

The Demand for Islamic Finance in Today's Economy

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Introduction

- Islamic finance is essentially a set of financial activities that conform to principles found in the Quran (command of God encompassing all aspect of human life) and the Hadith (the words/actions and acknowledgement of Prophet Muhammad) known as Shariah delivered more than 1,420 years ago, which to the surprise of many are the same as contemporary business and economic principles found and practiced in today's modern day business environment. Some even found that the business principles and economic theories expounded and introduced by modern economist and business gurus were already expounded and explained in quite detail much earlier in the Quran and Hadith.¹

The demand and growth for Islamic finance and banking exists for a number of reasons. These are due to the cultural and historical changes that have resulted post World War II with the independence gained by a number of former Muslim countries that had been colonies of the west. This self realization of religious and cultural identities, national development of demographic trends and the increasing incomes backed up by development of products, standardization developments and alignment with global regulation has all contributed to the rise of this sector.

The current economic crisis has highlighted the flaws and shortcomings in the conventional banking system and also resulted in the deleveraging of sovereign funding problems due to austerity programs to contain the debt exposures of the conventional markets. These countries are looking to Islamic finance for alternative funding of their programs based on Islamic debt. Here the Sukuk products will grow considerably both for sovereign and corporate debt.

According to the report "Global Islamic Banking – No longer unconventional" by Deutsche Bank in November 2011

"Our analysis of Qatar, Saudi Arabia, UAE, Turkey, Malaysia, and Indonesia highlights the superior growth trends of Islamic banks, as well as significant opportunities in key market segments. Trading multiples of Islamic banks show only moderate premiums despite the industry's superior long term growth prospects. We see GCC-based Islamic banks as emerging global winners in light of their strong

¹ The key driver of Islamic finance – demand and supply by Badlisyah Abdul Ghani and Shamsun A. Hussian, CIMB Islamic

stand- alone brands, and of the capital-export model of their economies.”²

There has been considerable development on the regulatory side and of course, it goes without saying, a lot still needs to be done bearing in mind the nascent state of the Islamic finance industry. The Islamic Financial Services Board (IFSB) is continuously working on regulation and supervision issues while the Accounting and Auditing organization for Islamic Financial Institutions (AAOIFI) is developing both accounting and Shariah standards. The harmonization of these standards in parallel with conventional banking is going a long way towards addressing the application issues and understanding of products by all stakeholders on all sides of the finance sector, both Islamic and conventional, thereby making Islamic finance products acceptable in the market in general. Besides the growing awareness and understanding of Islamic finance and its products, the opening up of new markets within the Muslim countries is engendering the growth. One must bear in mind that the conventional finance market though larger in amount of monetary terms is exclusive (Muslims who wish to utilise on a faith basis are excluded), whereas the Islamic finance sector is inclusive (you do not have to be a Muslim to utilize it). If a like for like product is available at the same cost and providing a similar return with the added benefits of ethical, moral and social responsible layers, under the current bias of investors post the economic crisis will find ready takers of it.

There is no question that a multitude of opportunities exist in the various sectors of the Islamic finance industry; trade finance which is very much a Shariah compliant activity per se has taken a back seat in the recent past but is now returning to the fore, retail banking segment needs to provide access to Islamic finance to the growing demand from the burgeoning middle classes, as this segment of the market grows it requires home purchase financing which in turn benefits the Takaful industry almost by definition, as the infrastructure development in Muslim countries accelerates, the project finance arena has attractions, the development of the Islamic debt market or Sukuks are evident and now it is not just governments but corporates, both local and international, that are tapping into this asset class. The area of fund management is an obvious gap that needs filling and a number of initiatives are due to be launched in the very near future.

“At present the global penetration of Islamic banking below 2% in most of these segments, and is c.1% of total banking assets. We think these ratios can easily double in the coming five years.”³

The question that needs to be asked and answered is where have we come from and where are we going?

The paradigm shifts affecting the global finance and banking resulting from probably the worst economic crisis the world has witnessed to date includes the aspect of excessive leverage used by the financial institutions and the manic search for funding alternatives; this has given a boost to Islamic finance because of the liquidity in many of the wealthy Muslim countries and thereby taking it from a small side show to

² “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

³ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

becoming a part of the mainstream and as the confidence in this space builds that in itself perpetuates the further acceptability, demand and growth of the Islamic finance sector.

“The Islamic debt market or Sukuk accounts for c.1% of global debt issuance, and around 1.4% of global DCM fees. Companies such as GE have already tested the Sukuk market, and the existing ownership of global blue chips by certain SWF may create a viable pipeline for future issuances in the short and near term.”⁴

As the sector grows and takes hold we have seen a number of jurisdictions desirous of becoming a hub for Islamic finance, those from non-Muslims countries are trying to foster it in their region or have a particular niche offering they wish to promote. The reasons behind this are very clear that Islamic finance is no longer a niche sideshow but a serious contender as an alternative financing system and is here to stay. Malaysia is well ahead in the South East Asian region, Singapore is keen to offer its international standards and long developed asset management capabilities to specialize in that aspect of Islamic finance for that region. Hong Kong offers itself as a bridge to the burgeoning Chinese market, London has been at the forefront in Europe and will likely keep the lead there, Luxembourg is attempting to “do” a Singapore in Europe. In the GCC, Dubai and Qatar are working on taking over from Bahrain which has been the traditional and early promoter of Islamic finance in the region, but it’s lead in the regulatory and supervisory systems developed by them will keep them going for some time to come. There are also rumors of Abu Dhabi planning taking over from Dubai due to the issues Dubai experienced in the current economic crisis. Also the development taking place in the further issuances of Sukuk, both, sovereign and corporate will hopefully induce a secondary market for trading of these securities that will assist in the further growth of the Islamic finance market.

The region has seen some upheaval with the Arab Spring and most of the repercussions are yet to unfold. These events were caused by long term misrepresentation and corrupt practices of the ruling elite who had done little for the average citizen in terms of education, healthcare, job creation etc. Islam, where practiced as it was intended, provides for justice and fair treatment of the nationals and some of the “newcomers” in these countries will look to Islam for leadership and guidance. Most likely countries such as Egypt, Tunisia and Libya will foster the growth of Islamic finance as the preferred financial system to ensure that, as perceived by them, the conventional system that was involved in aiding the previous regimes is avoided by them. This will increase the growth of Islamic finance in these formerly repressed nations.

