Islamic Financial in the Global Financial System

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Abstract

This paper investigates the question of whether the phenomenon of Islamic finance who based on Shariah, or Islamic law is truly globalizing and spreading as a universal system of finance and banking. The paper also addresses various aspects of the globalization for Islamic finance, among other, the issue of the rise of Islamic banking in the world, Islamic jurisprudence and finance, global standards and integration for Islamic finance, and obstacles facing Islamic finance's integration and growth into the global financial system. The paper suggested three key areas of priority warrant greater policy attention to further strengthen and enhance the entire Islamic financial ecosystem, through putting in place building blocks that will strengthen the resilience of the Islamic financial system and by the application of mutually acceptable rules and standards.

Key Words: Islamic Finance, Global Finance, Shariah (Islamic Law), Education, Evolution, Future Strategies, Financial Products.

Introduction

Islamic finance represents around 1% of global financial assets. The market has been growing at over 20% annually since 2000 and is set for continued strong growth. As at the end of 2010, the combined revenue of international Islamic financial services reached to amount to US$100 billion while Islamic profits totaled US $25 billion. It is estimated that by 2012, Islamic assets will reach about US $1.600 billion, with revenues of US$120 billion.

Exceptional growth in Islamic finance has been registered not only in the Muslim world, where its growth is premised on religious considerations, but now spans across the western world and the Asia pacific region where the growth is driven by commercial and business considerations. Although the Middle East and Asia remain by far the largest Islamic financial markets in the world, other regions and countries are also pursuing Islamic finance as a new asset class. Its potential for growth and development in the future has triggered strong interest from beyond Islamic incumbents.

Countries such as France, United Kingdom, Korea and Japan have initiated charges to their legal and tax structure to facilitate the introduction of Islamic financial products into their markets. Other countries such as Australia, China, Germany, Hong Kong, Italy, Luxembourg and Singapore in which there were some initiatives in introducing Islamic finance in their financial systems. Other countries have indicated their intention to advance this forward. This trend is expected to contribute towards greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening economic linkages.

Several key institutions have been established to provide the infrastructure for the continuous growth of Islamic finance. Among the key institutions are Islamic Financial Services board (IFSB) Accounting and Auditing Organization for Islamic financial (AAOIFI) and specialized institutions that provide Islamic financial services such as ration agencies, deposit insurance corporations and mortgage corporations. IFSB, an international prudential standard setting body was established in 2002 to develop and disseminate prudential standards.
for regulation and supervision of the Islamic financial services industry.

AAOIFI, an accounting and auditing organization, is responsible to develop accounting and auditing standards for the Islamic financial institutions. Several international rating agencies have developed ratings methodologies that recognize and incorporate the unique features of Islamic finance. Specific schemes on Islamic deposit in insurance have also been developed, while mortgage corporations have issued Sukuk to facilitate the widening of asset classes available to investors in the Islamic capital markets. Complementing these initiatives are the efforts by the central banks in issuing Islamic monetary instruments which is integral to the functioning of the Islamic money market and the Islamic financial system.

As a form of financial intermediation, Islamic finance incorporates several elements that guide the process of the mobilization and allocation of funds to generate productive economic activity and inclusive development. Fundamental to Islamic finance is the requirement that financial transactions must be supported by real economic activity. In addition, Islamic finance promotes profit sharing and hence risks sharing. These elements limit the extent of leverage and place emphasis on transparency and disclosures in the documentation of contracts. Embraced in its entirety, Islamic finance promises to enhance the discipline that contributes towards ensuring growth and financial stability.

The global financial crisis of 2008-2009 has brought to the forefront wide ranging issues concerning the international financial systems. Amidst this more challenging environment presented by the recent international financial crisis, the global expansion of Islamic finance has continued and its development has remained dynamic. Today, Islamic finance has become one of the fastest growing financial segments in the international financial system. It’s phase of development that began in earnest as domestic-centric for Muslim economies, has rapidly transformed in this recent decade to become internationally recognized and accepted as a competitive and robust form of financial intermediation by communities. As Islamic finance extends its reach to serve the global community and becomes an integral part of the global financial system and it will be increasingly tested by risks and developments in the international financial system.

The paper will be divided into three parts. First part will explain the evolution and current situation of Islamic finance, explaining the factors behind its growth in local and international markets and discusses the principals and basic functions of Islamic financial institutions. Secondly, to take stock of the progress of the Islamic financial services industry in the face of the challenges of the current global financial environment. Thirdly, it will suggest important strategies and key building blocks towards further strengthening the resilience of Islamic finance and advancing global engagements towards promoting financial diversify and grow in the years ahead.

Literature Review

There are numerous publications which have appeared on Islamic banking that made significant contribution to the theoretical discussion. However there is a scarcity of theoretical literature on IFIs internationalization process. Different authors looked at the process of internationalization from different views. Baba and Amin (2009) conducted a research on the offshore bankers’ observation on Islamic banking niche for Labuan: an analysis. The objective of their paper was to detail the findings of a study to determine the viability of Islamic banking as a niche for the Labuan International offshore Financial Center (IOFC). The results of the survey indicated the Labuan offshore banks did not have a clear idea of Islamic banking principles and practices. The results also showed that most of the offshore banks did not have officers and staff who were familiar with Islamic banking. The findings also indicated that Islamic banking was a viable niche for the Labuan IOFC.

