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.179-182

The Challenge of Reach and Richness in Islamic Finance

Iqbal Ahmad Khan*

ABSTRACT

The Internet continues to profoundly affect all businesses, particularly those in the evolving Islamic financial industry. This paper examines how informational economics is shaping the growing Islamic financial industry. A new business design that offers customers *sharīʿa*-compatible products in a much more convenient and cost-effective way is emerging, and this model will enhance the global reach of Islamic finance. Some of the practical ways in which the reach of Islamic finance can be broadened are explored, including the customization of information, interactivity among players, and reliability of information. As a new industry, however, Islamic finance must build enhance the richness of its products and services, a task that is fraught with challenges and that requires buying and commitment from regulators, investors, and issuers. Building richness also needs proactive collaboration between conventional and Islamic financial institutions. Finally, the paper analyzes the trade-offs between reach and richness.

I. INTRODUCTION

Islamic finance is a growing industry, and it is important to examine its trends and to see how the reach and richness paradigm can be applied to it. It is essential to focus especially upon means of building richness, on the fundamental proposition that enhancing richness builds the industry, and takes it to the next stage in its evolution. The creation of an infrastructure and a review of industry efforts and community initiatives toward this must be made. Similarly, it is important to discuss the expansion of the reach of Islamic finance, and means of accomplishing this using the new technologies introduced in recent years. From such discussions, a clearer picture of the future of this industry may emerge.

II. THE LANDSCAPE OF ISLAMIC FINANCE

Islamic finance is an emerging product in emerging markets, an industry in transition along with the markets in which it operates. Jassar Al Jassar of Kuwait Finance House recently put the market size of the industry at $180 billion, with a growth rate of 15%–20% per annum. It is an industry that is broadening the ownership base and building a strong, vibrant middle class, thus bringing a hope of stability to the 1.3 billion Muslims of the world.

A. The Five Stages

In stage one we find countries such as Singapore, Hong Kong, China, and Azerbaijan, which are all studying Islamic finance as a concept. Islamic finance is relevant to them on two accounts: either they have large Muslim minority populations, and want to offer products and services based on this ethical concept, or alternatively these countries are in areas where neighboring countries offer this value-added product that they wish to explore. This exploration lays the foundation for Islamic finance.

In stage two, a group of pioneering individuals start converting the concept of Islamic finance into a reality, through the establishment of an investment company, a fund management company, or perhaps a *takāful* company. This brings together retail investors and high-net-worth individuals behind Islamic finance. Many Muslim countries and some OECD countries are now at this stage; examples include Algeria, Syria, Lebanon, the United Kingdom, Germany, and the United States. At this stage the regulators, community, and the financial service intermediaries have a dialogue; it is a stage of consensus-building and establishing a way forward.

The next stage sees the creation of both banking and non-banking Islamic financial institutions. Thus Brunei has the Islamic Bank of Brunei, the Islamic Development Bank of Brunei, and Brunei Haj Fund. Indonesia has Bank Mumalat, Morocco has Faisal Finance, and Turkey has its own brand of Islamic financial institutions. Included in this category are Qatar, Palestine, Bangladesh, and even South Africa.

In stage four begins the creation of mutual funds and the initiation of full capital market activities. Countries in this category include Malaysia, Kuwait, Bahrain, the UAE, Saudi Arabia, Egypt, Jordan, Pakistan, Iran

* Managing Director, HSBC Amanah Finance, HSBC Group, Dubai, U.A.E.

and Sudan. In this stage, Islamic financial institutions participate in increasing the embedded capital of their home countries, and Islamic finance tries to establish mainstream relevance in the markets in which it operates.

In stage five, capital markets develop fully. In this stage, issuers and investors get together and create the infrastructure for full-blown capital markets, i.e., market-making leading to secondary markets. This is the stage to which Islamic finance aspires today.

B. A Brief History of Modern Islamic Finance

The decade between 1970 and 1980 marks the early beginnings of Islamic finance. During this time the concept was first translated into reality by the pioneers of the field, including Prince Mohammed al Faisal al Saud of DMI Group, Shaykh Saleh Kamel of Al Baraka, and a number of other entrepreneurs and leaders. This is the period in which the Islamic Development Bank (IDB), Kuwait Finance House, Dubai Islamic Bank, and Faisal Islamic Bank of Egypt were created. During this time *murāba®a* was the instrument of choice, and most transactions under such contracts were at the short end of the maturity spectrum. Considerable strides were made resulting in the evolution of the *mu∞āraba* contract. At this time there were serious industry and macroeconomic impediments preventing these pioneers from venturing into new territory or tenure-stretching. This was also a period in which equities were a no-go area.

