Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead
Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp.173-177

Islamic Finance

Successes, Prospects, and Neglected Areas

Jassar Al Jassar*

ABSTRACT

This paper will first detail the successes of the Islamic financial industry since its inception. These include acceptance by customers, investors, businesses, and bankers; its growing profitability; the increasing sophistication of Islamic financial contracts; the introduction of new instruments; and its ability to attract new players. Not content to deal with successes alone, in this paper we tackle the of the industry's lapses, especially its failure to develop transparency, standardize contracts, reach consensus on legal rulings, and create appropriate short-term liquidity and investment instruments. The continuing lack of a uniform regulatory and supervisory climate is also highlighted. The paper concludes by outlining the prospects of the industry for evolution and development, and suggests topics for research in areas that remain neglected, particularly public finance, secondary markets, and e-banking.

I. INTRODUCTION

It must be stated right at the outset that Islamic finance is based on religious belief, which provides the framework and encompasses and motivates all actions. Islamic finance is not about financing or investment alone. It is an integral part of the Islamic way of life and has philosophical repercussions at the core.

This paper attempts to take a critical look at where Islamic finance stands at present, taking account of its successes and prospects, as well as identifying areas that have remained neglected, to see what is needed for further progress and where Islamic finance is likely to be—or rather, where we would like it to be—at the end of this first decade of the first century of the new millennium.

II. SUCCESSES

Islamic finance is no doubt relatively young, but it has had to make giant strides to reach its present level of acceptance. Like every new system that has had to fight its way up to achieve parity with existing systems, Islamic finance has had its share of successes, and has had to get over daunting obstacles.

The first big success was winning over the skeptics who strongly doubted that economic activity could ever be interest-free. The disbelief was pronounced, especially since almost all Muslim countries are themselves dependent on interest-bearing loans from such institutions as the World Bank, the International Monetary Fund (IMF), and commercial banks. Thus, the first challenge to Islamic finance was to prove the skeptics wrong, and this was done, slowly but surely. Islamic financial institutions provided the solution and proved that Islamic finance can be a successful alternative to conventional loans. Most of the initiatives came from the private sector, and each one started from a small beginning. However, over the years Islamic finance has grown both in number of institutions and turnover, and now a significant number of the financial transactions in Muslim countries are *sharīʿa*-compliant.

The start of Islamic finance coincided with, and was even spurred by, the establishment of the Islamic Development Bank (IDB) twenty-five years ago. This was an important milestone and a great stimulus to the development of the Islamic finance industry.

Gradually even those Muslim depositors who were originally ill prepared mentally to accept the idea of possibly sustaining losses on bank deposits came round to accepting that Islamic finance was not, after all, a mirage, but a realistic, realizable, and reliable undertaking.

Other successes that can be noted are as follows:

The consistently high growth rate of the industry, with a track record of success proving the skeptics wrong. Islamic financial institutions have built a loyal core customer base. Over the last twenty-five years or so, the amount invested in *sharīʿa*-compatible investments has steadily increased, is now estimated to have exceeded $180 billion, and has been growing at the rate of around 15% per annum. It should be noted that the demand for good

* General Manager, Kuwait Finance House, Safat, Kuwait.

investments for Islamic investors' funds has been so high as to create demand for new and diverse product offerings. Perhaps the most convincing evidence of this success in overcoming skepticism and earning recognition, is the acceptance of the feasibility of Islamic finance as a business line by major Western banks such as Citibank, ANZ, HSBC, and Société Générale, as shown by their introducing separate Islamic finance subsidiaries or divisions in their own operations. Likewise, major conventional market benchmarking companies like Dow Jones have launched distinctive Islamic market benchmark indices.

Customers and users have shown approval of the increasing sophistication of Islamic finance products and instruments on offer and their broadening range. In the earlier years of the industry, concentration was on relatively simple *murāba®a* financing and a certain number of real estate ventures, the last five years or so have seen many new products and instruments added. These new products have been diverse, including, for example, project finance, securitization, structured financing transactions, lease finance, asset management/investment funds, direct investments, and other investment instruments, all developed in conformity with the principles of the *sharīᶜa* and adequately complying with the basic requirements of *ijāra*, *mushāraka*, *mu∞āraba*, *murāba®a*, *salam*, *istisnā'*, and the like. A growing number of major international banks are willing to arrange deals in cooperation with Islamic financial institutions. Islamic institutions have demonstrated an ability to work alongside major conventional banks on large regional financing deals structured so as to include an Islamic tranche alongside a conventional tranche (e.g. the $200 million Islamic tranche in the $1.2 billion project finance for the Equate Petrochemical Complex in Kuwait and the $100 million Islamic tranche in the $600 million financing for Thuraya Satellite Telecom, UAE).

