
Chapter 8. Future Outlook and Challenges for Islamic Finance

Islamic financial institutions are growing rapidly. For example, Noor Islamic Bank was launched by the government of Dubai with US\$1 billion in capital in early 2008. The bank began operations with 10 branches but expects to increase its market share of Islamic banking in the United Arab Emirates (UAE) to as much as 50 percent (Walid 2008). In April 2008, when Saudi Arabia launched the government-backed Inma Bank, it raised US\$2.8 billion in capital in an initial public offering. The establishment of these large Islamic banks, partly with state backing, is a departure for Islamic finance, which until recently was dominated by hundreds of small institutions.

With no significant assets four decades ago, the Islamic banking industry now accounts for 15–20 percent of the banking market across the Organization of the Islamic Conference (OIC) countries (Ahmad 2008). Islamic banking assets are expected to exceed US\$1 trillion by 2010 (“Morgan Stanley Says . . .” 2008). Some reports suggest that assets could rise by 17 percent a year to US\$1.3 trillion by 2012 (Zinkin 2008). The current tally of Islamic financial institutions stands at more than 300 in 75 countries (Mittal 2008).

Some reports state that Islamic banking assets in the Asia Pacific area account for as much as US\$450 billion, which amounts to 60 percent of the global Islamic banking market. The numbers are expected to grow (Nyee 2009). Indeed, prospects for Islamic finance in general are good. The International Monetary Fund expects Islamic finance to keep expanding, despite the global financial turbulence, because of the pool of liquidity in the oil-rich states of the Persian Gulf and the unabated appetite of Muslim investors for Islamic financial products (Kilner 2008).

Four locations—Kuala Lumpur in Malaysia, Dubai, Bahrain, and London—have their sights set on being the global center for Islamic finance. Kuala Lumpur is widely regarded as the hub of Islamic finance in Asia, whereas London is likely to emerge as the gateway for the industry in Europe. Malaysia has long been an established Islamic financial center, but it has been challenged in recent years by strong growth in the Persian Gulf driven primarily by huge oil-related revenues.

Challenges Arising from Interpretation of *Shari'a*

Shari'a is open to interpretation, and religious scholars on *Shari'a* advisory boards frequently hold different views on key issues. The existence of diverse interpretations of Islamic principles has resulted in a lack of standardization in Islamic

finance. In many countries, each financial institution relies on its own *Shari'a* board to review products. Different scholars can disagree on what is “Islamic.”

The varying interpretations of *Shari'a* can be attributed primarily to the five different schools of Islamic thought—Shafi'i, Shia, Hanafi, Hanbali, and Maliki. A *Shari'a* board thus has considerable discretion in the interpretation of Islamic law and may choose any school of thought to inform its decision-making process.

In Malaysia, scholars place priority on form over substance when deciding whether a particular product is *Shari'a* compliant. Scholars in the Gulf Cooperation Council (GCC) countries, however, contend that *Shari'a* compliance is determined by the intent of the transaction.²⁶ Conservative investors in the Middle East are uncomfortable with the principles of *Shari'a* followed in Malaysia. Such investors view Malaysia's interpretation of *Shari'a* as more flexible than is typical in the Arab world.

The lack of standardized religious decisions leads to uncertainty, confusion, and unease among scholars and investors. This situation restricts the industry from reaching its potential because a number of inefficiencies arise from the lack of standardization. For example, different interpretations of *Shari'a* mean that one Islamic bank may not be able to accept or use as a model another Islamic bank's products, which can stifle the integration of Islamic finance at both the national and international levels.

Controversy over acceptable transactions can also hinder the development of certain products or market segments. For example, in late 2007, Sheikh Muhammad Taqi Usmani, a prominent religious scholar who heads the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), jolted the industry by criticizing *sukuk* (Islamic bonds) as being “un-Islamic” (Halim 2007). He argued that they were akin to conventional interest-bearing bonds because risk was not shared among the parties involved. Until that criticism, most *Shari'a* scholars had approved the controversial structure as they sought to expand the market.

In mid-2008, Usmani clarified that he was criticizing two specific bond structures—*musyarakah* (partnership financing) and *mudharabah* (trust financing)—for breaking key principles of Islamic law. He was not criticizing the *ijarah* (leasing) structure that involves a sale and leaseback arrangement (for a refresher on *sukuk* structures, see Chapter 4). Furthermore, he specified that his guidance was for future reference and did not affect the existing US\$80 billion in outstanding *sukuk*. Nevertheless, the market reacted when Usmani made his pronouncement. This reaction and future similar reactions to the opinions of religious scholars reduce confidence in the market, add to market volatility, and reduce the value of securities.

