Risks and Challenges to Islamic Finance

The limited availability of Shariah scholars who are equally well versed in Islamic jurisprudence and modern Islamic banking is one of the major impediments in the September growth of IFSI. These scholars have not been able to find refined risk management techniques and hedging instruments. Experimentation, innovation, monitoring the results and impact valuation provide a robust toll box to address this issue. But the competence in these methodologies among the Shariah scholars poses problems. In today's world, the conventional finance is coming up almost every month with new products, hybrids, synthetics, more sophisticated forms of derivatives, options and hedging instruments

In my view the large uncertainty about the Shariah compliance or the huge costs of investment in innovation without any reasonable assurance that these will bear fruits have retarded the progress. The second reason for fewer new products in Islamic finance is that the current growth rates of 15-20 percent annually have lulled all of us into a false sense of complacency that the market demand is being adequately met by the current supply off-the-shelf. But we haven't focused on the build-up of a pipeline of new products that will be needed when the shelf becomes empty. After all, starting with a low base the potential for picking low hanging fruits has not yet been exhausted. But if Islamic finance has to assert itself for presence in the international financial market space on a sustained basis then not only the wrappings and packages but the contents have to be continuously changed to suit the demands of the buyers.

A related issue is the training and intake of new Shariah scholars. There are no systematic plans for the training and production of these scholars. While a lot of efforts are being made in training Islamic finance professionals for front office and back office operations an International Institute of quality should be set up to produce the Shariah scholars who are well versed in modern finance, accountancy, taxation, economics law and Islamic jurisprudence and are of high caliber. These individuals are our best hope for a continuous supply of new Shariah compliant products. As long as we do not meet this challenge we are likely to remain trapped in this low level equilibrium despite the impressive growth rates. Perhaps the emergence of London as the global hub of Islamic finance and consequent pressure on the universities, research institutes etc. in the U.K will help us move in this direction.

1. What is the appropriate form of legal entity for an Islamic Financial Institution? The Islamic principles of property rights, sanctity of contracts and incentive to enforce Shariah have to be incorporated in the legal entity model for Islamic Finance. Companies Law, Banking Companies Laws and other statutes available under English legal system do not fulfill these principles. Shareholder or owner-centred governance system dominates the English Commercial Law. Inclusion of other stakeholders – the individuals, the firm, community and the state in the governance structure did not figure in. There is no need to undermine the rights of shareholders to maximize profits but the legal arrangements should also allow the rights of stakeholders in legal arrangements in Civil Code jurisdictions. The incompatibility of the existing commercial laws and codes with the Islamic principles poses a fundamental conflict between what ought to be and what is in place. The regulators will be at a loss to design adequate prudential regulations for Islamic finance if the legal foundations are weak or unclear.
2. What is the nature and the legal force behind a Shariah board? Are they part of the governance structure because they protect the rights of depositors/ investors and borrowers who have put their faith and trust in the financial institutions to perform activities according to their beliefs? But the issuance of transaction based fatwas by the Shariah Boards lead to lack of transparency and unpredictability. Investment account holders (IAHs) occupy a peculiar position in the Islamic financial institution. They are neither shareholders in the traditional sense nor are they passive depositors. They are however not represented in the governance of the IFSIs and thus their rights are not protected. So any corporate governance structure for IFSI should incorporate these stakeholders as well define the role of the Shariah Boards. How the regulators perform customer protection functions when the rights and obligations of this category of stakeholders remains shrouded in obscurity.
3. What is the extent of the case law and what are the established judicial precedents on a range of issues such as true sale, collateral security, bankruptcy, insolvency, foreclosure applicable in case of Islamic finance. Either some of these issues have not yet been challenged in the courts of law or if they have been a critical mass of legal opinion under different circumstances, different jurisdictions and different Shariah interpretations has not yet emerged even in the common-law based legal systems. There is therefore absence of

legal certainty about Islamic finance in contrast to the conventional finance. The regulatory agencies do not know how to handle this uncertainty.

4. Shariah reports are not available to the public or they are full of inconsistencies across sectors and across jurisdictions. This situation is antithetical to one of the principles of good governance i.e. disclosure. How can this problem inconsistency in disclosure or less than full disclosure be handled to maintain the integrity of the corporate governance structure of Islamic financial system?
5. Islamic bank is a hybrid of the commercial and investment types of bank just like conventional universal banks but there are no firewalls to separate legally, financially and operationally – their investment and commercial banking services. Co-mingling of funds leads to difficult in identifying the sources of funds invested at the time of distribution of profits and losses. Although the regulators have succeeded in separation of funds of conventional and Islamic banking windows and subsidiary the further separation between investment and commercial banking operations requires scrutiny.