As a growing number of investors and businessmen in Islamic countries turn to Islamic finance as a business alternative, major corporations in the West are now increasingly open to using Islamic investor funds as an alternate source of finance. This is good news for the Islamic finance industry, as it stimulates the development of geographically and otherwise diversified high quality investment product offerings.

Acceptance on the regulatory level has been increasing, as evidenced by major initiatives of the central banks and monetary authorities in such countries with majority Muslim populations as Bahrain, Malaysia, and Kuwait. The Islamic Development Bank has often made important direct or indirect contributions to the developments leading to this acceptance. In Bahrain, the Bahrain Monetary Agency (BMA) is planning to issue Islamic government bonds. In Malaysia, an Islamic offshore financial market is being developed in Labuan, under the auspices of the Malaysian monetary and regulatory authorities. In Kuwait, a new banking law is being discussed by the parliament. Consultations are being held with all relevant groups, including the Chamber of Commerce and Industry, *sharīᶜa* and legal experts, and constituent institutions, to bring Islamic financial institutions under the Central Bank's umbrella and integrate them into the banking system. This is intended to build further upon the foundation laid twenty-three years ago when the Kuwait Finance House was established by *amīrī* decree, with express recognition of the *sharīᶜa* as the regulatory system for governing its operations. (The government of Kuwait continues to be the major shareholder of the KFH.) These initiatives by monetary and regulatory authorities can be seen as testimony of Islamic finance's acceptance and political recognition. Another such evidence is the slow but sure growth in the number of Islamic financial institutions and product offerings in Western countries, with their highly-developed regulatory climate, tried and tested compliance, reporting, accounting, and auditing standards and practices. This development is especially welcome, as it is likely to have beneficial ripple effects on the growing industry and help ensure that growth does not come at the cost of sidestepping compliance issues and normal standards of good practice. The recognition of Accounting Standards for Islamic Financial Institutions by central banks as well as international institutions like the IMF and the World Bank, is another important facet of this success.

Recognition at the theoretical level has been growing, with many prestigious seats of higher learning introducing research and study programs in Islamic finance and related subjects. Today such universities as Harvard, King Abdul Aziz University in Jeddah, the University of Durham in the United Kingdom, and the International Islamic University in Malaysia, among many others in Muslim as well as other countries, have introduced Islamic finance into the curriculum or initiated studies and research, while specialist institutions like the Institute of Islamic Banking and Insurance and the Islamic Foundation, among others, have made remarkable contributions to the spread of Islamic financial knowledge and are providing a basis for further development.

Thus Islamic finance has earned respect and come to be regarded more and more a part of the mainstream than, perhaps, an interesting idea.

All of the these developments can, with legitimate pride, be counted as successes achieved by Islamic finance, but in the competitive and constantly evolving world of modern finance can Islamic finance afford to rest on its successes? Certainly not. Islamic finance has to embark on an exercise in self criticism and take into account the neglect of certain important areas, thus preparing to repair lapses and weaknesses and visualize prospects of further growth in the direction of becoming, and being accepted as, equal members in good standing of the international financial community.

III. Neglected Areas

Attention is needed to the neglected areas, which we have outlined below, together with ideas for rectification.

A. Production of Popular Liquid Short-Term Investment Instruments

Traditionally, investment in short-term *murāba®a* transactions has been used by Islamic financial institutions as the closest substitute for such liquid investments as the marketable securities found on the balance sheets of conventional banks. However, even short-term *murāba®a* is not as readily convertible to cash as a conventional bank's portfolio of T-bills and negotiable CDs; therefore, no *sharīᶜa*-compliant alternative to T-bills or marketable securities is available as yet.

New products have recently been launched by Islamic financial institutions, such as securitizations with some liquidity features. However, neither do securitization-type issues have the liquidity of T-bills issued by a central bank. It will be necessary to develop Islamic instruments with full state credit backing (something similar to T-bills but within a *sharīᶜa*-compliant structure). We hope the initiative of the Bahrain Monetary Agency (BMA), who have been discussing plans to issue Islamic bonds, may prove to be the pioneering example that could fill the vacuum. However, much effort will be needed to reach that point.

