

Islamic Finance and Perspective within Global Financial System

Sorina AIOANEI
MK Romexterra Bank, Bucharest, ROMANIA

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Abstract: The paper examines the challenges to and from the Islamic finance, in the actual development and events in the global financial market. The subject is of an increased interest as in the last decade, a large number of Islamic banks or Islamic financial institutions were emerged in many countries. Islamic banking clients are not limited only to Middle East areas, but they are spreading across Europe, Asia and the US. Islamic finance has to develop its own Islamic financial instruments or to adapt the already existing conventional products, according to Shariah principles, but there are challenges to be met. New standards of accountability, transparency and efficiency should be applied for the genuine alternative to the current debt-interest-based international financial system.

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Islamic Financial Services and its latest development

Islamic Financial Services Industry (IFSI) is the fastest growing component of the financial services industry, in terms of the availability of the new products and also in the geographical spread.

Islamic banking clients are not limited to Middle East areas, but they are spreading across Europe, Asia and the US. According to “The Banker”¹ financial magazine, the main figures for the Islamic financial institutions at the end of 2007, show that the industry is under reported and it is expected the expansion to be correlated with larger disclosure.

Islamic banking, and generally Islamic Financial Services are a growing phenomenon, which came into existence to meet the needs of the devout Muslims around the world, who have the main wish to observe the Koran and Sunne.

More than 40 years ago the first Islamic bank Mit-Ghamr was established in Egypt and 15 years ago Iran and Pakistan opted for Islamic banking system. In the last decade, a large number of 525 Islamic banks or Islamic financial institutions were emerged in 47 countries. As a result of the increased interest in this large transactions, many Western banks started open their branches or subsidiaries in Islamic countries. Following the experience gained in the previous years, there is no doubts that non-interest based financial transactions are viable and feasible, and more and more interesting for western investors.

The Islamic Financial Services Industry is functioning through the following types of institutions:

¹ “The Banker”, November 2007, research done with Maris Strategy, a Cambridge consultancy

- a) Islamic banks, including full-fledged Islamic banks, Islamic subsidiaries and “Islamic windows” of conventional banks
- b) Islamic insurance and reinsurance companies or *takaful* and *retakaful* operators
- c) Islamic capital markets
- d) Islamic non- bank financial institutions, including Islamic leasing, factoring, finance companies, Islamic microfinance companies, etc.
- e) Islamic financial infrastructure including settlements systems, regulators and supervisors, rating and external assessment institutions

All have entered the sector within last 10 years and their move coincides with the rise in oil prices, as it happened 3 decades ago. Islamic Financial Institutions bloomed when the oil boom ensured them wealth.

Religious fervor and oil prices are on the rise again and now many western banks or companies are highly interested to do banking business in accordance with Shari'ah and to attract millions of potential clients.

On the other side there are Islamic banks opening branches or subsidiaries in Europe or US, and they are “forcing” the authorities to find some ways to integrate these services into the global financial system.

To the requests for the acceptance of these new types of financial institutions we shall add the more concerns for ethical investments of a large community in the world, which are similar to the Shari'ah concerns of the Islamic finance.

Shari'ah principles are applied to all aspects of the Islamic life, including financial services, enabling individuals and companies to adhere to these principles in their investment activities. The main requests of Shari'ah can be summarized:

- No interest (*riba*) will be charged or paid. Avoidance of interest has been abused by those who merely seek to be considered Islamic bankers. Many convert interest into capital gains and find a Koranic justification. The rules were tightened progressively as they have been in tax avoidance.
- Avoidance of risk (*gharar*), means that trading of risk or sale of something not yet obtained, must be avoided
- It will be financed only trade related business. There are western similar instruments, involving commercial papers and bankers' acceptance, which also have to be trade related. Many of the developing countries, having strict exchange control regimes, insist that all overseas financing or foreign exchange transactions to be trade- related.
- Part of the income must be given to charity (*zakat*). The word *zakat* means “purification” or “growth and it means that possessions are purified by setting aside a part for those being in need.
- An ethical investment, meaning that investments in certain activities are not permitted (*hala*). These includes production of alcohol, tobacco, pork, gambling and weapons.
- The concept of profit sharing business is the base of each credit contract.
- The principles are religious and generally are concerned how the income is generated, wealth's distribution in society or how the profit and loss are shared.