India is a secular country with a large Muslim population, probably the largest in the world but due to religious concerns the likelihood of Islamic finance becoming acceptable as an alternative system will require some mindset changes which do not appear to be likely in the very near future.

“Other countries that benefit from structurally favorable conditions for high growth in Islamic banking include Nigeria, Turkey, and Indonesia, where low financial development and credit penetration are combined with high demographic growth rates

⁴ “Global Islamic Banking – No longer unconventional!” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

and rising disposable incomes.”⁵

1. Demand Identification

There has been considerable media coverage on the topic of Islamic finance and banking, the demand is apparent, the growth is, on a percentage basis, phenomenal, though a 20% increase on 500 billion is only 100 billion and when considered on an industry or an economic sector basis it is not that much. So the question is why has the growth potential that so much is talked about unrealized.

Today in the world there are approximately 1.7 billion Muslims and regrettably a number of them are poor and under- banked or even un-banked. Some of the Muslim countries are some of the richest per capita in the world. Since the mid 1970’s, the Islamic finance and banking has been introduced but its growth had been slow until very recently.

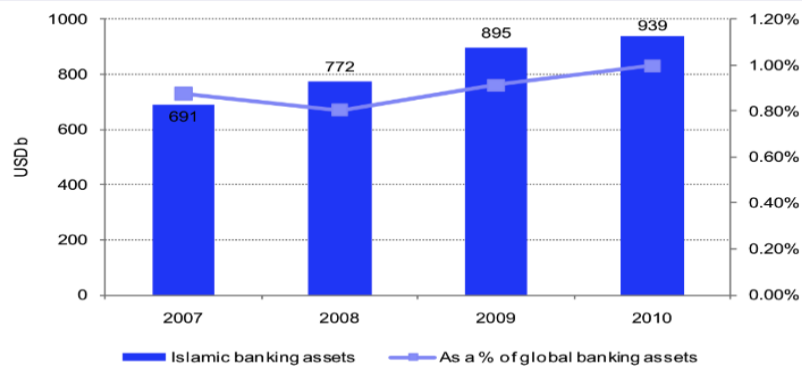
“Most estimates of the size of the Islamic banking industry are around USD 1 trn. Our analysis suggests this is about right. Our figure of USD 939bn of assets includes no fund assets under management or insurance assets and is limited to a sample of less than 15 countries, so we think the USD1trn figure may understate the actual size of Islamic banking assets worldwide.”⁶

The Deutsche Bank report also states that over the next five years the Muslim population share is expected to rise by 1% in relation to global population and its share of GDP to rise by 1.3% that in turn is likely to increase the share of Islamic banking by 0.8% of the global banking assets.

⁵ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

⁶ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

Figure 2: Islamic banking assets globally



Source: Deutsche Bank, company data, Central Banks, The Banker

The reasons behind this upsurge are identifiable and are as follows:

- Availability of Islamic finance products
- Acceptance by the market
- Faith identification/adherence
- Growing liquidity in the GCC market with increased oil prices

The interesting thing is that the growth has been in both Muslim countries as well as non-Muslim ones. In some cases the non-Muslim countries have led the way in development of the products and also amended their laws to offer a level playing field to Islamic finance products. The bankers and the lawyers in the UK have been the leaders in these developments and the former Governor of the Bank of England, Lord Eddie George was a principal crusader of bringing Islamic Finance into the mainstream in the UK during his tenure as Governor.

In the present day the growth is spreading from China, Hong Kong, Australia, Singapore, Malaysia, Indonesia, Thailand, Philippines, India (which is not a Muslim country but has the largest number of Muslims in any one country), Pakistan, Egypt, Tunisia, many of the Muslim countries in and around the GCC, France, Germany, United Kingdom and the United States.

Last year, the combined worth of assets among the top 500 Islamic banks climbed 28.6% to \$822bn from \$639bn the previous year.⁷

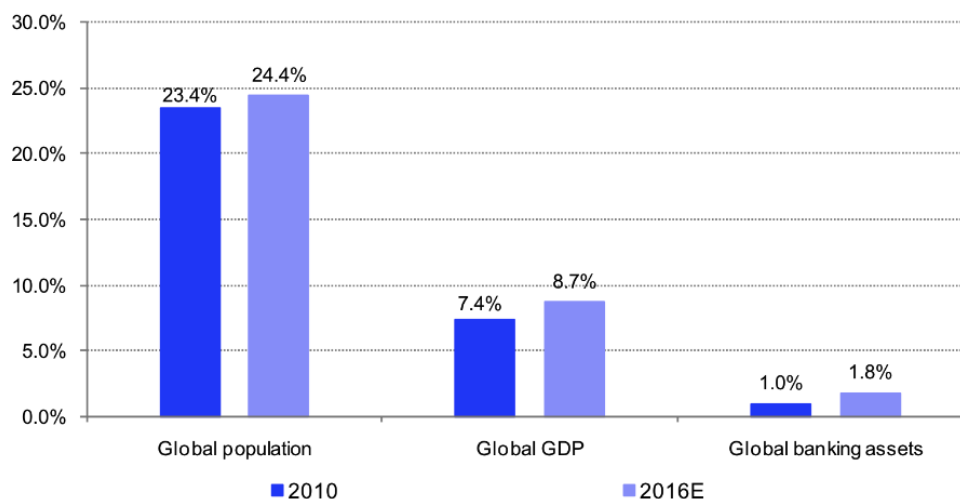
Given the size of the financial market and Muslims constituting nearly 23% of the world population, Islamic finance makes up only about 1% of global finance, which therefore leads to the thought that there is enormous potential for growth. Islamic finance although started entering the mainstream in the mid 70's, the growth has been staggering only in the last decade and the reasons for that are that the products were

⁷ "Demand Surge For Islamic Finance" February 2, 2010 by Rob Morris

being developed for this market and the Muslim population was becoming aware of its own faith identity post the end of the Colonialist era. With independence for many of the Muslim countries post World War II and the financial constraints endured by the Colonialists thereafter, faith identification was the main driver in self identification and the new nations began to look inwards at their own culture, language and who they were. Islamic finance was a spin off from this and it took some years of study by their intellectuals, politicians, bankers, economists and Shariah Scholars to establish the concept and structure products. Plain vanilla products based on trade as exercised in the Prophet’s time were the first to be introduced into this new alternative means of finance.

