Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities
Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. pp. 155-158

Islamic Finance

Sustaining Success

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Abstract

Two important principles of Islamic banking are the prohibition of *ribā* and cultural and financial integration between Muslim societies. Advantages of Islamic banking include off-balance-sheet financing, private sources of funding, and equity solutions. The Islamic capital market has grown over the last few years and is estimated to be around US$100 billion. The present market growth of this industry is around 10 to 15% and is expected to grow rapidly. Current developments in Islamic banking include turnkey solutions, Islamic private banking, widening the range of Islamic investment funds, Islamic indexes, mobilization of funds, securitization of assets, Islamic accounting standards, central bank supervision, liquidity management, and capital adequacy. The industry faces considerable challenges; its response to them will determine whether it becomes a significant alternative to the conventional system in global financial markets.

I. Introduction

The *sharīᶜa* prohibits charging an explicit interest-based return on funds lent. Consequently, Islamic financial and banking transactions operate on the principle of sharing risks and rewards with the borrower. While prohibiting the charging of interest on lent funds, the *sharīᶜa* invokes a financial system that operates on the mutual sharing of risks and rewards by borrowers and lenders. However, the dominant financial system of the day bases itself precisely on what the *sharīᶜa* prohibits. In an era that sees globalization as the dominant paradigm, with the increasing integration of societies, communities, and markets, one is led to wonder: how are Muslims, who cannot, (due to their beliefs and conscience) partake in the dominant interest-based financial system, to meet and take advantage of the opportunities created by globalization? Are Muslim communities to remain isolated in this era? Such a large segment of the world's population cannot be bypassed by a truly global economy. Surely, the contribution of Muslims as active participants in the global economy will only make it stronger. The absence of the enormous Muslim bloc in the global economy would raise difficult questions on the credibility and sustainability of such a system.

There exists a culturally acceptable tool and medium through which Muslim societies may draw efficiently on their national resources and integrate financially into the global economy. Islamic banking and finance, based on the principles of the *sharīᶜa*, allows Muslims to mobilize resources and provides them a bridge to global markets. The common techniques of Islamic finance, presently used by the institutions that practice it most commonly in trade, the raising of working capital, real estate, and equipment-related transactions, are well known. In *murābaha*, a cost plus fixed profit approach, the financier enters a simultaneous purchase and deferred-sale operation with two different parties. *Mushāraka* is partnership funding with the distribution of profits under a pre-agreed formula, with losses shared according to the contribution of capital. In *mudāraba*, an investing party provides capital while another provides management, with profits shared by a pre-determined formula. In *ijāra*, the financier acquires an asset and leases it out on a fixed or variable rental charge to a lessee. In *istisnāᶜ*, or pre-production financing, an investor finances the completion of a project or the manufacture or processing of goods.

II. Growth in the Islamic Banking Industry

The Islamic capital market, the global pool of money that demands to be catered to in a manner consistent with Islamic law, is large and growing. The chief contributions to this pool come today from the Persian Gulf region, though South Asia and the Far East are growing in importance. It is anticipated that the 16 million Muslims in Europe and North America will make increasing contributions to this market. The market itself has not only grown in size but has also matured over the last 5-7 years. It has undergone a natural progression from retail to commercial to investment and private banking. This change, at least in the Persian Gulf, can be attributed to two

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reasons. First, a larger middle-income group has recognized the importance of savings. Second, the Islamic banking industry itself has become increasingly sophisticated in meeting the needs of financiers and investors who wish to have part or all of their assets managed in an Islamically compatible manner.

The growth of the Islamic banking sector in the last 20 years is well documented. Most observers agree that this niche market has grown from scratch to $80-100 billion, giving the industry a yearly growth rate of 10 to 15%. It is believed that the Islamic capital market will account for at least 50% of the total savings of Muslims worldwide over the next decade. In a sense, the Islamic capital market is still an arbitrage opportunity, as it is bound to continue to receive attention and resources until it is brought to the mainstream global capital market in terms of price, quality, and variety of product offerings. Institutions such as Al Rajhi Banking and Investment Corporation, Kuwait Finance House, The International Investor (TII), First Islamic Investment Bank, and Abu Dhabi Islamic Bank have realized annual growth rates of 20% in the past five years. Dresdner Kleinwort Benson has an annual turnover of over US$6 billion in Islamic trade finance. According to TII's Annual Review 1999, TII currently manages around US$3 billion in funds, after having been established only in 1992.

The success of Islamic finance has been due to its ability to free up existing credit lines and capital resources. With the prohibition on paying and receiving interest as per the *sharīᶜa*, conventional banks working in Muslim communities face problems mobilizing the funds in these communities to their full potential. Islamic financial institutions have developed the market for Islamic customers that operates under the terms of the *sharīᶜa*, freeing up capital and credit lines by offering services that are acceptable in Islam.

