Challenges Facing Islamic Financial Industry

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Abstract

Zamir Iqbal in his article "Challenges Facing Islamic Financial Industry," discusses the challenges facing the Islamic financial services industry. Islamic finance began three decades ago but now has spread to investment banking, project finance, capital markets, insurance, wealth management, and micro-finance. Although, Islamic finance has survived well despite the obstacles and skepticism of the critics, it continues to face many challenges. The author argues that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth. On the contrary, if necessary policy measures are not taken, the industry may be adversely affected. The immediate need is to develop instruments that enhance liquidity; to develop secondary, money, and inter-bank markets; and to perform asset-liability and risk management. Its future growth and development will depend largely on the nature of innovations introduced in the market.

Introduction: Islamic finance has recently received considerable attention in academics and policy making. Started over three decades ago in the form of commercial banking, the financial activities conforming to Islamic Law (*Shariah*) have spread to investment banking, project finance, capital markets, insurance, wealth management, and micro-finance. Although, Islamic finance has survived well despite the obstacles and skepticism of the critics, it continues to face many challenges.[1] This paper argues that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth. On the contrary, if necessary policy measures are not taken, the industry may be adversely affected. The immediate need is to develop instruments that enhance liquidity; to develop secondary, money, and inter-bank markets; and to perform asset-liability and risk management. Its future growth and development will depend largely on the nature of innovations introduced in the market.

Section I of the paper identifies some areas of improvement in the banking and capital market sector and Section II makes some recommendations.

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[1]. For further discussion of issues see Iqbal and Mirakhor (1999); Iqbal (2005); Iqbal and Mirakhor (2007), and van Greuning and Iqbal (2007).

Section I: Areas for Improvement

Although, there are several areas where there is room for improvement, given the significant of the banking and capital market sectors in the development of the financial system, the following areas need immediate attention.

1. Small Assets and Capital Size:

Although Islamic banks have grown in numbers, the average size of their assets is still small compared to that of conventional banks. As of 2001, no Islamic bank was among the top 100 banks in the world. More than 60 percent of Islamic banks were below the $500 million in assets considered to be the minimum for an efficient conventional bank, and aggregate assets of all Islamic banks were less than those of any single bank among the top 60 banks in the world. Table I lists assets and capital of the top 10 Islamic commercial banks which shows considerable margin between top tier and the bottom tier banks. Finally, the size of assets of the largest Islamic bank amounted to a meager 1 percent of the assets of the largest bank in the world.[2] Large institutions have significant potential for efficiency gains due to economies of scale and scope, organizational efficiency, and lower cost of funding. Due to their small size, Islamic banks are unable to reap these benefits.

Table I. Islamic Banks Assets and Capital as of 2006
(US$ million)

	Commercial Islamic Banks	Total Assets	Total Equity and Reserves
1	Al Rajhi Bank (Saudi Arabia)	28,057	3,636
2	ABC Islamic Bank (Bahrain)	22,441	2,072
3	Kuwait Finance House (Kuwait)	21,953	1,479
4	Dubai Islamic Bank (UAE)	17,548	1,845
5	AlBaraka Banking Group (Bahrain)	7,639	708
6	Bank Al Jazira (Saudi Arabia)	4,094	538
7	Bank Islam Malaysia (Malaysia)	3,969	554
8	Bank Muamalat Malaysia (Malaysia)	3,813	202
9	Qatar Islamic Bank (Qatar)	3,035	500
10	Sharjah Islamic Bank (UAE)	2,081	515

Source: Islamic Banks and Financial Institutions Information System (IBIS)

[2] Iqbal (2001)

2. Liquidity:

Islamic banks are operating with a limited set of short-term traditional instruments, and there is a shortage of products for medium- to long-term maturities. One reason for these shortcomings is the lack of markets in which to sell, trade, and negotiate financial assets of the bank. There are no venues for securitizing dormant assets and taking them off the balance sheet. In other words, the secondary markets lack depth and breadth. An effective portfolio management strategy cannot be implemented in the absence of liquid markets, as opportunities for diversification become limited. Since the needs of the market regarding liquidity, risk, and portfolio management are not being met, the system is not functioning at its full potential. There is growing realization that the long-term, sustainable growth of Islamic financial markets will depend largely on the development of well-functioning secondary markets and the introduction of liquidity-enhancing and risk-sharing products.

