

ISLAMIC FINANCE INDUSTRY: POSITIONED FOR GROWTH

ISHRAT HUSAIN

The achievements made by Islamic Finance Industry during the last few years have indeed been impressive. The growth rate of 15-20% annually, the evolution of sukuku, fixed income, equity, money market instruments and the attraction of Islamic products among a large variety of issuers and investors globally have been the salient features that have characterized the Islamic Finance Industry (IFI). What I propose to do this afternoon is to spell out the challenges that the industry has to meet during the next several years to integrate itself within the framework of global financial system.

First, the host country leadership in resolving some of the legal and regulatory issues will remain absolutely critical. For example, some of the public sector issuers cannot lease or pledge the assets underlying the transaction. This legal issue needs to be satisfactorily resolved for larger volumes of public sector issues to take place. Another knotty issue is that the Islamic banks have to assume the ownership of the underlying assets even for a limited duration and they have to bear the risks associated with ownership. Buying insurance to protect themselves imposes additional costs. Who will pay for these costs? If it is passed on to the depositor or borrower it will appear as a lower rate of return or higher mark up putting the Islamic banks at a competitive disadvantage compared to the conventional banks. In case the banks absorb these costs, the profits earned by the shareholders will be lowered.

Second, the legal and documentary expenses as well as distribution costs of Islamic products and services are also relatively higher than those offered by the conventional banks. This is because the Islamic banks focus on single transaction and therefore the Islamic banks have to find means to reduce the overall cost by developing master agreement frameworks. Under which individual transactions can take place.

Third, there is a lack of standardization of Islamic products and instruments even among the banks in the same country. For further growth of IFI standard contracts should be developed across countries, regions as well as markets and different schools of thought. This improvement will help reduce the inherent unpredictability among the market players and also lower the transaction cost. Ex-ante approvals of each transaction by the Shariah Board are not only labor intensive but highly cumbersome.

Commented [HH/RFC@I1]: Only a 3% match with Islamic finance news.

Fourth, the Islamic Finance Industry has to balance and reconcile the diverse and at times competing interests of four classes of stakeholders – customers, shareholders and Shariah Boards. This last class of stakeholders is unique to the Islamic banks and due to wide divergences in the opinions of different Shariah scholars the product development cycle and the time required for structuring the transaction are elongated. The competing conventional banks are by contrast, more nimble as they do not face this additional constraint.

Fifth, the lack of clarity about the appropriate legal framework applicable to the disputes arising from the contracts in the IFI acts as a dampening influence on the choice of some potential customers who may otherwise be willing to switch their business from the conventional to Islamic banking. Islam favors expeditious alternate dispute resolution mechanisms but most countries rely mainly on formal court systems that are expensive, time consuming and discourage mediation, arbitration and other simpler processes of dispute resolution. Furthermore, there is a paucity of lawyers and judges trained and well versed in Islamic banking.

Sixth, the standards of corporate governance in financial services industry are becoming more stringent and demanding with the passage of time. IFI has to set its own standards of transparency, disclosure, risk management, internal controls, audit and accountability. The Islamic Financial Services Board (IFSB) is working on these prudential regulations and standards but the sooner these standards are developed and practiced the better off the Islamic Finance Industry would be.

Seventh, the range of products offered at present by the Islamic Industry is quite limited and is dominated mostly by murabaha. Product innovation and product development fully compliant with Shariah that can meet the changing requirements and preferences of the borrowers and depositors are absolutely essential for maintaining the competitive edge. The risk of losing market share will, otherwise, remain quite strong.

Eighth, a common factor that is impeding the expansion of Islamic banking is the scarcity of trained and experienced human resources available. In Pakistan we had to slow down branch licencing process as we were quite concerned with the non availability of professionals who were well rounded in both banking and knowledge of Shariah. The danger we see is that the existing pool of talent among the banks will out price Islamic banking products as they have to pay out of market compensation packages to retain their experienced staff. The Islamic Institute for Education in International Finance (INCIEF) setup recently in Kuala Lumpur is a step in the right direction but many more national institutes are needed to provide critical mass of Islamic bankers.

Ninth, Islamic banking has to be viewed as one of the components of the Islamic Economic System. The distinguishing mark of the latter is that all those participating in this system have to demonstrate values of high integrity, truthfulness, ethical behavior, compassion for the poor and absence of exploitation. But we are way off the mark as far as the practice of these values is concerned. This disconnect between the theory and the practice is likely to weaken the system.

Tenth, we are faced with an acute shortage of qualified and competent Shariah scholars who can serve on the Shariah Boards of Islamic banks. The limited pool of scholars is being taxed heavily putting some stress on the system. The regulators may have to prescribe and enforce the fit and proper criteria at some time in the future and also issue guidelines for avoiding conflict of interest. It is therefore imperative that the pool of Shariah Scholars should be widened or others trained so that they can qualify over time.

Eleventh, the key elements of financial architecture and infrastructure such as liquidity management instruments, rating and external credit assessments, statistics and information gathering, research and development, Shariah screening technologies are yet in their infancy. These elements are pre-requisites for well functioning markets but cannot be put together by a firm. Industry-wide institutions will have to take initiative in these areas.

Finally, the fund mobilization techniques of IFI are more akin to asset management rather than conventional fund management. If the latter is the case which institution should be entrusted with the regulation and supervision of IFI. Are the central banks the appropriate regulators or the Securities and Exchange Commissions? In case the SECs take over these functions will there be a market segmentation of the banking industry in countries which have both the conventional and Islamic banking systems running in parallel.

I have raised these issues for serious thinking, consideration and discussion. This is also to avoid ourselves from getting into a complacent or self congratulatory mode but to emphasize that there are many unresolved issues and challenges that we have to address and struggle with. I am quite confident that we apply our minds together we will be able to find or develop satisfactory answers to these problems.

Thank you.

Commented [HH/RFC@I2]: 2% match with internet source.