Current challenges of Islamic finance

Islamic finance faces many hurdles but the industry should see these as potential opportunities in a changing financial environment. MURAT YOLUKER explores.

Islamic finance has rarely been so frequently on the agenda of the world financial system as now, thanks to the current financial crisis. Investors looking to move from a speculative and profit-based financial system to a risk-sharing and control-driven system can look to Islamic finance as a safe haven.

However, the integration of Shariah principles into the financial system gives rise to problems that are multi dimensional in terms of their political, economic and social aspects.

From a regulatory perspective, most of the time it can seem like trying to fit a square peg into a round hole and both regulators and institutions face a difficult job.

Lack of expertise

One of the main issues with Islamic finance in our current financial market is the lack of technical expertise and application of standards on a consistent basis globally. This is due to the fact that every Islamic financial institution (IFI) applies Shariah principles in its own way through its designated Shariah board.

Consequently, decisions may vary depending on the scholars as well as the different mazhabs (schools of thought). Islamic finance has a relatively young history and the services and products offered by IFIs are often developed to fill a gap created by their conventional equivalents, which leads to immature products that have not been fully tested, rather than truly niche market products.

This is not the case for mature financial markets like the US or the UK, where a solution to a problem may have been found in conventional financial instruments in the last century, but new jurisdictions such as Dubai and Qatar may face such situations.

Political aspects

Another issue arises from the political aspects of Shariah, since this is a code of conduct for Islam and regulators coming from a strictly secular environment, like those in Turkey, may not want to adjust their financial system in accordance with Shariah. Even in countries where the majority of the population is non-Muslim, this issue arises in an environment which is mostly driven by conventional banking practices and a lack of consistency in the application of Islamic finance standards.

> *"The accreditation of Shariah advisors is also an important issue when discussing corporate governance"*

Adjustments

Perhaps the most challenging issue comes with the practice of adjusting conventional finance products into Islamic finance services and products, which are mainly separated from the funds raised from depositors. For example, a deposit account may be opened by an account holder without bearing interest.

However, some jurisdictions do not allow such kinds of deposit activity or current account facility, since IFIs cannot promise any guarantee for the funds they raise. Hence this may lead to problems when dealing with ordinary customers who only want to put some money in their bank accounts in order to make ordinary payments or carry out simple banking transactions.

During the recent global financial crisis, we witnessed some governments providing a 100% guarantee for deposits with institutions in their financial system, which was a rare and desperate solution for the volatile state of the financial markets but was inconsistent with general Islamic finance practices.

Extraordinary times require extraordinary measures. But the problem is that there is no free lunch when the option is choosing between the protection of depositors and the collapse of the financial system. An example of this is when the government and the Central Bank of Egypt did not take any corrective action during the crisis of 1988 and let some small investors (over one million individuals) lose their entire savings in Egyptian Islamic investment companies (which were not regarded as Islamic banks by the Egyptian authorities). The unregulated environment for Islamic finance companies in those days created an environment conducive to fraud but the authorities did not take any responsibility for the results.

Another example is the collapse of Souk Al Manakh in Kuwait, an unofficial stock market which specialized in highly speculative and unregulated non-Kuwaiti companies. It resulted in investors losing their investments as well as defaulting on their loan repayments. As the wave of defaults grew, some IFIs in Kuwait (including one of the biggest international IFIs) were faced with collection issues resulting in liquidity problems. As a result, the Kuwaiti authorities provided some temporary aid to investors in order for them to meet their obligations, leading to a safer financial market.

These two cases show two different sides of government action (or inaction) leading to different perceptions, where the original aim remained the same: a sound and safe financial market. Since no one can argue against the necessity of regulations as well as government intervention during hard times, Islamic finance should have a base for these kinds of operations as the concept of 'risk-taking' is at the core of Islamic finance and the risks involved in the cases described above may be deemed to be part of this 'risk'.

Social issues

Social issues with Islamic finance arise from the community's views towards Islamic finance. Can we really expect the same level of Shariah compliance in a jurisdiction where the population mainly consists of non-

Continued

Continued

Muslims and conventional financial institutions dominate the financial market? Furthermore, can we expect that investors will have a perception of Islamic finance as reliable and sound if Islamic scholars are able to issue two different fatwas regarding the same Islamic finance product?

The social aspects of Islamic finance can be analyzed through different perspectives:

- **Corporate governance**: Having the goal of benefiting society as a whole should result in much more comprehensive corporate governance practices. As Shariah requires purification of profits earned in violation of Shariah through zakat (the compulsory giving of a set proportion of one's wealth to charity), for example, some institutions choose to spend these 'tainted' funds by giving to charities. But these institutions should be transparent from the beginning, which would mean the segregation of these sums until they are spent by the charitable organizations, as the institutions cannot be relieved of their responsibilities if the funds are improperly spent.