B. Standardization

While most conventional banking contracts are fairly standardized, those used by Islamic banks can often differ significantly. Standardization of routine agreements could save a lot of time, effort, and other resources, including legal costs. If achieved, standardization would allow Islamic finance professionals and their business counterparts to focus energies on business and product development, rather than repeatedly reinventing the wheel. It would also promote more widespread familiarity with the principles of Islamic contracts and loan structures, enabling other institutions to know exactly what products are available and encourage them to become more actively involved in Islamic finance. So far, most of the institutions involved have been concerned more with the immediate bottom lines than in research that will produce future benefits. However, as the industry matures, this is starting to change and much more progress can be hoped for in this area. What is required is for resources to be committed, not only funds and outstanding researchers, but also line-management time—something in relatively short supply. Since issues related to intellectual property and the like will have to be addressed before private institutions will commit critical resources other than funds, the main role in standardization will probably be taken by public bodies, industry associations and larger institutions.

C. Evolving a Consensus on *Sharīᶜa* Rulings

By far one of the most controversial and complex problems in Islamic finance has been a lack of consensus among *sharīᶜa* rulings. Admittedly, there are various schools of thought within the brotherhood of Islam, which differ sharply on some matters, for example insurance and investing in stocks. It is tempting to take heart from the reality that even within the United Kingdom English law differs from Scottish law, and this difference has not seriously hampered business, making it possible that differences of opinion among *sharīᶜa* scholars may also be something that can be endured. However, achieving something closer to a consensus can only help the industry. A number of efforts are being made toward this end. For example, the Kuwait Finance House has been hosting annual *sharīᶜa* forums, inviting eminent *sharīᶜa* scholars to meet and exchange views on industry issues. Laudable efforts have also been made by other institutions. Much remains to be accomplished in this area.

D. A Uniform Regulatory and Supervisory Climate

Depending on country, Islamic financial institutions are regulated in different ways. In Saudi Arabia, all commercial financial institutions report to and are regulated by the Saudi Arabian Monetary Agency (SAMA, the Saudi central bank). In the UAE, a special Islamic banking law exists, and the Islamic institutions are under the umbrella of the Central Bank, which readily supported the Dubai Islamic Bank during the crisis it experienced several years ago.

In Kuwait Islamic banks are under the ministry of commerce, unlike conventional banks, which are regulated and supervised by the Central Bank. However, several drafts of a new Islamic banking law are being discussed in parliament, all agreeing on bringing all Islamic banks under the supervision of the Central Bank.

E. Public Finance

The lack of acceptable government-guaranteed liquid instruments poses a major challenge to the management of assets and liabilities and other balance-sheet items.

Islamic finance has so far failed to come up with alternatives to products with the credit quality and liquidity of the T-bill and T-bond. The kick-start could come with the commitment by a Central Bank of liquidity to a product.

F. Secondary Markets

Although a very small number of products launched recently are backed by trading arrangements for a secondary market, Islamic investments generally have tended to be illiquid. This aspect also needs to be given due attention. It is hoped that the IIMM (Islamic International Money Market, Labuan) will be of benefit in improving this situation, but perhaps it cannot realistically be expected by itself to provide a global solution.

G. Improving Reporting and Transparency

Differing regulatory regimens, together with differences in operations, have often meant differing reporting and disclosure requirements and practices. Credit rating agencies have normally focused on this issue. In some cases, a relatively lower level of disclosure, even when all current regulatory requirements and applicable accounting standards are met, has led to lower ratings for Islamic financial institutions than would given to a conventional institution with comparable financial standing. Another factor might be a lack of familiarity with Islamic finance.

IDB's recent sponsorship of a professional credit rating agency for Islamic financial institutions, and the initiatives of the Accounting and Auditing Organization for Islamic Financial Institutions are laudable steps, but much more needs to be done.

H. E-commerce and E-finance

The Internet and the development of e-commerce are considered likely to lead to major changes in banking and finance as we know them. The advent of electronic-commerce is likely to mean much more than just the addition of one more delivery system to the many old ones. Although Islamic banks have made some limited progress, they need to focus more meaningfully on this rapidly-developing dimension of the finance industry.

