LESSONS FROM THE CURRENT FINANCIAL CRISIS

"Corporate governance is one of the most important failures behind the present financial crisis."

de Larosière Group (2009)

"This Report concludes that the financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements."

OECD report (2009)

The current financial crisis is not simply the result of market failure: it was brewing for some time as a result of a gradual deterioration of business leadership, of lapses in governance and in the regulatory framework (particularly in derivatives markets), and of an ineffective risk management framework. Even the International Corporate Governance Network (ICGN) has argued that although corporate governance failures did not cause the financial crisis, they certainly aggravated it.[33]

There is consensus among researchers that the regulatory and supervisory framework was not adequate to the task of forecasting and preventing the crisis and there is a growing realization that the derivatives and structured products markets need regulation. Work is under way to address this particular issue in US and European markets. However, the crisis has highlighted other governance issues: the market discipline mechanism proved to be too weak; the decision-making of corporate leaders was overly driven by short-term goals; trust in corporate leadership declined; corporate boards were slack in their oversight and risk control; business ethics and values were compromised; and, finally, the corporate incentive and remuneration system was questioned. Key issues arising from this are summarized below.

Failure of Market Discipline

The financial crisis has delivered a blow to the widely held view that the invisible hand of the market would work to make market players resolve conflicts through market discipline and that there was therefore no need to regulate the market. It was soon realized that not only was financial market information incomplete but that the market could be manipulated by market players for their personal interests.[34] This observation is particularly applicable to the derivatives and structured markets, where the level of complexity is higher than in markets for other financial products.

Short-sighted Approach

There is a growing realization that financial firms, capital markets, and other large corporations are driven by the sole objective of maximizing share value. The de Larosière Group (2009) pointed out that "the financial

system at large did not carry out its tasks with enough consideration for the long-term interest of its stakeholders. Shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance."[35]

Breach of Trust

The current financial crisis has done significant damage to aspects of social capital. The Edelman Trust Barometer, which tracks the level of trust in different countries, observed that people began to lose trust in business leaders and became critical of their irresponsible actions, especially in the US.[36] In the United States, home to some of the largest corporate collapses, trust in business leaders dropped 20 percentage points as a result of the crisis. At just 38 percent, this was even lower than the levels witnessed during the Enron and dot-com crises and came close to the levels in Western Europe, which has historically displayed the lowest trust levels in business among all nations surveyed by the tracker.

Failure of Board Oversight

The role of board oversight in the governance structure is critical in financial institutions and there was considerable debate over the levels of remuneration being paid to board members even before the current financial crisis. The failure of boards to determine and monitor the strategy and risk appetite of the company and to respond in a timely manner was evident in many cases. Even when there was a proper risk management framework in place, boards failed to take timely action. Although the role of the boards of financial institutions has increased dramatically over the last decade, they have been criticized for being too complacent and unable to prevent collapses.[37] A recent G-20 report concluded that "the current financial crisis is a classic example of board failure on strategy and oversight, misaligned or perverse incentives, empire building, conflicts of interest, weaknesses in internal controls, incompetence and fraud."[38]

Failure of Risk Controls

Weaknesses in safeguarding against excessive risk-taking behavior in a number of financial services companies were exposed during the current financial crisis. Even when the risk models gave signals of trouble, lax corporate governance meant that often no action was taken by senior management because such information never reached them or they judged it to be of little importance. While the failure of certain risk models can be put down to technical assumptions, the way in which the information was used in organizations was also a major contributor to this.[39]

Deteriorating Business Ethics and Values

The current financial crisis has also highlighted the issue of a decline in moral and ethical values in senior management, who seemed to care more about circumventing regulatory constraints and finding loopholes in the law than about morally correct behavior. Increasing greed and personal empire-building became the norm on Wall Street, with little emphasis being placed on producing moral and ethical business leaders.

The following reflections on some of the corporate governance issues identified during the crisis may be of benefit to Islamic financial institutions.

