PANEL ON ISLAMIC FINANCE

I would like to state at the very outset that I am a believer in the mainstreaming of Islamic finance as an integral part of global finance. This is the only way it can expand and sustain itself rather than being limited as a small niche market. There are several trends in the global finance which make me optimistic in this regard

Convergence between ethical investments and Islamic finance:

First, the concerns for ethical investments on the part of a large investor community in the world are similar to the Shariah 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 business. 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 channeling 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 utilization of its funds.

Address delivered at the Malaysia – World Islamic Economic Forum Kuala Lumpur on May 29th 2007

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Islamic finance and poverty alleviation:

Second 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. This would require that Islamic financial services should be developed in an efficient, competitive, sound and sustainable manner. In developing countries they must perform the critical function of mobilizing 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 utilization 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 groups 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:

Third, there are investors all over the world who in their quest for diversifying their portfolios are looking for new asset classes, new instruments and new products with low correlation with existing asset classes or products. Islamic financial products cater to this particular need and have, therefore, become attractive to that investor group. This risk characteristics of Islamic finance are different on the liability side due to unique nature of profit sharing investment accounts and on the asset side Islamic banks take ownership stakes in the contractual relationships and offer different products and services compared to conventional banks. Institutional investors such as Pension Funds, Endowment Funds are shifting towards Islamic assets in order to achieve diversification objective. The emergence of London as the future hub of Islamic finance will not only help in bringing it within the fold of global finance but also introduce it to investor classes and Fund managers who have hitherto remained on the sidelines. The regulatory and supervisory oversight of Financial Services Authority (FSA) will provide comfort to the investors, issues and asset managers.

FUTURE CHALLENGES

Although there are several challenges facing the IFSI I will limit myself to only two of these today. The current group of Shariah scholars advising the industry is very small in size. They have the unique distinction of familiarity with English language, mastery over Islamic jurisprudence and knowledge of modern banking. But their horizon is restricted to the traditional modes of financing – musharaka, murabaha, modaraba, ijrah, salam etc – and has not extended beyond this limited range of product offerings. In today's world where the conventional finance is coming up almost every month with new products, hybrids, synthetics, more sophisticated forms of derivatives, options and hedging instruments, more refined risk management techniques the response of the Islamic finance has not been equally forceful. The way forward in my view is that the basic restrictions imposed by Islamic finance on both asset as well as liabilities should be taken as a starting point and without violating those restrictions the Shariah scholars should encourage the practitioners to experiment and innovate. The growing competition in the industry and the attraction of the big players towards Islamic finance provide some assurance that if they are given this kind of guidance the manufacturing of new Islamic products and techniques will be accelerated. 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

Commented [HH/RFC@I3]: Matching 25% with ceif.iba.edu.pk. Consider revising Though this could be CEIF copying post-interview 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. As I pointed out 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.