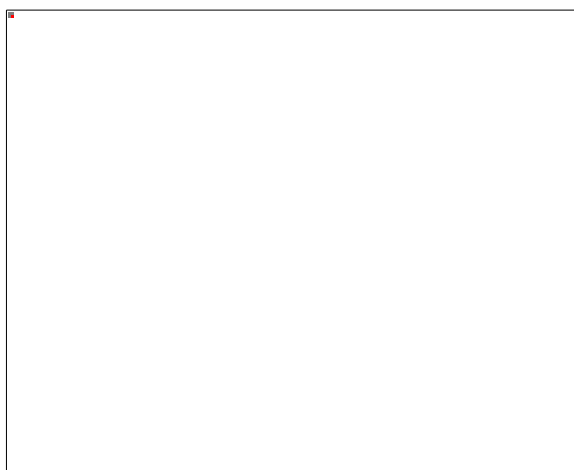


10th September, 2007



The surge in Islamic financial services

By Dr Ishrat Husain



The last five years have witnessed a huge expansion in Islamic Finance Service Industry (IFSI). The current assets are estimated at over \$500 billion in Islamic banking segment alone. More than 250 Shariah-compliant mutual funds are managing about \$11 billion in assets. Corporate and sovereign Sukuk bonds amounting to about \$18 billion have been issued so far. The annual market capitalisation of the stocks meeting the Dow Jones Islamic Market Index Criteria in Islamic countries is estimated at \$300 billion.

The total assets of the banking and non-banking financial services being offered in Islamic mode throughout the world are estimated to be in the range of \$800 billion to \$1 trillion. This growth has been spectacular considering that in the 1990s the IFSI was in a nascent stage of its formation. The annual average growth of the IFSI exceeds 15 per cent and is projected between 10-15 per cent for the next decade.

The highest spread of the industry has taken place in the GCC countries followed by Malaysia, Iran and Sudan. The annual growth rate in GCC countries is 24 per cent while in South East Asia it is 26 per cent. Pakistan which started Islamic banking in real earnest five years ago is also witnessing double-digit growth. In all these markets, the assets of Islamic banking have grown faster than the overall banking sectors.

This rapid growth is an indicator of the demand for Islamic financial products in the global financial markets. Consequent to this growing demand, the scope and coverage of IFSI has also gradually expanded and now extends to: (i) retail investments and consumer finance; (ii) private equity; (iii) structured products; (iv) commercial banking; (v) insurance; (vi) structured and trade finance; (vii) project finance; (viii) debt issues; (ix) public offerings; (x) mutual funds.

Despite this high growth and coverage, the penetration of Islamic banking has a long way to go. It is estimated that in GCC countries, the share of Islamic banking assets in total banking assets is only 15 per cent. The largest penetration level is in Saudi Arabia with 20 per cent followed by UAE 18 per cent and Qatar, 17 per cent. In South East Asia, Malaysia has reached 12 per cent in

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the loan portfolio and seven per cent in total deposits. The five most populous countries in the Muslim World – Pakistan, Indonesia, Bangladesh, Turkey and Egypt - are very much at a very early stage of development of Islamic financial industry.

Despite rapid growth, the assets of Islamic banking in Pakistan have just reached four per cent of the total banking assets. The arrival of several international Islamic banks of repute has accelerated the competition within the industry. In the period 2003-05, Islamic banking deposit growth was 82 per cent compared to 21 per cent recorded by the conventional banks. The awareness of and demand for the products of IFSI are increasing in other Muslim countries too.

Islamic financing is becoming popular both among the Muslim and non-Muslim population. The Muslim population can be divided in three market segments. First, those who are attracted purely due to the Shariah principles and are prepared to sacrifice some returns for this purpose. Second, those who prefer Islamic products but may not want to sacrifice returns. Finally, those who are indifferent to Shariah compliance but want performance, service and relationship.

