Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp. 277-280

Islamic Finance in the Contemporary Context

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I. INTRODUCTION

There is a popular perception that after the tragic events of 11 September 2001, Islamic finance came under intense scrutiny—a view that is disputed by many practitioners. In view of these perceptions, and the new circumstances in the international economic climate, the Fifth Harvard University Forum on Islamic Finance held a special discussion panel on the impact of recent events upon this young industry in early 2002. Both practitioners and academics were among the speakers: the session was chaired by Professor Mahmoud A. El-Gamal of Rice University, and participants included Fred Crawford, James Godec, Iqbal A. Khan and Abdulkader S. Thomas, representing the industry in both the United States and Europe.

II. THE IMPACT OF 11 SEPTEMBER 2001

The attack upon the World Trade Center, with its horrific loss of life, caused a shift in American domestic and foreign policy that, it was widely feared, would have a negative impact upon the overwhelmingly law-abiding Muslim population in the United States and elsewhere. When a number of Islamic charities were investigated for suspected links to terrorist organizations, a number of questions were raised about the Islamic finance industry: Have potential customers decided to stay with conventional banking? What are the trends in terms of flight of capital? If Islamic finance has indeed taken a hit, how may losses be cut and confidence restored? And more generally, in what measures does the industry's future growth lie?

The speakers were unanimously agreed on one point: the rumors of the death of the Islamic finance industry were greatly exaggerated. Despite such inflammatory headlines, in both the Western countries and the Middle East, as "U.S. Campaign Attacks Islamic Equity Funds," "Muslims Seek Islamic Investments as Religion Seen Under Attack," and "Global Scrutiny Triggers New Interest in Islamic Banking," the industry has not suffered tremendously.

James Godec identified three primary concerns among investors in the Middle East. First, there was the fear of assets being frozen: people were afraid that money invested in the United States risked loss. The extent of capital flight is not clear, with some claiming that as much as tens of billions of dollars in Saudi Arabian money had been withdrawn. This flight, whatever its extent, however, was certainly not permanent. Fears of the USA Patriot Act were allayed once Gulf financial institutions learned the new procedures and familiarized themselves with the new environment. Indeed, the demand to invest in the United States, as well as to find new products for capital that had stayed in the country, continued unabated. The need of the hour, then, is to find relatively low-cost products that meet the test of new U.S. products, without a complicated overlay of structuring requirements.

Second, there is a sense of anger at the policies of the United States government. Many institutions were actively trying to discover whether retail investors were willing to continue investing in real estate in this country. While there was some effect, it was by no means as dramatic as had been feared, particularly as the anger was felt to be directed at policy rather than the country or its people.

Six months before the Forum, in late 2001, the economic downturn also caused some alarm, particularly in conjunction with 9/11. By early 2002, however, these fears had been partly allayed. The losses of the two previous years affected both conventional and Islamic institutions indiscriminately, and market conditions and manager performance are as important an explanation for any drops in investment. At the end of the day, as Abdulkader Thomas pointed out, investors are aware that the best economy for the dollars that

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dollar-exporting economies in the Middle East cannot absorb, is still the United States. A recent consumer confidence survey of the top Middle Eastern clients, for instance, has consumer demand at an all-time high.

Fred Crawford, an advisor to the National Commercial Bank, corroborated this. Among the U.S. and U.K. institutions dealing with high-net-worth individuals and retail clients, there are some steady outflows going to Switzerland, or back to the country of origin, but the outflows were certainly not out of the ordinary. The National Commercial Bank's largest fund, the Global Trading Equity Fund, for example, saw outflows of less than 10%—less than the outflows from comparable conventional global funds, such as Fidelity, Janus, or the Massachusetts Financial Services.

Ibrahim Warde commented from the floor that the integration of Islamic finance in the global economy has slowed. Many conventional institutions that intended to start windows or products have suspended these plans temporarily. Secondly, the USA Patriot Act has affected correspondent banking negatively. Most western institutions have reviewed their relationship with banks in the Islamic world carefully, and as a result many Islamic institutions have suffered. Moreover, the focus on money laundering after 9/11 has been misguided, and resulted from earlier experiences with the drug industry. When targeting money laundering, the objective is to cut off the sources of money, but it is known that the entire 9/11 operation cost only $200,000-500,000, a very small amount indeed, when divided among twenty participants. In response El-Gamal pointed out that the U.S. Secretary of the Treasury Paul O'Neill had said the informal financial network of terrorism must eventually come in touch with mainstream financial institutions, and the point is not to block the flow of money, but to trace the trail back to where the money is coming from, once it comes in contact with institutions.