Anjum (2008) conducted a study on the Islamic world’s development policy responses to the challenge of financial globalization. He analyzed the nature mechanisms conventional and modern instruments dynamics and the future possibilities of the modern phenomenon of financial globalization from the point of view of
identifying and addressing the corresponding real politico-economic challenges confront by the contemporary Islamic world. He focused on the institutional responses of the contemporary Islamic world to the challenges of financial globalization. He developed a theoretical treatise on its subject in the light of research work of Ali Khan (2000) who points to the imperative of an Islamic institutional response to financial globalization by treating the institution of Islamic banking as the solid substitute of the Islamic financial institution to highlight the actual and prospective response of the Islamic financial institutions to the challenges of financial globalization. He found that financial globalization was an evolving reality. Because of its atheistic, money-oriented undemocratic, non-universal and interest-based world view and character, financial globalization had been posing a serious challenge to the contemporary Islamic countries’ agenda of economically empowering and developing themselves through the integration of their economies along the universal Islamic lines exhibit in the form of one Islamic Omaha. Burghardt and Fub (2004) conducted a research on the Islamic banking credit products in Germany and in the United Kingdom. They analyzed whether the predictions about a prosperous future of an international. Islamic banking market could be justified by evidence from the German and the United Kingdom markets. They focused on Islamic banking credit products, since their characteristic features were heavily influenced by the criticism of interest in Islamic Law. They showed that the Islamic population in Germany did not identify any particular need for German Muslims to actively demand Islamic banking credit products in Germany. These results were in line with the overall preferences of banks by entire German population.

First to establish and maintain London as Europe’s got away to international Islamic finance. Second to ensure that nobody in the UK was without access to competitively prices financial products on account of their confidence. The Government’s approach to achieving these objectives was characterized by the principle of equality collaboration and commitment. Significant progress towards meeting those objectives had been made. The UK was at that time important center for Islamic finance outside of the GCC countries and Malaysia. Bhatti and Khan (2008) conducted a study on the growth of Islamic banking with prospect with a financial risk-allocation approach they studied unequaled development in Islamic banking, its infrastructures and supporting institutions in current years. They expressive the case for Islamic banking in a very comprehensive and effective manner. It depicts Islamic banking as a growing regulation adding more ethical, competitive and diversified tools and systems into global finance. It highlights the paradigm theory and practice achievements, pitfall and future prospects of Islamic banking. They used the conceptual model and practice of Islamic banking. They cover other related issues over the recent development of Islamic banking across the globe. They observed that Islamic banking has made unparallelled progress over recent years. The Middle East, South Asia and Indian subcontinent have emerged as hub of Islamic banking. Western conventional regulators and investors and other agents have also shown a greater interest in and accessible attitude towards Islamic banking. Although all the Islamic banking has been facing some core problems and challenges that will have deeply impacts on its future growth and there improvements.

Hasan (2008) conducted a study on the credit creation and control. In view of a rapid development of Islamic banking in recent decades the answer to questions whether Islamic banks can create credit like conventional banks and if yes what methods central banks could use to control in their case of principal importance. An overview of the Literature on the subject is provided and credit creation process is explained as background material for the discussion. They found the Literature on the subject is insufficient, controversial and questionable. One reason seems to be the difference between structural design of Islamic banks and the objectives they are supposed to meet. It is conclude that Islamic banks can create credit in the usual manner but central banks will have to design new tools for credit control appropriate to Islamic banks. The findings of the paper may have serious implication for the current structure of Islamic
banking and legal framework for regulating their credit creation and activities.

Anjum (2006) conducted a study on globalization at junction of competition, revolution, and universally the Islamic universal remedy, strategy and policy instrument. The paper aimed at contributing an objective analysis of the nature agenda and political economic and strategic dynamites of the contemporary movement of globalization. The paper explored the important pattern of economic changes, which have culminate into global warfare resulting from the contemporary world level experiences of globalization and the corresponding revolutionary tendency responses encounter on the global level. In this background the basis for adhere to the Islamic program of universaliztion shall be addressed from the point of view of the sustainable development of the Islamic world. He found that because of either the perpetual nature or habitual nature of the economic crises of the Islamic countries within the current framework of the capitalistic globalization the expected way out for the realization of the sustainable economic and human development in the Islamic world seem to be offered only by the Islamic program of universaliztion.

Mohsin (1982) has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest free bank could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin’s model clearly was designed to fit into a capitalist environment, indeed he explicitly stated that riba-free banks could coexist with interest-based banks.

Basic Principles of Islamic Finance
The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as Shariah, governing economic, social, political and cultural aspects of Islamic societies. The basic principles of an Islamic financial system can be summarized as follows:

- Prohibition of interest (riba). Prohibition of riba- a term literally "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales".
- Money as "potential" capital. Money is not a commodity, but a medium of exchange, a store value and a unit of measurement. Money represents purchasing power and cannot be utilized to increase the purchasing power without any productive activity. Islamic finance advocates the creation of wealth through trade and commerce.
- Risk sharing. Because interest is prohibited, suppliers of funds become investors, rather than creditors.
- Prohibition of speculative behavior. Islamic finance discourages hoarding and prohibits transactions featuring extreme uncertainties (gharar), and gambling (maysir).
- Sanctity of contracts. Islamic finance upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.
- Shari'ah approved activities. Only those business activities that do not violate the rules of the Shari'ah qualify for investment. For example, any investment in a business dealing with alcohol or gambling is prohibited.
- Social justice. Any transaction leading to injustice and exploitation is prohibited.

