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The Road Ahead for Islamic Finance

Jay Collins[1]

Now is an extraordinary and fascinating time in the development of Islamic finance. The market continues to mature, albeit not as fast as many of us might hope. Nonetheless, progress is enormous, and innovation, far surpassing the days when one could count the Islamic products set on one hand, should be applauded. The numbers speak for themselves: $13 billion in *sukuk* issuance, perhaps as much as $350 billion in Islamic funds under management, and a market that is growing in excess of 15 percent per year.

Our research has pulled together the key lessons regarding the challenges facing Islamic finance, and has highlighted the steps taken to ensure standardization and transparency. Unfortunately, regulation and corporate governance have generally struggled to keep pace with the unprecedented growth in this industry, and with an ever higher bar in the global environment, there is a need for redoubled efforts. In the spirit of developing a forward-looking road map, this article lays out the ten most critical components of future success. Businesses and governments around the world are increasingly benchmarking success with best practices, performance metrics, and long range plans; the more that today's leaders in the field can agree on the components of future success in Islamic finance, the more likely the market is to prosper.

KEY DRIVERS BEHIND THE MAINSTREAM INTEGRATION OF ISLAMIC FINANCE

We begin with what should be an uncontroversial judgment: the growth of Islamic finance has thrust the sector into the mainstream of global finance. Five years ago senior management of large money center global banks could get away without understanding its fundamentals—it was a niche

[1] Chief Executive Officer, Public Sector Group, Citigroup, New York.

market without global scale. That is simply no longer the case today. The move to mainstream will continue given that Islamic instruments are expanding beyond their dedicated base and have strong potential to become a core element of portfolios of non-Islamic institutions and investors. It is useful to put the Islamic finance market's move to mainstream in the context of a number of external factors:

- Petrodollar inflows are creating extraordinary regional liquidity conditions. The improvement in the balance of payments in oil exporters due to the run-up in oil prices is conservatively estimated at $500 billion per year. This liquidity is pushing local equity and bond markets to record highs, boosting central bank reserves and filling stabilization and future funds. Internationally, the shift in wealth to regional investors is contributing to a further spread of compression and diversification from the U.S. dollar. And of great importance, the petrodollar liquidity is driving Middle East regional conventional banks into the Islamic arena.
- Ongoing political trends appear to have dampened the interest of regional investors in direct investment in the United States, while the surge in oil wealth has spurred a desire to find more investment opportunities closer to home. We should be open about the misperceptions and concerns that emerged after September 11, which caused many mainstream investors to hesitate rather than embrace Islamic finance. This bias has now been reversed, and while there is more work to do in telling the story, we are on the right track.
- Further, there is a global surge in investment in infrastructure, both as a result of a renewed government focus and a tremendous growing appetite for infrastructure investments. The potential to target capital from Islamic countries that have a traditional understanding and deep experience in the field of infrastructure toward correcting the historic global problem of underinvestment in infrastructure is enormous. In addition, the infrastructure needs of the Middle East and North Africa region are also huge, giving us the opportunity to marry need with supply of capital.
- Finally, the world has flattened. Financial markets are integrating in an extraordinary way and global markets are converging with local markets. The exponential advances in the pace of information and capital movements, the increasing sophistication of global markets and the tremendous effort of global regulators to keep up with these changes have only fed the integration process. This means that one can no longer look at areas like Islamic finance as discrete and isolated market segments.

Governments will be critical to the success of this effort. Governments play multiple roles in facilitating the development of the Islamic finance market. First and foremost is the role of the central banks and financial service authorities as regulators and supervisors, providing a sound financial framework that supports the market's development. A second important role is that of the issuer, both because sovereigns continue to represent an important share of the market, and because markets look to sovereign issuance as a benchmark and signal of official support for the market's development. A third role, no less important, is that of the asset manager. Considering the vast amount of petrodollars noted above, the decision to invest even a small percentage—say 10 percent—into Islamic assets by central banks, government pension funds, and reserve funds would be absolutely revolutionary in its market impact. At the same time, government intervention should not be so heavy-handed that it dampens market dynamism. In many countries in the Middle East and North Africa, governments continue to dominate the ownership of the banking sector and therefore are also at the table as banks, and consequently, must be part of the solution.