Thomas and Godec argued that the conventional banks backed away from Islamic finance for entirely different reasons, and that the timing was coincidental. When only a few large institutions are interested in investing just $50-100 million in the United States, it is hard to get the attention of the senior management of U.S. banks, dealing in hundreds of billions of dollars, who have never heard of Islamic finance. A consolidation of the Islamic finance industry would help create a greater presence, as would more strategic relationships between U.S. and the Islamic world.

9/11 had an impact upon Muslim charitable institutions, many of which came under strong scrutiny. Financial institutions are increasingly donating only to the safest charities, such as the United Way, or the Red Crescent. As Islamic finance institutions concentrate on conforming to standards, so too do charities and the organization of *zakat* distribution, including an accounting of which institutions do and do not pay *zakat* on behalf of their clients. More attention is paid now to who customers, investors, and retail investors are and where the money flows. Even before the terrorist attacks, there were initiatives to streamlining and rationalize charitable donations, particularly among multilateral institutions, such as the Islamic Development Bank. The IDB is looking at providing investors with the opportunity to make donations to *waqf* (*awqaf*), and has created a Waqf Fund, and also offers services such as the distribution of meat at Eid al-Adha.

III. Scrutiny and Regulations for Islamic Finance

Abdulkader Thomas, an independent consultant based in Washington, D.C., identified a problem endemic to the Islamic financial industry: the lack of scrutiny. This scrutinizing is important across the board after the turmoil of the Enron scandal. It is especially important for the Islamic financial industry, in order to restore confidence after 9/11. Even before 9/11 the Islamic financial industry was a weak industry: at first it lacked self-confidence, then it had not developed its own instruments sufficiently, and suffered from slow growth and little depth.

Who is watching the industry? The AAOIFI is recognized only within its own element, i.e., with the GCC countries and Malaysia. Since the AAOIFI is affiliated with the Bank of International Settlements, however, it has started to have a clear podium at the United States Treasury, the Federal Reserve Bank, and the Financial Services Agency. Thus its credibility is improving even outside GCC countries.

Islamic finance does not have the answers that the conventional industry lacks, Thomas said: it can do nothing in the face of tricky accounting, or collapsing currencies, or tax management. With perverse derivatives, however, it possesses an advantage. In the Enron case, long-term capital management had serious effects. Enron had volunteered to be the last holder of all risk, which proposition was very agreeable to everyone in the derivatives market—this resulted, of course, in disaster. Similarly, long-term capital management had made the reasonable assumption that over time, credit for any country that joined the Euro would be convergent—an assumption that caused some distress in August 1998. With Islamic finance there is the advantage that it is asset-delimited. It is not dependent upon differentials in credit pricing, or on taking the last element of risk. Assets, El-Gamal corroborated, do not give a high rate of return in a boom market, and are thus unpopular among conventional institutions. They are, however, the best protection against reversals in the market.

IV. INDUSTRY FRAGMENTATION

In response to a question from the floor, James Godec remarked on three layers of fragmentation that make it difficult to do business. The reliance on different schools of jurisprudence makes it difficult for institutions and *shari^c^a* boards alike. The regulations of different countries often vary widely, practically forcing the industry to fragment. And finally, there is the problem of verticality: many banks are controlled by families, who are often unwilling to give up control for greater consistency, which would benefit the customers the most.

Fragmentation, El-Gamal said, has both advantages and disadvantages. In the short term it may be profitable, as a bank can dominate a niche of the market. Once an institution has developed an instrument, it does not wish for others to capitalize on its innovations. So while an easier environment is desirable for newcomers, the older institutions who have sunk the costs in creating that environment do not want to allow others in just yet. Godec gave the example of Key Bank, which spent three-quarter of a million dollars in legal fees alone to create the *istisna^c^-ijara*, and added that Gulf-based institutions had actually been suspicious of attempts to syndicate interests in construction loans using this instrument. Thomas advocated the creation of industry associations in order for providers to negotiate, and to establish standardized instruments, and agreements on how to approach problems, even in highly competitive markets. Consumers need a common literature, no matter the disagreements of the providers.