Islamic Financial Products
The market for Islamic products, which include retail banking services, mortgages, equity funds, fixed income, insurance, private equity, and derivatives have become increasingly more
creative in the design of new financial products.

**Musharakah (Joint venture)**

Is an agreement between two or more partners, where by each partner provides funds to be used in a venture. Profits made are shared between the partners according to the invested capital. In case of loss, no partner loses capital in the same ratio. It is this financial risk that justifies the bank’s claim to part of the profit.

**Murabahah**

It refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset, with a fixed rate of profit determined by the profit margin; however the asset remains as a mortgage with the bank until the default is settled.

**Mudarbah (Profit Sharing)**

Is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The capital investment comes from the first partner, who is called the “rabb-ul-mal” while the management and work is the exclusive responsibility of the other party, who one party providing 100% of the capital and the other party providing its specialist knowledge to invest the capital and manage the investment project. Profits generated are shared between the parties according to a pre-agreed ratio.

**Musawamah**

Is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated they are under no obligation to reveal these costs as part of the negotiation process. This difference in obligation by the seller is the key distinction between Murabahah and Musawamah.

**Bai’al inah (sale and buy-back agreement)**

Is a financing facility with the underlying buy and sell transactions between the financier and the customer. The financier buys an asset from the customer on spot basis. The price paid by the financier constitutes the disbursement under the facility. Subsequently the asset is sold to the customer on a deferred-payment basis and the price is payable in installments. The second sale serves to create the obligation on the part of the customer under the facility.

**Bai’bitaman ajil (deferred payment sale)**

It refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. Like Bai’al inah, this concept is also used under an Islamic financing facility. Interest payment can be avoided as the customer is paying the sale price which is not the same as interest charged on a loan.

**Bai’muajjal (Credit sale)**

It means a credit sale. It is a financing technique adopted by Islamic banks that takes the form of murabahah muajjal. It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. Bai’muajjal is also called a deferred-payment sale.

**Bai Salam**

It means a contract in which advanced payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. Bai Salam covers almost everything that is capable of being definitely described as to quantity, quality and workmanship.

**Hibah (Gift)**

This is a token given voluntarily by a debtor to a debater in return for a loan. Hibah usually arises in practice when Islamic banks voluntarily pay their customers a “gift” on saving account balances, representing a portion of the profit made by using those savings account balances in other activities. This is a voluntary payment made (or not made) at the bank’s discretion, and cannot be “guaranteed”

**Ijarah**

It means lease, rent or wage. Generally, the
Ijarah concept refers to selling the benefit of use or service for a fixed price or wage. Under this concept, the bank makes available to the customer the use of service of assets/equipments for a fixed period and price.

Qard Hassan (Good Loan/ Benevolent Loan)
This is a loan extended on a good will basis, and the debtor is only required to repay the amount borrowed. Qard al-hassan is a kind of gratuitous loan given to the needy people for a fixed period without requiring the payment of interest or profit.

Sukuk (Islamic Bonds)
This is the Arabic name for financial certificates that are the Islamic equivalent of bonds. Sukuk are securities that comply with the Islamic Law (Shariah) and its investment principles, which prohibit the charging or paying of interest. The issuer of a sukuk sells an investor group the certificate, who then rents it back to the issuer for a predetermined rental fee. The issuer also makes a contractual promise to buy back the bonds at a future date at par value.

Takaful (Islamic Insurance)
This is an alternative form of cover that Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risk of many people enables each individual to enjoy the advantage provided by the law of large numbers.

Wadiah (Safekeeping)
In Wadiah, a bank is deemed as a keeper and trustee of funds. A person deposits fund in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositer demands it.

Islamic Equity funds
Islamic investment equity funds market is one of the fastest-growing sectors within the Islamic financial system. It is an investment vehicle that allows investors to take advantage of investing in a diversified group of stocks which manages risk and exposure to one or a few stocks.

Islamic Derivatives
The financial engineering in Islamic banking and finance has resulted in a number of Islamic options, forward and futures contracts that maybe used for risk management and hedging. This derivatives is in conformity with Shariah. The creation of shariah-compliant derivatives is imperative to the general welfare (Maslaha) and future of the Islamic financial industry.

Evolution of Islamic Finance
Modern Islamic finance was initially developed as an intermediation channel for Muslims to conduct their savings and investment activities in accordance with the Islamic principles. As recent as ten years ago, however, Islamic finance has experienced major transformations. Its rapid evolution is particularly evident in five dimensions of its development. Firstly, from being concentrated in Muslim populated regions, Islamic finance is now viewed as a competitive form of financial intermediation that has drawn significant participation by non-Muslims. For borrowers, it is seen as an alternative means of financing. For investors, it is seen as a new asset class. Islamic finance has thus witnessed exceptional growth, not only in the Muslim world, where its growth is premised on religious and business considerations, but also across the Western world where the growth is driven by commercial and business considerations.

Secondly, the nature of the business of Islamic finance has also evolved, from being mainly focused on retail and trade financing to the financing of other commercial business activities. With the emergence of more diverse Islamic financial institutions and the development of the Islamic financial markets, the scope of Islamic finance business has been expanded to include private equity, project finance, the origination and issuance of sukuk, and fund, asset and wealth management activities. The pace of product innovation has also intensified with more sophisticated Islamic banking and takaful products as evidenced by the surge of structured products and investment-linked products. These products have become competitive both in terms of product structure and pricing. The enhanced depth of the Islamic financial markets has also increased its
attractiveness as an asset class for investment. These developments have resulted in an extensive range of Islamic financial products and services that is being offered to consumers and businesses. Table 1 shows the stages of evaluation of the Islamic financial services industry since the 1970s.

