The Paradigm of the Islamic Banking System

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Islamic banks have constantly grown their activity and expanded across the world economy, in a matter of decades. Today, their assets cover a wide range of categories and a broad geographical area, as new financial centers emerged in Middle East and East Asia. An insight on the Islamic banking system, reveals not only a different approach to finance, but also different ways to tackle issues arisen in practice. In this respect, Islamic banks address equally to Muslim and non-Muslim customers, developed different banking products without implying the concept of "interest rate" according to holy Islamic laws, as well as created new econometrical models to monitor and estimate the dynamics. Based on innovation, the Islamic banking emerges as an alternative to classic and nowadays troubled waters of universal banking system.

Islamic banks and financial institutions managed some $260 billion of assets, according to estimates provided in 2004 by the General Council for Islamic Banks and Financial Institutions (GCIBFI). A further $200 billion to $300 billion was managed by the Islamic subsidiaries of international banks in the world's major financial centers. These sums are representative for potential Islamic assets. Islamic bankers know that Muslim and non-Muslim consumers and investors are interested in their activities. The challenge for them is to make Islamic banking products and services fiscally sound and competitive, and then to make them available to all who want them.

At the GCIBFI conference held in Dubai in 2004, to discuss issues facing the industry, Professor Samuel L. Hayes of Harvard University made a remark that the mindset of Islamic bankers seems to have changed for the better, allowing for meaningful discussion of the industry's problems and weaknesses to take place. "When I first began to look into Islamic finance in the early 1990s, my impression was that Islamic bankers then were committed to a set way of doing things," he said. "These bankers were quite happy to wait for the world to come to them, and I thought then that it would take a long time for Islamic banking to take off."

But Islamic banking did take off, and has enjoyed an average annual growth rate over 10% per annum since it first emerged in the 1970s, according to the GCIBFI. Hayes attributed much of this success to the increasing sophistication of Shariah scholars and the effort put into Islamic financial engineering, as well as the vital motivator of market demand.

Though the reason of Shariah-compliant banking is to give Muslims an alternative to interest-based conventional finance, Hayes remarked that the series of scandals in corporate America has helped to close the gap between the ethical demands of Muslim and non-Muslim investors. Non-Muslim investors were not pleased by the revelations of lies and cheating found in the Enron fraud and the Wall Street investment banking research scandals. They also didn't like the enormous severance package awarded to Richard Grasso of the NYSE. The arrangement was one of greed and a lack of financial perspective. In fact, investors in the US are increasingly keen to invest on an ethical basis.

So if the world is increasingly appreciative of the ethical standards that are part of Islamic banking, so the potential demand for the industry's products and services increases. Iqbal Khan, CEO of HSBC Amanah Finance, observed that Islamic banking has emerged as a new paradigm of financial services, espousing corporate social responsibility and value-defined activities, but it is still chasing the scale and achievements of conventional finance. Innovation is key to the industry's future in his view, and to understand the scope for innovation one first has to understand where Islamic financial structures have come from.

The foundation of any Islamic financial engineering is an understanding of the balance between fixed features of Shariah, such as certain prohibitions and the fixed tenets of Quran law, and dynamic features, such as rules on Muamalat (dealings), secondary sources of law, and the understanding that everything is permissible unless it is forbidden. Bankers have used doctrines of necessity (Darurah) and common need (Al Hajjah Mushtaraka) as justification, and in some cases classical Islamic instruments have been adapted to modern needs (for example Ijarah for operating leases and Mudarabah for investment management) while in others conventional instruments have been reverse engineered (for example deriving Sukuks from bonds).

Financial engineering has enabled Islamic bankers to create Shariah-compliant products, but some worry that the re-engineering of conventional instruments is a sign in itself that the industry is lacking in imagination and its own theoretical foundations.

Atif Abdulmalik, CEO of First Islamic Investment Bank (FIIB), called on Islamic financiers to recapture the spirit of invention that once led Muslim scientists and mathematicians to invent algebra and algorithms, and to introduce the West to the study of astronomy. While it is clear that conventional finance operates on academically sound principles, Islamic finance has ethical and religious principles to adhere to, but lacks the convictions of accepted financial theory. "Those of us who have studied finance will have studied the Modgliani and Miller model as a tool to calculate the cost of capital of a company," Abdulmalik said in explanation. "Since in Islamic banking we have investment account holders rather than depositors, it may not be appropriate to use the M&M model because investment account holders will not receive a fixed rate of return. We need research to be carried out into developing an Islamic version of the M&M model, and in many other areas of Islamic finance such as risk management and securitization, so that we can build the Islamic banking industry on sound theoretical foundations."

One of the greatest challenges facing Islamic banking is the provision of short-term investment instruments. Several institutions have tried to develop high quality short-term instruments, but have been hampered by their ability to generate assets, by their credit ratings, and by liquidity. FIIB's solution to this problem has been to partner with international banks to develop suitable vehicles that can compete with the returns offered to investors by traditional conventional money market products. In this arrangement the international banks provide the liquidity support and asset generation capabilities, and the Islamic bank gets a solution to its problem, albeit not a fully independent one.

Speaking specifically about Islamic debt instruments, Islamic Development Bank's experiences from launching Sukuks have taught a lot about the importance of innovation. Until recently Islamic Sukuks have been seen as bilateral rather than tradable products. Now the focus is on an Islamic alternative to the bond markets, to see how this market can be developed, but also how it can be integrated with the global markets.

Providing that good governance backs Islamic instruments (as all should be), and that they offer an acceptable level of return (as all aspire to do), then they can appeal to a wide range of issuers and investors. In fact, US firms expressed interest in issuing their own Sukuk, and the Arab partner banks need to demonstrate economic efficiency and financial discipline, as well as to have a secondary market - the greatest challenge of them all.

Given that necessity is the mother of all invention, perhaps it is a good thing that Islamic bankers face quite a wide array of problems that they must surmount to guarantee their industry's future. Some of these problems are tangible, such as diminishing Murabahah returns, constrained asset allocation and the need for Islamic financial training institutions. Some of these problems are rather less easy to tackle head on, such as the lack of Shariah credibility in some products, the rather short-term nature of research and development, and the lack of think tanks to guide the industry with the theoretical foundations. They identified structured alternative assets, Sukuks, treasury products, and private equity as the areas they believe should be top of the innovation agenda for Islamic bankers. What is clear is that the replication and re-engineering of conventional products will never be enough in isolation.

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