IV. PROSPECTS

The prospects for the growth of Islamic finance remain very strong. The ten largest Muslim countries have a combined GDP of $1.2 trillion. The Islamic banking market exceeds one billion people, including some 150 million Muslims who reside countries where Muslims are a minority. Six million of them live in Western Europe. Many of them appear keen to channel their assets into Islamic finance, and many have quite sizeable disposable incomes. They, therefore, represent potentially a very lucrative market for high quality Islamic financial institutions. Currently only a small segment of Muslim-owned monies are invested Islamically (mainly in equity funds, real estate, and short-term instruments managed by Islamic financial institutions or international banks operating Islamic banking windows). The investment funds of public bodies in Muslim-majority countries are among the assets that are not yet a part of the Islamically-run finance market.

Demands have been voiced by Muslim clients in the Middle East and elsewhere for their pension funds to be placed in *sharīʿa*-compliant investments. These pension funds are very sizeable, especially in the oil-exporting Middle Eastern countries, but their investment is usually, and rightly, managed by conservative public institutions. Once a suitable range of high quality Islamic products is available to choose from, it is reasonable to expect that pension monies will start pouring in, very significantly boosting the prospects of the Islamic finance industry.

V. CONCLUSION

In conclusion, without trying to deride older economic systems, but just stating the facts, it is now common knowledge that Communism and its centrally planned economic and financial system has either been given up altogether or has been drastically toned down. As for Capitalism and its market-economy system and free market finance, its virtues have also come under serious questioning recently as an aftermath to the huge, even violent, demonstrations in places as far apart as Seattle, Bangkok, Prague, and Melbourne. The violent price swings in financial markets, speculative stock market booms and busts, unsettling currency rate volatility and wide fluctuations in asset prices and the like have put the free market's perceived role in question as the only viable allocator of resources and puzzled or disturbed many eminent Western economists and financial experts enough for them to start advocating radical changes ranging from a return to the gold standard, to calls for greater regulatory intervention to discourage debt financing, and to transaction taxes on secondary markets for controlling unbridled speculation. None of these ideas has so far been seriously tried.

Without going into the merits and demerits of this criticism, it can safely be concluded that the older economic systems have either failed or need drastic changes if they are to meet the needs of mankind as a whole. And it is here that the Islamic system of economics and finance—which combines in itself the virtues of free enterprise and social justice—can, if properly defined and applied, present itself as a viable alternative.

Alternatively, the Islamic financial system need not necessarily compete with other systems, but may exist side by side and even act in cooperation where possible. This is demonstrated by the joint arrangements involved in some major regional financing schemes, with conventional and Islamic banks cooperating, with the approval of the *sharīʿa* supervisory boards of the Islamic banks and by having an Islamic tranche alongside a conventional credit tranche to make up the total financing. The landmark financing for Equate of $1.200 billion comprised of an Islamic tranche of $200 million, with the remaining amount arranged conventionally by the other banks, is one such example. The $600 million financing for Thuraya Satellite Telecom Co., UAE, contained a $100 million Islamic tranche.

Having reviewed the successes, neglected areas, and prospects of Islamic finance, and having noted the increasing recognition and acceptance, and the current demand-driven momentum of the industry, it seems reasonable to us to expect that Islamic finance will be able to build on its successes, and address the issues it has neglected so far. On the basis of conservative estimates of present-day wealth and growth predictions for the population of the Islamic and potential Islamic investor markets, it also seems reasonable to estimate that ten years from now Islamic finance could well be an industry with the equivalent of at least $1 trillion under management. However, in order to get there, and it will likely get there—such being the pull of existing demand—it needs to be ensured that the major issues are addressed as much as necessary to develop new products and solutions to the problems discussed above. The issues can be generally identified as compliance- and innovation-related, for example:

1. Ensuring the suitability of products sold to retail investors,
2. Ensuring proper management, especially in regard to credit/investment quality and asset-liability management,
3. Improving professional expertise to become able to face increasingly the complex challenges emanating from the growing size and stature of the industry in an increasingly sophisticated and competitive environment, and, most importantly,
4. Maintaining focus on its real purpose, which is to offer financial products complying with the spirit of the *sharīʿa*.

Thus it is apparent that Islamic finance, though relatively young as an industry, has grown so fast and become so robust that it can legitimately claim not only to have come of age also to be here to stay.

Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp.173-177