The third dimension in which there has been significant evolution is in the regulatory and legal framework for Islamic finance which has taken into account the distinct features of Islamic financial transactions. This has ensured that the growth and developments of Islamic finance is accompanied by the corresponding development of the supporting legal, regulatory and supervisory framework to ensure its soundness and stability. The establishment of the Islamic Financial Services Board in 2002 also marked an important milestone in the development of the prudential regulatory standards and best practices for Islamic financial institutions. Its establishment has also contributed to the harmonization in the development of Islamic finance across different jurisdictions.

Fourthly, the international dimension of Islamic finance has rapidly gained significance as it evolves to become an increasingly important part of the international financial system, and as it becomes poised to contribute towards greater global financial integration. Islamic financial institutions have now ventured beyond their domestic borders and funds raised in Islamic financial markets in different jurisdictions have drawn investors from financial centers across the globe. As market players across continents participate in the expansion of inter-regional investment flows, it has enhanced financial linkages among the major regions. To date, the number of Islamic financial institutions worldwide has increased to more than 300, spanning more than 75 countries both in the Muslim and non-Muslim countries. The expansion of the inter-linkages among intermediaries and markets across regions would contribute towards a more efficient allocation of financial resources across borders and thus contribute to enhancing global growth prospects.

The fifth dimension that has seen significant change is in the development of human capital in Islamic finance. It has been a vital development that has been key in ensuring an adequate supply of talent and expertise for further expansion and development of the Islamic financial services industry. High caliber professionals that have the combined knowledge and understanding of the Shariah with the necessary skills in finance are now in great demand. Recognising this, several major institutions of higher learning are offering more focused and structured programmes in Islamic finance.

The rising role of Islamic Finance in the global financial system

Islamic finance has become an increasingly integral part of the global financial system. Since the developments of the modern Islamic finance in the 1960s, the IFSI has evolved from a “fringe industry” that catered to the specific banking requirements of the Muslim community to a global industry encompassing banking, insurance and capital market. The Islamic financial landscape has now been dramatically transformed with more diverse players with an extensive range of financial products and services. The rapid expansion of Islamic finance as a viable form of financial intermediation reflects its ability to meet the changing pattern of demand by consumers and businesses, its competitiveness and its ability to withstand the more challenging environment. This has encouraged strong interest from conventional global players from the developed economies that have increased their participation in Islamic financial markets. More recently, there has been increased initiatives to acquire strategic stakes in Islamic financial institutions in different parts of the world. With increased liberalisation, the Islamic financial system has become more diversified and the Islamic financial markets have deepened. As a result, Islamic finance has now emerged as among the fastest growing segments in the international financial services industry. While the Islamic financial services industry currently represents approximately only 1% of global assets, it has been growing by more than 20% annually since 2000. chart 1 is a snapshot of current global Shariah-compliant position.
Several key developments highlight the rising role of Islamic finance in the global financial system:

a. The expanding asset base. The industry has recorded strong growth with total Islamic banking assets of USD660 billion at the end of 2007. In terms of geographical distribution, the Middle East is now the largest Islamic finance market, accounting for about 80% of global Islamic finance assets. Chart 2 illustrates the regional distribution of Islamic assets.

b. Strong performance. The strong performance of Islamic financial institutions amid the crisis has further supported its growing significance. Table 2 shows the comparison in terms of aggregate size of Islamic financial institution and conventional banks in the year 2009.

A more recent survey encompassing the top 500 IIFS showed that assets held by fully Shari’ah-compliant banks including Islamic banking windows of conventional banks rose by 33% to USD1100 billion, from USD822 billion in 2008. During this period, the world’s top 1,000 conventional banks achieved an annual asset growth of just 6.8% as of July 2009 to amount to USD96,395 billion.

Exceptional growth in Islamic finance has been registered not only in the Muslim world, where its growth is premised on religious considerations, but now spans across the western world and the Asia Pacific region where the growth is driven by commercial and business considerations. Although the Middle East and Asia remain by far the largest Islamic financial markets in the world, other regions and countries are also pursuing Islamic finance as a new asset class. Its potential for growth and development in the future has triggered strong interest from beyond Islamic incumbents. Non-Muslim countries such as Australia, China, France, Germany, Hong Kong, Italy, Japan, Korea, Luxembourg, Singapore and United Kingdom, in which there are some initiatives in introducing Islamic finance in their financial systems. China has issued its first licence for Islamic banking, while five Islamic banks have been established in the United Kingdom as at end 2009. Countries such as France, Korea and Japan have also initiated changes to their legal and tax structure to facilitate the introduction of Islamic financial products into their markets. Other countries including Hong Kong and Australia have indicated their intention to advance this forward. This trend is expected to contribute towards greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening economic linkages.
Table 1 Stages of evolution of the Islamic financial services industry

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<td>Commercial Islamic banking products</td>
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<td>Mutual Funds / Unit trust</td>
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<td>Global Offshore Market</td>
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Table 2  
c. Growing significance across regions, beyond