Using a wide range of financing tools, Islamic financial institutions are able to undertake financing, directly or as fund managers for clients. In the latter case, the institutions act as agents for borrowers or arrangers for lenders, in which case the financing is strictly off-balance-sheet, with the institution acting merely as a fiduciary agent. Islamic financial institutions are now able to undertake private investment activities, either in direct competition, or by way of cooperation, with conventional banks. These activities have increased the earnings of Islamic banks in areas that had traditionally been dominated by conventional banks. With the introduction of asset-based financing, the potential for Islamic financial institutions to grow has increased. Fixed-rate term money can now be accessed freely.

Much of the growth has come in the areas of equity, commodity funds, and leasing. Islamic principles encourage allocation of resources on a productive basis with the mutual sharing of risk and return. Equity finance seems to be a natural fit for Islamic financial institutions.

The past success of Islamic finance naturally leads to a few questions. Is this growth sustainable? Or has it all been a flash in the pan, a temporary success that will be followed by failure? What must Islamic financial institutions do to sustain growth? Perhaps a review of some recent developments in the industry and the issues they raise will suggest answers.

III. Recent Developments and Issues in the Islamic Financial Industry

A. Turnkey Solutions

Turnkey solutions offer a long-term yet flexible arrangement by which a strategic ally is armed with a comprehensive range of solutions that enable it to serve the Islamic marketplace. Turnkey solutions involve more than delivering products and services. They also entail channeling expertise and technologies, along with a brand name that has a proven track record to the client. If successfully implemented, they result in effective, low-cost, low-risk entry into the Islamic capital market. Islamic financial institutions have been acting as advisors for asset managers who wish to address the needs of investors to identify Islamically acceptable securities. They have also been offering wholesale Islamic products and services through franchising. The distribution of the products and services is effected through retail banking networks. TII, for example has provided turnkey solutions to the Gulf Bank of Kuwait (GBK) by making available TII's product under the brand name "Al Deema," to be marketed through GBK's Kuwaiti branches. In addition, TII provides a wide variety of services, including, training, to GBK. At present, no other group has introduced similar turnkey solutions. Al Deema products range from lower risk *murābaẖa*-based solutions, which returned nearly 6% in the 12 months to May 2000, to riskier portfolio profiles that have returned nearly 50% in the 12 months to May 2000.

B. Islamic Private Banking

High-net-worth individuals, at least in the GCC region, have shown great interest in private Islamic banking services. Like their conventional counterparts, an emphasis is placed on performance as well as on the traditional requirements of safety, confidentiality, and forming personal relationships. Private bankers and asset managers often need to buy or bring in expertise not available to them internally, and this is done typically through takeovers, alliances, and distributive agreements. TII has, for example, started a joint venture called "Al-Bait" with Pictet & Cie, the largest private bank in Switzerland. Al-Bait is a specialized Swiss Islamic financial company that provides full private banking services, including highly personalized asset management, along with custodial, trade, and estate planning services. Investments in the Al-Dar Islamic Fund have seen growth rates ranging from 24.26% to 47.32% in 1999. As IslamiQ Financial Daily reported (May 24 and 30, 2000), Kanz Bank, a Geneva-based Islamic investment bank, is also expanding in the GCC by offering Swiss banking services and a growing range of Islamic investment products.

C. Islamic Indices

Dow Jones has constructed an Islamic Market Index with over 2700 well-traded and fully accessible stocks. The index includes the most liquid securities meeting *sharīʿa* investment criteria in the stock market. Other institutions have followed in the footsteps of Dow Jones. TII, along with FTSE International, has launched a Global Islamic Index Series that can be tracked by referring to major international providers of financial information. These indices will help Islamic investors benchmark the performance of their investments in the growing range of equity funds being offered to them. The constituent list also provides a pre-screened list of Islamically compliant equities. Recent returns for the Islamic versus conventional FTSE Global Indices are as follows:

	1998	1999
FTSE World Index	22.78%	25.57%
TII Global Islamic Index	23.56%	20.19%

The FTSE brand name is widely respected and followed. Plans to launch a tracker fund based on the FTSE Global Islamic Index are well advanced under the banner of a UK-based fund manager. The screening criteria involve the exclusion of non-Islamically acceptable sectors, gearing ratio screens, and the exclusion of companies whose income is influenced by interest or other non-Islamic industries by greater than 5%.

D. Islamic Funding through Securitization

Islamic banks and financial institutions have pioneered the concept of funding through securitization. The goal is to raise or obtain low-cost capital financing by the issue of debt instruments in the capital market. The debt is secured against the financed asset and covered by the receivable cash flow cycle of the borrower. The risk profile of the security is thereby isolated and assessed separately from that of the borrower.

Given the large demand for infrastructure funding projected over the next few years in different parts of the world, Islamic investors will logically want to become involved alongside the conventional market. Increasingly, retail investors will have to be accessed for such purposes when the conventional banking market reaches the limits of its capacity. The integration of *muḏāraba* and Islamic leasing into a structure through which infrastructure assets are acquired should present the most acceptable Islamic solution for securitization of these assets.