The first segment forms the core of the IFSI while the second segment shifts between the IFSI and the conventional banks. A survey carried out by McKinsey in 2005 has revealed that the respect of Shariah principles was the single most important factor identified by the Islamic banking customers in choosing their banks. This finding showing that the customers believe that the Islamic banking products do respond to their needs augurs well for the future of IFSI.

Among the non-Muslim population, the Sukuk issues that are analogous to asset-backed securities help in promoting an efficient capital market, bringing in an investor and saver base that has traditionally remained outside the organised financial system and providing an avenue for long-term fund placement. Forty per cent of the recent Abu Dhabi Islamic Bank issue of \$800 million was subscribed by investors coming from Europe. Japan is also reported to be considering issuing Sukuk in Malaysia, Pakistan etc.

Islamic banking is also gradually moving into the retail banking space with the introduction of Islamic cards and Shariah compliant consumer finance products. The retail loans/ GDP ratio in Pakistan is four per cent, in Indonesia seven and eight per cent in Egypt – three large countries. There is thus a substantial room to increase Islamic modes of retail banking underpinned by strong economic and demographic fundamentals. This will be helped by the fact that leading Islamic banks are enjoying attractive returns and are expanding cross-border businesses in Muslim countries. The recent move by Kuwait Finance House (KFH) to acquire RHB in Malaysia is a leading indicator of this phenomenon.

The large international players such as HSBC, Citigroup, Deutsche, Standard Chartered, BNP Paribas are also entering into the Islamic banking market. With their global reach and proven capacity to innovate and generate world-class products, the IFSI is likely to benefit from qualitative up-gradation and a large distribution network. The presence of these well-known global players will provide comfort to the new entrants in this industry.

Another boost to Islamic banking is coming from the pro-active approach of the regulators particularly under the aegis of the Islamic Finance Service Board (IFSB). The setting of standards in corporate governance, risk management, auditing and accounting are beginning to address and clarify some of the outstanding issues faced by the industry. The regulators in some key Islamic banking markets are encouraging the development of the industry by acting as facilitators and this will provide further impetus to this industry's growth.

Some of the ways in which the Islamic finance industry is integrating into the global financial system and adding value are outlined below.

Convergence between ethical investments and Islamic finance: The concerns for ethical investments on the part of a large investor community in the world are similar to the Shariah

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compliance concerns of the Islamic finance. Social investment and Green Funds in the western countries are based on promotion of socially healthy and environment friendly businesses. Prohibition of incomes from sources disallowed under the Islamic banking can be subsumed in the larger ambit of ethical investment.

Many funds have emerged that are exclusively devoted to meet the specifications of investments in ethical products or socially responsible services. Islamic finance conveniently fits into this food chain because of its natural affinity and congruence with its end-use restrictions. To that extent, this convergence, which is likely to be further strengthened in the future, is a precursor of the form and shape of global finance in the coming decades.

There is a growing trend, particularly among the younger population to shun unethical or socially irresponsible investment funds and businesses. Islamic finance does not allow undertaking or financing the anti-social and unethical businesses such as gambling, prostitution, alcoholic liquor, nightclubs and narcotics.

Islamic banks are prohibited from opening accounts or provide financing to persons and institutions involved in such activities. In this respect, it is clearly ahead of the recent surge in ethical finance and socially responsible finance that are becoming quite popular in the Western world. Islamic financial institutions, because of their active involvement and knowledge of the nature of businesses of their clients, are in a better position to detect and prevent the channelling of depositors' money for financing highly risky but equally remunerative anti-social activities. The financing it provides is mostly asset-based, whereby the Islamic bank knows the actual utilisation of it funds.

Islamic finance and poverty alleviation: Islamic finance should be viewed as part of an evolutionary process in the deepening of the financial services industry, stimulation of real sectors in the economy and alleviation of poverty in the developing countries. In developing countries, they must perform the critical function of mobilising savings and intermediating them for investment to generate growth and alleviate poverty.