<table>
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<th>2009</th>
<th>USD trillion</th>
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<tr>
<td>Global banking assets</td>
<td>94.4</td>
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<tr>
<td>Shariah-compliant assets</td>
<td>1</td>
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<tr>
<td>% Contribution</td>
<td>1.04%</td>
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<table>
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<th>2009</th>
<th>USD trillion</th>
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<tr>
<td>Worldwide bond</td>
<td>82.2</td>
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<tr>
<td>Islamic sukuk issued</td>
<td>0.1</td>
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<tr>
<td>% Contribution</td>
<td>0.12%</td>
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<table>
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<th>2009</th>
<th>USD billion</th>
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<tr>
<td>Global insurance premium</td>
<td>4,300</td>
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<td>Takaful premium</td>
<td>9</td>
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<tr>
<td>% Contribution</td>
<td>0.21%</td>
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d. Rapid expansion of the sukuk market. With regard to Islamic securities or sukuk, Thomson Reuters reported that the sukuk market grew from USD6 billion to USD24 billion between 2004 and 2007. However, in 2008, the sukuk market registered a decline of about 30% due to the uncertainty in the global capital markets. Nevertheless, as the overall market conditions improved, the sukuk market rebounded in the second half of 2009. The huge potential in the Sukuk market is evident from the active participation of global players including international investment banks, Islamic banks and securities firms that have participated in the issuance of sukuk.

e. Growth potential of takaful in new and existing markets. Takaful premium contributions have grown from USD1.4 billion in 2004 to over USD3.4 billion in 2007. The largest global markets include Saudi Arabia and Malaysia. Saudi Arabia remains the largest takaful market in the GCC with contributions of USD1.7 billion in 2007. Malaysia remains the largest takaful market in Asia with contributions of USD0.8 billion in 2007. The other markets for takaful are Bahrain, Sudan, Kuwait and Indonesia. Globally, takaful continues to record rapid growth in new and existing markets.

f. Strong upside potential of Islamic fund management industry. In terms of Islamic funds, Shari’ah-compliant investible assets in 2008 in the GCC and Asia reached USD736 billion compared to USD267 billion in 2007. This represents a potential annual revenue pool of USD3.86 billion for the Islamic asset management industry. Fund sizes however remain small, with more than 50% having assets under management of USD20 million or less.

g. Development of comprehensive Islamic financial infrastructure. Several key institutions have been established to provide the infrastructure for the continuous growth of Islamic finance. Among the key institutions are the IFSB, AAOIFI and specialised institutions that provide Islamic financial services such as rating agencies, deposit insurance corporations and mortgage corporations. IFSB, an international prudential standard setting body was established in 2002 to develop and disseminate prudential standards for regulation and supervision of the Islamic financial services industry. AAOIFI, an accounting and auditing organisation, is responsible to develop accounting and auditing standards for the Islamic financial institutions. Several international rating agencies have developed ratings methodologies that recognise and incorporate the unique features of Islamic finance. Specific scheme on Islamic deposit insurance has also been developed, while mortgage corporations have issued sukuk to facilitate the widening of asset classes available to investors in the Islamic capital markets. Complementing these initiatives are the efforts by the central banks in issuing Islamic monetary instruments which is integral to the functioning of the Islamic money market and the Islamic financial system.

Current Obstacles

There are several obstacles currently preventing faster up take of Islamic financial products. These include:

Risk weighting

In 2006 the Islamic Financial Services Board (IFSB) issued two standards – the capital Adequacy Standard (CAS) and the Guiding Principles of Risk Management for Institution offering Islamic Financial Services. CAS offers guidance on the requirements for minimum capital adequacy to cover for credit market and operational risks of Islamic Financial Institution (IFIS) that is equivalent to the Basel II capital framework for conventional banking institutions. According to the IFSB, the key difference between CAS and Basel II provisions is the computation of an institutions risk-weighted capital ratio (RWCR). In Islamic banking, given that the risk on assets financed by profit-sharing investment account holders do not represent risk to the capital of the institution, the CAS allows risk-weighted assets that are funded by the account holders to be deducted from the institutions to Tai risk-weighted assets in the calculation of RWCR. In addition, the assets of IFIs often have different risk characteristics to conventional products, and hence calculating their risk weights may not necessarily be as straightforward as the Basel II proposals. It is the intention of the IFSB to bridge this gap.
**Human capital**

Human capital development is crucial, as the current lack of qualified young Islamic bankers looks set to hamper the development of the sector should it not be addressed. In part, this low investment is the industry stems from the fact that the sector lacks a global industry body to oversee standardization of continuous education and training. The lack of human capital in the sector affects all regions. Training of Islamic bankers has not kept pace with the rapid growth of the sector and as a result, there are shortages throughout the industry.

**Regulation and legal frameworks**

While rising demand for Islamic finance has helped lead to handsome returns for key players, some experts in the industry are concerned that the rapid proliferation of IFIs has not been matched by development in the Islamic finance regulatory and supervisory true architecture and infrastructure, especially in the Arab countries. If a country is going to have Islamic banks operating in its system, one of the most important issues is to have a high quality regulatory framework and good supervisory standards. Many countries still do not have enabling legislation in place covering the authorization of Islamic banks, issuance of Sukuk and securitization, establishment of trusts and special purpose vehicles (SPVs), the introduction of Takaful (Islamic insurance) products, and other such issues. In this regard, the IFSB has started to establish prudential regulations to govern the IFIs, the IFSB has released prudential regulations on corporate governance and an exposure draft on disclosure and transparency. These prudential regulations should now be considered and adopted by the various countries offering Islamic finance.

