islamic banking

Drawing the roadmap for Islamic banking

At the recent International Islamic Finance Conference organised by the General Council for Islamic Banks and Financial Institutions (GCIBFI), senior delegates discussed how to grow and enhance the industry as a whole

According to estimates provided by the General Council for Islamic Banks and Financial Institutions (GCIBFI), pure-play Islamic banks and financial institutions today manage some $260 billion of assets. A further $200 billion to $300 billion is managed by the Islamic windows and subsidiaries of international banks in the world's major financial centres; such as New York, London, Paris, Geneva and Tokyo. These sums may be nothing to sniff at, but they are by no means representative of the entire universe of potential Islamic assets. Islamic bankers know that Muslim, and indeed non-Muslim, consumers and investors are interested in their activities. The challenge for them is to make Islamic products and services fiscally sound and competitive, and then to make them available to all who want them.

At a recent GCIBFI conference held in Dubai to discuss issues facing the industry, Professor Samuel L. Hayes of Harvard University was invited to share his views on Islamic banking as an independent commentator. One of the first observations he made was to say that the mindset of Islamic bankers seems to have changed for the better, allowing for meaningful discussion of the industry's problems and weaknesses to take place. "When I first began to look into Islamic finance in the early 1990s, my impression was that Islamic bankers then were committed to a set way of doing things," he said. "These bankers were quite happy to wait for the world to come to them, and I thought then that it would take a long time for Islamic banking to take off."

Common ground

But Islamic banking did take off, and has in fact enjoyed an average annual growth rate over 10% per annum since it first emerged in the 1970s, according to the GCIBFI. Hayes attributed much of this success to the increasing sophistication of Shariah scholars and the effort put into Islamic financial engineering, as well as the vital motivator of market demand.

Though the raison d'etre of Shariah-compliant banking is to give Muslims an alternative to interest-based conventional finance, Hayes remarked that the series of scandals in corporate

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America has helped to close the gap between the ethical demands of Muslim and non-Muslim investors. “Unconsciously, conventional finance has been moving towards the societal values of Islamic finance,” he said. Non-Muslim investors were not pleased by the revelations of lies and cheating found in the Enron fraud and the Wall Street investment banking research scandals. More recently, they didn’t like the enormous severance package awarded to Richard Grasso of the NYSE. The arrangement smacked of greed and a lack of financial perspective, and one doesn’t have to be Muslim to find that distasteful. In fact, Hayes said that investors in the US are increasingly keen to invest on an ethical basis: “$1 in every $8 invested in the US now follows moral investment criteria.” Such criteria commonly include a prohibition on investing in tobacco stocks or firms publishing pornography.

So if the world is increasingly coming round to an appreciation of the ethical standards that are part and parcel of Islamic banking, so the potential demand for the industry’s products and services increases. Iqbal Khan, CEO of HSBC Amanah Finance, observed that Islamic banking has emerged as a new paradigm of financial services, espousing corporate social responsibility and value-defined activities, but it is still chasing the scale and achievements of conventional finance. Innovation is key to the industry’s future in his view, and to understand the scope for innovation one first has to understand where Islamic financial structures have come from.

> **"We need research to be carried out into developing an Islamic version of the M&M model, and in many other areas of Islamic finance such as risk management and securitisation, so that we can build the Islamic banking industry on sound theoretical foundations"**

Applied creativity

The foundation of any Islamic financial engineering is an understanding of the balance between fixed features of Shariah, such as certain prohibitions and the fixed tenets of Qur’anic law, and dynamic features, such as rules on Mu’amalat (dealings), secondary sources of law, and the understanding that everything is permissible unless it is forbidden. Bankers have used doctrines of necessity (Darurah) and common need (Al Hajjah Mushtaraka) as justification, and in some cases classical Islamic instruments have been adapted to modern needs (for example Ijarah for operating leases and Mudarabah for investment management) while in others conventional instruments have been reverse engineered (for example deriving Sukuks from bonds).

Financial engineering has enabled Islamic bankers to create Shariah-compliant products, but some worry that the re-engineering of conventional instruments is a sign in itself that the industry is lacking in imagination and its own theoretical foundations. Atif Abdulmalik (pictured), CEO of First Islamic Investment Bank (FIIB), called on Islamic financiers to recapture the spirit of invention that once led Muslim scientists and mathematicians to invent algebra and algorithms, and to introduce the West to the study of astronomy. While it is clear that conventional finance operates on academically sound principles, Islamic finance has ethical and religious principles to adhere to, but lacks the convictions of accepted financial theory. “Those of us who have studied finance will have studied the Modgliani and Miller model as a tool to calculate the cost of capital of a company,” Abdulmalik said in explanation. “Since in Islamic banking we have investment account holders rather than depositors, it may not be appropriate to use the M&M model because investment account holders to not receive a fixed rate of return. We need research to be carried out into developing an Islamic version of the M&M model, and in many other areas of Islamic finance such as risk management and securitisation, so that we can build the Islamic banking industry on sound theoretical foundations.”

Instruments that meet demand

Abdulmalik went on to say that in his view one of the greatest challenges facing Islamic banking is the provision of short-term investment instruments. Several institutions have tried to develop high quality short-term instruments, but have been hampered by their ability to generate assets, by their credit ratings, and by liquidity. FIIB’s solution to this problem has been to partner with international banks to develop suitable vehicles that can compete with the returns offered to investors by traditional conventional money market products. In this arrangement the international banks provide the liquidity support and asset generation capabilities, and the Islamic bank gets a solution to its problem, albeit not a fully independent one.

Speaking specifically about Islamic debt instruments, Dost Mohamed Qureshi, Adviser to the Islamic Development Bank (IDB), said that his institution’s experiences from launching Sukuks have taught it a lot about the importance of innovation. “Until recently Islamic Sukuks have been seen as bilateral rather than tradeable products,” he said. “Now we are focusing on an Islamic alternative to the bond markets. We want to see how this market can be developed, but also how it can be integrated with the global markets.”

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Providing that Islamic instruments are backed by good governance (as all should be), and that they offer an acceptable level of return (as all aspire to do), then Qureshi believes they can appeal to a wide range of issuers and investors. In fact, the IDB is now talking to a US firm that is interested in issuing its own Sukuk. “The main challenges as we strive to take Sukuks forward are that we must identify a credible pool of assets to convince the buyer,” he added, “Then we must demonstrate economic efficiency and financial discipline. Finally, we have to have a secondary market - the greatest challenge of them all.”

Given that necessity is the mother of all invention, perhaps it is a good thing that Islamic bankers face quite a wide array of problems that they must surmount to guarantee their industry’s future. Some of these problems are tangible, such as diminishing Murabahah returns, constrained asset allocation and the need for Islamic financial training institutions. Some of these problems are rather less easy to tackle head on, such as the lack of Shariah credibility in some products, the rather short-term nature of research and development, and the lack of think tanks to guide the industry with the theoretical foundations called for by Atif Abdulmalik. Iqbal Khan identified structured alternative assets, Sukuks, treasury products, and private equity as the areas he believes should be top of the innovation agenda for Islamic bankers. What is clear is that the replication and re-engineering of conventional products will never be enough in isolation.

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