

AN AGENDA FOR REVIVING ISLAMIC FINANCE¹

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Islamic Finance is still a small player in Global Financial System with a share of less than 2 percent. The growth has been impressive but the takeoff has been bumpy.

The vision of Islamic Finance is to offer itself as a source of stability to the Global Financial System that is coming out of a crisis of gigantic proportions –next only to the Great Depression of 1930s. If Islamic Finance can demonstrate that its unique and distinctive features and asset-backed transactions are able to reduce the fragility and volatility of the financial system in a convincing manner then there would be a lot of interest generated in Islamic Finance among other players in the world.

In my view, however, there are at least five main gaps that have to be bridged before the robustness of Islamic Finance can be proved.

First, there are serious misconceptions, misunderstandings and misplaced notions as to what Islamic Finance is all about. There is hardly any common or shared understanding about its objectives, underlying principles, mechanics and outcomes. As it was evident from the discussion at this Forum for last three days some of the practitioners believe that profit maximization by Islamic Banks is antithetical to the precepts of Islam and they should engage only in Social Justice without realizing the repercussions of such an assertion. Banks can play an important role, along with the state, charity, zakat, waqf and other instruments in contributing towards this goal but to assign this sole responsibility to Islamic Banks is highly unrealistic. This view does not take into account that banks exist for financial intermediation – mobilize savings for which they remunerate the depositors by financing investment for which they charge the borrower. Therefore, the communication gap that exists between the various stakeholders and the public at large has to be filled in.

Second, there is a Trust gap between the borrowers, depositors, investors and managers. As Social Capital has dissipated fast in our society, the virtues espoused by our religion such as Truth, Honesty, Fair play have also become rare commodities. The transaction costs of Islamic Finance would have been much lower compared to other forms if Trust had prevailed, Islamic values were practiced in true spirit and obligations assumed by each party were carried out according to the commitments made by them. Protracted litigation, non-recovery of loans, high rates of default

¹ Concluding Remarks as Chief Guest at the Global Forum on Islamic Finance organized by COMSATS Institute of Information Technology (CIIT) at Lahore on March 13, 2013

would have been avoided and this would give an advantage to Islamic Finance providers. The State Bank of Pakistan has reported that the non performing financing by Islamic Banks (IBs) has continued to rise while return on assets and return on equity has witnessed a decline. Risk aversion on the part of Islamic banks can also be detected as 71 percent of overall investment was made in Federal Government Securities. On the other hand, financing registered no growth. So they behave no differently from other conventional banks in providing negligible financing for productive activities that generate employment and economic growth. This combination of heightened risk aversion by playing safe and avoiding financing of productive activities is a manifestation of Trust Deficit. To play its assigned role in real capital formation Islamic Banks have to reverse their financing pattern and this cannot be done unless Trust Gap is filled.

Third, IBs have been too much obsessed with the tendency to replicate conventional banking. It seems too many critics, Islamic Banking is nothing more than bells and whistles wrapped around conventional banking assets and services. We think that making these assets Shariah Compliant through financial reengineering we have done our duty and we can therefore carry on business as usual. It is not realized that some of the sectors and sub sectors neglected by traditional banks such as Agriculture, Agri-Business and Produce Marketing, Small and medium enterprises, Low Cost Housing offer enormous opportunities for Islamic Banks to step in and meet this unmet demand of the economy. But in their quest to mimic the established banks no effort on Research and Development has been made in a systematic manner. The dearth of new products and services by Islamic Bank stares so starkly in our face. Unless this 'Innovation Gap' is filled and we desist from the temptation of blindly following what is happening on the other side Islamic Banking would not be able to translate its competitive advantage into real gains. We make a lot of unflinching assertions about the superiority of Islamic Finance but we are a long way from establishing this proposition based on unequivocal empirical evidence. Innovative products and services meeting the requirements of the productive economic agents particularly in neglected sectors are the only tangible answer to this.

The fourth and most pinching and piercing effect felt throughout the Islamic Financial Services Industry is the inadequate supply of qualified, skilled well trained and competent human resources. Either we have imported conventional bankers, who by their background and training, are unable to comprehend the differentiation between the two and therefore perpetuate the re-engineering and adaptive approach to the products. Or we are bidding up the compensation package of those who have gained some hands-on experience in the industry and luring them away. This may be beneficial in the short term to an individual institution but it has very detrimental long

term consequences for the industry as a whole. By doing so we may unwittingly out price the Islamic Banking products and services and make them non-competitive compared to the rival banks. Alternatively, we may compromise on the quality of professionals by relaxing standards of recruitment. I have been trying my level best as head of IBA to set up a program for training Islamic Bankers but have failed to do so because we are unable to locate and find high caliber fulltime faculty that can provide the leadership for such a program. Unless we take measures to bridge this 'Talent Gap' the Islamic Financial service industry would not be able to make the leap it is aspiring to.

Finally, ethical values are embedded in Islamic Finance. These are not add ons as being practiced in many parts of Europe. The Ethics based assets class has expanded to \$8 trillion and is growing rapidly. The ethic embedded Islamic Products have transformational features that are relatively more attractive. For example, the asset based nature of Islamic Finance can reduce the volatility inherent in contemporary complex and advanced financial products. But the investors will only opt for Islamic products if they are assured that corporate governance, Risk Management, Transparency and disclosure, Internal Cost Control requirements while adapted to meet the specific needs of Islamic Banks and compliant with Shariah Principle are atleast as stringent as other providers. The opportunities for unscrupulous elements to take advantage of any arbitrage should be minimized.

These are some of the gaps that are hindering the rapid spread of Islamic Finance. Unless we work together to resolve these issues we may have lot of talks, conferences and Forums but very little tangible results.