The Islamic principles of sharing risks and rewards, joint partnership in the wealth creation by lender and borrower, through substituting equity for debt, is a possible positive solution that promotes entrepreneurship and creativity. Usually, this model is transformed into a partnership through risk sharing and sharing of the profit and loss.

At least 47 countries have institutions performing Islamic Financial Services on their territory. The world Muslim population is approximately 1.6 billion ² and Islam is considered to be the fastest growing religion in the world. So, the very high-speed development of the Islamic Financial Services could be explained by the size of the market on the one hand and by the increasing wealth of the regions dominated by Islam, i.e. Middle East (see table 2).

Table 1

REGIONAL AND GLOBAL GROWTH TOTALS			
\$m	2007	2006	%change
GCC	178,129.55	127,826.55	39.35%
Non - Gcc MENA	176,822.17	136,157.64	29.87%
MENA total	354,951.72	263,984.19	34.46%
Sub - Saharan Africa	4,707.98	3,039.32	54.90%
Asia	119,346.46	98,709.56	20.91%

² Information downloaded on 6th September 2007 from www.islamicpopulation.com

Australia / Europe / America	21,475.72	20,300.24	5.79%
Global total	500,481.88	386,033.31	29,70%

Source: The Banker, Nov.2007

The current assets in Islamic Banking segment alone are estimated at over \$ 500 billion. The annual market capitalization of the stocks meeting the Dow Jones Islamic Market Index Criteria in Islamic countries is estimated at \$ 300 billion. The growth and development is more spectacular taking into account that in the '90s the IFS were in a nascent stage of its formation.

This rapid growth shows the demand for Islamic financial products in the global financial markets and consequently the demand for such services increased.

The Islamic Financial Services offered previously for retail business, expanded to new areas like private equity, structured products, project finance or mutual funds. For some countries the share of Islamic banking assets in total banking assets is still at very low level, despite the very aggressive development, with a penetration level of 15 up to 22%. The five countries with the largest Muslim population in the world: Pakistan, Indonesia, Egypt, Bangladesh and Turkey are still at very low level of development of the Islamic financial industry. For some countries the ratios of the Islamic Financial Services are improved by the large international players like, Citibank, UBS, HSBC, Deutsche Bank or BNP which entered recently into these markets.

Many financial products were developed and meet the specifications of investments in ethical products or socially responsible services. The optimists consider this like a precursor of the shape and form of global finance in the coming decades. It is true that there are a lot of conventional banks, similar with the Islamic banks, which do not enter in business partnership with companies involved in activities like gambling, prostitution, alcoholic liquor, narcotics, etc. There is no international financial institution which will agree to grant loans to banks which will credit such a/m activities and ethical and socially responsible finance are becoming popular in the Western world (Wilson, 1997).

As more and more we hear about Ethical finance in the western world, we should consider Islamic investments as a potential opportunity to the conventional financial services.

When analyzing majority of the products, we notice common features for both types of systems, conventional and Islamic, and the final result is basically the same. Like in the limited case of conventional banks, not extended to Islamic ones, the banking products are almost all "invented" already. It will harder be to develop a new product. But the difference is done by the marketing and targeted clients, as far as all products have the same basic features.

Due to the different Shari'ah interpretation among the Muslim countries, even when the capital controls and foreign exchange restrictions were removed, national and regional markets will continue to be segmented due to the different national legal systems or financial products.

As Islam is a universal religion, financial products designated as Islamic should reflect the Muslim value systems rather than national characteristics. Standardization of Islamic products and services can be done by adhering to international standards coming from secularist institutions such as IMF, BIS, World Bank or from specially designed international institutions such as the IDB (International Development Bank), AAOIFI (Accounting and Auditing Organization for Islamic Financial institutions), IFSB (Islamic Financial Services Board) based in Malaysia or IIRA (The Islamic International Rating Agency). It is well known fact that many non-Muslims are concerned with the ethics of how their money is used and their financing derived, so the ethical finance industry developed by some western banks and mutual funds had a great success.

Islamic finance should not be judged only by its quantitative impact on global markets, with its total assets of more than 500 billion USD, which though increasing, remains small, but more important by the quality of services and products. Islamic finance seems to be more concerned with social responsibility, including that towards the less fortunate in the global economic order. That means that Islamic financial institutions will not invest in corporations dealing with forbidden items like alcohol and gambling or in transactions involving *riba* or usury. In practice this is not so strict or dramatic as it sounds. Muslims effect daily transactions like investing their surplus funds, house purchasing, loans for their business, etc. For investment purposes Islamic financial institutions use similar criteria to those used by the ethical investment funds. The difference is made only in the way they structure loan transactions, both for personal finance and business purposes. Simply said, lenders enter into risk-sharing contracts with borrowers and return is based on the outcome of the investment, rather than a predetermined rate of interest.