“A significant demographic boost over the coming 20 years: by 2030, 26.4% of the global population will likely be Muslim against 23% today. Combined with rising levels of literacy, social mobility and disposable wealth in emerging markets, this should result in the creation of a large addressable market with the inclination and the means to choose Islamic banking.”⁸

Figure 4: Muslim share of population, GDP, and banking assets



Source: Deutsche Bank, Pew Forum on Religion and Public Life for population data, IMF World Economic Outlook (April 2011) for GDP 2016E forecast. The projection on global banking assumes is the median outcome of three scenarios wherein global banking assets show either no growth, low growth or recede mildly, as Islamic banking assets rise as per Figures 30 and 31.

A number of products have been developed to cater to the Muslim client base. One must accept that most individuals dealing with the financial sector, irrespective of faith, nationality etc., is with the banks and for the basic products such as current account, savings account, credit card, home finance (mortgages), leasing and insurance. In this respect, these basic offerings are available as Shariah approved products in most Muslim countries by Islamic financial institutions. Exotic products for the investment banking side have been worked on those that could be developed in a Shariah compliant manner and have been utilized by the market. *Sukuks* (fixed income products) are a prime example of such products that have been enormously popular with the market place. The sad part is that due to the dearth of issues most of the *Sukuks* are held to maturity and there is a minimal secondary market. There is need for more issues and more trading to boost the Islamic finance sector. Many critics state that Islamic finance mimics conventional finance, but do not forget that

⁸ “Global Islamic Banking – No longer unconventional!” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

Islamic finance is playing catch up and also that the Islamic marketplace needs the same or similar products that are available to the conventional market, but in a Shariah compliant manner. No need to “re-invent the wheel” of course, but, nevertheless, there should be a parallel development of Islamic products from the ground up that engender truly Shariah compliant products to replace or provide products that exist in the conventional market that would be required or appeal to the Islamic finance adherents.

Although there has been much development, a lot still needs to be done. Many views are proffered as to the direction and debates are held as to what direction should be taken. There is some merit in all of them and the best arguments and suggestions need to be taken to stabilize the offering into a global acceptance to attain the status of a truly alternative system to what is referred to as conventional finance.

The economic and financial crisis witnessed by the world since 2008 and its reverberations still being felt with the damages in the Eurozone, the ratings downgrading of major European nations has drawn attention to Islamic finance. Let us not be enthused by some commentators stating that this crisis would not have happened in Islamic finance and did not happen. The truth is that being a part of the global economy, when the major financial powerhouses suffer their effect is felt across the globe. For example, in the case of property, the location, tenant or rental income has not changed but the price is down due to perception and the fall in the market. Therefore if there are two properties next to each other and one is financed conventionally and the other under Islamic financing, both properties values will reflect a fall in the market equally.

The saving grace of Islamic finance in the present crisis is, in my humble view, down to a few things that were the cause of the problems encountered under the acceptable norms of conventional finance. Firstly in Islamic finance there is no short selling (selling something you do not own is impermissible in Shariah), high leveraging and trading of debt.

These are the reasons stated above that are driving the acceptability of Islamic finance as an alternative offering. The more products from more providers in more regions is what is creating this market acceptance and growing the demand for Islamic finance globally. The reasons for the push by international banks into the Islamic finance arena is not for religious reasons but purely economic, as they are not willing to give up their market share and so are using their resources to court the Muslim client by producing Shariah compliant products; they have the products, they have the systems, the balance sheets, human capital, their reputations and client relationships.

Although the industry is growing at the rate of between 15-30% per annum, subject of course to which data one is relying on, there is a lot of ground that needs to be covered to make Islamic finance a true alternative financial offering that can compete at a par with conventional finance. There seem to be many apologists for the low acceptability levels and a number of factors have been submitted for the rationale for this state of affairs. These being;

- Shariah convergence

- Standardization
- Central Governing body
- Governmental support
- Risk management factors
- Dispute resolution
- Transparency

These are just a few of the factors mentioned and I am sure there are more. Shariah is Shariah and it emanates from the Quran, Sunnah and the Hadith so the issue of Standardization and harmonization in this regard is redundant. Of course there are the different schools of jurisprudence and the followers of each school can retain their beliefs and therefore this gives rise to jurisprudential opinion and rules but that does not make it Shariah un-compliant. The other area of concern is the tax rules of each jurisdiction, but again it has nothing to do with the Shariah compliance of the product.

According to Dr Zeti, there is now a scholarly consensus on some 80% of issues pertaining to Islamic finance, while there are still a few product structures that are accepted only in some jurisdictions.⁹

Standards have been and continue to be developed by the likes of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) for accounting, Shariah and capital adequacy etc. and let us not forget that this is a very young industry, barely forty years old compared to the conventional one that is around seven hundred years old. Nevertheless, in a real sense the global marketplace does not behave in this manner and there are many variances in standards in many industries and continue to be so. Equivalences are stated but the variance, though maybe minor, still remain.

In terms of a Central governing body, it does not really exist in the conventional side, every jurisdiction has its Central Bank and then there are the supra national bodies such as the World Bank, IMF and so on. Equivalent entities do exist in Islamic finance though much is made of their shortcomings and lack of depth.

However, the demand potential is evident from the size of the current market size and the liquidity in some of the Muslim countries due to their surplus capital account due to the oil prices prevailing. It has been suggested that these surplus economies can only absorb up to US\$40 per barrel of oil revenue, any amounts beyond that will need to be used or invested outside their borders. The question is where? Primarily traditionally these surplus funds are invested in the Western economies and they have produced good returns and have also suffered from their boom-bust syndrome of the debt-based economies.