10 STRATEGIC COMPONENTS OF FUTURE SUCCESS

1. The Need for Greater Standardization and Regulatory Alignment; the Road to a Harmonized Financial Code

The need for greater legal, regulatory, and accounting standardization has been much discussed among Islamic finance professionals. While we must respect the important and legitimate differences in views among Islamic scholars, there is little doubt that convergence on a common regulatory framework would support the development of the market. Such a framework must be broad enough to achieve the benefits of standardization and maturity, but flexible enough to accommodate the continued innovation and creative process now underway.

Internationally, the Accounting & Auditing Organization for Islamic Financial Institutions (AAOFI), based in Bahrain, has set the international market practice standard for documentation and regulation. AAOFI's accounting and audit standards are constantly under review and continue to develop in parallel with the development of innovative structures. Additionally, there is the Islamic Financial Services Board (IFSB), based in Kuala Lumpur, which will soon have international regulatory standards for the Islamic banking industry. On a regional level, Bahrain, Dubai, and Malaysia are the main centers of Islamic finance. Qatar and Singapore also have recently enacted laws and regulations to cater to Islamic finance, with a view to becoming important Islamic financial centers. The U.K. Treasury has leaped ahead of many Muslim countries in its laws dealing with the taxation of Islamic retail banking products, which supports London's role as the center of Islamic finance in the West. English law is the choice of law for Islamic banking documentation, and U.K. GAP principles apply. Altogether, the top ten Islamic financial institutions are subject to no less than five separate regulatory standards.

Each jurisdiction is to be complimented on its efforts to regulate Islamic finance. For everyone involved, there are many lessons that may be learned, including the following:

- Bahrain and Malaysia have the oldest sets of Islamic banking regulations, and the Malaysian courts appear well prepared to deal with disputes relating to Islamic finance.
- Bahrain Monetary Agency (BMA) has led the way in developing a modern regulatory framework with rules and regulations governing Islamic finance.
- The Dubai Financial Services Authority (DFSA), the regulator of the Dubai International Financial Centre (DIFC), also has a set of Islamic banking regulations separate to those imposed by the UAE Central Bank. The DIFC's rules have been drafted by international law firms and cover a range of products.
- The innovations by the U.K. government and the Monetary Authority Singapore for introducing regulation for Islamic finance have also played a constructive role.

There may be no one-size-fits-all answer, and there are strengths to each system, but convergence must be an objective. Convergence will take time, and a degree of "messiness" is inherent in a dynamic and innovative market. These principles are not inconsistent. Consider the common law system in the United Kingdom, which has fostered convergence over time in legal standards within a framework that accommodates change and precedent. However, regulatory and supervisory competition among competing financial centers comes at a cost. Markets will benefit to the extent that governmental policy—in major Western countries as well as in Islamic markets—supports the eventual development of a uniform international regulatory framework for Islamic institutions. And just as convergence is slow in coming in the Islamic world, the Western world, with the exception of the United Kingdom, also has a long road ahead to achieve appropriate supervisory and regulatory standards.

