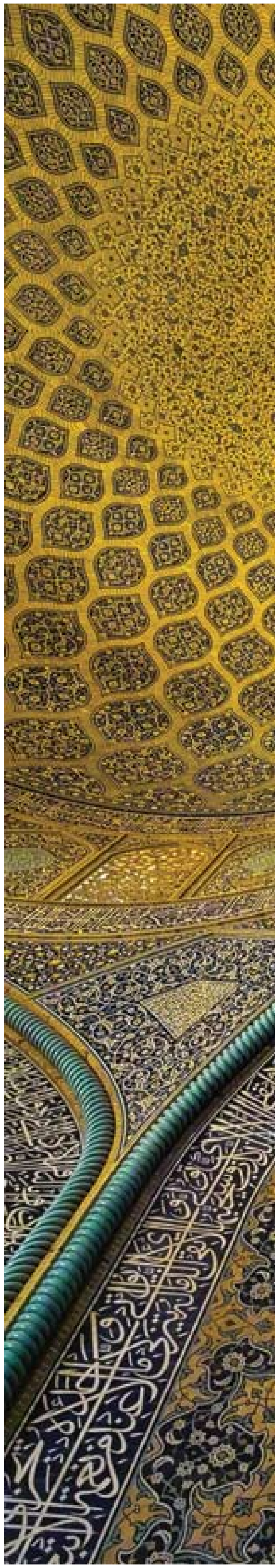
feature

Do Western financial markets have lessons to learn from Islamic finance? asks Aziz Tayyebi

eclipsed by the crescent moon:

Islamic finance provides some light in the global financial crisis



Islamic finance, as one of the fastest growing segments of today's banking industry, has gained significant global exposure in the last decade. Numerous sources estimate the global market for Islamic financial services (based on Shari'a-compliant assets) to be well in excess of $500bn. Although this is a relatively small fraction of the total assets amassed by the global banking industry, more impressive are the sustained growth rates for Shari'a-compliant assets which, at 15-20% for the last decade or so, very much eclipse their conventional counterparts. In 2007 alone, according to a report by *The Banker*, growth in Shari'a-compliant assets amounted to 29.7%, compared with the 16.3% across the top 1000 banks in the report.

Although these figures are not likely to be matched when the results of the banking industry's *annus horribilis* are reported, many commentators have suggested that Islamic banking has proved and will continue to prove more resilient than the industry as a whole.

some light in the darkness: Islamic finance escapes the worst

If we take the once-sure-bet equity markets, the S&P (Standard & Poor's) 500 Index fell a staggering 38.5%, with the Dow Jones Industrial Index also showing a record decline, of 33.8%, in 2008. By contrast, the Dow Jones Islamic Financial Index showed a more modest loss of 7% for the year. Islamic investment in shares, in principle, are essentially the same as those of conventional equity investments. However, the type of stocks that can be invested in are restricted, and thus investments in companies involved in for example, gambling, pork, pornography, tobacco or those that have excessive debt (greater than 30% of equity) would not be Shari'a-compliant. Perhaps, due to the latter restriction in particular, it appears that Shari'a-compliant investors have benefited from the screening of financial stocks, while their proportion in conventional indices is likely to have contributed to their poor performance. It could be argued that Islamic banking and finance has largely escaped the worst of the financial crisis due to it not being entrenched in many of the economies that have been worst affected. Additionally, the fact that it is a relatively new phenomenon has meant that it has perhaps not reached the same stage as conventional finance in terms of innovation and advanced market infrastructure, such as secondary markets. Thus Islamic financial institutions (IFIs) have not been able to participate in the type of transactions which their conventional counterparts have been exposed to. However, what is more apparent is that some of the abiding principles that underlie Islamic finance would in themselves have restricted an IFI's involvement in some of the investments and practices that have exacerbated the crisis.

> 'Islamic finance stresses the importance of underlying assets to back transactions. This inherently limits the ability of IFIs to trade in debt securities, and certainly restricts excessive leveraging through the repackaging and selling in of that debt'

sub-prime mortgages

At the epicentre of the global financial disaster was the lending practice that led to the creation of the sub-prime mortgage fiasco. IFIs can finance home purchase, and could in theory be exposed to sub-prime lending. However, the inherent risk management within most IFIs would in all likelihood have meant that greater initial deposits would have been required, thereby automatically restricting the exposure to 'sub-prime' consumers. Furthermore the conservative nature of most IFIs means that they tend to lend less as a percentage of assets and deposits (ie tend to hold higher capital reserves) than many of the most exposed conventional banks.

debt trading

What has really pushed the global meltdown to the levels we are now seeing has been the bundling-up of these assets and the subsequent trading of the debt securities in secondary markets, through often-complex derivative instruments such as collateralised debt obligations (CDOs). Islamic finance stresses the importance of underlying assets to back transactions. This inherently limits the ability of IFIs to trade in debt securities, and certainly restricts excessive leveraging through the repackaging and selling in of that debt. While there are concerns that some Islamic finance securities have moved away from this basic premise by attempting to mirror conventional products, it is generally accepted that diluting the link to the original underlying assets is looked upon with suspicion by most Islamic scholars. For this reason, it would be highly unlikely that many of the derivative instruments

Islamic finance (continued)

which have driven the unsustainable credit bubble over the last decade or so would have been passed by the Shari'a Supervisory Boards (SSBs) of most IFIs.

speculation (misar) and uncertainty (gharar)

Contractual risk is also forbidden within Islam. In general, this prohibits the selling of goods or services that the seller is not in a position to deliver, or the making of a contract which is conditional on an unknown event. You cannot sell something you do not own. While there are some prohibitive exceptions, this again limits IFIs from dealing in certain derivatives such as conventional futures contracts. In particular, the rise in speculative trading in these instruments that has flourished since the demise of delivery-settled to cash-settled contracts would be prohibited under Islamic finance.