**Financial reporting**

The quality and transparency of financial reporting and disclosure in the Islamic finance industry differs significantly from one regulatory jurisdiction to another. There is a general concern in the market that IFIs should have more rigor in their disclosure and financial reporting, especially to the general market. Standardization of financial reporting is a key challenge for the rapidly growing Islamic finance industry. The international financial reporting Standards (IFRS) constitute the main reporting framework for IFIS, but domestic regulation has also encouraged heterogeneity over uniformity.

**Shariah convergence**

There are significant differences in the shariah interpretation of Fiqh al-Muanalat (Islamic law relation to financial transactions). This can apply not only to products, but also to operations and systems because compliance can depend on certain processes being undertaken. These can cause problems, but it is important to remember that while harmonization of contracts, documentation and standards is a desired objective, equally diversity in Shariah opinions (Fatwas) is enshrined in Islamic Legal history, and will thus remain a feature of the market by definition. The lacks of Shariah convergence is not only a phenomenon between different countries. It also applies within the same region. Much work has been done to bridge the gap and to promote greater Shariah convergence in general. But such efforts have probably reached their limits. Shariah scholars do not always communicate clearly with each other. It is this and not the [theological] differences that creating the variances. Scholars also lack a background in finance, and most also have language barrier.

**Measuring Performance**

The process of measuring the performance of Islamic financial products can be tough. Nonetheless, Basel II demands that banks allocate risk by rating, meaning that banks allocate risk by rating, meaning that the rating of IFIs and instruments such as Sukuk will grow significantly in importance over the next few years. Whether setting the margin in a transaction or the pricing for commercial paper. Lending institutions and institutional investors will scrutinize balance sheets and corporate structures. Ratings for bonds and Sukuk, especially sovereign issuances, are important to set a benchmark for individual institutions pricing of a specific instrument. The Islamic finance sector needs a tailormade rating agency to rate the performance of IFIs using a methodology and nomenclature that is consistent with the
specificities of Islamic finance. The measurement of performance differs even though the start and end result of Islamic finance is the same as conventional financing. However, in the middle, there is a huge difference. The western rating agencies have so far declined to develop a specific rating methodology and criteria for IFIs and instruments based on their unique shariah-compliant structures. To fill this gap, in Malaysia both the Rating Agency of Malaysia (RAM) and the Malaysian Rating corporation (MARC) have pioneered new methodologies and criteria specifically for rating IFIs and instruments such as securities.

Suggested future strategies
The recent international financial crisis has revealed that fragilities exist in the world’s financial system, including in the more advanced economies. These have brought to the forefront key issues regarding financial intermediation, financial innovation and the regulatory and surveillance framework that needs to be put in place. Although the Islamic financial services industry was relatively less affected by the crisis, its underlying causes bear important lessons for the Islamic financial industry going forward. This is even more important as Islamic finance operates within the global financial system that is characterised by increasingly large and volatile cross-border capital flows amid an environment of deeper international financial integration.

To support the orderly development of Islamic finance, it is vital to accelerate the development of critical building blocks of the Islamic financial system to respond to the changing economic and financial landscape. This is important to ensure a more integrated Islamic financial services industry globally that is able to withstand shocks and adverse market developments through putting in place building blocks that will strengthen the resilience of the Islamic financial system and by the application of mutually acceptable rules and standards. There are three key areas of priority warrant greater policy attention to further strengthen and enhance the entire Islamic finance ecosystem.

**Strengthening Islamic Financial Infrastructure**
It is critical to build the robust components of the financial infrastructure as well as strengthen the key institutions, at both the national and international level, to ensure the stability and dynamism of Islamic financial system. This paper has identified eight building blocks aimed at further strengthening the Islamic financial infrastructure at the national and international levels to promote a resilient and efficient Islamic financial system.

1.1 the development of a set of comprehensive, cross sectoral prudential standards and supervisory framework covering Islamic banking, takaful and capital market which takes into account the specificities of the IIFS. The IFSB has issued a whole spectrum of prudential and supervisory standards which constitute the equivalent of Basel II in Islamic finance — covering risk management, capital adequacy, corporate governance, transparency and market discipline. These standards take into account international prudential standards across the banking, investment and securities and insurance markets issued by the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commission (IOSCO) and International Association of Insurance Supervisors (IAIS), respectively, and simultaneously cater effectively for the specificities of Islamic financial firms, their risks and Shari’ah compliance.

Significant efforts to issue comprehensive prudential standards for the Islamic banking sector have contributed towards establishing an internationally consistent framework for Islamic banking that is equally robust as those applicable to the conventional banking sector. This includes a sound capital adequacy framework equivalent of Basel II for Islamic banking.

It is also important to ensure closer cooperation among policymakers and financial supervisors with different mandates and in different jurisdictions in order to enhance the resilience and stability of the IFSI. In this regard, the IFSB has emphasised the need for the adoption of a coordinated cross-sectoral approach to the
regulation and supervision of IIFS that encompasses the banking, the investment and securities market and the takaful sectors. To address contagion risks, the regulation of non-financial activities of financial conglomerates would also need to be appropriately structured.