What the possible options are for cross – sectorial regulation and supervision of IFSI? First, we have to distinguish between those regulating in a wholly Islamic jurisdiction and those regulating both Islamic finance and conventional finance. As the former category contains a very few cells the thrust of the discussion would be focused on the latter category.

The question then arises: do we opt for a single unified, integrated regulatory regime where the securities, banking, asset management, takaful, all are under the jurisdiction of a single regulator or have multiple regulators specialized in a different component of the IFSI and set up a coordinating and information exchange mechanism among these regulators.

In a certain way the unification of Islamic financial industry under a single regulatory agency may address some of the current concerns such as the difference in the liabilities structure of Islamic banking and the Mutual Fund, in Modarabas and venture capital, investment banking and Commercial Banking that are difficult to handle. It may also smooth out the links in the value chain of Islamic finance from Securities markets at one end to non-banking financial institutions on the other hand. This approach may also help in identifying, measuring and determining the distribution of risks throughout the financial system. For example, the banks may off load their assets from their balance sheets through securitization, disperse the risk, diversify and prospectively lower the cost of funding. A unified single regulator would be in a better position to assess whether such a transfer of risks from individual banks to other institutions under IFSI would promote financial stability or give rise to new systemic risks. The question of where the ultimate risk resides in the complex web of transactions under financial engineering and financial innovations can also be better handled under a single integrated regulator.

The institutions practicing Islamic finance should be subject to all global standards and regulations that are applied to other financial institutions.

Second, financial inclusion which has become one of the main endeavors of many policy makers and regulators can be promoted and spread by Islamic banking. The principles of microcredit can be applied under Islamic finance framework to provide financing to the poor through social mobilization and awareness campaign.

Third, it is essential that the perception that IFSI is applicable to Muslim countries should be removed. Islamic finance should be offered as an integral part of the global financial markets that has attractive features, to make it as an alternative to the conventional financial system.

There has been some thinking among the regulatory agencies and standard setting bodies about the role of Shariah boards. AAOIFI has come up with some proposed standards and guidelines which attempts to resolve disputes or conflicts between the Shariah boards at individual institution and the Central Shariah Board.

The interests of the investors and depositors in Islamic banking institutions should be strictly watched, safeguarded and enforced with full vigilance and oversights. No laxity or deviations from the standards, policies from the standards, policies, practices and regulations should be allowed, although there would be need to adapt and modify to bring them in conformity with the Shariah principles.

Fourth, the governance, risk management, transparency and internal controls have to be strengthened. These ought to be actually superior to conventional banking as the Islamic banking would have to go through to filters: One Shariah compliance and the other established banking rules and norms.

Fifth, the spread of Islamic financial services industry has so far been uneven across industry segments, products and geography. It is highly encouraging that the momentum has indeed been accelerated in the GCC countries in the last couple of years and that augurs well for the industry. But the concentration so far has been on Islamic banking and asset management funds. The other complementary parts of the financial services value chain such as Takaful, Capital markets, micro finance, non-bank financial institutions have not made much headway so far. Across geography Malaysia, Bahrain, Pakistan, Iran and Sudan are the early movers but the coverage ratios in the first three countries are slid low although the growth rates are impressive. I expect Islamic Capital markets to grow more rapidly in future as the issues of Shariah compliant equity and Sukuk are becoming more standardized and their transaction costs lowered with the passage of time. But the Shariah compliant alternatives to swaps, options, futures synthetics and warrants have yet to be developed.

Sixth, the dearth of adequately trained and skilled human resource base is a severe danger that needs to be addressed. International institutions such as INCEIF have stepped in to fill the gap, but their efforts have to be augmented and multiplied across the countries. Pakistan has recently established the Centres of Excellence in Islamic Finance (CEIF) with the mandate to produce high level bankers and retrain the existing cadre of professionals working in the industry. Similar efforts have to be duplicated in other jurisdictions.

Finally, some of the key elements of financial architecture and infrastructure such as liquidity management instruments, rating and external credit assessment, statistics and information gathering, research and development, market micro structures and Shariah screening technologies have not yet been fully embedded and integrated in the nationwide or cross-border systems. I must, however, admit that there has been a spurt of activity in the last few years and greater attention is being paid to fill these gaps by the newly formed institutions such as the Islamic Financial Services Board, the AAOFI and others. The recently drafted the ten years Master Plan is highly commendable as it lays down the general framework and the path for specific actions by different stakeholders including the national authorities, multilateral institutions.