2. Transparency is Critical to Market Development

In this market, as in others, transparency is an essential complementary to standardization in order to achieve greater depth, liquidity, and efficiency. Governments in the Middle East, which are admittedly not always comfortable with the kind of transparency expected in efficient markets, need to achieve a delicate balance. Greater transparency should aim to put the maximum feasible information into the public domain. Governments should maintain an ongoing dialogue with market participants, providing advance guidance as to how the market is going to be regulated and supported (such dialogue will also help the regulator by enhancing market understanding). Non-public information can be disclosed to ratings agencies to assist in their evaluations. Governments should also encourage secondary market development to allow greater price discovery and dissemination of that information to the markets. In sum, if Islamic financial institutions are to play a leading role in the evolution of the market, transparency through standardization in reporting, as emphasized by the ratings agencies, will be an important element of the effort aimed at "defeating the culture of excessive financial secrecy."[2]

3. Simplify the Diverse *Shari'a* Board Process

An additional aspect of the need for convergence concerns the *shari'a* board process. This is an area where significant progress has been made. Structures have become more harmonized in the past few years, and it is quicker to complete transactions compared to before. Differences in documentation and *fatwas* haven't stopped us from doing deals. *Shari'a* scholars are to be thanked for this, for their input in earlier transactions that have assisted in precedents for legal documents. This process continues. But the kinds of innovations that I discuss below are likely to strain the current process, making further simplification all the more important.

Here again, AAOFI has had a critical impact on the development of *shari'a* standards. These standards should be adopted by countries around the world. Were this to happen, the *shari'a* boards could share the critical mass of agreement and turn their focus to areas or transactions that diverge from the standards.

This would also help the capacity constraint on *shari'a* scholars. There are really only a handful of top *shari'a* scholars dealing with Islamic finance in the world today. These scholars share a number of positions on each Islamic bank's *shari'a* board. However, we are not seeing a growth of

[2] "Enhancing Financial Reporting and Transparency: Keys to the Future of Islamic Finance," *Standard and Poor's Ratings Direct*, December 14, 2005.

young talent entering this field. The answer to this is to train more *shari‘a* scholars with training in conventional as well as Islamic banking, markets, and economics. This initiative has been encouraged and supported by the DIFC. However, training is still woefully inadequate to keep pace with market growth. This is another area where public-private partnerships can make a difference.

It is also useful, albeit controversial in some countries, to have a *shari‘a* board within the appropriate regulatory authority that oversees the appropriateness of the *shari‘a* process. This does not require a convergence of the *shari‘a* transaction approval process with the secular regulatory process. Instead, what is needed is consistent oversight of the standards and process for *shari‘a* boards.

4. Time is Money: Speeding up the Issuance Process

Many more corporations and governments would issue Islamic paper if the deal issue process were not so daunting. Yet improvements have been made. Today, if the regulatory framework exists, a full ratings advisory service is not required, and assets are easily accessible, it is possible to do a *sukuk* issue within 6–8 weeks. Marketing and road shows are also now easier and faster to arrange. In contrast, the Islamic Development Bank issue took 15 months to execute, and the debut Government of Malaysia issue was under planning and discussions for about a year. The additional legal costs of a *sukuk* issue as compared to a conventional bond are $40–50,000. This is much lower than earlier levels, but still an impediment to some issuers. Both the improved time and cost efficiencies are due in part to increased familiarity of bankers, lawyers, and rating agencies with *shari‘a* considerations, as well as increased competition for Islamic transactions among banks. *Shari‘a* scholars are increasingly familiar with conventional capital market considerations as well.

Despite these improvements, there is still a long way to go before an issuer can tap the market on a *sukuk* format as opportunistically as can be done in a conventional bond. Turkey is a good example of an Islamic country that can execute a long dated, conventional benchmark issue within 24 to 48 hours through its shelf program. From a structural perspective, the same can be achieved through an Islamic EMTN program and a pool of assets being available “on tap.” Although no one has yet taken the initiative to develop and implement such a template, it will likely happen in the future. Such an initiative would go a long way to address the chicken-and-egg issue of lack of issuance and lack of liquidity.