E. Islamic Accounting Standards

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990 with the main objective of developing accounting and auditing procedures relevant to Islamic financial institutions. The AAOIFI has made significant headway in establishing standards. To this end, the AAOIFI has established a Standards Board, composed of renowned *sharīʿa* scholars, university professors, certified accountants, and users of the financial statements of Islamic institutions. The Board has introduced Twelve Accounting Standards to date, which very precisely cover disclosures and the presentation of Islamic financial activities. The Board is working to further enhance the transparency of financial statements.

The standards deal extensively with a range of issues such as the objectives of Islamic banking, definition of financial transactions, and the formulation of accounting policies. After adopting the AAOIFI's Financial Accounting Standards, the nature of Islamic banks' business activities will certainly become more transparent. This will enable depositors, investors, and analysts alike to enhance their knowledge and comprehend the institutions' underlying financial strengths. Standardization of accounting policies is important to Islamic financial institutions for the same reason it is to conventional ones: to facilitate meaningful comparisons and analyses of results. Outsiders, even those familiar with the concepts of Islamic financial accounting, may gain confidence in the standards of accounting and disclosure within Islamic banks' financial statements. It is likely and desirable that the standards become widely adopted as the industry norm. Perhaps this will gain impetus and acceptability with the backing of the central banks under whose jurisdictions Islamic financial institutions fall.

F. Supervision

Each Islamic financial institution is, at least theoretically, under the constant review of its *sharīᶜa* board, which reviews the investment transactions of the institution and confirms that they comply with the *sharīᶜa*. Furthermore, as mentioned, the AAOFI has introduced Islamic accounting standards on the basis of which qualified accountants may audit the accounts of each institution to prepare a report for shareholders. While there definitely is a trend toward enhanced and constant supervision of activities and thus toward greater transparency, more is needed.

Central bankers, lacking comprehensive knowledge of Islamic law and practices, fail to understand the operation of Islamic banks. As a result, Islamic financial institutions are left to operate without effective control from central banks. This may seem like freedom from government-imposed constraints, but it has been a bane—Islamic banks must operate without the protective cover that central banks provide. Increased involvement of central banks in Islamic finance is thus necessary; it will push the industry toward much-needed standardization, and will increase the transparency that customers and investors crave. It will also raise protections for Islamic finance. Increased central bank involvement is a win-win situation for all: customers, investors, and Islamic financial institutions alike. Government supervision, however, cannot come without efforts aimed at increasing central bankers' awareness of Islamic finance.

Though a trend is clear in which central banks are taking steps to bring Islamic financial institutions under their supervision, it is still to be determined how well these institutions can be regulated and supervised, since no comprehensive regulatory framework has been created. Although efforts must be made to devise comprehensive legislation on the matter, very few examples of regulatory frameworks that have been or are being introduced come to mind. Bahrain has an Islamic banking law under which all Islamic financial institutions are regulated. The Central Bank of Kuwait is currently attempting to pass a new Islamic banking law through the Kuwaiti parliament.

G. Liquidity Management

One problem faced by Islamic financial institutions is in liquidity management. This has arisen due to the unwillingness of central banks to extend borrowing privileges to Islamic banks. Retail banking operations in most cases thus run on self-imposed 100% reserve requirements. There has been much study and work in this direction to introduce an Islamic money market that could solve the problems of liquidity management in the long run.

Investors with savings and deposits accounts in Islamic banks would be sharing risk with the bank. It would therefore be inappropriate if a proportion of these deposits were placed with the central bank, which pay interest to conventional banks on deposits, while deposits from Islamic banks must be interest-free. Moreover, Islamic banks are not allowed to hold treasury bills or other interest-bearing government securities on their balance sheets. Until central banks develop instruments without the element of interest, the issues surrounding liquidity will continue to remain of major concern. Islamic banks are increasingly taking on more long-term exposure, while the maturity profile of their deposits is essentially short-term. A mismatch between assets and liabilities is thus imminent. A suitable treasury-type instrument that central banks can employ for the liquidity management of Islamic banks is needed.

IV. Conclusion

It is true that Islamic financial institutions have witnessed substantial growth in the past twenty years. However, it is clear from the developments and the issues raised above that the industry cannot rest on its laurels. It has not yet grown out of infancy, even though it has grown much. This has two implications. First, the potential for growth is still great; the future holds grand promises. As noted, the sector constitutes an arbitrage opportunity for investors who may realize enormous profits from their involvement. Second, the industry faces enormous challenges as well. Accounting standards are being set; they now need to be enforced. Regulatory frameworks have to be created. The possible mismatch of the term-structure of assets and liabilities was discussed. New opportunities will challenge the industry to take on new roles. For instance, private banking may be growing, but it dares the industry to strive for new levels of performance.

To face the challenges presented by the future and to achieve their promise, Islamic financial institutions must evolve. But in this task they cannot be alone. Increased government awareness of the working of the sector is much needed. Investors must continue to demand higher levels of sophistication in their investments. The scenario, it has been claimed here, is a win-win one. The active participation of Muslims in the global economy in a culturally satisfactory way rests on favorable outcomes in response to these challenges.