

Challenges and Risks of a Fragmented Islamic Finance Market
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Islamic Finance Market

Modern Islamic finance is a young but vibrant sector of global finance. Its growth rate of 15 to 20 percent over the last few years and suggestions for the future rate of growth of 30 percent raises concerns due to the fragmentation of the sector. It still remains uncoordinated, un-standardised and a collection of operations in pockets in Muslim countries globally. This growth, however, underscores the fact that the Islamic Finance system has taken roots and is becoming an alternative form of finance and an integral part of mainstream finance.

Islamic banking today represents merely 1 per cent of global banking assets, however, it is expected that this rapid rate of growth will continue for many years subject to the various factors that drive this momentum including economic and political factors.

Islamic finance has grown in size and complexity but displays signs of fragmentation and disharmony that has raised risk issues which need to be addressed to ensure a robust and sustainable sector.

Fragmentation

It is recognised that there is considerable potential for Islamic finance but the perception that the sector is too fragmented to positively mine the liquidity assets that are in the sphere of Shariah compliance remains. This begs the need to ensure a convergence and connection between the various diverse factors influencing this sector to make Islamic finance a credible and serious alternative offering in global finance.

The problems of fragmentation emanate from the different interpretations, lack of standardisation of contracts and harmonization of the Shariah Scholars opinions which puts hurdles in the path of the globalisation of Islamic finance. Only overcoming these hurdles will put Islamic finance as a true alternative in the global market place and enable it to take its relative share of global finance. There are a number of tried and tested products that could be standardised and established as valid in all markets with local jurisdictional and tax regimes requirements incorporated as and when necessary, these could be implemented in the first instance.

If one considers the statistics regarding the Muslims in the world we can see the depth of the potential versus the actual marginalisation of this population and its impact on global finance. There are 57 OIC (Organisation of Islamic Countries) countries with a population of 1.5 billion and a GDP of US\$17.7 trillion, whereas making only a 12.8% of global GDP and 3.3% of global market capitalisation. With the lack of finance facilities and products this population is under served and therefore not fully participating in world finance.

Now this leads to the need for the OIC members and their regulators to take on the task of integrating the Islamic markets through facilitation of developing and acceptance of common standards for all manner of financial interaction such as transparency and corporate governance based on these standards and harmonization to enable the ability for all players in

the global market place to work from the same page. This would enable the sector to grow as an internationally accepted alternative via cross border offerings under the same rules for disclosure, debt securities offering rules, distribution rules for IPOs, adherence to International Accounting and legal standards.

Challenges

Mohamed Nedal Alchaar, Secretary General of AAIOFI, acknowledges that a lot more needs to be done. “The industry has to be standardised – otherwise it will be local. For it to be a real viable alternative system it needs harmony. You cannot have a product be one thing in Bahrain and another in Malaysia,” he says.

The growth is phenomenal and the industry is still opaque, which raises concerns regarding the need for formalised regulation and supervision.

Solutions need to be innovative to better the tradability of these products so as to enhance liquidity and improve asset-liability management, products need to include changes in the dynamics of the market. It is inherently obvious that Islamic financial instruments without markets will inhibit development, and therefore this development is essential for proper risk management as well as for cash-flow management. Once the primary markets have been developed sufficiently there is a need for a sustainable secondary market and that part of the equation still remains lacking to enable the Islamic finance sector to be a credible alternative.

For the success of Islamic finance it is imperative to address some of the key challenges facing the industry, there needs to be a critical mass to develop solid pricing benchmarks, human resources are required to meet the expertise, experience and talent pool demands that will be faced by the industry to sustain the long term growth that is anticipated. This means training programs for all the players, including the increase in effective Shariah Scholars, in the value chain need to be created to efficiently manage the risks, internationalization, and the production of professional qualified practitioners in the field of Islamic finance. This will also require the establishment of institutional infrastructure and standard setting and regulatory bodies. Much of this exists in the conventional sector and the aim should be to find ways to align it with the Islamic sector to create a global finance offering that meets the needs of all the utilisers of finance and Shariah for the Islamic finance’s alternative delivery.

Dr Frank Vogel of Harvard University at the 8th Harvard IFP forum in April 2008 stated in his presentation that for a proposed law to be considered authentic it must be grounded in the Quran and the Sunnah, and as there are only a handful of verses in the Quran that deal with issues relating to finance it becomes essential to innovate. Due to the colonialist occupation period Muslim countries suffered the tension between authenticity and innovation because of the imposed sweeping legal reformulations which destroyed the ability of *fiqh* to adapt to change at a time when rapid change started to happen in western societies. This then led to abnormality in the balance between Shariah authenticity and societal alterations, and was replaced by a gap between modern life and the provisions of Islamic law.

Risks

The rapid growth of the sector in benign credit times has left a number of risk related issues that need to be contended with. These risks come in the form of variance in Shariah opinions, jurisdictional and tax implications as well as standardisation of documentation to ensure acceptability in a global perspective. The regulatory requirements need to be in place so that the products can be applied and utilised globally to engender the robustness and sustainability elements for a viable alternative offering in the context of finance universally.

One can concede the fact that in its formation stages Shariah standards were fragmented as different regions adapted and initiated Islamic finance at different times and therefore the domestic perspective was at the forefront in the Shariah thinking and were created with those jurisdictional legal and tax considerations.

