



Islamic finance: Some aspects of the research and policy nexus

Tariqullah Khan*

Qatar Faculty of Islamic Studies, Qatar
Foundation, Doha, Qatar

*Email: tkhan@qfis.edu.qa

INTRODUCTION

Islamic finance is a dynamic, practical and academic field of contemporary Islamic studies. It is based on the universally shared ethical values of transparency, fairness and justice and operates in conformity with the Shariah in the framework of laws existing in a jurisdiction. During the past 35 years Islamic finance has emerged as a way of financing production, projects and trade and facilitating the required financial intermediation and payments systems. The recent global financial crisis has increased interests in the Islamic finance business model. The focus has been on the products offered by Islamic finance, its architectural foundations, the unique risks of its assets and liabilities and its implications for the inclusiveness and stability of the interconnected financial systems. In the coming years we expect that these interest areas will remain in focus of the academic and policy research works in the field of Islamic finance. This note intends to highlight some of the pertinent themes in the research and policy nexus related to Islamic finance.

SYSTEMIC SIGNIFICANCE OF ISLAMIC FINANCE

Fig. 1 briefly captures the current and future systemic significance of Islamic finance by highlighting the size of assets of the industry based on two alternative scenarios – 10% annual growth and 15% annual growth [1]. These estimates put the total assets of the industry, respectively, in the range of US\$1.1 and 1.4 trillion in 2010 and US\$1.8 to 2.8 trillion in 2015. It is worth noting that some other estimates put the compound annual growth rate of these assets at 23.46% from 2006 to 2010 [2].

BUSINESS MODEL AND FINANCIAL STABILITY

During a short period, Islamic finance has come a long way in developing and offering all the required financial services for the rapidly globalizing economies under a fast changing, regulatory, technological and market environment. Being a new and innovative industry, Islamic finance had remained a concern for regulators in terms of its unknown implications for financial stability. Hence the global financial crisis was a major test case for Islamic finance. A recently released study undertaken by the Task Force on Islamic Finance and Global Financial Stability, led by Dr. Zeti Akhtar Aziz, Governor of Central Bank Malaysia, clearly concluded that the Islamic finance business model showed significant resilience during the crisis [3]. Another new study released by the International Monetary Fund also supports the above conclusion about the stability of Islamic banks [4]. However, both the studies emphasized the need for robust governance, transparency and risk management systems in Islamic financial institutions, and that the industry requires stronger architectural and support infrastructures.

As a response to the crisis, transformation of banking models has attained an important place in the coordinated policy initiatives within the institutional framework of the G20. The G20 Seoul Summit (November 11–12, 2010) endorsed the response of Basel Committee for Banking Supervision for strengthening the global banking industry within a new regulatory framework known as Basel III. By analyzing the implications of Basel III for European banking systems, a study by McKinsey concludes that “Basel III will have significant impact on the European banking sector. As the rules are written today and based on Q2 2010 balance sheets, by 2019 the industry will need

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about €1.1 trillion of additional Tier 1 capital, €1.3 trillion of short-term liquidity, and about €2.3 trillion of long term funding, absent any mitigating actions” [5].

As Islamic banks are holding risk weighted capital assets well over 12%, coupled with substantial liquidity buffers [4], the situation of Islamic banks is different in terms of profitability implications of Basel III. On the other hand the impact of Basel III can be read to imply greater risk sharing in the global banking industry. This is indeed a move towards the business model that Islamic finance follows. Despite that potential convergence, Islamic finance certainly faces risks from within – as a result of unauthentic products and weaker architectural foundations, and risks from outside – in the form of transmission of external vulnerabilities to Islamic banking through the gaps in products and architectures.

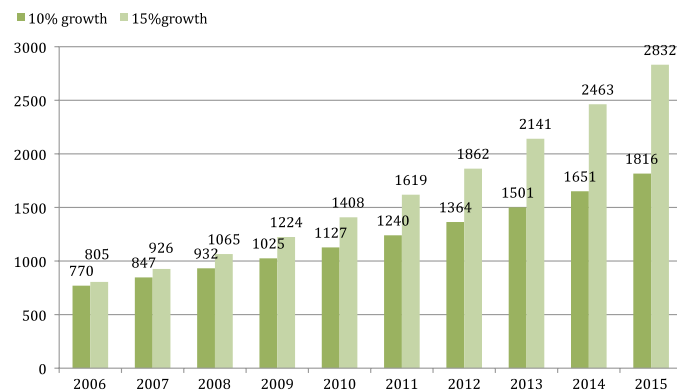


Figure. 1 Islamic financial services industry asset growth projections in billion US\$.

INNOVATING TO ENHANCE FINANCIAL INCLUSION

On one hand indeed Islamic finance has emerged as an innovative segment of the financial services industry. It offers additional items in the menu of financial products and hence adds to competition and efficiency in resource mobilization and allocation. Like other ethical financial services, the conditions imposed by Islamic finance are consistent with socially responsible businesses. On the other hand a sizable part of the world’s Muslim population avoids interest-based financial services due to religious beliefs and Islamic finance removes this barrier to accessing financial services. Hence several financial sector development policy initiatives worldwide including those recently introduced in the United Kingdom, Singapore and France — to name only a few, aim to promote financial inclusion through introduction of Islamic finance.