  The institutions may also be faced with anti-money laundering and counter-terrorism financing issues regarding these charitable funds. Shariah scholars may act as facilitators of good corporate governance throughout those institutions since the considerations the scholars are supposed to take into account are those in compliance with Shariah rather than the profitability of the institution. Also, non-executive directorship is a good practice for challenging the management of the institution, since independent views of transactions are a growing trend in risk and compliance assessment. Transparency is also important while providing necessary information to the Shariah advisors of an institution without taking any harmful profit goal into consideration.

  Shariah advisors should also have full access to the kind of information and personnel throughout the institution necessary for them to render an appropriate ruling.

  The accreditation of Shariah advisors is also an important issue when discussing corporate governance. Malaysia's national Shariah advisory council stands as a role model for setting standards in Islamic finance. In Malaysia, the civil courts and not the Shariah courts have the authority to deal with Islamic banking and finance cases. Since the introduction of legislation in 2009, any deliberation of the Shariah advisory council binds the courts and must be followed by all IFIs in Malaysia. In conclusion, IFIs should be pioneers of transparency and corporate governance compared to their conventional equivalents.

"A lack of standardization of Shariah compliant products may create credibility issues for Islamic finance"

- **Reputation management**: In terms of their reputation, IFIs will always have a "beta co-efficient" larger their conventional counterparts. Society seems much more sensitive when the subject is an Islamic bank. For example, the collapse of an IFI in Turkey due to the mismanagement of funds created a wave of blame and condemnation among other IFIs. As a result, people have been very hesitant to invest their money in these institutions.

  Due to a change in the regulatory framework at the beginning of the 2000s, IFIs were designated as 'participation banks' in Turkey and made subject to the regulations of the Banking Regulatory and Supervisory Agency, which requires strong corporate governance and risk management practices.

  The reputation factor does not always play against IFIs as many of these institutions managed to survive the latest global financial crisis due to the fact that they did not bear many of the risks associated with toxic assets and dealt mostly with trade-related activities. And this was well perceived throughout various communities.

  Another point is that a lack of standardization of Shariah compliant products may create credibility issues for Islamic finance. Again, national and international standard-setting committees may overcome this problem. As a result, Islamic finance institutions should manage the reputation not only of their firms but also of the sector itself in a professional manner.

Communication: Having a sensitive business model, Islamic finance institutions should communicate their aims and business practices to investors and non-investors in order to encourage a broader perception of Islamic finance throughout different segments of the community. These efforts may include training and degree programs not only for university students but also for everyone who is interested, as well as nation-wide events and regular reports to be published in dedicated magazines, newspapers etc. Also, Shariah advisory committees may act as communication channels for investors.

The last, but by no means the least important challenge for the Islamic finance business are the risk management policies and profit-generating products of the institutions. Islamic banks cannot hold interest bearing securities like treasury bills and bonds, so Sukuk reveals itself as not only an opportunity for liquidity management but also as a tool for fundraising.

Central banks should encourage national as well as international issuances of Sukuk in order to meet Islamic banks' prudential requirements and relieve them from the restrictions of the interbank money market. Moving from real estate and asset-based

Continued

Continued

financing structures to a universe of innovative financial products, Islamic finance will need many products: from liquidity management to complex financial solutions for profit, including an integrated risk management approach.

Given that Islamic finance institutions should undertake representational faithfulness of transactions (i.e., they should record transactions to reflect their economic substance), as per the requirements of the AAOIFI, they are not supposed to engage in speculative/destructive transactions purely for profit. So, when an IFI carries out a classical Murabahah financing transaction, the institution will also need:

- To proceed with the verification of the underlying asset;
- To ensure compliance with the Shariah fatwa on a case by case basis;

“Central banks should encourage national as well as international issuances of Sukuk in order to meet Islamic banks’ prudential requirements”

- To ensure compliance with Islamic financial limits (debt to assets, cash and receivables held in the portfolio, etc.);
- To proceed with purification if interest (riba) is in question;
- To make proper and not misleading disclosure for any of its Shariah compliant securities. Disclosure is especially important for retail clients as they may not able to understand the underlying hedge system of a capital protected fund, for example. Therefore, an innovative Shariah compliant product should also bear the costs of those items.

Conclusion

The Islamic finance industry faces many challenges but should see these as potential opportunities in a changing financial environment.

Murat Can Yoluker is the compliance manager at KBH Kaanuun and he can be contacted at murat.yoluker@kbh.ae.

184x130