

ISLAMIC FINANCE SECTOR HAS ROOM TO GROW

It must focus on some key issues and challenges

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ISLAMIC banking has, to a large extent, been shielded from the credit crisis which has devastated conventional banking and finance.

As such, many proponents of Islamic banking, such as Deputy Prime Minister and Finance Minister Datuk Seri Najib Tun Razak, have said the principles of Islamic finance could provide concrete and realistic measures to tackle the financial crisis.

However, the Islamic finance industry still has some way to go before it can be a serious alternative to conventional finance and banking. While Islamic finance is growing at a rate of 5%–10% per year, it still only constitutes a small proportion of the global financial services sector, with a market valued at between US\$500mil and US\$1bil.

For Islamic finance to take a greater share and to expand in other jurisdictions, it needs to focus on a number of key issues and challenges, such as enhanced risk management and product development, syariah standardisation and human capital development. Critically, many risk management tools, such as complex derivatives, are not available to Islamic institutions.

Therefore, the product development pipeline needs to keep pace with demand to produce other viable risk management methods, while ensuring that the principles of Islamic finance, which have served syariah-compliant institutions so well prior to the credit crisis, are maintained.

Differences of opinion from syariah scholars on whether certain practices or products are syariah compliant continue to impede the pace of progress. At the same time, a common set of standards and closer links between regulators and standard setters such as Accounting and Auditing Organisation for Islamic Financial Institutions, the Islamic Financial Services Board and other national regulators are crucial, especially as Islamic finance looks to expand its conventional borders.

Finally, the nuances of Islamic jurisprudence and its assimilation with conventional banking require a great deal of expertise.

To overcome the current dearth of expertise, investment in training and formal qualifications will be vital to attract and maintain the right level and number of professionals to allow the industry to develop.

The industry needs to develop more talent, either by training graduates from scratch or attracting experienced bankers from conventional banking over to join Islamic finance. If these challenges could be addressed, the Islamic banking platform could be a viable complement and a source of guidance for conventional banking. Indeed, many Islamic banking's fundamental principles protected the industry from the excesses of the credit crunch, and offer valuable lessons.

Notably, Islamic financial institutions are able to make 'loans', such as for financing home purchase and could, in theory, have been exposed to subprime mortgage problems. However, their inherently conservative risk management limits not only their ability to lend as a percentage of their own assets, but also the granting of excessive interest rates which enabled unqualified borrowers to take out such loans.

The sharing of risk between lender and borrower, another pivotal tenet of Islamic finance, provides a clear incentive for lending institutions such as banks to take a more active role in the performance of the investment, as well as ensuring any deals that are entered into are sound.

The nature of capital as solely being a medium of exchange (i.e. having no intrinsic value) is central to the prohibition of interest, which forms the central tenet of Islamic banking and finance. However, other important principles include the prohibition of contractual risk, advocating sharing of risk and return and asset-backed finance. These have all helped to buffer the Islamic finance industry from the worst of the credit crisis. In general, the prohibition of contractual risk forbids the selling of goods or services that the seller is not in a position to deliver – or the making of a contract which is conditional on an unknown event. In other words, you cannot sell something you do not own, thereby ruling out the bulk of high-risk and highly-complex derivatives instruments that were the downfall of financial institutions during the credit crunch.

Also, the price and nature of the goods being transacted are defined in detail and agreed upon by both parties, thereby avoiding a sale that may represent a gamble. Thus, sales on margin or conventional "short selling" are prohibited – a move which regulators in the US and other markets initiated for periods in 2008, in order to stabilise the markets.

In hindsight, conventional banking could take a cue from Islamic banking on how to integrate finance and ethics in the quest for financial system reform. Fundamentally, the principles of Islamic banking which comply with syariah or Islamic law prohibit many of the high-risk activities that triggered the financial crisis for some of the world's largest and most well respected banks and financial institutions.