Similarly, the price and nature of the goods being transacted are defined in detail and agreed upon by both parties, thereby avoiding a sale that may represent a gamble. Thus for example, conventional short sales or sales on margin are also prohibited. The damage that such trading can do to the efficiency of markets has not gone unnoticed by regulators around the world too – the Securities and Exchange Commission (SEC), albeit temporarily, restricted such trading during 2008 in order to bring stability to the markets.

'Contractual risk is also forbidden within Islam. You cannot sell something you do not own'

Islamic finance is not totally immune

Islamic banks have to hold assets. Given the restrictions on the type of investments that they may hold, they have tended to hold less diversified investment portfolios than conventional banks. While this may well have positively limited their exposure to many of the toxic assets associated with the global financial crisis, the value of their balance sheets is extremely vulnerable to falling market values in two particular asset classes, namely equity portfolios and (local) real estate. As 2008 results start to be published, the extent of their exposure to dipping equity markets will become more apparent. However, perhaps more worrying is what could happen if house prices in countries where Islamic finance is prevalent begin to unravel. With signs of the property boom in countries like the UAE and Malaysia appearing to wane, Islamic banks there may look less comfortable.

The emergence and growth of sukuk instruments (sometimes referred to as 'Islamic bonds') has revolutionised the Shari'a-compliant debt securities sector and given momentum to the Islamic financial industry on a global scale. While there is still some controversy within the Islamic finance industry, in terms of the structure that a sukuk should take, and the role of secondary markets, figures from Thomson Reuters (TRI) show that the sukuk market grew from \$6bn to \$24bn from 2004 to 2007. However, in 2008, the uncertainty in the global capital markets also manifested itself in the sukuk market, which showed a decline of about 30%. Nonetheless, reports by BNP Paribas and S&P suggest that issuances will recover beyond 2007 levels in 2009.

rising across the world: Islamic finance's global growth

The growth of Islamic finance in recent years has been driven by the conjugation of two forces. The first is a renewed awareness of a faith-based concept, which in turn resulted in increased undertaking of theoretical work and research to understand whether a banking/economic system could function without 'interest'. Secondly, the internationalisation of financial markets, attracting the immense rush of wealth to the Middle East in the 1970s, fuelled the demand in this area of financing.

Continuing demand in the 1980s and the sustained growth of the 1990s meant that the market for Islamic financial products had attracted the attention of a number of commercial banks. This has led to a situation where there are now over 300 financial institutions operating on the basis of Shari'a-compliant instruments in more than 70 different countries.

A report by *The Banker* in 2008 showed that the top countries by Shari'a-compliant assets (based on 2007 figures) were essentially Muslim-populated countries, largely from the Middle East (Iran, Saudi Arabia, Kuwait, UAE and Bahrain) and other parts of Asia (Malaysia, Brunei and Pakistan). Interestingly, the United Kingdom was placed 8th on the list.

Perhaps the most well established centres of Islamic finance are Bahrain and Malaysia. They both provide best practice models, with their increasingly robust regulatory frameworks, sound institutions and regulatory bodies. Organisations such as the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) in Bahrain, and the Islamic Financial Services Board (IFSB) in Malaysia have influence beyond their own jurisdictions and actively engage with other international bodies.

bearing the standard: Islamic finance in the UK

The fact that much of the growth is being seen outside the traditional markets has meant that global market participants and policy makers are increasingly paying attention to its potential. The UK Government has played a major role in trying to make the City of London the global centre of Islamic finance by extending support wherever possible. In conjunction with the Financial Services Authority (FSA), the Government has put in place a number of regulatory and legislative changes, including additional tax reliefs recently announced in the 2009 Budget. These aim to facilitate the growth of Islamic finance in the UK, and in particular are geared towards the initiation of sukuk transactions, which have hitherto been listed, but not issued in the UK. The well thought out and positive steps taken in the UK are a sound example of how emerging markets in Islamic finance can aid the growth in the sector, and the success has prompted other countries such as France and Germany to increasingly consider how to support the sector in their jurisdictions.

some concluding thoughts

Finally, it is clear that there are some inherently stabilising factors within Islamic finance which would, in all likelihood, have capped the extent of the current market turmoil for many Islamic banks, although the interlinked nature of global capital markets has meant that they too have suffered from falling business confidence.

As regulators and other stakeholders seek to manage the current crisis, and put in place frameworks to ensure that the like does not happen again, there are clearly a number of factors which provide food for thought. As Islamic finance already operates successfully within the current financial system, it should not be a major leap of faith for institutions and regulators alike to incorporate some of the guiding principles of Islamic finance, not only for their own benefit in terms of risk management and governance, but also for the wider benefit of consumers. ■

Aziz Tayyebi – financial reporting officer, ACCA