Islamic banking: An asset of promise?
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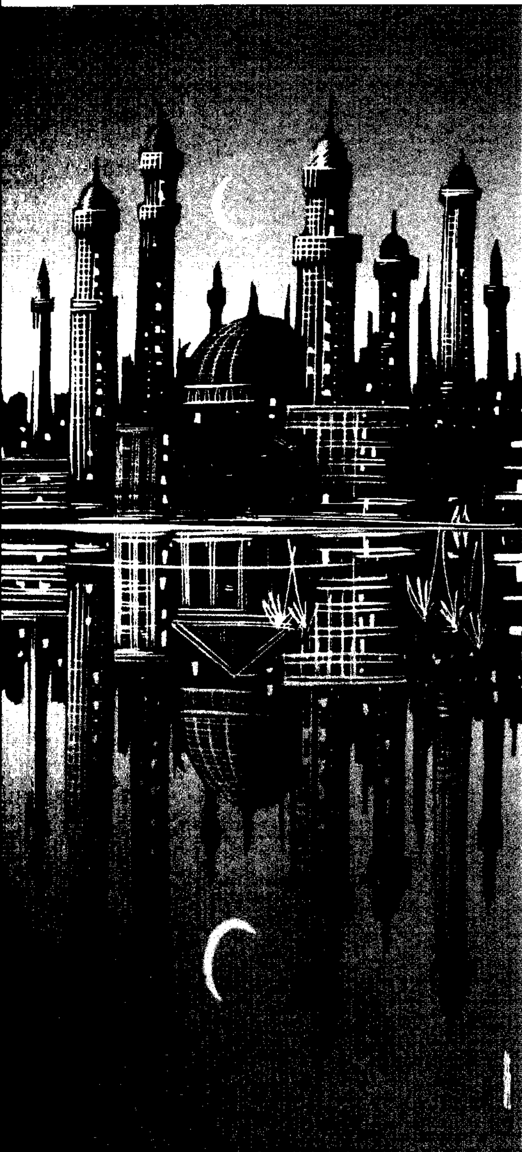

Islamic banking

An asset of promise?

Crisis-weary bankers, financial regulators and investors could look to Islamic banking for inspiration.

Almost non-existent 30 years ago, modern Islamic finance has risen to become a trillion dollar industry. The sector, though small in global terms, appears to have held up well in the crisis, with the Asian Development Bank putting annual growth at more than 15% over the next 5-10 years.

Long focused on a potential global market of 1.5 billion Muslims, Islamic banking is now drawing attention from players the world over. Nowadays, major establishments such as Al Rajhi Bank of Saudi Arabia, the Kuwait Finance House, and Malaysia's Maybank Islamic compete with western financial institutions such as Barclays, HSBC and Deutsche Bank.

Several banks have set up separate Islamic financial services departments in their home markets as well. In the UK, the Financial Services Authority has introduced regulatory standards for Islamic financial products and has a separate department dealing with Islamic financial institutions.

Moreover, non-Muslims make up as much as half of Islamic bank customers in some cases.

The failure of financial markets in OECD countries should inspire policymakers to take a closer look at other models, such as Islamic banking. There are clearly lessons to be learnt. For a start, Islamic banking is not only considered as a relatively safe refuge from global financial turbulence, but is also seen as broadly equitable and fair compared with the hitherto rather cutthroat western model.

Furthermore, the Islamic banking model offers much to consider in a broad range of topical areas, including risk management, transparency and regulatory oversight.

Fairness and equity is perhaps the fundamental principle behind Islamic finance. In fact, profits and losses are shared between lenders and the borrowers, and not just stacked up on one side or the other as is commonly the case in OECD-based banks. For example, under an investment partnership mechanism known as *musharaka*, a company that receives a loan will pay the bank through instalments that include both the principal and a percentage of the company's profits. Under another venture capital system called *mudaraba*, banks waive handling fees for company loans that fail to return a profit.

Or take **risk management**. Modern financial markets have tended to focus on maximising returns for investors, but paid too little attention to risk. In the end, financial innovations that were intended to spread the risk in the system, by slicing and dicing mortgages and other credits into derivative products, for instance, actually had the reverse effect of increasing systemic risk. Financial products whose value was uncertain were used as collateral to drive the market for ever bigger, ever riskier, products. The financial innovations simply hid the true risk of the products being traded. A collapse in confidence was inevitable.

Islamic finance takes a far more conservative approach in several ways. First, the value and pricing of these products must be backed by existing physical assets, such as real estate or commodities, like oil and wheat. They cannot be based on other financial products. Any profit from other financial products–in particular interest–is considered to be usury (*riba*) and contradicts the principles of the Koran. That is why, to avoid using interest, Islamic finance has developed a number of alternative investment vehicles, including *musharaka* and *mudaraba* (see fact sheet).