The creation of institutions such as AAOIFI (the Accounting and Auditing Organisation for Islamic Financial Institutions), IFSB (Islamic Financial Services Board), IIFM (International Islamic Finance Market), and LMC (Liquidity Management Center), etc., was just for this purpose to create a supervision and regulatory framework for the entire industry, by appointing Shariah Scholars from diverse jurisdictional schools of thought, so as to be able to generate a strong offering that with a semblance of standardisation can be competitive and cost effective as a bona fide alternative to the conventional finance products.

Specific supervision and regulation for Islamic banks globally still needs to be implemented with only Kuwait and Bahrain issuing separate regulatory regimes for the sector.

Islamic banks need to become more aware of the advantages of diversification and thereby the risk on their own balance sheet. At the same time the investor base of Islamic finance has become more sophisticated rather than relying on the plain vanilla products of the retail end of the market, such as deposit accounts, real estate products, commodity murabahas and equity funds etc., to place their funds. As the availability of more complex and exotic capital markets products increases, such as second generation liquidity management tools and structured products, investors are keen to partake of them. Western bankers faced with the current crisis are now “turning to face Mecca” and have realised lately that many of the concepts which have been developed by them in other fields can be applied to Shariah-compliant products. The conventional finance market is exclusive in the sense that Muslims are excluded from participating in their offerings, but Islamic finance is inclusive in those terms and therefore offers a larger market for these products.

As a rapidly growing area of finance, the sector is fragmented and opaque but can often produce high margins, particularly where products are not commoditised. This is a means of attraction for International banks and with standardisation this will encourage the take up by many more investors. However, it is just this sort of rush that needs an awareness of the pitfalls that can exist without regulation and monitoring.

The efficient management of risk is a prime consideration. Risk is now a defined and separate managerial decision along with risk transfer innovations to assist the efficiency of risk-diversification. Risk strategies can be adopted from conventional finance that meet the Shariah criteria for a more effective management of investors funds. With the nature of risk-sharing in the Islamic finance model can enable the mitigation of poor lending practices and instill greater discipline.

The Scholars are also concerned with the rapid growth of the market and to ensure Shariah compliance is adhered to throughout the processes and In this regard Sh. Nizam Yaquby has cautioned about the difficulty of giving blanket pronouncements for a wide range of products.

Solutions/Conclusion

Having considered the state of affairs of the sector, integration of its various components needs to be undertaken to work towards achieving greater collaboration initially in the OIC countries and then the other international arenas. More strategies such as the initiative jointly promoted by the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB) for their 10-year Framework & Strategies to develop a complete, robust, sustainable, scalable and innovative Islamic financial services industry that is truly integrated within the international financial system, need to be taken.

Further, even though International Islamic institutions such as the IFSB and AAOIFI have attempted to provide guidance and harmonisation leadership, with the considerable expertise built up in Malaysia more collaborative initiatives are the need of the hour, especially in the areas relating to follow-through on providing much needed clarity and consistency on the interpretation of the Shariah principles and their application to Islamic products. Education and awareness programs must be undertaken by the regulators and financial institutions in educating the public about the principles including the risks and benefits of Islamic banking.

The U.K. government announced draft legislation to enable companies issuing Shariah-compliant bonds to avail of the same tax relief as those issuing conventional bonds, by permitting them to offset the coupon payments on the securities against the company's profits in terms of corporation tax. It even removed double stamp duty on Islamic residential mortgages and commercial property loans. These events need to be replicated and adopted globally, both in Muslim and non-Muslim nations and this is where Islamic Finance will enter the international finance arena.

Dr Shamshad Akhtar, Governor, State Bank of Pakistan (SBP), has said the Islamic financial services industry needs to consolidate itself to be able to better compete with global players through achieving scale efficiency and cost effectiveness in addition to rapidly building its capacities to standardise regulation, supervision and accounting practices, while strengthening the governance of the industry.

In the current world-wide financial crisis the Islamic financial industry has generally remained insulated mainly because Islamic banks' transactions are backed by real economic transactions and risk management benefiting from the application of and compliance with Shariah principles. This positive of Islamic finance needs to be communicated to finance practitioners generally and to the investing public. Economic theory clearly states that the higher the risk the higher the reward. Islamic finance is more cautious and does not experience similar volatility as conventional finance.

The Islamic financial sector is in a unique position to bring financial innovation and stability to global finance as long as it is correctly nurtured and developed to conform with internationally accepted, tried and tested prudential and regulatory frameworks.

Islamic products are akin and therefore of considerable interest to investors that have

a leaning towards offerings that are ethical, socially-responsible and environmentally-friendly.

Islamic countries have to take on the responsibility to integrate their Shariah-compliant financial systems within the international financial system to ensure that where capital markets are concerned, rules should, as far as is possible, be harmonised, in line with globally accepted standards and best practices, while retaining adherence to Shariah principles and criteria.

Regulation and monitoring development is essential to ensure the smooth functioning of Islamic financial institutions, but at the same time the relevant authorities should not constrict but rather facilitate growth. They must also encourage the development of new and innovative products that can compete with conventional products and contribute to functional markets.

Sources:

Dato' Zarinah Anwar, Chairman, Securities Commission Malaysia, at the 5th Islamic Financial Services Board Summit, Amman, 13 May 2008, Amman, Jordan

Dr Shamshad Akhtar, Govenor State Bank of Pakistan, as the Chairperson of the Islamic Financial Services Board (IFSB) on “Financial Globalization and Islamic Financial Services Industry” at the 5th Annual Summit of the IFSB held in Amman, Jordan