5. Broadening the Market Requires Continued Outreach to Non-Islamic Players

There is little doubt about the explosion of Islamic-dominated institutions, from the first one in 1975 to the over 300 in existence today.[3] In addition to the private participants, the asset class includes—as both issuer and investor—governments, social security systems, central banks, pensions, and investment authorities. Less noticed but essential for the growth of the sector is the issuance and purchase of Islamic assets by non-dedicated players. Indeed, with its maturity, Islamic finance now needs to be seen as an asset class that includes a wide range of investors and issuers, including anchor-dedicated investors, (non-dedicated) banks with Islamic accounts, and high-net-worth investors. The participation of each depends on the others. For example, the presence of anchor-dedicated Islamic institutions is often critical to generating interest in distribution to retail systems. Policy should encourage the continued broadening of the asset class, and set policies with an eye to avoiding fragmentation or compartmentalization of investors or instruments. To reach the next stage of development the following steps are critical:

- Non-dedicated investors need to be drawn to the market by their interest in exposure to regional governments, energy, or infrastructure projects, all of which are inherently Islamic finance friendly.
- Somewhat paradoxically, an important part of the future success of the Islamic market will depend on its ability to grow issuance and interest from non-Islamic issuers. Be they Western governments or energy companies, the Islamic market must convince non-Islamic issuers to embrace the Islamic market as an incremental pool of capital. It should describe itself as it does the Japanese Yen market.[4]
- The broadening of the market should stimulate greater competition on both sides of the market, with the consequence that there should no longer be high premiums for Islamic structures. This will also support the development of an active secondary market for trading, as discussed further below.
- The product range should be increasingly broadened, and there should be innovation particularly with high-net-worth individuals and retail clients in mind.

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[3] Mohammed El Qorchi, "Islamic Finance Gears Up," *Finance and Development: A Quarterly Magazine of the IMF* 42 (December 2005).

[4] In 2004, Citigroup underwrote the first non-Muslim government issuer to tap the global Islamic debt market with the 100 million euro *sukuk* issue by the German State of Saxony-Anhalt, an issue designed to broaden the government's range of issuers.

- We need the non-dedicated "street" to follow firms like Citigroup and HSBC in establishing dedicated teams of experts with the ability to operate effectively in both Islamic and conventional markets.

While less government involvement in markets is generally better than more, there is a compelling case for governments to play a limited, focused role in promoting the widening of the market. This brings us to the sixth building block.

6. Governments have a Role to Play in Signaling a Commitment to Islamic investments

The governments of Bahrain, Qatar, Malaysia, and Pakistan have encouraged Islamic financing with the issuance of sovereign *sukuk* and are leading a variety of initiatives. This is leading to other governments realizing the potential and also following suit. Recently, Turkey, Indonesia, and Brunei have indicated their intentions to issue Sovereign *Sukuk* and get involved in a variety of Islamic banking efforts. Brunei is finalizing its first sale of Islamic debt in a bid to develop a local Islamic bond market. Governments will likely be the core of the issuance market in coming years.

7. Liquidity, Liquidity, and Liquidity

We should not underestimate the importance of liquidity in bringing Islamic finance into the mainstream. Most of the early international issues of Islamic instruments have been purchased by buy-and-hold investors, which will not generate an active liquid market in which investors are confident they can sell if and when they see fit. For example, *sukuk*, which are structured to be listed and traded in the secondary market, actually have quite limited trading activity. The imbalance in the supply of Islamic paper versus huge demand creates a buy-and-hold gridlock.[5]

How do we get key institutions to trade the instruments? Increased supply is critical, but is only part of the answer. Governments and central banks that hold a significant portion of the outstanding Islamic paper can do more to attack the problem than they presently are, and work to create an environment in which efficient trading can take place. Central banks

[5] *Murabaha* (a purchase and resale contract in which a real asset is purchased by a bank at the request of its customer by the supplier) is more actively traded, providing greater liquidity at the short end. Yet in this case as well, banks tend to hold the bulk of the assets acquired.

can help by initiating secondary market trades. It would then be up to the street to sustain and nurture the market.