The development of a robust national and international liquidity infrastructure, which encompasses the potential for monetary policy and money market operations. This is important not only to reduce the cost of intermediation, but also to influence the level of liquidity in the financial system and achieve effective management of monetary policy. Robust liquidity management infrastructure is also vital in reserving financial stability for central banks to perform the lender of last resort (LOLR) function and to provide liquidity to the market. The ability of IIFS to weather a liquidity crunch is contingent upon the access to a robust liquidity management infrastructure, which is currently still underdeveloped in most of the jurisdictions in which Islamic financial services are offered. The tools for liquidity risk management presently available for use by IIFS remain rudimentary and markets are insufficiently liquid, leading to inefficiencies in normal times (due to low returns on liquid assets) as well as the potential for systemic risks in times of crisis owing to the relative limited liquidity of the instruments involved.

Towards addressing this, the IFSB has established a High Level Taskforce on Liquidity Management (HLTF), mandated to develop a liquidity framework to facilitate and offer liquidity solutions to market players so as to promote better liquidity management by the Islamic financial institutions. The HLTF is also mandated to study the viability of the proposal to establish an entity which would issue Shari’ah compliant instruments that are highly liquid and transferable in the secondary financial market.

The financial safety net mechanism, namely, LOLR facilities and emergency financing mechanisms as well as deposit insurance, all of which need to be compatible with Shari’ah principles. While the current 44 Islamic Finance and Global Financial Stability practice of managing liquidity through interbank Murabahah or Wakalah arrangements, structured finance and enhanced deposit schemes may function well under normal market conditions, more efficient and tradable Shari’ah compliant financial instruments are required for LOLR facilities and emergency financing operations when inter-bank liquidity comes under pressure in a crisis situation. This calls for the development of an adequate range of tools and instruments for LOLR and emergency financing operations that are consistent with the core objectives and principles of Shari’ah both in form and in economic substance. The implementation of a well-designed Shari’ah compliant deposit insurance scheme for Islamic financial services is particularly challenging given the intricacies of the funding structure of IIFS. The on balance sheet funding structure of IIFS in almost all countries is composed mainly of current accounts and unrestricted profit sharing and loss bearing investment accounts (UPSIA), and in most IIFS, these investment accounts constitute the major source of funding.

The development of a reliable crisis management and resolution framework in addition to financial safety nets, which includes bank insolvency laws and the arrangements for dealing with non-performing assets, asset recovery and bank restructuring, as well as bank recapitalisation. An integrated crisis management framework is essential to ensure that any emerging crisis in the Islamic financial system will be promptly managed. Jurisdictions that offer Islamic financial services are confronted with the challenge of adapting the framework of crisis management and resolution to the specific circumstances of the IFSI, and which has compatibility with Shari’ah principles.

The legal challenges relate to the issue of whether the conventional legal systems, common law jurisdictions and codified systems adequately address, among other things, bank liquidation and insolvency issues arising from Shari’ah compliant financial transactions, for example, in terms of the priority of claims of depositors and shareholders during liquidation of an IIFS. The IIFS would also be exposed to a number of risks in jurisdictions with established insolvency rules that are not tailored to deal
with insolvency issues in Islamic financial transactions. It is therefore important that policy actions be expedited to develop a Shari'ah compliant framework for crisis management and resolution in order to be able to restore stability and confidence in the IFSI, should the need arise.

Auditing and disclosure standards for IIFS and their counterparties, supported by adequate governance arrangements. This would enhance financial reporting to facilitate the effective monitoring and assessment of Islamic financial institutions. For IIFS, the IFSB has developed a standard on the Shari'ah governance systems, and has designed a transparency and disclosure framework to reflect the risk characteristics of IIFS. In parallel, further progress is needed in updating the accounting and auditing standards for IIFS to that of the international standards, in order to complement the developments in prudential and risk management standards. Above all, there needs to be a monitoring and assessment mechanism to encourage countries to implement the standards.

The development of the macroprudential surveillance framework and financial stability analysis, which is an integral part of the strategy to strengthen the resilience of the Islamic financial system and to minimise the risks of financial fragility. The traditional micro prudential supervision approach cannot effectively address system-wide stress that might develop due to common exposures of financial institutions. In this respect, there is a need to have a macro prudential surveillance framework that complements the traditional micro prudential supervision of individual institutions.

One of the challenges in the implementation of this macro prudential framework relates to the development of indicators that would not only provide a basis for the assessment of financial soundness and risk to vulnerabilities of the financial system as a whole and its components, but also facilitates an analysis and assessment of how these indicators might interact with broader macroeconomic developments. Such an assessment of systemic implications would enhance the ability to anticipate the potential threats to financial stability. In this regard, the IFSB has embarked on an initiative to establish a global database of prudential Islamic finance statistics.

This would contribute towards standardising the measurement methods and reporting structures of key financial soundness indicators for Islamic finance, thereby promoting international data comparability. As timely and accurate information and statistics is key enabler to this process, it is therefore necessary to ensure that similar advancement in information technology is made to cater for the unique characteristics and features of Islamic finance.

1.7 To review the rating process for Islamic institutions or instruments by re-examining and improving the related core processes to encourage greater transparency on the risks involved. A robust rating process is an integral part of the building blocks to address the apparent failure of the rating agencies to assign accurate ratings on new, complex securities, before the onset of any crisis. Rating agencies need to fully appreciate the unique features, characteristics and risk profiles of Islamic institutions and instruments. It is important to adopt a more holistic rating process, encompassing the fiduciary aspects and credit risk while giving due consideration to the transparency and visibility of the underlying transactions and the quality of the management. The rating and methodology process also need to be re-examined to encourage greater transparency. As Islamic financial institutions are involved in fiduciary relationship, the rating process should emphasise on the management of risk sharing in certain products and services (such as PSIA), and must be recognised in the credit rating assessment.