3. Limited Scope:

In the absence of debt markets, underdevelopment of equities markets, and lack of derivatives markets, financial intermediaries play a critical role in the provision of Islamic financial services. Financial intermediaries not only are the main source of capital and risk mitigation but also are expected to undertake activities with wider scope. The changing global financial landscape will require Islamic banks to go beyond their traditional role as commercial banks and develop areas such as securities, risk management, and insurance that are either lacking or functioning on a limited scale.

The distinction between traditional commercial banking and investment banking is getting blurred, and there is a global trend to mix financial services with non-banking services. Although this trend is prevalent in major industrial economies, it has not been embraced by many of the emerging markets where Islamic finance is practiced. For example, a recent study that ranks several countries in the Middle East according to their level of financial development finds that countries throughout the region have a weak institutional environment and a poorly developed non-bank financial sector (Creane and others 2003).

4. Concentrated Banking:

Islamic banks tend to have a concentrated base of deposits or assets. They often concentrate on a few select sectors and avoid direct competition. For example, one Islamic bank

may specialize in financing the agricultural sector, while another might do the same in the construction sector, and neither attempts to diversify to other sectors. This practice makes Islamic banks vulnerable to cyclical shocks in a particular sector. Dependence on a small number of sectors—lack of diversification—increases their exposure to new entrants, especially foreign conventional banks that are better equipped to meet these challenges.

This concentration in the base of deposits or assets reflects a lack of diversification, which increases their exposure to risk. Islamic banks' assets are concentrated in a handful of products. In terms of sector allocation, average financing activities of Islamic banks have been oriented primarily to trade (32 percent), followed by industry (17 percent), real estate (16 percent), services (12 percent), agriculture (6 percent), and others (17 percent; see Kahf 1999). Islamic banks are not fully exploiting the benefits that come from both geographic and product diversification. At present, they rely heavily on maintaining good relationships with depositors. However, these relationships can be tested during times of distress or changing market conditions, when depositors tend to change loyalties and shift to large financial institutions they perceive to be safer.

This risk of losing depositors raises a more serious exposure known as "displacement risk." Displacement risk refers to a situation where, in order to remain competitive, an Islamic bank pays its investment depositors a rate of return higher than what should be payable under the "actual" terms of the investment contract; it does this by forgoing part or all of its equity holders' profits, which may adversely affect its own capital. Islamic banks engage in such practices to induce investment account holders not to withdraw their funds. By diversifying their base of depositors, Islamic banks could reduce their exposure to displacement or withdrawal risks. With the changing face of banking and the introduction of Internet-based banking, achieving a high degree of geographic diversity on the liabilities side is conceivable and should be encouraged.

5. **Weak Risk Management and Governance Framework**:[3]

Several studies have identified weaknesses and vulnerabilities among Islamic banks in the areas of risk management and governance. Operational risk, which arises due to the failure of systems, processes, and procedures, is one area of concern. Weak internal control processes may

[3] For further discussion, see Grais and Iqbal (2006) and Van Greuning and Iqbal (2007)

present operational risks and expose an Islamic bank to potential losses. Governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. The role of Shariah boards brings unique challenges to the governance of Islamic financial institutions. Similarly, human resource issues, such as the quality of management, technical expertise, and professionalism, are also subject to debate.

6. Disparity in Theory and Practice:

By design Islamic banks are supposed to be "pass-through" financial intermediaries where the profit or loss on the assets side is passed to the investors (depositors). In addition, Islamic financial system encourages risk-sharing financial contracts which implicitly favor equity- and partnership-based financial instruments. However, the practice is very different from the theory in both aspects but especially in case of risk-sharing instruments. Table II shows assets composition of select Islamic banks and it clearly shows a bias towards trade-based, short-term and fixed-income like instruments. For example, the share of equity and other partnership based instruments like *Musharakah* and *Mudarabah* is less than 10 percent which is very different from the structure of the assets envisioned by the theoreticians.

Table II: Asset Composition of Select Islamic Banks

	1999	2000	2001	2002
Murabahah & Deferred Sales	80.1%	83.0%	86.7%	84.3%
Istisna	10.8%	8.7%	7.5%	7.0%
Ijarah (Leasing & Hire Purchase)	2.5%	2.4%	1.9%	2.9%
Mudarabah (partnership)	1.6%	1.6%	1.2%	3.1%
Musharakah (equity participation)	0.9%	0.8%	1.3%	1.2%
Qard Hasan	0.2%	0.3%	0.4%	0.5%
Other	0.2%	0.2%	0.5%	3.0%

Source: Islamic Banks and Financial Institutions Information System (IBIS)

Section II: Steps Forward-- Some Recommendations

Improvement can be made in several areas to promote and enhance the functioning of Islamic banks and other institutions providing Islamic financial services. However, certain areas deserve immediate attention, and these are discussed further in this section.