The next stage of the evolution of Islamic finance, the years between 1980 and 2000, has seen a gradual evolution of this growth industry. Covenant-based project-financing has become more common, and institutions practice tenure-stretching with 3, 5, 7, and even 10 years financing. *Istisnā'*, *ijāra*, *bay^c salam* and a combination of other melded instruments are used more frequently. Islamic financial institutions have begun to reach Euro Money league tables as arrangers and providers of finance. This happened primarily because Islamic financial institutions, like any group of investors, have their own unique perception of risks. Investors who are close to the risk understand it better and therefore price it better, and perhaps take a longer-term view. Islamic financial institutions have become among the leading providers of cross-border lines in a belt of IDB member countries, and have consequentially gained competitive advantage.

This period has also witnessed equities opening up as an asset class. A pioneering group of institutions has partnered with asset managers to move boldly into this field, to secure higher economic profits for customers. The second generation of Islamic financial institutions, such as the First Islamic Investment Bank, the Citi Islamic Investment Bank, Abu Dhabi Islamic Bank and many others have entered the market, bringing an enthusiasm for change and innovation. Islamic finance has finally established itself as an industry that is here to stay. When we look beyond the year 2000, we find Islamic finance operating in the economies of the OECD world, which are gradually opening up. The rulebook for Capital Marketing is being written. In this period it can be envisaged that Islamic finance will achieve mainstream relevance in the OIC world by increasing its embedded capital, and will establish itself as a niche product in the rest of the world.

III. "Reach and Richness"

For the Islamic finance industry to be successful it requires an enabling legal and regulatory environment, which is, regrettably, currently not available. It needs both local and foreign investors, of whom there is an abundance, investment and financing opportunities of which there is a shortage, and a competent management with performance incentives. The industry still has a long way to go for most of these.

We now move on the central theme of this paper: the reach and richness paradigm of Islamic finance. Being a growth industry, Islamic finance does not have the traditional conflict between reach and richness: it is a market of around $180 billion growing at 15% per annum, with revenue spreads of approximately 2%. New levels of reach and richness are therefore attainable. In order to build the richness profile of Islamic finance, first the extant richness profile must be analyzed. Then means of creating an enabling infrastructure in terms of macroeconomic, regulatory, and fiscal framework for Islamic financial instruments must be considered, and industry efforts and community initiative briefly looked at. Finally, the routes to richness must be examined, before addressing the issue of building the reach of Islamic finance.

A quick snapshot of the richness profile of Islamic finance reveals that products currently available include OECD *murāba®a*, emerging market *murāba®a*, emerging market credit-enhanced leasing opportunities, global equity funds, regional equity funds, principal-protected funds, *sharī^{c}a*-compatible themed funds based on either sector or country funds, and most commercial banking services. Other product propositions are available, including OECD leasing programs, private equity in OECD markets (such as an initiative by First Islamic Investment Bank), corporate finance advisory, and infrastructure finance. More quality issuers and a greater focus on *takāful* and retail banking products in OECD markets are needed. Products that may be seen in the future include OECD home financing, *sharīᶜa*-compliant money market instruments, and private equity in IDB member countries. This effort is being strategically led by the IDB through its subsidiary ICD and Gulf Finance House. Other new products include convertible *ijāra*, preferred shares, and variable risk securitization. Thus new frontiers keep changing with the evolution of Islamic finance.

IV. Routes to Richness

The history of the frameworks for financial instruments shows that the macroeconomic framework, the regulatory supervisory framework and the accounting framework have all been created for conventional financial instruments. Islamic financial instruments are generally not even acknowledged in the financial infrastructure and regulatory frameworks of IDB member countries and OECD markets.

Historically, Islamic finance has its roots in IDB member countries, which were generally emerging markets breaking free of their colonial legacies and searching for new economic models. Most chose state-control-based economic models. Thus Islamic finance had its roots in state-controlled macroeconomies with little room for private sector initiatives. Over the years, Islamic finance has adjusted to this framework and infrastructure, which have, themselves, expanded to accommodate Islamic financial instruments, but generally only on an exceptional basis. A mainstream industry cannot be build on exceptions alone, and therefore there is a need to create an infrastructure for Islamic finance in both IDB member countries and other markets with Muslim communities. Such a framework should include not the regulatory and supervisory framework for Islamic financial institutions, as well as deal with issues such as risk weightage, stamp duties, ownership covenants, withholding taxes on leases etc. Once this country framework has been created, it should be widened to create a cross-border framework through IDB and non-IDB countries. There is a need for global *sharīᶜa* standards, allowing products to migrate from one market to another without needing clarification. The initiative taken by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) to create a *sharīᶜa* standard for Islamic financial instruments is encouraging in this regard. The regulatory framework should take the unique needs of Islamic financial institutions and instruments into account. For example, Islamic financial institutions ought to be allowed to invest their statutory reserve funds according to their *sharīᶜa* investment principles. Similarly, Islamic financial instruments should be given a risk weightage no greater than that given to similar conventional instruments. This is essential to create a level playing field. The Islamic finance industry itself can build industry institutions such as accounting and auditing organizations, international associations, and programs such as the Harvard Islamic Finance Information Program (HIFIP). These industry initiatives are important as they will help to build the richness and the reach of Islamic finance.