Muslim countries development needs some of these funds, but they must be non political, have a very strong developmental drive and must be of economic benefit to both the investor and investee nations and targeted towards infrastructure project

⁹ The Global outlook of Islamic financial services industry An Economist Corporate Network Management Brief 2010

development, education and healthcare. This will result in institutional development and have the aspects of social benefit as well as developing democratic norms.

One of the essential areas of investment should be in the Agricultural sector as food and water requirements are essential to human survival and specially the GCC nations need to ensure food security.

The richer countries by setting the investment criteria subject to sustainability can engender development programs that provide security to them and encourage the further growth of Islamic finance at the same time. It becomes a win-win situation for all, while at the same time working within the global financial scene and ensuring the critical mass of Islamic finance needed to make it a true and viable alternative financing system.

Similarly, attention needs to be focused on the risk management and regulatory requirements as the sector grows from strength to strength to enable fair competition and provide comfort and confidence in the system to the market so that Islamic finance can become an acceptable norm side by side with conventional finance. Due to differing opinions in Shariah compliance, we are continually saddled with what is now called Shariah Risk. Shariah is straightforward and its source is undeniable, opinions may differ due to *Madhabs* (Islamic Schools of Jurisprudence) but as long as it is based on the principles stated in the sources of the Quran, Sunnah and Hadith then the issue is solved and Shariah scholars should back it. However, one cannot expect non-Muslim secular jurisdictions to enforce these Shariah laws and therefore the sector needs to ensure that the legal contracts utilized based on these sort of jurisdictions are taking this into account. Countries like the United Kingdom are working to develop a level playing field for Islamic finance *vis a vis* conventional finance as far as possible and this is very encouraging for the Islamic finance industry. In this respect, Muslim countries should be doing more at the National level to encourage the development of Islamic finance, Some countries have dual systems running conventional and Islamic financial systems running side by side and that is to be encouraged as in time with the growth of Islamic finance it will be a substantial part of global finance and the two systems will have to work with each other anyway.

One of the things they can do to encourage it is by means of allocating a certain portion of all their investments and transactions to be based on the Islamic financial system. For example, if sovereign wealth funds were to allocate between 25-40 % of their portfolios to be based on Shariah compliant structures and modes then this will spur the growth and also when investments are made based on this criteria this will generate more investment opportunities and products that are Shariah compliant.

As the IFSB and AAOIFI continue their stalwart work and standardize many of the issues relating to Accounting, Shariah and regulatory and risk factors the sector will become more transparent and acceptable to the market. Currently there remain concerns of transparency in company accounts and transactions in some of the Muslim countries. However, coming back to the young nature of the Islamic finance industry, these developments will take time but the fast paced communication era we live in will assist in the growth and acceptability of the industry. These institutions will also need to establish standards for attending to dispute resolutions, which will increase as the sector grows, but they must address it on business levels and issues of

a Shariah nature should be dealt with a respected body of Shariah scholars covering a consensus of opinions from the different *Madhabs*.

Post the current economic crisis Islamic finance has drawn a lot of attention and that has to do with its conservative approach. Although being a part of global finance it has not suffered the same impact as conventional finance, but there are explanations for this phenomenon. Some of it has to do with the size of the market in itself while there are some of the elements that are in a large part to do with the causes of the crisis. These elements are high leverage, debt trading and short selling. All of these are impermissible in Islamic finance due to the constraints of Shariah.

Also the fact that Islamic finance has developed from the top down, that is to mean that it was governments and high net worth individuals who embraced the concept of Islamic finance, whereas conventional finance grew from the bottom up.

The drivers above gave the impetus in the early days to Islamic finance. The analysis is that post colonialism and on gaining independence, the new nations looked at who they were and this identity search led to faith and cultural awareness, which in turn led to the path of economic independence and the study of Islamic economics. Historically, we have had the Islamic schools of medicine, science etc., but not economics. This is a new development and is being generated in our lifetime. With the internet age and communications capability global research can be undertaken as long as one has an internet connection.

Not to mention that once Shariah compliant products became available, the international banks were loath to give up their market share and gave further impetus to the development of further products that they offered to their existing clients. The patriarchs of these high net worth individuals and the national leaders watched the development with much interest, but it was their children who had been educated abroad and had a greater curiosity of their faith and culture and began to embrace and encourage their elders to undertake their financing activities under the Islamic precepts.

This was the early impetus and it was a niche market but still a sideline. It was not until the early 2000 that Islamic finance came to be considered entering the mainstream as an alternative financial system.

The other aspects are the ethical and social responsible nature of Islamic finance that the non-Muslim finds attractive. There is no real systematic development to cater to the demands of this market as developed and committed resources as are provided in Islamic finance. This is a huge niche that Islamic finance can offer the ethical and Social responsible market.

The way to look at it is that the conventional market is exclusive in the sense that Muslim cannot avail of it if they are faith based, while Islamic finance is inclusive as it does not preclude non-Muslims from using it.

In this sense the conventional banks have offered Islamic banking through the model of Islamic windows. This model has been successfully operating in many countries. These have helped the penetration of Islamic finance and banking by raising the

awareness of the alternate financing system but that has run its course in some ways as the Shariah Scholars have requested that there must be no co-mingling of the two forms of banking and finance. To this extent, Qatar has delineated the system by requesting banks there to be either Islamic or conventional and banks that offered a successful Islamic window operation, such as Doha Bank have had to decide which direction they wish to pursue and slowly diminish their Islamic portfolios or place them with Islamic banks. In some sense this is the correct step as it clearly defines the business model of the financial institution and removes the confusion arising from the dual offering from the same financial institution.

The GCC has the largest number of Islamic banks but to compete on the Global arena they need to be of a substantial size and for that reason alone they need to merge to attain economies of scale and reach the wider audience. Due to the rise in oil prices the resulting liquidity needs to be harnessed to launch these institutions into global brands. With the development of competitive and innovative Shariah compliant products the market is there; the delivery is required. It has been stated that beyond the US\$40-50 per barrel of oil price the excess dollars need to be invested outside the oil producing economies as they will have reached the capability to absorb that spend. This is an enormous opportunity for these oil producing nations to make an impact on Islamic finance in particular and to invest for future generations in sustainable projects such as alternative energy that Abu Dhabi is developing and also to attain food and water security. There is hardly any food production worth mentioning in the GCC due to the terrain but that does not preclude these countries to invest in this asset class globally to ensure that they will be able ensure food and water supplies in the future.