²⁶The GCC consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

Need for Harmonization of Islamic Banking Standards

Greater consensus on standards and product design in the Islamic financial system is required before the system can fully mature. Not only will greater standardization increase scalability of services and industry efficiencies, but without greater standardization in certain core products and markets, Islamic banks will struggle to develop the volumes enjoyed by their conventional banking counterparts. Suggestions include the formation of *Shari'a* advisory boards at the national and international levels and for the creation of a council—representing the five Islamic schools of thought—that would decide as a single body what types of financial services conform to Islamic law and would define cohesive rules to expedite the process of introducing new products (Ahmed 2007).

The AAOIFI is working hard to develop common regulatory standards for Islamic financial institutions and to carry out *Shari'a* training. The AAOIFI states that more than 16 jurisdictions follow or consult its standards, which take into consideration all the Islamic schools of thought. The AAOIFI standards are not enforceable, however, so different scholars within the same jurisdiction may continue to produce divergent opinions.

Similarly, the Malaysia-based Islamic Financial Services Board (IFSB), established in 2002, has issued standards and guidelines pertaining to capital adequacy, risk management, and corporate governance for institutions offering Islamic financial services (other than *takaful*, or Islamic insurance). The IFSB maintains that the adoption of such standards will lead to harmonization of *Shari'a* interpretations, promote homogeneity in the Islamic finance industry, and enhance investor protections. Like the AAOIFI, the IFSB has no enforcement powers.

Without the consensus of a single regulatory, accounting, and *Shari'a*-compliance framework, the expansion of Islamic finance into Muslim countries with large populations and great potential, such as Indonesia, can proceed only at an unnecessarily slow pace.

Other Challenges Facing Islamic Banking

In addition to the issues associated with varying interpretations of *Shari'a* and a lack of regulatory standardization, Islamic finance faces other challenges.

The first challenge is dealing with the charge that Islamic financial products are “*Shari'a* synthetics”; that is, the products are basically copies of conventional products that are structured in a way that makes them appear to be *Shari'a* compliant. These critics assert that new products increasingly contravene the *spirit* of Islamic finance. Products such as derivatives and hedge funds, for example, are considered particularly controversial, given the Quran’s ban on *gharar* (speculation). Critics argue that Islamic banking needs to “innovate within” and develop more of its own products to avoid imitating conventional financial instruments.

In contrast, given that the industry is relatively young and that many of its products are still nascent, others question how much product innovation is actually needed at the moment. They stress that the market is as much in need of consolidation and refinement as it is of innovation and new products.

Second, Islamic financial institutions are challenged to offer better customer service—service that matches international standards—and also to invest in effective technology, such as using the internet to create new distribution channels to reach more customers. Such concepts as “quality” and “creating value for customers” are central to the success of banks entering the Islamic market today. A step toward meeting this challenge is the move by Noor Islamic Bank in the UAE to offer a bank service delivered through post offices, which targets the 50 percent of the population in that country with no formal bank account. The new service is expected to attract low-paid workers, including many expatriates from such countries as India, Pakistan, and the Philippines, who represent a significant part of the UAE’s workforce.

Third, proponents of Islamic finance are concerned about the current environment and future regulatory regimes in terms of the treatment of conventional banks versus the treatment of Islamic banks. Separate supervision and regulation of Islamic banks have yet to take hold in most countries; only Kuwait and Bahrain operate separate regulatory regimes for the sector at this time. In most markets, Islamic banks follow the standards set by local regulators for conventional banks, even if those standards are not always appropriate for Islamic institutions.

Fourth, the shortage of skilled and well-trained professionals is limiting the ability of Islamic banks to compete and expand market share. The industry needs new talent and needs to retrain conventional bankers in the practices of Islamic banking. A few educational institutions offer specialized degrees in Islamic finance, but the demand is overwhelming the supply of graduates. The arguments are being made that universities should offer master’s programs (MBA and PhD programs) that focus on Islamic finance and that a globally recognized professional certification should be created.

Fifth, the industry needs universally accepted terminology to aid communication across the broad expanse of the Muslim community.

Sixth, Islamic financial institutions need to increase investment in research and development, including products and mechanisms related to risk management. Development of the investment side of the Islamic finance market has been rapid, but *Shari’a*-compliant risk management for Islamic finance has evolved at a slower pace. As Islamic financial institutions expand beyond national borders, they need sophisticated tools to manage the risks associated with diversified portfolios and global customer servicing. Islamic derivatives may provide answers to many of the industry’s risk management needs; thus, they are being aggressively pursued. Meanwhile, however, some analysts would like to see banks build links to top-quality academic institutions to support research on Islamic banking and finance.