Khan added that fragmentation is a function of the development of the market: every market starts with a degree of fragmentation. With time, however, the consolidation increases, as is already the case in Bahrain. The entry of multinational banks also has a positive effect on fragmented or niche markets: it gives them mainstream relevance, increases the shelf-space available for niche products. Moreover, as a multinational, there is an awareness that the industry rules must be respected, and if one adds value to that industry, one's own business grows.

V. INNOVATIONS

Iqbal Ahmad Khan, of HSBC Amanah Finance, attested to a positive increase in interest in the Islamic financial sector after 9/11. Regulators, as before, wanted a community banking initiative focused on the Muslim community to be brought out in a timely and effective manner, and in the United Kingdom, the Bank of England and FSA were very supportive of community banking initiatives. There were more requests for presentations to regulators in the six months after 9/11 than ever before. The speakers strongly advocated a focus on Socially Responsible Investing (SRI), which is an increasing concern in many countries, and which would help to break down the mystique of Islamic investment. A recent Euromoney conference on SRI did not have a single representative from the Islamic financial industry. Khan attested to a strong interest in corporate social responsibility in the United Kingdom, where the Labour MP Tony Coleman heads an all-parties parliamentary committee on the issue, and the Church of England has a movement for interest-free banking.

Similarly, there is a trend toward increased institutionalization and regulations within the industry itself. The creation and consolidation of the AAOIFI and its *shari^c^a* board, creating uniform standards, are instrumental in blurring the line between institutions in Malaysia and the Gulf. Thus in the debt capital markets, for instance, there has been a meeting of minds. The Financial Services Board and the Accounting Standards now focus on the financial treatment of Islamic instruments, to make sure they were treated the same way as conventional risk weightage.

The importance of secondary markets has long been recognized, and the infrastructure and instruments have finally started to become a reality. This important area of growth was aided by the increased regional liquidity, since equity markets had not been doing well in Europe and the U.S., and led to a boom in infrastructure in the Middle East. Tenures have been stretching, and Islamic investors and institutions, previously confined to 5-7 years, are now looking at 10-12 years. There is a greater appreciation of the need for active *shari^c^a*-compliant debt-capital markets. At present total issuance in the Middle East is still low: less than 2%, compared to 15% for East Asia, 25% for Europe, and 65-70% of all financing in the United States. The first issuance of *sukuk al-ijara* came from Malaysia, and the first sovereign issuance from the Bahrain Monetary Agency. *Sukuk al-ijara* is clearly acceptable to investors, and more quality issuers need to come forth. Both investors and issuers are looking for more paper issued by leading sovereigns, public sector companies, etc. Ultimately there should be a yield curve for Islamic financial instruments, filling an important gap for portfolio managers, who presently do not have *shari^c^a*-compatible securities instruments.

A question was raised about the extent to which small debt markets in Muslim countries are attributable to a lack of Islamic markets, versus a more general lack of capital markets. Malaysia, for instance, has a vibrant conventional market, and good Islamic capital markets, while Pakistan has an insignificant (though growing) conventional corporate debt market, and a huge government debt market. While there is now an Islamic ratings agency, there is no developed network of primary and secondary broker dealers who can trade in the instrument, and good quality issuers such as large public sector companies or multinationals, which would produce a yield curve of similarly rated paper in the Islamic world. With some developing countries, such as Pakistan, the problem is compounded by the fact that the government is such a large borrower that it crowds out corporate borrowers.

Linked to the need for an emphasis on debt markets is a realization within the industry that it needs to focus on learning and innovation. The artificial boundary between scholar and practitioner needs to be blurred: *shari^{c}a* scholars must learn more about the markets, and practitioners need to know more about the roots of Islamic finance. Similarly, the need for innovation is acute. Recognizing that the future of Islamic finance depends upon its innovation, the Islamic Development Bank has set up a financial engineering board. The urgency is only enhanced by the crises of the global economy in the past few years. Innovative instruments, such as tuition financing, are urgently required.

VI. CONCLUSION

It is clear that while 9/11 had an inevitable impact upon the Islamic financial industry, it was by no means as strong as had been feared. Indeed, other events such as the Enron scandal and the global recession were quite as important in shaping the state of the industry today. The participants in the discussion agreed that Islamic finance should grasp this opportunity for self-reflection, and consider how it may develop further. Due to its unique position as a developed form of SRI, and the increased interest across three continents, Islamic finance stands poised to become a leader in global finance. The need for consolidation and cooperation, for transparency, and most of all, for innovation, has never been greater.