1. Financial Engineering:

Financial engineering and financial innovations are driving the global financial system toward greater economic efficiency by expanding the opportunities for sharing risk, lowering transaction costs, and reducing asymmetric information and agency costs. Financial engineering involves the design, development, and implementation of innovative financial instruments and processes as well as the formulation of creative solutions. Financial engineering may lead to a new consumer-type financial instrument, or a new security, or a new process or creative solution to corporate finance problems, such as the need to lower funding costs, manage risk better, or increase the return on investments.

For Islamic financial institutions, a financial engineering challenge is to introduce new Shariah-compatible products that enhance liquidity, risk management, and portfolio diversification. Generally, attempts to apply financial engineering techniques to Islamic banking will require committing a great deal of resources to understanding the risk-return characteristics of each building block of the system and offering new products with different risk-return profiles that meet the demand of investors, financial intermediaries, and entrepreneurs for liquidity and safety. Securitization is a prime candidate for financial engineering. New financial innovations are also needed to satisfy the demand for instruments at both ends of the maturity structure: extremely short-term deposits and long-term investments. Money markets that are Shariah compatible do not exist at present, and there is no equivalent of an Islamic interbank market where banks could place, say, overnight funds or could borrow to satisfy a need for temporary liquidity. Although securitization of a pool of lease portfolios could help to develop the interbank market, the volume of transactions offered by securitization may not be sufficient to meet the demand (Iqbal 1999).

With increased globalization, integration and linkages have become critical to the success of any capital market. Such integration becomes seamless and transparent when financial markets offer a wide array of instruments with varying structures of maturity and opportunities for portfolio diversification and risk management. Financial engineering in Islamic finance will have to focus on the development of products that foster market integration and attract investors

and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic.

As impressive as the record of growth of individual Islamic banks may be, so far they have served mostly as intermediaries between Muslim financial resources and major commercial banks in the West. It has been a one-way relationship. No major Islamic bank has been able to develop ways and means of intermediating between the supply of Western financial resources and the demand for them in Muslim countries. There is an urgent need to develop marketable Shariah-based instruments by which asset portfolios generated in Muslim countries can be marketed in the West.

Related to the challenge of financial engineering is another operational challenge for Islamic banks: the need to standardize the process for introducing new products in the market. Currently, each Islamic bank has its own religious board that examines and evaluates each new product without coordinating the effort with other banks. Each religious board adheres to a particular school of thought. This process should be streamlined and standardized to minimize time, effort, and confusion.[4]

Development of new products and financial engineering are resource-intensive activities. All major conventional banks have dedicated departments that conduct background market research, product development, and analytical modeling. These activities demand financial and human resources, which are costly. Conventional financial institutions can justify these costs, because they are able to recover them, in most cases, from the volume of business generated as a result of the innovative product. Costs associated with the development of new products are rising due to the increasing complexity of the business environment as a result of regulatory or accounting and reporting standards.

Islamic financial institutions are, in general, of small size and cannot afford to invest substantial funds in research and development. They are unable to reap the benefits of economies

[4]. Informal discussions with practitioners revealed that religious boards sometimes are extremely rigid on minor technical matters and make the process of introducing a new product difficult and lengthy, resulting in missed business opportunities.

of scale. Considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products. Conducting basic research and development collectively may save some of the costs required to build this infrastructure individually. A good example of such collective effort would be to sponsor research in the development of analytical models, computer systems, and tools to analyze the risk and return on different instruments.

Financial engineering is an area where Islamic financial institutions could benefit from more experienced Western institutions, which are more sophisticated in engineering and marketing the right product to the right client. Conventional investment banks, which have invested heavily in the infrastructure for developing new products, can work for or with Islamic financial institutions to develop Shariah-compliant products. Once a financial engineering shop is set up, it can develop different products with different risk and return profiles. In this respect, Islamic financial institutions would do well to develop synergies and collaborate with conventional institutions. Islamic financial institutions could outsource the development part to conventional institutions and keep the marketing part to themselves, a division of labor that could benefit both institutions.