- In general, if corporate governance is designed and practiced following Islamic principles governing property rights, contracts, and higher ethical and moral standards, the intensity of several of the issues confronting the conventional framework will be reduced. While conventional finance also expects business leaders to exhibit ethical behavior, it does not have a sound enforcement mechanism other than market discipline, which has come under attack during the current financial crisis. On the other hand, the Islamic financial system derives its values from the teachings of Islam and can expect ethical governance from leaders, managers, and other stakeholders, who follow the rules prescribed by *Shari'ah*. Promoting ethical governance fosters trust and formal governance mechanisms will become more effective in protecting the interests of stakeholders.
- Islamic financial institutions should increase transparency and disclosure, both internally and externally. Implementing transparency and corporate governance standards designed by international institutions such as the AAOFI and IFSB can enhance transparency in the system. Table 15.3 shows the guiding principles adopted by the IFSB for the governance of institutions offering Islamic financial service. All countries where Islamic finance is practiced should consider implementing these principles. The IFSB has issued similar guidelines for institutions offering *takaful* and Islamic funds.
- Islamic financial institutions should take risk management seriously. They should put in place mechanisms to measure and monitor risks and ensure that all types of risks (market, credit, liquidity, operational) are reported in timely fashion. Generating reports is the first step but the institutions should ensure that these risk reports are duly reviewed by senior management and board members. There should be mechanism to take timely action after the review.

There is no denying that good governance promotes economic growth and financial stability in the Islamic and conventional financial systems alike. Despite considerable progress being made in strengthening governance in the conventional system, the current financial crisis has highlighted several shortcomings. The governance principles of Islam are much broader in recognizing and including stakeholders. The ultimate objective of the Islamic

TABLE 15.3 IFSB's guiding principles on governance of institutions* offering Islamic financial services (IIFS)

Principle 1.1: IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders.

Principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Shari'ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.

Principle 2.1: IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.

Principle 2.2: IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.

Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining rulings from *Shari'ah* scholars, applying *fatwa* and monitoring *Shari'ah* compliance in all aspects of their products, operations and activities.

Principle 3.2: IIFS shall comply with the *Shari'ah* rules and principles as expressed in the rulings of the IIFS's *Shari'ah* scholars. The IIFS shall make these rulings available to the public.

*Corporate governance: A defined set of relationships between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined.

Source: IFSB (2006)

system is to enhance social justice and welfare. To this end, it expects the highest moral and ethical conduct from the business leadership as well as from policymakers, regulators, and industry participants.

The governance framework, as defined by the principles of Islam, will focus on achieving the objectives of *Shari'ah*: the promotion of social justice, unity and social cohesiveness; the curbing of counterproductive behavior such as greed, deceit, misrepresentation, and the misappropriation of property; a strong commitment to contractual obligations; and transparency in decision-making. Such a structure is crucial to the stability of any financial system.

ENDNOTES

1. Al-Jarahi (2000).
2. Mirakhor (1989).
3. Boatright (2002).

4. Zingales (1997).
5. Donaldson and Preston (1995); Freeman (1984).
6. *Shari'ah* scholars consider that the human self or soul (*nafs*) has "rights" as well as many duties and responsibilities.
7. Imam Zayn al-Abidin's treatise on rights, *Risalat Al-Huquq*, covers a full spectrum of rights in Islam. For example, the right to one's property (*al-mal*) means that one takes it only from what is lawful and spends it only on what is proper. The right of the associate (*khalit*) is that one neither misleads him, nor acts dishonestly toward him, nor deceives him. The right of the adversary (*khasm*) who has a claim against one is that, if his claim is valid, one gives witness to it against oneself. See Ali ibn al-Husayn (1990).
8. Islam (1999). The term "*mal*" or its derivatives are mentioned in more than 90 verses in the *Qur'an* and in numerous sayings of the Prophet (pbuh).
9. See Mirakhor (1989) and Ahmed (1995).
10. Allah (*swt*) explicitly states that "Believe in Allah and His messenger, and spend of that whereof He made you trustee." *Qur'an* (57:7). By implication, the ownership of property (*al-mal*) is understood to be a trust and is considered to be a test of faith. See Bashir (1999).
11. Mirakhor (1995) makes reference to a number of verses to support this axiom.
12. Islahi (1988) claims that this distinguishing characteristic of his economic views is not found in any other scholars.
13. The Prophet (pbuh), during his last sermon at Arafat, declared the inviolability of property to be at par with that of life and honour: "Like this day of this month in this territory, sacred and inviolable, Allah (*swt*) has made the life and property and honor of each of you onto the other until you meet your Lord." This is further endorsed by the *hadith* stating that "Muslims' blood, property and dignity are protected against each other."
14. Islahi, op. cit.
15. These rules are supported by various verses in the *Qur'an*: see, for example, 2:188, 17:27 and 25:67.
16. The concept that man has an unrestricted handling authority over his wealth is unacceptable. Allah (*swt*) condemned the people of Shuayb for adopting such an attitude. See the *Qur'an* (11:87). Ahmed (1995).
17. Bashir (1999) argues that Islam attaches great importance to protecting people from harm caused by others. The Prophet (pbuh) is reported to have said "to cause harm to others is not allowed in Islam."
18. The classical definition of stakeholders is given by Freeman (1984) as any group or individual who may affect or be affected by the attainment of the firm's goals. Clarkson (1995) offers a refined view of a stakeholder based on the stakeholder's exposure to the risk (a hazard, a danger, or the possibility of suffering harm or loss) as result of the firm's activities.
19. Iqbal and Mirakhor (2007); Kourides (1970).
20. Verses of the *Qur'an* dealing with trust are: 2:27; 2:40; 2:80; 2:177; 2:282-83; 3:161; 4:107; 4:155; 6:153; 7:85; 8:27; 8:58; 9:12; 9:75; 9:111; 11:85; 13:20; 16:91; 16:94; 16:95; 17:34; and 23:8.
21. Asad (2004).
22. Dr Sabahuddin Azmi, http://www.renaissance.com.pk/Mayviewpoint2y5.htm. The significance of high morals and good was reinforced by the Prophet (pbuh)