The principle of risk-sharing have far reaching implications, due to the fact that borrowers have to be willing to provide much more information about their financial statements than conventional banks would seek for lending against collateral. It will include confirmation that the funds will be used for permissible activities, as well

as transparency in reporting their financial information about the progress of the business for which the loan was given.

There are more and more heard opinions that finally the conventional banking system will converge to the Islamic Banking system, as they both go through the globalization process. This can happen if at least two conditions will be met: the first one if the global finance will rely more on equity financing and will innovate the risk-sharing instruments and the second refers to the Islamic finance' capacity to innovate and to adapt the institutional structures to the new global financial environment. Innovation and financial engineering in Islamic finance was acting now, due to the lack of expertise, as a redesign of the conventional products adapted to the Shari'ah principles (Mirakhor, 2007).

At least in one single issue conventional and Islamic banking should find common ways of working, and this is in microfinance activity.

Microfinance is defined as the provision of financial services to the people with low economic standards, excluded from the conventional or Islamic banks. In many Muslim developing countries there is apparently a huge interest in promoting microfinance, as the final task for governments, banks or microfinance institutions is to fight against poverty and misallocation of the resources. Unfortunately, there are only few banks, conventional or Islamic, performing microfinance activities.

When we see so many conventional banks opening their Islamic windows or fully-fledged banks in Muslim countries, we wonder why there is none of them involved in microfinance. Project finance, investment credits, *sukuks* (Islamic bonds) are more visible, with high and rapid rate of returns and refer always to bankable people or companies. On the other side microfinance offer the financial services to non bankable people with no guarantee. We do not speak here about the poorest people, but about the poor people with entrepreneurial ideas, who need access to financing or depositing services.

Islamic and conventional finance should share a common objective of risk sharing, fulfilled by the legal and institutional developments in both systems. We cannot say, at this moment that the actual conventional banking system is more profitable and stable. Due to the latest developments resulted from the sub-prime crisis we can argue that the fragility of this system, operating on the fixed interest rate, is seen today.

In 1988, Stiglitz argued that "Raising interest rates may not increase the expected return to a loan; at higher interest rates one obtains a lower quality set of applicants (adverse selection effect) and each one's applicant undertakes greater risks. These effects are sufficiently strong that the net return may be lowered as banks increase the interest rates charged: it does not pay to charge higher interest rates."

Microfinance and Islamic finance share common features, which can be also met to the ethical finance, like:

- support to the entrepreneurship
- participatory approach
- risk sharing
- egalitarian approach (there is no limitation to any category of clientele)
- exclusion of all kind of economic activities which can socially or morally injure the society
- promote the social justice
- disbursement of loans without collateral (valid only for Islamic finance and microfinance)

Grameen Bank³ in Bangladesh is considered an example and a model for microfinance. The bank was established in 1974 by Mohammad Yunus and currently provides services to more than 74,000 villages. In 2006, The Nobel Committee decided to award the Nobel Peace Prize for M. Yunus and for Grameen Bank for their effort to create economic and social development and to struggle against poverty.

As Islamic law allows now a lot of room for product development and financial innovation, there are many expectations for new products design for microfinance. If there will be Islamic mode microfinance or conventional mode, I would say it will be used by the poor families as far as social welfare, unemployment or public debt are issues treated equally by both systems, and all the micro credits will be used to eradicate the unemployment and the poverty.

Microfinance Financial Institutions have to continuously innovate their techniques and their products and they have to face challenges for their future development like:

- credit interest rates established according to the cost (the banks involved in microfinance have high costs as they do not have clients with large accounts to subsidize the costs of microfinance)
- minimizing the fraud, especially in those countries with high corruption in business
- ability to face the threat of the political involvement in the microfinance
- increasing the rate of the retained clients, as they proved already their ability to repay their credits and they will transform into a larger client for the bank
- increasing the loan volume in order to the operating costs as a percentage of total assets

³ Grameen Bank website, <http://www.grameen-info.org/bank/>

-keeping loan repayment rates high

-ability to survive in uncertain climate and macroeconomic instability

If we add to the a/m issues, those related to the stable source of funding in the actual lack of liquidity and scarcity, I may say there are certain similarities with the challenges to be faced by the conventional or Islamic banks.