Taking into consideration the large proportion of poor in the World Muslim population, an orderly development of these innovative financial services could therefore be highly instrumental in promoting access to financial services and achieving the UN Millennium Development Goals. Islamic finance also contributes to the development of formal and regulated financial institutions and markets, and consequently facilitates resource mobilization for financing economic development. Therefore, Islamic financial instruments are increasingly being utilized by the multilateral development banks [6] to supplement their existing instruments to make finance work more effectively in a significant number of their member countries. In this regard joint initiatives by the Islamic Development Bank (IDB), the World Bank and the Asian Development Bank are being undertaken for the development of a sound and inclusive Islamic financial services industry ¹.

FINANCIAL ARCHITECTURE AND INFRASTRUCTURES

The two anchoring features of Islamic financial services are participation and risk sharing on the funding side and deferred trading on the assets side of a financial institution’s balance sheet. As a consequence, the nature of liabilities and assets of Islamic finance changes as compared to the conventional finance where lending is a common basis of both assets and liabilities. The actual materiality of the nature of assets and liabilities was revealed in an earlier perception survey of

¹ These initiatives include the establishment of \$1 billion IDB-World Bank MENA Infrastructure Fund and \$500 million IDB-Asian Development Bank Islamic Infrastructure Fund.

participants in the Islamic finance market that showed market risks being considered more significant in Islamic banks as compared to credit risks in conventional banks [7].

Several other unique considerations for the nature of assets and liabilities form the basis of a number of international standards that have been formulated by the Islamic financial architecture institutions. The Islamic Financial Services Board (IFSB) has formulated a number of prudential standards. Managing the core deposits of Islamic banks, namely profit sharing investment accounts (PSIAs) as the most unique product offering by Islamic banks is central to these IFSB standards in addition to capital adequacy to meet the risks of assets generated through deferred sales. Similarly, transparency and disclosure issues are being addressed in the standards of the Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI). On the other hand the International Islamic Financial Markets (IIFM) is addressing issues for evolving common framework for the various Islamic financial contracts especially for risk and liquidity management. Among the latest significant collaborative initiatives is the establishment of the International Islamic Liquidity Management Corporation (IILMC) on October 24, 2010 in Kuala Lumpur by governors of a number of central banks and the IDB President. The IILMC will primarily address the systemic liquidity requirements of the industry which under Basel III require benchmarking and regulatory surveillances.

Nevertheless the implementation of the standards in local jurisdictions require several significant changes in legal, tax and regulatory framework as well as putting in place other support infrastructures for the Islamic finance industry. At present there is a visible lack of these in many jurisdictions and several efforts are underway in strengthening these infrastructures. One such initiative is the effort of the IDB, IFSB, IMF and World Bank in adapting a modified framework for assessment of development and stability of the Islamic financial services within the framework of the IMF-World Bank Financial Sector Assessment Program (FSAP). The objective is to cater to the special architectural and infrastructural requirements that can ensure the orderly development of an inclusive and sustainable Islamic financial services industry in different jurisdictions [8].

AUTHENTICITY AND EFFICIENCY

Authenticity of financial products in terms of Shariah compliance and the competitiveness of these products are both crucial for the confidence of the users and sustainability in a market environment. If there is any single most important challenge being faced by the industry at the present, it is the balancing of these two often dichotomous objectives. For example, driven by cost considerations and competitiveness most Islamic investment certificates (Sukuk) are structured based on the originators' credit risk as reflected in its credit rating. However, the Resolution of AAOIFI Shariah Board dislikes this trend and calls for asset-backed Sukuk that could be genuinely driven by the market risk of the underlying assets; the assets themselves being truly owned by the investors in the Sukuk [9]. Another example of the authenticity and efficiency dichotomy is the better performance of Islamic investment portfolios under the more liberal Shariah screening strategies as compared to the more genuine Shariah strategies [10].

As mentioned previously the future of Islamic finance and its sustainability depends on the design of the products it will offer both in terms of blocking transmission of vulnerabilities from the conventional system as well as in terms of preservation of the Islamic finance business model and the users confidence. This highlights the ongoing challenge of genuine financial engineering and product development – continuous innovation and improvement while remaining authentic.

HUMAN CAPITAL DEVELOPMENT

The foregoing themes summarize the key areas where Islamic finance is progressing *albeit* facing challenges. These and related areas require concerted research and policy support. Availability of competent and committed human capital for meeting the current and growing needs of the industry will remain the most important precondition to overcome the challenges. In recent days there has been hype and proliferation in Islamic finance related international events, teaching and executive development programs and various types of professional certification programs. In the interest of the industry and the academic discipline of Islamic finance only those initiatives making significant value addition are expected to survive. Research is also needed to support such human capital development initiatives to supply high quality of teaching material and learning resources.

CONCLUSION

To conclude this note four points are worth reemphasizing. First, the experience with Islamic finance so far has been encouraging in terms of its potential to contribute both to the stability and inclusiveness of financial systems. Second, in recognition of the first point significant policy initiatives and collaborative works are being undertaken worldwide to encourage and support the development of the Islamic finance industry. Third, there is a need to emphasize the challenge of harmonizing authenticity and efficiency considerations of Islamic finance. Any persistent dichotomy could be detrimental to the progress of Islamic finance. Finally, issues relating to the development of genuine products, the required legal and regulatory environment and implementation of Islamic finance specific best practice standards constitute priority areas for academic and policy oriented research.

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