A good example of illiquidity in the secondary market would be a comparison of the Kingdom of Bahrain's $250 MM *sukuk* in 2009 with their $500 MM conventional issue in 2008. Both issues are FRNs. The conventional bond trades to the tune of $250 MM in annual turnover and so one might expect the *sukuk* to have an annual trading volume close to $125 MM. Yet it barely reaches $50 MM. As far as examples go, this is among the best in terms of liquidity. Furthermore, we often find banks quoting bid and offer prices based on an estimate of where the bond would trade, rather than an actual observation of levels at which trades have been executed.

There are already concrete examples of liquidity being bolstered by government initiatives. Bahrain's Liquidity Management Centre (LMC) has been set up to allow Islamic institutions to manage their liquidity through short and medium term liquid investments structured along Islamic lines. The LMC has recently launched an open-ended Short Term *Sukuk* Program (STS) of US $100 MM as of September 2005.

8. Overcoming the First-Mover Disadvantage can Justify a Government Role

A signal of support from governments can play a valuable role in overcoming "first-mover disadvantages." Conversely, any sense that governments are not supportive can have a chilling effect. From energy to infrastructure, governments can help overcome impediments to innovation. For example, for many years it was thought that any country introducing collective action clauses into debt contracts would be punished in the markets. However, once international support mobilized behind the innovation aimed at making debt rescheduling easier following financial distress, markets readily accepted them and there was no measurable premium paid.

9. The Future of the Market Depends on Continued Innovation

Innovation is key in any market, and even more so for Islamic finance. Meeting the demand for innovative and efficient solutions from both issuers and investors requires that we continue to strive to make Islamic products more acceptable and cost efficient. At the same time, it is necessary to create new products by listening to our customers, and arbitrage the best innovations from mainstream markets. Below are a few promising areas for innovation:

- Project finance and infrastructure represent significant opportunities, reflecting the desire of investors for long-dated assets as well as the desire of governments to leverage private markets in the provision of critical public goods. Several recent energy-related project finance deals containing Islamic tranches have been closed, and have proven popular with non-Islamic banks. Further innovation should help extend the acceptance of these products among dedicated Islamic investors.
- Structured products, including real estate and mortgage securitization, is another area of rapid innovation, reflecting the judgment that the monetization of these assets could become an important source of liquidity in the coming years. It is expected to increasingly see real estate used not just to “Islamatize” a transaction, but also used as a “real” security.
- Derivatives are likely to be a key feature of future product development, with an early focus on investors with significant exposure to commodity price or interest rate risk (the latter through a profit rate swap). For governments that have been appropriately conservative in the early years of this market, there is an understandable hesitation to embrace derivatives. They do require that the investor and supervisor have strong risk management and credit systems in place, and give careful consideration to the risks. At the same time, derivatives can play essential risk shifting, mitigation, and diversification functions. While arbitrage and short selling are not acceptable under *shari‘a*, other products have been allowed in some cases; notably, transactions involving the purchase and sale of debt contracts in secondary markets (Malaysia). Well designed, each of these functions is consistent with the spirit of Islamic finance principles.
- Domestic money market innovations are critical to increase the effectiveness of monetary policy. These innovations include Islamic profit rate swap products, Islamic CDOs, and FX hedging instruments. One concrete example of innovation in this area is Islamic repos: one regional central bank will soon launch the Gulf Arab region’s first Islamic repo transaction as a way to manage liquidity in the Islamic debt markets.
- It is likely that as we progress on many of the issues discussed here, the number of multi-tranche transactions will explode. The compression of the documentation period to more closely approximate that of conventional transactions will eliminate a major break on issuers adding an Islamic tranche to other conventional tranches.