Also, some highly risky practices are banned, not least short selling, which many people blame for accelerating the financial meltdown by betting on the global financial market's decline.

Islamic banks are prudent when it comes to leveraging their assets to invest in capital too. Consider that the typical leverage ratio of assets to capital was over 20:1 in the US (Lehman's leveraged around 30:1 before bankruptcy) and over 30:1 in Europe compared to well below 10:1 in the Middle East and North Africa. It is partly this more conservative approach that has made Islamic banks well equipped to recapitalise their operations in the wake of the financial crisis.

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Instruments and principles
Besides the Koran admonishment of *riba* (interest), *gharar* and *maisir* (contractual uncertainty and gambling), and *haraam* industries (prohibited industries, such as those related to pork products, pornography, or alcoholic beverages), other principles must be observed by practitioners and supervisors to comply with Islamic jurisprudence and are reflected in financial products:

- *Ijara*: a leasing agreement whereby the bank buys an item for a customer and then leases it back over a specific period.
- *Ijara-wa-Iqtina*: a similar arrangement, except that the customer is able to buy the item at the end of the contract.
- *Mudaraba*: a specialist investment in which the bank and the customer share any profits. Customers risk losing their money if the investment is unsuccessful, but the bank will only charge a handling fee if the investment returns a profit.
- *Murabaha*: a form of credit which enables customers to make a purchase without having to take out an interest-bearing loan. The bank buys an item and then sells it on to the customer on a deferred basis.
- *Musharaka*: an investment partnership in which profit-sharing terms are agreed in advance, and losses are pegged to the amount invested.

Regulatory framework and bodies
Islamic Financial Services Board (IFSB) is a standard-setting organisation of 150 members (January 2008), including 37 regulatory and supervisory authorities as well as the IMF, World Bank, Bank for International Settlements, Islamic Development Bank, Asian Development Bank, and 108 market players and professional firms operating in 29 countries. It issues standards, guiding principles and technical notes in the areas of: risk management, capital adequacy, corporate governance, supervisory review processes, transparency and market discipline, recognition of ratings on Shariah-compliant financial instruments, and money market development and conduct.

Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) formulates standards in areas such as corporate governance, accounting and capital adequacy.

International Islamic Financial Market (IIFM) was founded with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank. Based in Saudi Arabia, it is an infrastructure institution with the mandate to take part in the establishment, development, self-regulation and promotion of Islamic capital and money markets.

The **IMF**– particularly in the context of its Financial Sector Assessment Programs and work on standards and codes–tangentially considers issues relating to Islamic finance as they concern banking stability. The **World Bank** also works on the subject, for instance, as it relates to corporate governance.

Islamic banking's strict requirement to back all investments with well-documented physical assets not only helps reduce such risks, but it also removes the need for credit ratings from a third party. Off balance-sheet vehicles (or conduits) for risky structured derivatives would not be possible under Islamic finance either, since companies are required to specify all assets and liabilities on the balance sheet.

While reassuring to some, this restrictiveness contains drawbacks too. Islamic banking lacks some of the more sophisticated tools that help modern finance to better manage risk. For instance, currency hedging is forbidden, even to protect against sudden shocks, in part because the transaction is not backed by physical assets. Commodity futures are banned because you cannot profit from assets that do not yet exist.

Islamic finance is starting to be considered as an important source of liquidity for cash-strapped governments and companies in the west. The German state of Saxony-Anhalt issued Islamic bonds, known as *sukuk*, in 2004, launching a €100 million ($125.9 million) debt programme. In 2008, the UK government was considering issuing some £2 billion (nearly $3 billion). As with other Islamic financial products, *sukuk* valuations are based on physical assets rather than debt, with arrangements such as leasing back assets like government buildings to ensure rental payments for the bond holders and buying them back when the *sukuk* matures. In just ten years, the global *sukuk* market has developed into a $112 billion industry and should reach $200 billion by 2010.

Some highly risky practices are banned, not least short selling

As to banking supervision, there are religious and ethical dimensions to take on board. All Islamic banking institutions must ensure that the products and services they offer are Shariah compliant, and this is usually verified by a specialist Muslim scholar. This requirement applies to western competitors wishing to enter Islamic banking, too. It is a challenge, since Shariah banking scholars are in short supply, making it hard to offer acceptable financial products and services to the market.

However, formal principles and standards are also key, and these are set by organisations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI). Great strides have been made in standardising regulations, but there are still niggly variations in how principles, including those based on Shariah, are applied, depending on the country. Ironing these out could boost the potential growth of the wider Islamic finance industry and make it a truly global force. ■ *RJC/AOS*

For more information on OECD's Middle East and North Africa Initiative on Governance and Investment for Development, contact Anthony.OSullivan@oecd.org

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