating, interpreting, and acting on all issues related to Islamic banking is absolutely essential.

### **B. Standards**

A globally consistent set of accepted products in accordance with *Shari'ah* principles—and in accordance with conventional banking and investment products and systems is needed. This requires creativity and flexibility. For example, many of the risk management products that emerged in the past decade have been forbidden in Islamic finance because these same products could be used for speculative purposes. An acceptable Islamic rationale is needed for modern products that have an application for either reducing or increasing risk. A case-sensitive analysis that considers products like swaps and futures and accepts them when they reduce risk but rejects them when used for speculation would dramatically broaden the range of products.

In addition to a standard product set, a globally accepted policies and procedures must also be developed. A global *Shari'ah* board, independent of any one institution, but funded by the banks collectively could promote market standards for the approval of products and services. The Islamic Development Bank, along with key players must play a major part in mobilizing the effort and creating a global platform for success.

### **C. Transparency**

Years ago, secrecy was the hallmark of the private banking business. Today, secrecy is dead and transparency is the minimum standard. Transparency is the invisible hand that will drive this business. Open markets and rules forcing complete and accurate disclosure will increase investor confidence and give them the tools to evaluate risk. Only then will higher level of participation be achieved.

### **D. Liquidity**

Investor confidence and liquidity are the accelerators of a “virtuous cycle” of market depth and growth. Only when standardization and transparency are entrenched can liquidity evolve. Standardization and transparency increase investor and issuer confidence to a level that permits the easy issuance and exchange of securities with low transaction costs. When this happens, benefits can accrue quickly and markets can grow rapidly. The need exists for cross-border lender of last resort to provide a liquidity cushion for previously approved products. Perhaps a reshaped IDB can play a role.

### **E. Professionalism**

The injection of professionalism into the system is an enormous opportunity, but the challenges it poses require the participation of more institutions that can attract top talent, provide training, and commit the necessary resources to encourage and support it. Professionalism and understanding go hand in hand. A system that supports the sharing of information to promote a better understanding and respect for the religious and ethical underpinnings of Islamic finance will attract top talent.

We must continue to work together to foster a better understanding between the Islamic and non-Islamic worlds. The Harvard Islamic Finance Information Program (HIFIP) is already playing a significant role in facilitating this dialogue through seminars, lectures, and forums on topics relevant to Islamic finance.

## **IV. CONCLUSION**

The structure of modern Islamic finance has to be built on the foundation of stable markets with standards. Transparency backed up by enforcement of standards draws sufficient capital to ensure that critical mass is achieved and that top talent and professionalism thrive. The opportunity is enormous and the challenges, while stringent, are not onerous.