

DAWN

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Promoting Islamic finance

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THE government recently formed a high-powered committee to examine the current state of Islamic finance and suggest measures for future development.

The share of Islamic banks, introduced in Pakistan in parallel to the conventional banking system in 2001, has risen to 10pc of the banking assets in the country.

This achievement is not at all unimpressive considering that the growth rate of Islamic banking here is twice that of conventional banking.

Why is Islamic finance becoming popular worldwide and not only in Muslim countries? Muslims may be shifting towards it for reasons of faith but it is also receiving attention in the UK, Europe, Singapore, Hong Kong, etc.

The UK government has committed itself to making London the global hub of Islamic finance, and the UK treasury is issuing a Sukuk worth £200 million, becoming the first sovereign state outside the Muslim world to issue an Islamic bond.

The 2008-09 financial crisis has led to greater scrutiny of Islamic finance as an alternative to the global financial system because it offers itself as a source of stability, reducing fragility and volatility.

During the crisis, Islamic banks didn't suffer as much as conventional banks because they did not deal in exotic derivatives or artificial money-creation instruments such as collateralised debt obligations. Every transaction in Islamic financing must be backed by real assets i.e. buildings, structures, factories, machinery etc.

The risk characteristics of Islamic finance are different both on the liability and asset sides. Profit-sharing rather than a fixed pre-determined rate of return on deposits (investment accounts) insulates Islamic banking from volatility and abrupt movements.

On the asset side, Islamic banks take ownership stakes in the businesses of borrowers and offer different products and services that are not feasible under conventional banking.

As a partner in the borrower's business, the bank has to monitor and ensure proper utilisation of financing. Thus credit appraisal and risk management are much stronger. There is a growing trend to shun unethically or socially irresponsible investment funds and businesses.

Islamic banking prohibits financing of anti-social and unethical businesses such as gambling, prostitution, alcohol, nightclubs and narcotics. In this respect, it is clearly ahead of the recent surge in ethical finance and socially responsible investment that are becoming popular in the West.

Islamic finance's other distinguishing feature is its emphasis on poverty alleviation and reducing income inequalities. In a world where such inequalities with their pernicious effect on social cohesion are a source of major concern, Islamic finance appears as an attractive candidate to address this concern.

Inequality's origins can be traced to the nature of conventional banking where the risk is concentrated solely in the borrower and the fruits of good fortune or adversity are borne by the individual or firms that have borrowed the money.

Should the business fail, the underlying collateral is forcibly realised by the bank. The cause of many bankruptcies, business collapses and financial insolvency lies in this inbuilt characteristic of conventional banking.

In Islamic finance, the supplier of funds or the investor demands returns on investment after the business transaction has produced the outcome. As the risk is shared between the supplier and user of funds, returns on investment, whether positive or negative, are shared equitably between the two parties in the proportion they had agreed upon.

The burden of adversity does not fall on the borrower only — the winner ie the bank does not take it all while the loser ie the borrower does not become financially insolvent.

Despite its many attractive features the unfinished agenda of promoting Islamic finance is quite long. First, there's a need to raise awareness and educate the public as there is hardly any common or shared understanding about the objectives, underlying principles, mechanics, mode of operation and outcomes of Islamic finance.

Second, there is a lack of new products and services. Islamic banks in Pakistan have been too obsessed with making conventional banking products Sharia-compliant. To critics, this is nothing more than bells and whistles wrapped around existing products.

Third, deposit mobilisation has picked up speed but asset deployment has not kept pace. The ratio of financing to deposits is dismally low.

Fourth, sectors such as agriculture, agribusiness, small and medium enterprises, low-cost housing, etc neglected by conventional banks but forming the core of Islamic financing haven't been covered.

Fifth, the proliferation of Sharia boards at the level of individual financial institutions has added to uncertainty and raises questions about the nature and legal force behind these boards. Are they part of the governance structure or decision-making process?

Sixth, the lack of standardisation of Islamic products has made transaction costs relatively higher, and the issuance of transaction-based fatwas by Sharia boards leads to lack of transparency and unpredictability.

Seventh, investment account holders are neither shareholders nor passive depositors. They are, however, not represented on the governance of the institutions and thus do not have much of a voice.

Eighth, the human resource base is becoming a major constraint in the expansion of Islamic banking. Individuals who are trained and competent in basic banking as well as Islamic jurisprudence are limited in supply.

The committee, therefore, has a challenging task ahead to address some of these issues and problems that can remove the hurdles in the way of rapid growth of Islamic finance.

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