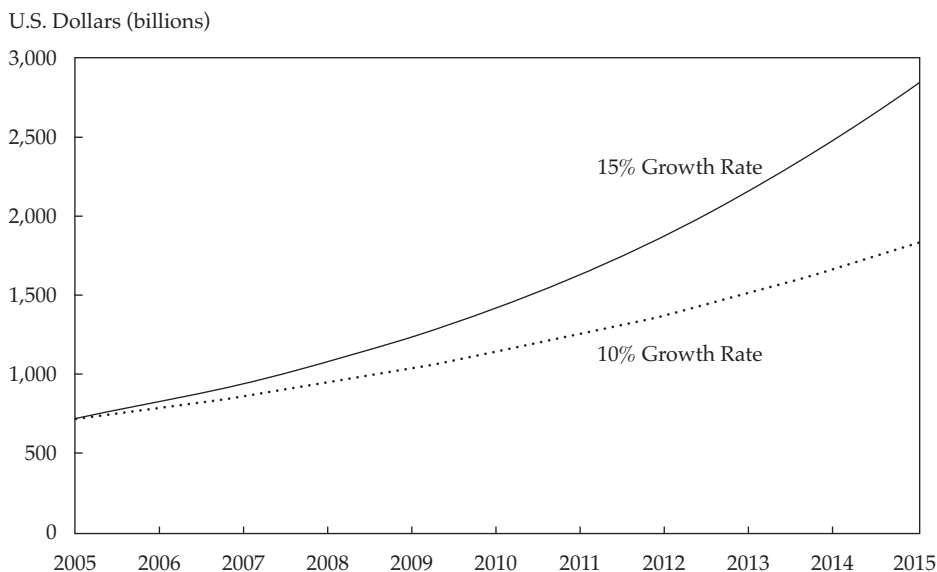
Finally, replacing Arabic terminology with comparable terms used in conventional banking has been discussed as a way to appeal to non-Muslim customers. A change of this type would also facilitate comparisons between Islamic and conventional financial products. Islamic finance appeals to non-Muslim investors who are not keen to invest in securities that could be potentially harmful to human beings, such as the equity or debt of tobacco, alcohol, and gambling companies. Thus, a market exists if the industry can reach it.

The Future of Islamic Finance

Figure 8.1 shows two paths of the Islamic finance industry—one at 10 percent growth leading to US\$1.2 trillion by 2010 (and US\$1.8 trillion by 2015) and one at 15 percent growth leading to US\$1.4 trillion by 2010 (US\$2.8 trillion by 2015). Drivers of global growth in Islamic finance are expected to be growth in Western countries, acceptance of *takaful*, and improvements in the sector as financial institutions deal with the challenges noted in this chapter.

In several Western jurisdictions, nonbanking Islamic financial services (specifically, mortgages) are expected to continue to grow steadily, particularly if regulators pursue the principle of “social inclusion” as part of the goals of the financial sector. In the United Kingdom, HSBC was the first major bank to offer mortgages (in

Figure 8.1. Projected Size of the Islamic Finance Industry



Source: Islamic Financial Services Board (2007).

2003) that comply with Islamic law. The country's first purely Islamic bank, the Islamic Bank of Britain, opened for business the following year, 2004. Her Majesty's Treasury and the Bank of England have been encouraging Islamic mortgages, investments, and current accounts in the United Kingdom. The market research group Datamonitor has predicted that the Islamic mortgage market in the United Kingdom could climb to about US\$2.2 billion in 2009 from US\$260 million in 2005. The United Kingdom has nearly 2 million Muslims ("Sharia Mortgage Market Continues to Grow" 2008).

Future growth in Islamic finance will also be helped by the robust outlook for *takaful*, which is receiving growing acceptance by Muslims despite some criticism it has received. Islamic insurance is an underdeveloped market in certain regions, particularly the Persian Gulf area. Familiarity with *takaful* is helping to reduce Muslim suspicion about paying premiums, however, which has traditionally stunted growth in the conservative Persian Gulf countries.

Population growth and new government regulations, including mandatory corporate insurance schemes, are expected to make the *takaful* sector one of the fastest growing sectors in the next few years; it will quadruple by 2013. In the past five years, several *takaful* companies have entered the market, and they now represent almost 10 percent of the 280 insurance companies in the region. In the UAE, the government is pursuing mandatory health insurance that should drive the industry's development (Ernst & Young 2007).

Finally, industry players acknowledge the challenges discussed previously and are working to deal with them. Islamic banking, in particular, emerged on the scene only a little more than four decades ago and faces the challenges of a young industry. But the AAOIFI and IFSB are on a mission to promote better transparency in Islamic banking and to provide regulatory guidance across the global Islamic finance landscape.

Summary

Despite the challenges facing the Islamic finance industry, the future looks promising indeed. The combination of a large untapped Muslim population, a significant increase in the oil-related wealth of high-net-worth individuals from the Middle East, and religiously inspired demand has created a significant target market for Islamic financial institutions. As the range of *Shari'a*-compliant products and services expands, the ability of firms to offer competitive returns to clients also expands.

The obstacles currently preventing faster spread of Islamic financial products and acting as a drag on industry growth are being addressed by the major market players. These institutions are aware of the need for greater standardization within product lines and for better and more consistent regulation and governance if the industry is to flourish and be competitive with the conventional banking and financial industry.