2. Risk Management and Diversification:

Financial markets are becoming more integrated and interdependent, thus increasing the probability of expeditious contagion effects and leaving little room for swift measures against unexpected risk. Insufficient understanding of the new environment can create a sense of greater risk even if the objective level of risk in the system remains unchanged or is even lower. The current wave of capital market liberalization and globalization is prompting the need for enhanced risk management measures, especially for the developing economies and emerging markets. Whereas risk management is practiced widely in conventional financial markets, it is underdeveloped in Islamic financial markets.

Due to limited resources, Islamic banks are often unable to afford high-cost management information systems or the technology to assess and monitor risk in a timely fashion. With weak

management and lack of proper risk-monitoring systems, the risk exposure of Islamic banks is high.

Providing a more diverse mix of financial services or spreading risks over a larger geographic area imply at least the potential for improved diversification, so the same protection against financial distress can be attained with fewer resources. For Islamic financial institutions, geographic expansion of the depositor base could achieve diversification on the liabilities side. Diversification on the assets side could reduce the variance of the returns that accrue to claimholders of the financial intermediary. Also, geographic and sectoral diversification on the assets side could break up the financial institutions' concentration in a region or a sector and thus reduce its exposure by creating less perfectly correlated risks. Geographic spread of products can further help the financial intermediary to improve its credit risk by selecting borrowers with the best credit and avoiding those with the weakest. With diversification, Islamic banks would be able to extend the maturity frontier.

Islamic financial intermediaries need to adopt appropriate risk management not only for their own portfolio but also for that of their clients. Diversification and risk management are closely associated with the degree of market incompleteness. In highly incomplete markets, financial intermediaries are in a better position to provide diversification and risk management for the client because the responsibility for risk diversification shifts from the investors to the financial intermediary, which is considered to be better at providing intertemporal risk management. Islamic financial institutions need to take immediate steps to devise an infrastructure for implementing proper measures, controls, and management of risk and to create innovative instruments to share, transfer, and mitigate financial risk so that entrepreneurs can concentrate on what they do best: managing exposure to business risk in which they have a comparative advantage.

Exposure can also be reduced by working closely with clients to reduce their exposure, which will ultimately reduce the intermediary's exposure. In other words, if the debtor of the bank has lower financial risk, this will result in better quality credit for the bank. Furthermore, monitoring becomes vital in cases where Islamic banks invest in equity-based instruments

because an institution with limited resources may not be equipped to conduct thorough monitoring. An institution with adequate resources may develop processes, systems, and training to undertake effective monitoring. There is clearly a need for Islamic financial institutions that can offer guarantees, enhance liquidity, underwrite insurance against risks, and develop hedging tools for a fee.

Finally, Islamic financial institutions need to realize the importance not only of financial risk and its management but also of operational risk, which is risk due to the failure of controls and processes. Currently, there is a serious lack of a risk culture and of enterprise-level sponsorship of active risk management. Formulating a strategy for risk management in Islamic financial markets will require (a) holding comprehensive and detailed discussion of the scope and role of derivatives within the framework of the Shariah; (b) expanding the role of financial intermediaries with special emphasis on facilitating risk sharing; (c) applying *takaful* (Shariah-compliant mutual insurance) to insure financial risk; and, finally, (d) applying financial engineering to develop synthetic derivatives and off-balance-sheet instruments.

3. Non-Bank Financial Services:

For further growth, the role of intermediation should be extended beyond its traditional setup. In particular, there is a need to broaden the scope and range of financial services offered, similar to the concept of a “financial products supermarket.” Such a supermarket would act like an “all-in-bank” covering all sorts of financial services. In this role, the Islamic bank would serve as a one-stop shop catering to different types of customers, ranging from private individuals, institutions, high-net-worth individuals, and corporations and offering products that serve their investment, borrowing, risk management, and wealth management needs. For example, such an institution would serve retail customers, manage investment portfolios, and provide various services for corporate customers. At the same time, like a broker, the financial products supermarket would be a retail firm that manages assets and offers payment and settlement services.

As financial systems become more sophisticated, institutional investors have grown significantly in size and importance. For instance, contractual savings with defined benefits, like

insurance and pension funds, are managing a large volume of assets. In a financial system where securities markets are underdeveloped, which is the case of Islamic financial markets, financial intermediaries will have to provide a broader set of services, including non-bank financial services. Most Islamic banks are not adequately equipped to provide typical investment banking services, such as underwriting, guarantees, market research, and fee-based advisory services. The refinement and development of fee-based services would enhance the functionality of Islamic financial services. Fee-based contracts like *joalah*, *wakalah*, and *kifalah* require further development if they are to be recognized and operationalized to exploit the full capabilities of Islamic banks.