European Challenges of the Islamic Financial Services

Growing Muslim communities internationally has led to the request for more Islamic banking services. Much progress was made in UK for launching Islamic products from an UK authorized and established Islamic bank. This is expected to be followed by similar initiatives among 20 million Muslims in Europe, US and Canada. UK made important steps in making allowances such as abolishing the double stamp duty on Islamic mortgages. In Europe the main challenge will be to make the Islamic mode of financing widely accepted among a constituency which transcends Muslim communities. Still the main concern is the European countries like Germany or France is either not interested or even reluctant to agree with the establishment of the Islamic financial institutions despite the fact that as Khan (1986) noted, the appearance of interest-free based transactions are not an alien subject for western economies.

The global Islamic finance sector is growing year by year. Islamic banks are able to offer new and innovative products, but there are challenges to be met, especially when they have to compete in Europe with international sophisticated and experienced banks. Definitely, the Islamic banks had a fierce competition in their own countries, as many international banks open "Islamic windows" there, but the challenges they have to face are mostly the same in their origin countries or in Europe(I would say even more in Europe ,and I'll explain later on):

- Shortage of experts in Islamic banking, I refer here to executive specialists not to scholars
- Tax regimes not meeting the needs of Islamic products
- Lack of uniform rules in credit analysis
- Lack of relevant of accounting and auditing standards for Islamic banks. Basel II and IFRS changes will act as catalysts to improve the quality and consistency of disclosure of the Islamic financial institutions.
- Enhancement of product development, according to the market needs, taking into account the offers of conventional banks. I insist on the fact that Muslim population in Europe, having at least a medium living standard level, applied already to conventional banking products. They opened accounts in European banks, because they needed it and they did not wait for a potential establishment of an Islamic bank. We do not have to forget the 2 generations families living in Europe, who were using the conventional banking services for many years. It is quite difficult now, irrespective of their religiosity, to shift to another bank without comparing the cost, the quality and diversity of services of the two banks. Management of the Islamic banks in Europe and not only have to be more creative, developing product variations and enabling their banks to compete with their conventional peers.
- Improvement of corporate governance and risk management. Worth to be mentioned here that definitely Shari'ah board should be totally separated by the Risk Committee.
- Shortage of Shariah scholars. Shari'ah principles are set forth by qualified religious scholars. There are estimations of the existence of about 250 clerics, and they have to provide to all Islamic financial institutions support to product development according to Shari'ah rules. General practice states at a Shari'ah committee consists of three or more scholars, but in fact these scholars, due to their limited number serve more committees. Therefore, Shari'ah clerics need more trained scholars that combine an understanding of Islamic law, Islamic economics and global financial markets
- Strict Anti-Money Laundering rules, which have to be observed

In his paper⁴, Sayyid Tahir noted as a challenge innovation to create "financial instruments yielding stable income flows for orphans, widows, pensioners and other weaker segments of the society." Like in other papers or articles, there are mixes among the challenges for the Islamic banking and those of Islamic religious institution. In my opinion there is clearly a need for separating the social life's requests from those of banking or, generally Islamic financial services. For the above mentioned issue, the Muslims and not particularly those dealing with the banking sector, have a specific instrument "zakat", which is used and must be used by every religious Muslim. Including this issue on a list with possible challenges will complicate more the Islamic banking system, adding to it components which belong to social assistance activity and not banking.

⁴ Sayyid Tahir is professor of Economics in Islamabad .His paper "Future of Islamic Banking" was prepared for the course on Islamic Banking in Tehran, on 2-6 March 2003

Conclusion

There is a certain need for designing the new global financial architecture, which should promote the strong infrastructure for better global integration of both conventional and Islamic finance. Both types of institutions will have to work together with the supervision and regulatory bodies, national or European, for ensuring a free, fair and transparent market. Providing banking services in line with Shari'ah rules could enhance the accessibility of a significant part of population, not only Muslim, to financial services and should have positive implications for social justice and economic development.

Due to their specificity, Islamic banks need to invest more in their research for new products in order to ensure a proper financial risk management, resource mobilization at a competitive price and a proper balance sheet management through securitization.

The Islamic microfinance will improve the quality of life and will reduce poverty, transform in an important part of poor population in reliable clients.

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