2. Potential

The potential is enormous, about that there is no doubt. But how do we go about making it a reality.

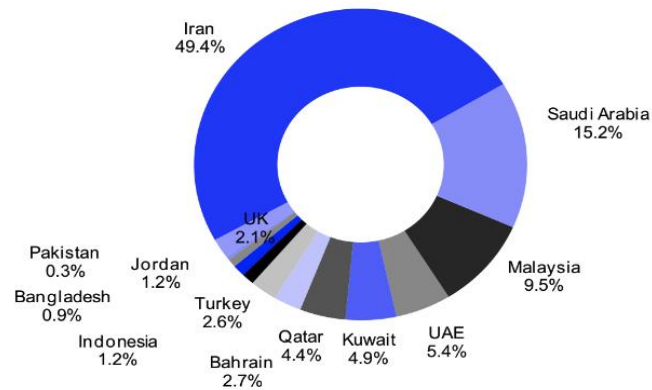
The bulk of Islamic funds are small scale with two thirds being less than \$100m and many of these having attracted only \$10m to \$15m. The domicile of funds is heavily concentrated with nearly two thirds of the total number of funds being in five jurisdictions: Malaysia 23%. Saudi Arabia 19%, Kuwait 9%, Luxembourg 7% and Bahrain 6%. Cayman, Ireland and Indonesia each account for a further 3-4% each, but the remaining 25% is divided between a further 23 countries, including 1% in the UK.¹⁰

The initial premise we need to accept is that the Muslim population in the world exceeds 1.5 billion and a large portion of these are under 25 years of age. As mentioned earlier a lot of them are under banked or unbanked but will need the services of a financial institution based on the way the world is moving. Some of the younger populations in many of the Muslim countries may not be educated but they

¹⁰ “IFSL RESEARCH^[1]_{SEP} ISLAMIC FINANCE 2010” January 2010 ifsl.org.uk

are internet and computer literate. The social networks contributed to the Arab Spring, these same tools can be applied to educate and make aware these people and others about Islamic finance.

Figure 3: Detail of global Islamic banking assets, FY10



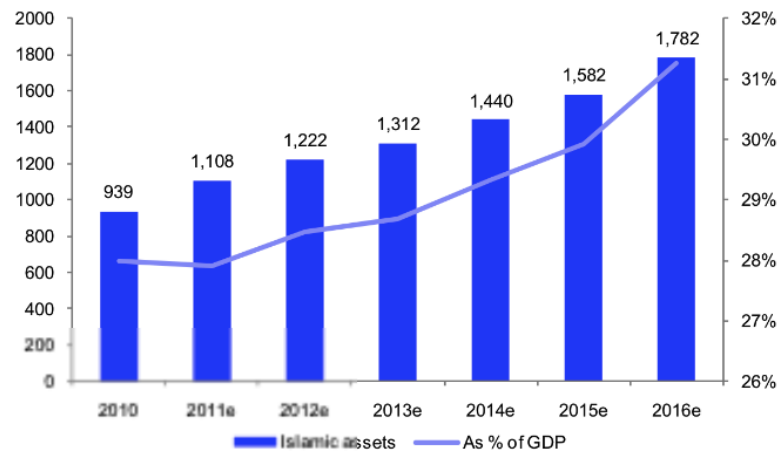
Source: Deutsche Bank, company data, Central Banks

Other attractions are of course, the ethical aspect, the social responsibility, fairness, justice and the betterment of the community. The fact that real economic activity must be undertaken and benefit must be created and the avoidance of speculation add a dimension that post the current crisis people are looking to replace some of the excesses of the conventional side of finance that is found to be abhorrent. The backlash to banker's bonuses in the conventional finance side is a demonstration of the unhealthy aspect that the conventional finance sector is finding reaction against. The politicians are now supporting this, as well as considering the banning or at least limiting short selling.

“As a consequence of current demographic trends, the share of Muslim population that could potentially be in the ‘credit bracket’ in 2030 could be around 50% of the total, implying a retail market of around 1.1bn people.”¹¹

¹¹ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

Figure 9: Forecast growth of global Islamic banking assets



Source: Deutsche Bank, company data, IMF, Central Banks (The sample group of countries includes Iran, Saudi Arabia, Malaysia, UAE, Kuwait, UAE, Qatar, Bahrain, Turkey, Indonesia, Jordan, Bangladesh and Pakistan)

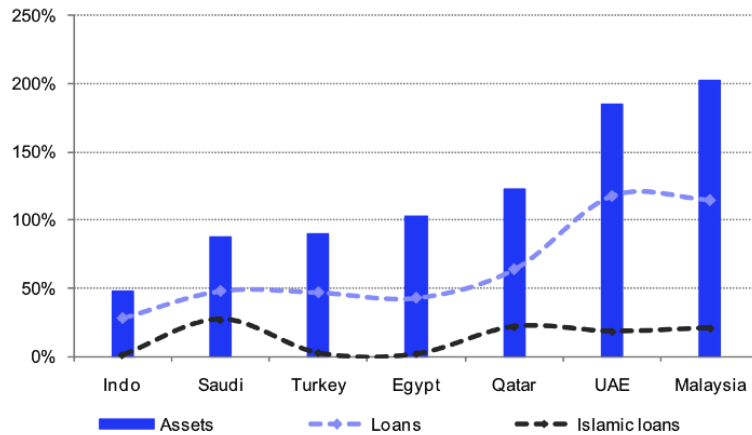
“Only about 18% of the Islamic financial industry’s potential market – equivalent to USD700 billion of an estimated total of some USD4 trillion – is currently being exploited, leaving a vast arena for new entrants.”¹²

3. Sustainability

A major concern of Islamic finance is its sustainability factor, but when looked at closely the basics of Islamic finance are attuned to provide stability to a financial system. The reasons for this is due to the very fact that Islamic finance is very conservative in its approach and is asset based with very low leverage. The fundamentals of Islamic finance dictate that a real economic event must be evinced. Islamic finance requires genuine economic activity, it forbids debt trading and short selling (selling something you do not own), the very factors that were the main causes of the current economic crisis.