4. Development of Capital Markets:

Responding to the current wave of oil revenues and growing demand for Shariah-compliant products, Islamic capital markets are expanding at a quickening pace, and stakeholders are starting to realize their potential. Development of institutional infrastructure, such as accounting standards and regulatory bodies, is a step in the right direction.[5] However, the market needs host governments to undertake strong leadership and constructive policy actions.

Well-developed Islamic capital markets will not only benefit borrowers and institutional investors, they also can enhance the stability of Islamic banks, providing them with improved portfolio, liquidity, and risk management tools. Ultimately, these developments will help to integrate Islamic financial markets, as well as the institutions that form them, into the broader conventional international financial system.

On the supply side, the volume of Islamic investments, with a preference for Shariah-compliant instruments, has grown to form a critical mass that can support a well-functioning and efficient capital market. It is evolving into a truly international market. Not only highly rated borrowers, such as the multilateral development banks (for example, the World Bank), but also developing-country borrowers with lower credit ratings, such as Pakistan, have successfully raised a considerable volume of funds in this market.

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[5]. These institutions include the IFSB, AAOIFI, Liquidity Management Center, International Islamic Financial Markets, and International Islamic Rating Agency.

On the demand side, countries in the developing world, especially the middle-income countries, will require a significant volume of investments in infrastructure over the next decade. For Indonesia alone, additional infrastructure investments of $5 billion (2 percent of GDP) are required annually, to reach a 6 percent medium-term growth target (World Bank 2004). Because the domestic capital markets of these borrowers are often too shallow to satisfy their large investment needs, they will have to access external sources of financing.

Furthermore, Muslim stakeholders in middle-income countries are increasingly expressing their preference for Shariah-compliant financing. In turn, financial intermediaries, including private sector commercial and investment banks, as well as development finance institutions, will have to start paying more attention to the “non-financial” needs of their clients.

For the multilateral development banks, the development of Islamic capital markets is a highly relevant topic. First, multilateral development banks are deeply involved in infrastructure finance and are naturally interested in the Islamic capital market as a new and alternative source of financing. Second, by channeling the funds available in Islamic financial markets, which are mostly based in the countries with high savings such as the Gulf Cooperation Council countries and Malaysia, to finance investments in developing countries, multilateral development banks can create a new model for international cooperation while responding to the stakeholders’ voices on both sides. Third, multilateral development banks can promote financial stability by encouraging the development of Islamic capital markets and providing the momentum to integrate the Islamic financial markets into the international financial system.

In the near future, structures such as *ijarah* (a lease) and *murabahah* (a cost-plus sales contract used to purchase commodities) that provide investors with a predetermined return as well as full recourse to the obligor probably will have more market potential than other structures. This will be driven primarily by investor preferences, but a large proportion of potential borrowers will prefer to lock in their borrowing costs rather than engage in pure profit-sharing schemes.

While the future appears promising, certain obstacles lie ahead, and market participants and regulators need to take concrete steps to support market takeoff. First and most important, market development requires strong sponsorship and leadership on the part of the host-country government, especially regarding legal and regulatory issues. For example, for an *ijarah* transaction, the owner of operating assets enters into a leasing transaction. While the owner of operating assets is often the government itself or related public sector bodies, the relevant laws and regulations in the host country may not allow these bodies to pledge or lease assets needed to structure an *ijarah* transaction. This is a fundamental point; the host country's policy actions are a key prerequisite for further market development.

In addition, borrowers, investors, and intermediaries need to nurture the market patiently. Islamic transactions are often less cost-efficient than conventional bond issues. Each new issue incurs higher legal and documentary expenses as well as distribution costs because it involves examining structural robustness in addition to evaluating the credit quality of the obligor. Since the terms available in Islamic capital markets are derived mostly from pricing levels in the more liquid conventional bond markets, there is no inherent cost advantage for borrowers tapping Islamic markets. Borrowers, therefore, need to formulate a comprehensive, long-term, and strategic view on how to reduce the overall cost of tapping Islamic markets, rather than focus on a single transaction. Investors can support market development by expressing their preference for *Shariah*-compliant instruments, namely, in their bid prices. Intermediaries can lead the process, perhaps through further standardization of transaction schemes and instruments.

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