



Article for WIBC on **Islamic Banking and Finance**

Islamic banking and finance gaining global acceptance

Islamic banking and finance industry has crossed regional boundaries and come to be accepted on the global stage, due to the demand for an alternative to western banking products structured along ethically-aware Islamic principles. The global Islamic finance industry is now worth more than \$1 trillion in terms of assets, having quadrupled in the last three years. Although this figure remains just a fraction of global assets, given a world Muslim population of around 1.5 billion people, the industry has enormous potential, and some of the largest western-based banking, fund management and insurance groups have now launched banking facilities compliant with Shari'a law.

Over the past five years, the Islamic Financial Services industry has made considerable progress and is growing at a faster rate than conventional banking. The various segments of the industry and the related intellectual capital, institutions and policy initiatives have developed rapidly and attained a degree of maturity and international recognition. Further growth of the industry is dependent on the establishment on new Islamic banks and the integration of the industry within the existing financial system with greater regulatory guidelines based on the Shari'a.

One key shari'a ruling on economic activities of Muslims is the strict and explicit prohibition of Riba, most usually described as usury or interest. Shari'a scholars consider exchanging interest payment within the conventional banking system as a type of Riba.

Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations.

The concept of Sukuk

In Islamic finance, the sukuk provides a good example of how the market has grown in recent times. As concepts such as interest (riba) and the trading of debt are prohibited in Islamic finance, conventional bonds that are offered by western banks are unacceptable. Sukuk is the closest thing to a bond in Islamic finance, the difference being that its returns are strictly linked to the asset that has been purchased. In this way it has some similarities to an asset-backed security.

The Islamic Law of Contracts plays a pivotal role within the Islamic financial system. Islamic commercial jurisprudence consists of principle and rules that must be observed for transactions to be acceptable in Islam; and the Islamic Law of Contracts is at the heart of this. One important principle is contractual certainty. Under this body of law, uncertainties or ambiguities that can lead to disputes may render a contract void under Shari'a.

While some of these principles and rules are based on clear and explicit rulings of shari'a, others are derived from shari'a scholars' interpretations and understanding of the law, known as Fiqh, as set out in the Qur'an. These interpretations can and do differ between shari'a scholars. Certain contractual terms deemed to be valid under shari'a by the scholars of one school of Fiqh may not be acceptable to scholars from another school. This has had significant implications for the development of Islamic finance.

Basel II and Islamic finance

Risk management in Islamic finance can be looked at as a challenge, as standards such as Basel II were prepared without much thought about how to interpret Islamic financial instruments. Looking at Basel II implementation, different countries are at different stages. Bahrain and Saudi Arabia have set a target of 2008 for their banks to be Basel II compliant, while the Qatar National Bank is already reporting the monthly capital adequacy ratio to its central bank. It is this sort of rich diversity that means that both corporates wishing to invest in Islamic finance instruments and western banks wanting to set up Islamic finance subsidiaries or take Islamic products to existing foreign markets need to pay a great deal of attention to every last detail.

There are challenges presented by Islamic banking that have an effect on slowing down Basel II implementation, such as availability of data and the unique risks of Islamic finance. Profit and loss sharing shifts the risks in the institution to investment depositors. Islamic banks, by their nature, take on a lot of risks that are usually borne by equity investors.

With regard to Islamic finance's approach to various types of risk, unlike interest, some forms of gains in capital are permitted under shari'a law. In Mudaraba contracts, the holder of the investment account shares the profit and also bears, at the same, all the market risk as well as the credit risk of that position. The investor provides capital and therefore is eligible to share the profit, rather than receiving interest that is initiated from the banking activities and products. Of course the potential downside of this for the investor is that they also share the risk exposure and so could make a loss. In terms of credit risk, most Islamic banks favour the standardised approach, one of two approaches suggested by the Basel II committee.

The challenges for growth

As well as creating opportunities, the growth in Islamic finance is also posing a challenge to the sector. For example, Islamic finance institutions rely on Shari'a committees of scholars for advice and instruction on their services - as the number of institutions

increase, the relatively small number of scholars is being stretched, and there is pressure to ensure that a new generation is being groomed to handle the increasing demand. Islamic banks in the Middle East and Asia are also facing competition from western banks that are setting up their own Islamic products to compete in the growing marketplace.

There is a diversity of opinion as to whether particular or products are Shari'a compliant. This means that some product and services may be approved as being shari'a compliant by some Shari'a scholars but not by others. On a global level, the approval of Islamic firms' products and services may also depend on the jurisdiction they are to be offered in.

For Islamic finance providers, gaining approval from the Shari'a Supervisory Board [SSB] on shari'a compliance of a product before its launch is vital. Equally important for firms is recognizing that shari'a compliance is a continuous process, meaning that their products and services are adequately monitored. Unlike conventional finance, this has implications for an Islamic firm's prudential requirements as well as conduct of business: some products, if they breach shari'a compliance rules, can adversely affect a firm's solvency by converting an asset into a liability on the balance sheet. Effective monitoring of shari'a compliance by an Islamic firm may involve reinforcing more remote SSB oversight through the Internal Shari'a Audit process in addition to developing more knowledge and expertise within the firm.

The Islamic economic model has been developed over time, based on the rulings of shari'a on commercial and financial transactions. The Islamic financial framework, as seen today, stems from principles developed within this model, emphasizing fairness. This is reflected in the requirement that everyone involved in a transaction makes informed decisions and is not misled or cheated. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific shari'a rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society.

Islam encourages and promotes the right of individuals to pursue personal economic wellbeing, but makes a clear distinction between what commercial activities are allowed and what are forbidden. For example, transaction involving alcohol, pork related products, armaments, gambling and other socially detrimental activities.

The current global crisis has again drawn positive attention to the fundamentals of Islamic banking and is sure to generate greater awareness as well as help the Islamic banking industry gain global acceptance thanks to its ethical roots and strong regulatory guidelines.