- Finally, there is growing talk about hedge fund products, including a fund of funds, and while it is in the early stages, there is reason to be optimistic that these products will develop further. A balanced fund of equity and debt would likely be well received, but a number of technical challenges remain, including that of identifying enough *sukuk* to put into the fund. So we are back to liquidity.
- Local markets and local currency issuance is currently a hot topic in global markets, and talk of reducing "original sin" through liability management trades into local currency debt abounds. In this regard, governments can take advantage of their home market local currency Islamic demand. Consider the example of Malaysia, where over 90 percent of the capital market issuance is in local currency, and half of that issuance is Islamic. This trend should spread across other markets.
- Many observers might be surprised if innovation in the consumer product space surpasses that of the institutional side. Yet it is possible. International bank operations for the Islamic consumer are already quite profitable, and some banks are very focused on this opportunity. Local conventional banks in Muslim countries are focusing their efforts on Islamic consumer products, such as Islamicaly structured mortgages, personal loans, savings products, credit cards, and insurance.
- With the introduction of new Basel capital rules globally in the next few years, and against the backdrop of a rapidly expanding market, corporates will demand instruments that address their growing capital needs, including Tier II issuance and Tier I hybrid instruments. These equity-driven investments should be inherently *shari'a* friendly but will also depend on how regulators treat Islamic bank capital.

Many of these innovations will be aimed at pension funds. There are a number of opportunities for Islamic finance in the pension fund arena, given the desire of such funds to diversify and raise performance, and the scope for massive growth. Insurance also remains an area of potential innovation.

10. International Banks Can and Should Play a Major Role in the Innovation Charge, but They Will Not be Alone

Citigroup remains strongly committed to the growth and development of Islamic finance. Recently, Citigroup and Dow Jones launched the first Global Islamic Bond Index. The launch of the index is in line with Citigroup's global strategy to offer Islamic issuers and investors world-class and innovative products that contribute to expanding the frontiers of Islamic capital markets. The long-term strategy of the index is to unlock the global potential for Islamic bonds. The index is seen as the first step toward standardizing the criteria to measure the performance of global bonds complying with Islamic investment guidelines.

Global banks, with their broad product platforms and diverse international experience, are well positioned to lead the innovation charge. For these large banks, the cost of innovation should be lower than a dedicated Islamic bank, as they begin with and can leverage existing conventional product know-how. For example, Citibank's innovative issuance of an Islamic CDO was based on the strength of its global platform for CDO products.

In addition to conventional and Islamic banks—local or global—and central banks, we expect pension funds and social security systems to emerge as important demand and an innovative force. We will likely see international banks introducing innovation in derivatives, real estate, and securitization in the coming months and years with distribution targeted to the growing fund community, and this will create waves of new products.

CONCLUSION

It is an undisputable fact that Islamic finance has experienced immense growth in the past few years. Factors such as increased regional liquidity as a result of petrodollar influxes, a reversal of the negative biases that formed after 9/11, and a global rise in infrastructure investment are moving Islamic finance out from the position it once occupied of a discrete and isolated segment of the market and into the mainstream. It is now necessary for the various players involved to take steps that will encourage the field to continue on its path to success.

There is a need for greater standardization and regulatory alignment that should be achieved through the development of an agreed-upon framework. This framework must be flexible enough to accommodate the creativity and ongoing innovation that is characteristic of the field. In the same vein, it is necessary to have consistent oversight of the standards and processes for the *shari'a* boards that watch over this sector. There must be increased transparency in order to increase the depth, liquidity, and efficiency of the market.

A number of players can do more to carry Islamic finance into the future. Governments, while their role should be limited, can do more to signal their commitment to the field. Simultaneously, it is important that the market be broadened by appealing to non-Islamic players. Islamic finance needs to be viewed as encompassing a wide range of investors and issuers, including anchor-dedicated investors, banks with Islamic accounts, and high-net-worth investors. Undoubtedly, international banks have a role to play as well. With their wide international experience, global banks are well positioned to lead the innovation charge.

The challenges that will arise in carrying out these developments are enormous. It is a process that will take time and will require much innovation and creativity. Citigroup is committed to continuing as a leader in the development of the market for Islamic finance. We accept these challenges and approach them with great optimism. We look forward to working with public and private sector participants in the years ahead as we drive Islamic finance into the mainstream.