Islamic financial instruments by producing new tangible assets and trading in these assets have a positive and direct effect on real sectors of the economy. Long-term investments such as infrastructure projects which have long gestation periods are ideally suited for Islamic finance. The risk of default in case of debt issues and capital loss for equity investor is lower under Islamic finance contracts.

Unlike the conventional bond holders or initial offerings, the investors in Islamic financial claims have an implicit right of information on the use of their funds and the nature and performance of underlying assets. The comfort level of investors through this implicit guarantee on the proper utilisation of their funds is a plus point for Islamic finance.

Islamic finance enables access to that particular segment of population that has hitherto been outside the domain of formal financial services. This segment, in many developing countries, has also been enjoying living standards below median incomes and consumption. Thus bringing them under the fold of Islamic financial services offers significant potential in achieving the goals of sustainable and inclusive economic development and social progress.

To the extent the poor and low income group are able to participate and benefit from the fruits of economic growth, these excluded classes would have little incentives to indulge in creating disorder, violence and terrorism. Therefore, the linkage between economic and social exclusion, poverty, vulnerability on one hand and violence, terrorism on the other, should not be dismissed lightly and taken seriously.

Islamic finance and risk diversification: The attraction of Islamic finance to the non-Muslim investors all over the world lies in their quest for diversifying their portfolios. Islamic finance

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provides them new asset classes, new instruments and new products with low correlation with established asset classes or products. Islamic financial products cater to this particular need and are, therefore, drawing increased attention of that investor group.

The risk characteristics of Islamic finance are different on the liability side due to unique nature of profit sharing investment accounts. On the asset side, Islamic banks take ownership stakes in the contractual relationships and offer products and services different from those offered by conventional banks. Institutional investors such as Pension Funds, Endowment Funds are shifting towards Islamic assets in order to achieve diversification objective.

Islamic finance and anti--money laundering: In this world where caution and concerns about possible risks arising from money-laundering and terrorist financing have become acute, Islamic banks by explicitly prohibiting proceeds from activities such as gambling, prostitution, night clubs, drug trafficking provide adequate safeguards. These are the main channels used for money laundering, terrorism financing and organised crimes etc., Islamic financial institutions enjoy a head start in mitigating these risks.

Unlike conventional banks which rely on documentary evidence and usually have impersonal, arms-length, passive relationships with the majority of their clients, Islamic banks have more stringent 'know-your-customer' requirements. The reason for this difference is quite commonsensical. Conventional banks rely on a fixed pre-determined return framework and are, therefore less concerned about the character and credibility of their clients. They are often, more pre occupied with the underlying securities and assets.

On the other hand, Islamic banks are engaged in a quasi-partnership profit-loss sharing framework and therefore have to know their clients, their businesses, as well as, their sources and uses of finding in order to satisfy themselves about the authenticity and legitimacy of their counterparties. Thus, they would be in a much better position to detect, prevent and disengage quickly from suspicious transactions compared to conventional banks.

In addition to normal audits, Islamic banks have to conduct Shari'ah review of their transactions for ensuring Shari'ah compliance. This review will catch any funds mobilised or used for 'haram' (prohibited) activities. This unique feature of Islamic finance as possible prevention of money laundering has not yet been widely disseminated and its potential not fully recognised.

The writer is a former Governor of the State Bank and one of the founder-directors of the Islamic Finance Services Board (IFSB). He is currently serving on the governing council of the International Centre for Education in Islamic Finance (INCEIF). He also pioneered Islamic banking in Pakistan in 2002.

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Founder: Quaid-i-Azam Mohammad Ali Jinnah
Editor: Tahir Mirza

The DAWN Group of Newspapers

Haroon House, Dr. Ziauddin Ahmed Road, Karachi 74200, Pakistan.

Phone: +92 (21) 111-444-777 Fax: +92 (21) 569-3995

webmaster@dawn.com

[Contributions](#)

For Marketing: mktg@dawn.com

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