¹² Special Comment Moody’s Global Banking – Islamic Finance in France: Strong Potential, But Key Obstacles Persist July 2008

Figure 5: Banking penetration vs. 2010 GDP

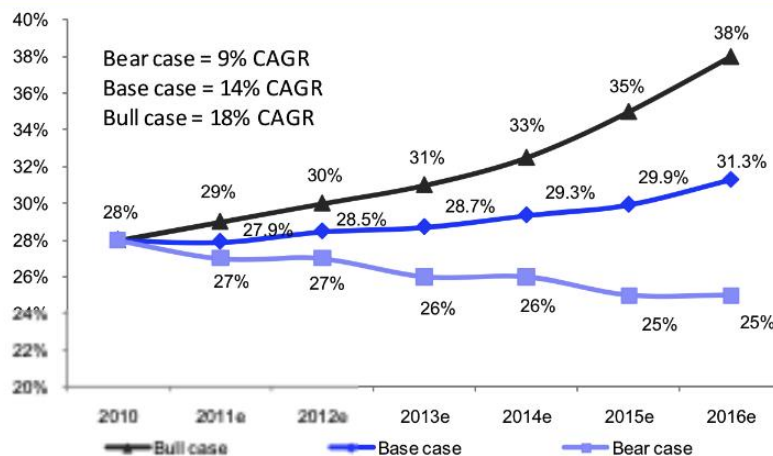


Source: Deutsche Bank, , Company data, Central Banks, IMF data for GDPs

It is an alternative system based on real values and generates growth through economic production and creates jobs and ensures active involvement of the people.

“Growth in key market segments: progress in product development, coupled with strong demand, should sharply accelerate growth due to pent-up demand in key market segments. We see project finance of USD2.1trn in Gulf Cooperation Council countries alone), fund management of USD470 bn of Shari’a sensitive assets, trade finance (only c.10% of intra-Muslim trade is Shari’a compliant) and mortgage finance (Saudi Arabia alone is a potential c.USD100 bn for Islamic banks) as the low-hanging fruit “¹³

Figure 10: Scenarios for Islamic banking asset growth based on penetration levels (assets / GDP)



Source: Deutsche Bank, IMF World Economic Outlook (April 2011) for GDP forecast. (The sample group of countries includes Iran, Saudi Arabia, Malaysia, UAE, Kuwait, UAE, Qatar, Bahrain, Turkey, Indonesia, Jordan, Bangladesh and Pakistan)

¹³ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

4. Challenges

The challenges faced by Islamic finance at present include the globally developed regulatory requirements acceptable and applicable in all jurisdictions such as the Basel requirements and similar initiatives to take root for accounting and Shariah standards. A number of institutions are working on these needs but they need to work closely together to achieve a harmonious result that becomes a global standard. People will still raise issues, especially when it comes to the Shariah standards, but that is really an issue of interpretation. Take for example English Law where the law is stated but for an offence there is reference to case law and different lawyers, barristers and judges apply interpretation. In Shariah we have the stated law from the Quran and similarly reference and interpreted opinion is applied.

Another challenge faced by Islamic finance has to do with the financial institutions not being adequately capitalized in the sense that the largest Islamic bank is much smaller than many of its conventional counterparts. We need to see mergers and the resulting balance sheet footings and economies of scale, will enable those institutions to enter the field on a par basis.

Standardization issues persist but the likes of AAOIFI, IFSB, International Shariah Research Academy (ISRA) etc., are making strides in this direction but there is still a long way to go. The growth of the industry is bringing more players into the field and as the demand continues to grow the standards are and will continue to come. Let us not forget that this is still a young industry.

One of the major drawbacks in the sector is perceived to be the shortage of human capital. However, bear in mind that banking is banking and the requirements in the functions, for both Conventional and Islamic, are the same. The application in the services, the risk profiles and credit considerations are similar with an understanding of the criteria in the case of Islamic banking, which, if truth be told does not require that great a change in mind set and is not “rocket science”. What that means is that it is not such a great move for an experienced banker to step across from conventional to Islamic banking. Of course they would need to educate themselves on the variance between conventional and Islamic but it is not an insurmountable task. At present what takes place is that institutions poach “Islamic” bankers from each other and increasing their costs by hiring at higher salaries to attract these “Islamic” bankers. There are also a number of courses in Islamic banking on offer from many areas all over the world, including online programs.

One other thing to consider is the perceived shortage of Shariah Scholars, in my view there is no real shortage but there are two concerns that need to be highlighted in this case. One, it is the banks that want to hire the same “known” Scholars as they feel that since they are on most Shariah Boards then it will be easier to get their product accepted with their target clientele. There is some merit in that as these Scholars have gained experience, exposure and expertise, but this is dangerous for the industry as it restricts the entry of newer and younger Scholars. The main drawback in my view is that constraint is caused by the Scholars ease with the English language, as well as legal and banking structures, but this will come from exposure and experience. Established Scholars should get other younger Scholars as apprentices and train them as the future Scholars.

If the Islamic banks, specially new setups, were to get a trainer on Islamic finance to train their staff and then do refresher courses every quarter for one to two years there will be no shortage of “Islamic” bankers. Training is a continuous exercise and Islamic banks should put in these activities as part of their program for their staff. There can be the initial introduction course and then followed on by specific product training.

There is also a shortage in the development of innovative Islamic banking products built from the ground up rather than mimicking conventional products. However, we must also be aware that the needs of the banking customer in both conventional and Islamic are the same,; current account, savings account, lease, home finance, credit card and Takaful etc., so there is no issue in replicating those and that has long been done. The development of the Sukuk has been a huge success. Many Islamic financial institutions are not in a position to hire a dedicated team of product developers as that would be an inefficient utilization of their resources. It would make a lot of sense for them to outsource that to specialist product development teams that they can provide a brief to and that product would be developed and presented to them for their use. This will help grow the industry faster as the product development company would concentrate on these products for many institutions and the variety of products would be increased immensely as well as lead to product diversification.

