

SHARIAH COMPLIANT FINANCIAL PRODUCTS

The Future

Forecasting the future is never easy especially when dealing with a subject such as the evolving and growing market of Islamic Banking and Finance. The sectoral market is in a revival phase and only three decades old in its current development. At this stage, it has been primarily aimed at the institutional client and is now turning to the retail aspect of the business.

The Islamic finance and investments sector has been developing at a rapid pace and presently there are more than 250 institutions managing assets and client money of over \$400 billion. The sector is set to register high growth although the industry will have to apply itself to overcome many of the unresolved challenges which are likely to present hurdles in its timely development. The Islamic financial industry mainly comprises of small players and finding suitable investment opportunities that deliver high returns remains one of the main challenges.

After the events of 9/11 there has been a greater resurgence of Islamic banking and finance for a number of reasons, these being the migration of funds back to the region and the oil price hike leading to enhanced liquidity. The regional banks are now becoming involved in larger ticket transactions and are developing their own capabilities or allying with larger international banks to distribute product. The larger international financial institutions, seeing this movement, are joining it so as not to lose market share by entering the growing Islamic finance and banking sector.

Until recently there were very few products that met with Shariah compliance, that is, to be certified as meeting the requirements of Shariah law relating to finance (*Fiqh al Muamalat*). For any institution planning an initiative in Islamic Banking, it must realize that every product, to be marketed to Islamic investors or customers, must meet the faith-based requirements and be certified as such by one, or a number of Shariah Scholars who act as a Shariah Supervisory Board for this express purpose.

The sector requires some of the components available in the conventional market to enable it to offer like for like capabilities such as an inter-bank Islamic money market along with Islamic money brokers to assist treasurers of Islamic financial institutions in making sound judgments on investments.

As it is, with the launch of many Sovereign and corporate asset backed Sukuk issues available offering competitive yields, they still lack from relatively poor liquidity, spreads between the bid and offer prices are not predictable, and there are no reliable market makers. The secondary market needs to be developed, and will likely come with the further issues of sukuks and other tradable instruments.

The Islamic finance and investment sector has not had available to it the tools with which to manage and mitigate risk. It appears that, until very recently, it was presumed that short selling as required in hedging was not allowed according to Islamic Shariah. However, recently Noriba Bank has begun advising and distributing a Hedge Fund compliant to Shariah, created by Eric Meyer's Shariah Funds Inc.

As stated above, the corporate and sovereign sectors of the market are well attended to, but it is the retail market where the true mass-market appeal really lies, this is where the future lies. The initial Murabahas, Ijaras and Mudarabas are now very much progressed from their use in the institutional arena to the mass market in the Islamic countries. The Sukuks are also moving from the sovereigns to the corporate levels.

Islamic banking is similar to conventional banking with additional elements of an ethical nature and faith based prohibitions. These restrictions mainly cover the application of Interest (*Riba*) and ambiguity of contract (*Gharar*) and Pork and its associated industries, ethically unacceptable sectors such as gambling, pornography, armaments etc.

Following on from the above, it is fairly obvious that every banking customer is served a number of products in one form or another, namely mortgage, savings account, leasing, current account, pension, credit card and insurance. The Muslim customer's needs are the same and concentration on the provision of these products by financial institutions is where the next stage of development in Islamic finance will be. The market is anxiously waiting to be offered these products in a Shariah compliant manner in Muslim countries as well as globally. The development of Shariah compliant mortgages and the removal of the element of double stamp duty in the UK is an indication of the momentum developing in the market place. Major banking groups internationally are initiating Shariah compliant products as the indigenous Muslim populations are making the demand.

The Muslim populations are growing in Europe and the US and the availability of Shariah compliant financial products is increasing demand, that is why a lot of the large global commercial and retail banks are starting their Islamic divisions, Islamic windows or even their own stand-alone Islamic bank subsidiaries. UBS and Citibank have already set up in such a manner. HSBC has set up the Amanah division and the regional banks from the Muslim countries are also offering their products internationally in centers such as London, Frankfurt, Paris etc.

The main driver for the Muslim client is to be able to get an Islamic Shariah compliant mortgage, as that is the major asset class. In the future, there will be securitisation of pools of mortgages and this area will develop fairly fast. The attraction of the Shariah compliant mortgage for non-Muslims will be the long-term, fixed repayment nature of the product and hence will provide an impetus to the market. In Malaysia more non-Muslims than Muslims avail of some of the Islamic products.

Following this, I expect a major demand for leasing, which by the means of the *Ijara* method, is a well established and widely used Islamic Shariah compliant means of financing. The pension funds side will also grow when corporates start to offer Shariah

compliant pensions, as the Islamic workforce could demand that their pension is invested in a Shariah compliant manner. With residential and commercial mortgages, there will be a need for property and household contents insurance to cover both the general and life areas.

The market size for mortgages in the UK alone is estimated at Pounds Sterling 20 billion. Specialist niche players will be more nimble at the outset, as it takes the larger banks a longer gestation period. These smaller players will be the ones to benefit the most as the larger institutions will eventually buy out the competition.

However, even though there is a pent up demand many Muslims are not clear on how this all works and in many cases the expectation that no interest is allowed in Islam can cause confusion about how there is still a mark up or profit charge being made. This is a steep learning curve and to some degree the potential Muslim clients need to be educated on these initiatives. The path to success for the Shariah compliant products has to be through imparting the knowledge to the market through seminars in the areas of Muslim concentration in countries like the UK.

These shortcomings are to be expected in the marketplace when the sector is only some three decades old, but it is one of the fastest growing sectors and being adopted worldwide. Nevertheless the future is excellent.