

Future Challenges for Islamic Financial Services Industry. **(ISHRAT HUSAIN)**

Islamic Financial Services industry (IFSI) is currently catering to a particular segment of populating in several Muslim countries and is also attracting interest among non-Muslim investors and fund managers. They consider Islamic financial assets to be a distinct asset class. Its low correlation with other existing asset classes provides an excellent opportunity for diversification of risk. The socially responsible nature of the funds mobilized and funds utilized by the IFSI adds a new dimension to the attractiveness of this industry. Finally, a large number of Muslims who have hitherto refrained from participating in the banking activities due to their faith and belief have begun to resort to Islamic banking thus deepening the financial sector in these countries. In the contest of the developing countries, this newly established access to financial services industry has some important repercussions. If we assume that the poor and low income groups in the Muslim countries benefit disproportionately from the access to the Islamic financial services it would be beneficial toward achieving the goal of poverty reduction. To the extent that the unemployed youth in the Muslim countries are able to find gainful employment and improve living standards through financial sector – real sector nexus the incentives for diversion of their energies and time towards violence, terrorism, crime and other undesirable social behavior would be reduced. To my mind this an empirical question that needs to be carefully explored and the baseline data established as soon as possible. The international financial institutions can sponsor this kind of work as it will not only carry credibility but also respond to the critics of the Islamic financial services industry. I will revert to this suggestion at the end of my talk.

The policy makers can draw some satisfaction that the emergence of the IFSI can have potential for diversification of assets for the global financial sectors in the developing countries and through social inclusion utilize the opportunities for gainful employment and improved living standards for the youth in the Muslim countries.

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I would therefore focus my attention this afternoon as to how this potential can be conformity with the beliefs and infunctions followed by the Muslim communities and individuals. The Shariah Boards at the financial regulatory agencies should therefore consist of people with credibility who command trust on the basis of their knowledge and integrity. The fragmentation of Shariah boards at individual institution level can hamper the process of standardization, uniformly in interpretation and therefore the growth of the industry and the process of broadening the access and deepening of the financial sector. Second, the socially responsible and inclusive approach of the Islamic financial services industry can be nurtured and harnessed by merging the successful principles of micro credit and the Islamic banking. The poor and those without any tangible base asset base in many Muslim countries presently shun the micro credit institutions as they consider them antithetical to their religious beliefs. There is a need for the Islamic financial institutions to provide microcredit to this particular segment of population through social mobilization and awareness campaigns informing them about the characteristics of the Islamic micro credit.

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Third, the Islamic financial services industry should be fully integrated into the global financial markets while maintaining at the same time its distinctive nature and the uniqueness of its services. These institutions should be subjected to the full ambit of the banking regulations and supervised as intensely as other financial institutions.

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The depositors and investors must have the same level of comfort as they enjoy under conventional banking that their interests are being constantly watched and safeguarded by a vigilant regulator. Any laxity in the standards, practices or enforcement on the part of the regulators would not only be counterproductive but also act as an impediment towards the acceptance of these assets by international financial markets. These, in my view, would be a major setback.

Fourth, the corporate governance, risk management, transparency and disclosure, internal controls requirements in the Islamic financial services industry are in a state of evolution. They are being adapted to

meet the specific needs of the Islamic banks. Any variations or divergences that emerge as a result of the Shariah compliance imperatives should be fully explained, documented and disclosed. It is not enough to say that these charges have been made to comply with the Shariah injunctions. We have to go an extra mile in order to justify the changes that have been made. These charges at times may in fact strengthen the financial institutions and industry.

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 Sukuks 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, one of the biggest challenges that I personally faced in Pakistan was the dearth of adequately trained and skilled human resource base for Islamic banks. I decided to slow down the opening of these branches and banking institutions because I was deeply concerned that (a) we were outpricing the Islamic banking products and services by bidding up the compensation package of the few experienced Islamic bankers who were involved in a merry go round and (b) the Islamic banks were compromising on the quality of the professionals by relaxing stringent standards of recruitment in their quest of finding people for their branches. Both these trends were likely to prove dangerous to the incipient growth of Islamic financial services in Pakistan. We could not find skilled Islamic bankers even in the Middle

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East on the contrary we discovered that some of our well reputed Islamic bankers were being lured by the banks in Dubai, Jeddah and Bahrain. I have heard other central bankers complain about this human resource constraint too. Bank Negara Malaysia has taken the lead in setting up an International Centre for education in Islamic finance and the State Bank of Pakistan has initiated a certification course for Islamic bank branch managers. But there is a lot to do in this area failing which the momentum will indeed be hampered.

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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 AAOIFI 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.

This leads me to offer some thoughts on what multilateral institutions such as the IMF and World Bank can do to further expand and strengthen the Islamic financial services industry.

I don't think the agenda should be so vast and expansive that it may overtax the limited capacity of these institutions. To begin with these institutions should allocate some modest resources towards building a reliable data base, macro prudential and financial soundness indicators and research studies on the pattern, trends evolution, prospects and constraints facing the Islamic finance. Both these institutions are highly respected for their data, analysis and research on a wide variety of economic and financial issues. The investors, fund managers and markets, do listen carefully and respectfully to what they have to say. Your work on Islamic finance will add to the knowledge

base and provide the international financial community with facts and analysis on the basis of which they can make informed judgments. I would not encourage those of you who are very keen at this stage to initiate technical assistance programs in Islamic finance. This will happen but at a later stage when your data bases and analytical capacity have equipped you to make sound needs assessments and offer practical and feasible solutions based on the knowledge and experience acquired. Cross-country comparative studies are the source of competitive advantage for the World Bank and the IMF and this would be the route you should take before embarking upon policy advice and technical assistance work. One of the appropriate and readily available entry points for you is the Financial Sector assessment program (FSAP). In many of the countries in the Middle East, North Africa, South Asia and East Asia it may be advisable to bring in experts to prepare an evaluation of the current state of art in Islamic finance in the country. These reports may be drafted under common analytical framework and can then be utilized for the next step i.e. the cross-country comparative study.

The other area of work where the IMF and the Bank can collaborate is the modeling of behavior and responses of participants in the Islamic finance industry. Do they exhibit the same constrained rational optimization behavior or other constraints that are added