The risk profiles are very different in Islamic finance as some products require on balance sheet financing and therefore the issues of risk management are present. Also there is the concern implied of Shariah risk, though there is a lot made of Shariah opinion divergence, although it is not such an issue.

"Islamic finance is a marketplace that's growing and getting a lot of attention, but a lot of people don't fully understand it," says Max Linnington, the regional head for Middle East and Africa of Bloomberg News.¹⁴

Another task for the Islamic banks is to be more transparent and this means that the Islamic banks annual reports must provide adequate relevant information for the customers to comprehend the risk profile of the bank’s business, its strategies and mechanisms in place to avert any undue events and have in place good corporate governance practices.

This is important in conventional banking but even more so in Islamic banking due to the fact that its structures are based on profit and loss sharing for its account holders.

Effective disclosure can help market participants to assess the bank’s performance. For Islamic banks, transparency is an important supervisory pillar and has considerable relevance for enhancing their ethical responsibility and credibility, thereby contributing to their greater acceptance, and to the elimination of any

¹⁴ “Islamic finance comes of age” Gregor Hunter The National Abu Dhabi Mar 6, 2011

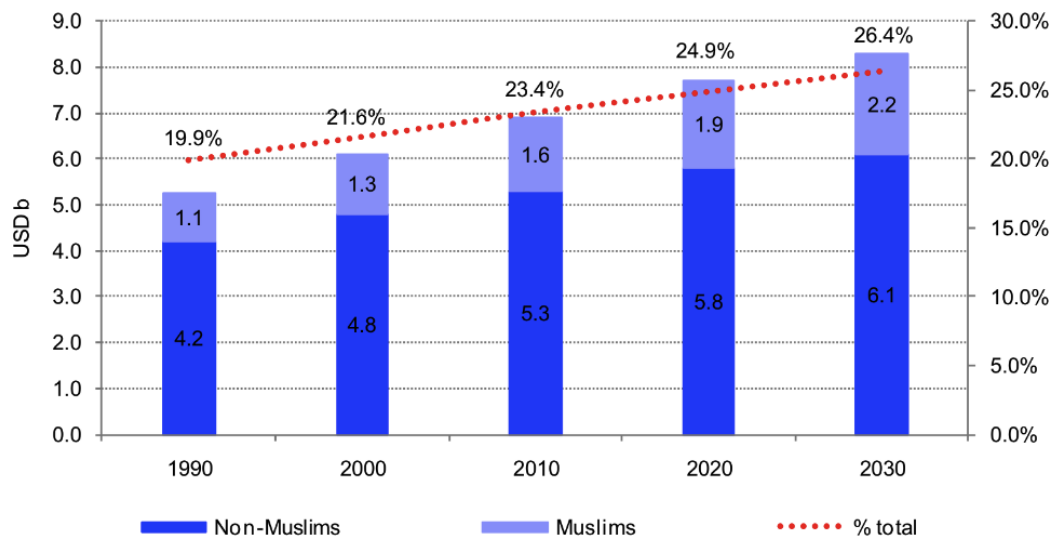
misconceptions about their activities.¹⁵

5. Future

So what does the future hold for Islamic finance? The various issues highlighted in this paper suggest that due to events such as the “Arab Spring”, more awareness of Islamic finance and its alternative offering coupled with the economic crisis effects on conventional finance, the increase in the price of oil, more education and institutional standards development through the likes of IFSB, AAOIFI, Basel and IFSB is leading to the wider acceptance and availability of Islamic financing alternatives.

But where is it happening? Besides the growth in the expected places such as the Muslim countries, especially post “Arab Spring”, we are seeing the growth in, what I would call the reluctant entrants such as Turkey, North Africa and Indonesia, as well as CIS nations and above all the conventional markets such as France, Germany and others are showing interest. Places such as the UK, Hong Kong, Singapore, Luxemburg are vying for the status of Islamic finance hubs for their specialized capabilities. The North American market is still very lukewarm to the idea of Islamic finance though there is some activity there, but when they open their arms to embrace Islamic finance there can be an expected “tsunami” in the growth of Islamic finance.

Figure 14: Worldwide population projections, Muslims and other groups



Source: Deutsche Bank. Pew Forum on Religion and Public Life. UN Department of Economic and Social Affairs. Population division (2011)

The demands due to the austerity programs resulting from the economic crisis for liquidity will give an enormous boost to Sukuk issuances, which currently stands at

¹⁵ “Issues of transparency in Islamic Banks” *Noraini Mohd Ariffin, Simon Archer and Rifaat Ahmed Abdel Karim Review of Islamic Economics*, vol. 13, no. 1, 2009

only 1% of global debt issuance. Most of the demand will come from corporates as they are starved of funding. To date most of the major Sukuk issues have been Government (sovereign) or quasi-government, this will continue but will be further enlarged by the corporate demand. This is due to the liquidity expected from increased oil prices and surpluses enjoyed by the oil producing countries.

“Greater diffusion of wealth, improving education, communication, and wider disposable incomes in key emerging markets with large Muslim populations across Africa, the Middle East and wider Asia is leading to the democratization of credit, facilitating an economic choice for Islamic products.”¹⁶

Conventional banks due to their diminished balance sheets post the crisis and bailouts by taxpayers are now tending to focus on shoring up their balance sheets by improving capital adequacy ratios, looking at refinancing, restructuring and more than anything else deleveraging. This aspect is likely to offer an enormous opportunity to Islamic banks with liquidity to enter the arena of corporate finance in a big way globally. This will also provide an opportunity for the Islamic banks to further strengthen their capabilities and offerings in the fields of trade finance, project finance, home financing, fund management and Debt capital markets.

As the product range grows so will the demand and the future for Islamic finance is one to watch closely and move in early to derive maximum benefits.