1.8 International Islamic supranationals and developmental bodies need to consider more involvement in capacity building. Islamic finance is an industry that is dynamic and complex with rapid product innovation. To excel and produce results in a more challenging globalised environment, practitioners and stakeholders in the Islamic financial services industry need to be highly qualified and equipped with the requisite technical knowledge and skills. Of importance is the need
for more collaborative efforts by various research and training institutions in different jurisdictions to design and offer capacity building modules in key areas across multiple jurisdictions.

Collaboration in this area would also enhance capacity building among countries and Islamic financial services industry players to develop the best practices and standards, harmonise of Shari'ah practices, review standards to facilitate policy development and implement of standards and policy framework. Efforts to enlarge the human capital pool are imperative to keep pace with the rapid growth of Islamic finance. Investments in human capital development through specialised training and educational institutions are important to support the global development of Islamic financial services industry. Talent development and educational institutions specializing in Islamic finance that have been established in several jurisdictions should be encouraged to forge strategic alliances across borders.

Accelerating Effective Implementation
Effective implementation is important to ensure enhanced resilience of the industry and greater linkages among Islamic financial institutions and markets. There are three Dimensions to this process:

The implementation of the prudential standards that have been issued by the IFSB is important. This is critical in the harmonisation of prudential standards, in promoting and enhancing the soundness and stability of Islamic financial services industry, as well as in contributing towards the consistent development of Islamic finance across different jurisdictions. Several jurisdictions have implemented the prudential standards issued by the IFSB, which have been designed based on the unique features of Islamic finance and will contribute towards ensuring its soundness and stability. This should be supported by a transparent and credible assessment process which would serve to assist jurisdictions in evaluating their level of compliance with international standards and make recommendations for improvements.

Mutual recognition of financial standards and products across jurisdictions would facilitate the integration of Islamic finance across the world and in bridging the global markets. This convergence and harmonization is taking place with the greater engagement among the regulators, practitioners and scholars in Islamic finance across jurisdictions. The industry also needs to develop innovative and diversified Islamic financial instruments which can be readily accepted by the Islamic financial institutions in various jurisdictions.

Key to this is to ensure that a consistent interpretation across jurisdictions is applied to the issues facing the industry. It is important for the industry to have a general understanding of the fundamentals of Islamic finance and in embracing the uniqueness of Islamic financial structures and their risk profiles. The industry needs to recognize the theoretical merits of Islamic finance as espoused by Shari'ah objectives and principles. When embraced in its entirety, these essential features reduce the risks of financial instability. While innovation is to be encouraged, it must be consistent with the essential features of Islamic finance that are in compliance with the principles of Shari'ah and aligned to the objectives of Shari'ah. This is an important transformation of Islamic finance from the dominant strategies pursued in previous decade of emulating the products and services of its conventional counterpart. This would separate Islamic finance from the same misalignments between assets and liabilities prevailing in the conventional system, and thus reduce the risks of financial panics. In attaining a sufficient degree of differentiation, Islamic finance can become a valuable partner within the global financial system.

The development of a more inclusive system, within a broader Islamic financial ecosystem. The hardships of the vulnerable segments of the society are often compounded during economic and financial crises. In the Islamic financial ecosystem, the institutions of zakat and awqaf contribute towards alleviating such hardships. In addition, greater access to financial services enables broader participation in the nation’s development process. Islamic finance, in achieving the objectives of Shari'ah (Maqasid al-Shari'ah), makes financial services relevant for a larger segment of the world population.
The Establishment of a Platform for Constructive Dialogue

Key to achieving financial cooperation is to have a strategic platform for conducive and constructive dialogue among the regulators of the international Islamic financial system. As Islamic finance continues to become an integral part of the global financial system, there is scope for the current framework of cooperation to be strengthened and broadened to address the new challenges that have emerged. The objective of the platform will be to facilitate better understanding of emerging developments in the Islamic financial system and their implications for national and global financial stability. It also would have the potential to promote collaboration and cooperation in remedial policies to prevent, contain and manage emerging issues in Islamic finance. The platform will to be a dedicated forum to promote cooperation and collaboration among its members in areas such as surveillance, sharing of experiences in crisis prevention, management and resolution, implementation of international standards as well as international cooperation in capacity building and in the development of emergency infrastructure and facilities.

Conclusion

Against a backdrop of an increasingly uncertain global environment, Islamic finance continuous expansion to become an integral part of the international financial system, presents unique opportunities and challenges. Islamic finance needs to further strengthen its resilience to withstand all possible market imperfections and future shocks. It has to draw on its intrinsic strengths to solidify its position towards attaining greater robustness of the overall system. The challenge for the Islamic financial system is to consolidate itself to be able to better compete with global players through achieving scale, efficiency and cost effectiveness in addition to rapidly building its capacities to standardize regulation and supervision, and accounting practices, while strengthening the governance of the industry. Islamic financial industry can reinforce and support globalization by bringing to it financial innovation and stability. The financial globalization has the potential to promote and reinforce Islamic financial industry by ensuring its conformity with conventional finance by fostering newer and better linkage with the global financial markets.

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