V. Industry Efforts and Community Initiatives

The efforts of the industry and community, such as those of the pioneering *sharīᶜa* scholars who support efforts to build richness with their guidance and supervision need to be saluted. The leadership role of the Islamic Development Bank in establishing the ICD, the IDB infrastructure fund and its whole range of initiatives is also praiseworthy. The Bank has taken its role as a leader of the industry with great enthusiasm and seriousness. It is incumbent upon all industry members to support such initiatives. The Accounting and Auditing Organization for Islamic Financial Institutions is playing a pioneering role by creating the accounting and *sharīᶜa* standards for Islamic financial instruments. Similarly, community organizations such as the Islamic Society of North America and the Muslim Council of Britain play an important role in building awareness of Islamic finance and educating the regulators. It is important that a coalition of professionals, *sharīᶜa* scholars, and community leaders coalesce to talk to regulators, in order to take Islamic finance to the next stage of evolution.

The route to richness lies in affiliation and strategic alliances. There is an increasing need for research and developmental projects in which *sharīᶜa* scholars, leading universities, and practitioners should come together to pertinent issues. While there are a number of examples of this collaboration, more such initiatives are needed. Collaboration and partnership between the public and private sector, and between conventional and Islamic financial institutions is essential, as is the need for investors to partner with asset managers. The latter will allow for the transfer of technology and know-how from established institutions into the emerging world of Islamic finance. Additionally, attracting quality issuers is important for IDB member states and OECD markets alike. Good issuers have to be proactively originated, otherwise institutions will be confined to dealing with second-tier issuers.

There is a need to harmonize standards among institutions, and to take the best from conventional institutions. The most important route to richness lies with culture, people, and training. We can replicate tangibles but never intangibles. It is important to invest in people and their training, so that a strong, innovative, and open culture is created; a culture in which there is a realization that every business opportunity competes with Islamic finance, and the final competitors are the consumers themselves. It is time that Islamic financial institutions asked themselves what they are to do for consumers that they cannot do for themselves.

VI. Expanding the Reach of Islamic Finance

The reach of Islamic finance can be expanded by following several measures, including increasing market share in home markets, opening up new markets, reaching the unreachable and by embracing e-commerce. In order to increase market share in home markets, first and foremost practitioners of Islamic finance must build credibility. Creditability is built by creating a culture of transparency, *sharīʿa* credibility, earning power, enhancing legality, improving the quality of service, providing richness based on added value, and above all, educating customers. The market share of industry can be built by supporting industry initiatives such as conferences, seminars, workshops, associations, and research programs. It is also important to reach out to other communities. Islamic finance is rooted in inclusiveness, not exclusivity, and institutions must reach out to other communities and welcome them into the fold. Islamic financial institutions should strive to increase the embedded capital of the local market in which they operate. This can be accomplished by participating in project finance, and infrastructure finance, and by increasing the embedded capital of local markets. Finally, practitioners can increase market share by achieving mainstream relevance.

A second measure toward expanding the reach of Islamic finance is opening up new markets, which requires educating regulators, working with community organizations and supporting industry initiatives such as AAOIFI, the international association of Islamic banks, IAIB/IBC and programs such as HIFIP. It also requires working in association with credible partners, respecting local traditions and demonstrating a long-term commitment to new markets. These initiatives can pave the way toward improved growth and evolution.

To reach the unreachable, in this context, means to strive to tap markets that may seem difficult or unprofitable. Today there are significant Muslim communities in the United Kingdom, United States, Germany, France and India, which form the untapped markets of the future. Here institutions can adopt a partnering approach with local institutions that provide access to the markets, while Islamic financial institutions provide structure and the *sharīʿa* authentication.

This brings us to an extremely important initiative: accessing clients through the Internet and thus taking the issue of reach to a whole new dimension. Reach can be significantly enhanced by embracing e-commerce wholeheartedly and with total commitment. E-commerce is not about glittering Web sites and storefronts, but about connectivity and common information standards. There are opportunities in the business-to-business as well as business-to-consumer areas. Several new e-commerce initiatives have been launched: iHilal.com and islamiq.com are only two of the new entries in this field, as the third generation of Islamic financial institutions. It is essential that they all talk to each other to create common information standards and connectivity, and decrease searching and switching costs for customers.

A successful e-commerce proposition needs, first of all, credible shareholders who are committed to the industry. It needs to be an alliance of synergistic partners providing both reach and richness. It should be an enabling business design and certainly a "value for money" proposition, with low searching and switching costs. It should provide richness both in terms of the product proposition and services. It should certainly be very easy and convenient to use. Above all, a successful e-commerce proposition should be based on the partnership culture: partnership within the entity, as well as with clients.

VII. Conclusion

When one looks to the future, new levels of reach and richness are visible, and reachable. The current size of the Islamic financial market, around $180 billion, is just a beginning. Although there is much potential to enhance both the reach and richness of Islamic finance, major challenges in gradually building and enabling the supporting framework persist. Meanwhile, the Internet offers new opportunities to expand the reach of Islamic finance.

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