6. Conclusion

Until fairly recently Islamic finance has developed in a fragmented manner in local pockets in a diverse geographical arena and there is no universal model, but as the sector is growing and its institutions are being developed through harmonization and standards there is a move towards global acceptance and unification. For example there are a number of Islamic banks but most of them are small in comparison to the conventional banks. There needs to be a merger of some of these smaller banks into a larger institution that will impart confidence in this space for the customers. One must bear in mind that the Shariah emanates from the Quran and therefore there is no variation save for interpretation by the different *Madhabs* (schools of Islamic jurisprudence), principally the four main ones, *Maliki, Hanbali, Hanafi and Shafi*. However, there is very little difference between them. There is more in common than not. However, once there is some form of formal standard then the course ahead would be clearer. As the Shariah Boards of institutions such as AAOIFI come from diverse schools of thought and deliberate on the standards, this will give a universal opinion for the market to work with and this in turn will lead to wider acceptance and thereby growth of Islamic finance on a world wide basis.

The current economic crisis has managed to focus the industry to reevaluate its offering and review what went wrong and why. It is this exercise that has provided the impetus to look at alternatives such as Islamic finance. Islamic finance is conservative but due to its nascent state it does not yet have a full range of asset classes and it took a bit of a knock due to over exposure to real estate, but the conservative nature of Shariah with little leveraging meant that effect was not catastrophic as witnessed by

¹⁶ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

conventional banking where there was more debt than there ever were assets. This pile of debt was too heavy a burden for the conventional system to bear and hence the ongoing crisis that is like quicksand for the conventional system.

“Long-term deleveraging in developed markets will most likely constrict corporate financing through regular channels and depress traditional investment options. We forecast over USD2 trillion in deleveraging in USA and Europe. Over \$100 billion of bank recapitalization has been identified in Europe as being needed. People, corporations and governments are suffering from fiscal austerity, lack of credit, and a severe lack of trust in institutions. Investors are nervous. The developed world, more than ever before, is ready for alternatives.”¹⁷ [L] [SEP]

Awareness is fundamental, while the investors have on offer a variety of options in their “backyard” that they understand the risk/reward profile of, they are unlikely to look for alternatives that they are unfamiliar with. This has been the drawback for Islamic finance, but with the current economic downturn the investors seek refuge in calmer waters and this is where Islamic finance appears to offer a stable solution. With time to ponder alternatives, the market is studying Islamic finance as a viable alternative for liquidity, stability, ethics, morality and all round less risk due to the Shariah criteria and the overlay of monitoring by the impartial Shariah Supervisory Boards to ensure justice and fairness while diligently pursuing profit within the Shariah constraints.

“The lack of information on Islamic finance, the fact that it was still in infancy and that investors had plenty of better / clearer options elsewhere all added to the lack of capital flows into the sector, in our opinion. [L] [SEP]”¹⁸

“To that end, improving the development of human capital and establishing best-practice international standards for the industry, remain important priorities. Many in the industry are calling for greater international co-operation among academic institutions to establish common standards, as well as a code of conduct across financial centres. Meanwhile the industry itself needs to offer more support to up-and-coming students. More research will also be needed to promote innovation, from new risk management systems to a greater and more inclusive range of products and services, to maximise the opportunities for further growth.”¹⁹

“Growing awareness: the awareness of Islamic finance is probably higher today than it has ever been. Islamic financial products and services are currently available in over 39 countries on four continents. The growing availability and awareness of Islamic financial products is a result both of strong demand, and of diminishing barriers to entry. We believe that these factors are strongly linked to the increasing convergence

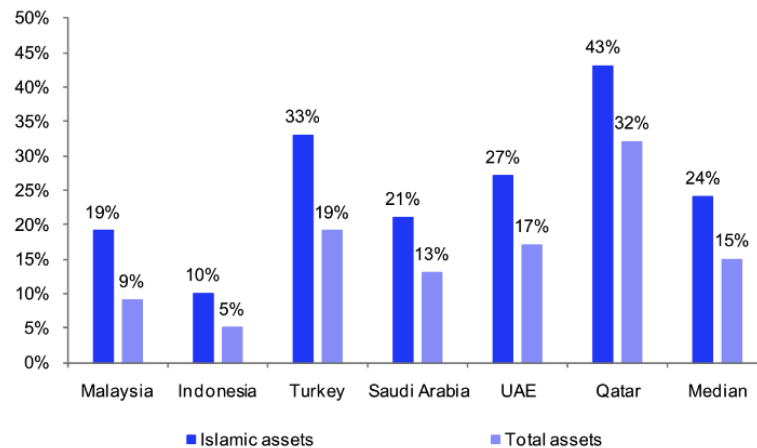
¹⁷ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

¹⁸ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

¹⁹ The Global outlook of Islamic financial services industry An Economist Corporate Network Management Brief 2010

of regulatory and accounting standards between Islamic and conventional finance.”²⁰

Figure 7: 2006-2010 CAGR of Islamic and conventional banking assets



Source: Deutsche Bank, Bank, Central banks, company financials (NB: 2006 is estimated for Saudi Arabia)

According to the Deutsche Bank’s Global Research report “Global Islamic Banking – No longer unconventional” by Ryan Ayache and Global Banking Sector Team dated November 2011, it is stated they expect that as there are no real global plays in Islamic banks, new and/or merged entities will emerge to take center stage as serious contenders in the Islamic banking field to work alongside the conventional banks. The mooted creation of an Islamic mega-bank has been on the cards for some time by Sheikh Saleh Kamil of Al Baraka Bank and it seems to be approaching reality. There are also developments of trading platforms for commodities, gold, trade finance and most importantly we need to see the development of an active secondary market for Sukuk trading as the number of Sukuk issues is rising and is expected to continue rising.

The development of sizeable Islamic banks will most likely emanate from the GCC region to attain global status as they are reasonably well capitalized and their own economies are relatively smaller and absorbability of surplus revenues is an issue. This will provide the impetus for them to go beyond their borders. This in turn will provide them much needed exposure to the international markets and those inherent dynamics. [LSEP]

²⁰ “Global Islamic Banking – No longer unconventional” by Deutsche Bank in November 2011 Ryan Ayache Research Team leader.

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