who said: "The truthful merchant [is rewarded by being ranked] on the Day of Resurrection with prophets, veracious souls, martyrs and pious people" (Tirmidhi, No: 1130).

23. Boatright (2002).
24. Considering the fact that several of the "renowned" corporate leaders involved in the current financial crisis are graduates of top academic institutions in the US, including the Harvard Business School, a national discussion has started to review academic programs. Schools have also started to make one course in corporate responsibility a requirement for graduation.
25. See Grais and Iqbal (2006); Iqbal (2006); and Greuning and Iqbal (2006) for further details.
26. Grais and Pellegrini (2005).
27. They exist in all Islamic countries with the exception of Iran, where compliance of the whole banking system with the *Shari'ah* is guaranteed and monitored by the central bank.
28. A *fatwa* is a religious edict or proclamation. It is a legal opinion issued by a qualified Muslim scholar on matters of religious belief and practice.
29. Grais and Pellegrini (2005).
30. *Shari'ah* Scholars—A Network Analytic Perspective, 12th April 2010, Version 4.0, Funds@Work.com
31. Ibid.
32. Ibid. A survey of 13 IFIs shows the level of transparency to be low. All 13 declared the existence of an SSB within the organization and disclosed information on its composition. However, only seven made the annual report of the SSB easily accessible and seven did not provide detailed information on the professional background of the SSB members. Moreover, only two IFIs disclosed the *fatwa*s authorizing the provision of financial services and products. Only one disclosed provisions for decision-making and interaction with other bodies of the firm. Finally, only one IFI disclosed on its website the duties and obligations of the SSB. The IFIs' practice of limited disclosure would not inspire confidence in *Shari'ah* compliance.
33. Van Den Berghe (2009).
34. Ibid.
35. Ibid.
36. Edelman (2009).
37. Van Den Berghe (2009).
38. Becht (2009): 2.
39. Kirkpatrick (2009).

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CHAPTER 16

Globalization and its Challenges

The last few decades have witnessed dramatic and rapid changes in the structure of financial markets and institutions across the world. Advances in financial theory, the rapid pace of financial innovation, the revolution in information technology, deregulation, and institutional reforms have changed the nature of financial relations irreversibly and a "new finance" has emerged. As a result:

> *. . . people can borrow greater amounts at cheaper rates than ever before; invest in a multitude of instruments catering to every possible profile of risk and return, and share risks with strangers from across the globe. These changes have altered the nature of the typical transaction in the financial sector, making it more arm's length and allowing broader participation. Financial markets have expanded and have become deeper. The broad participation has allowed risks to be more widely spread throughout the economy.*[1]

The new finance has an important role in leveling the economic playing fields, thus becoming the great equalizer of our time: it requires no passport, and does not discriminate on the basis of color, creed, race, or national origin. It unwinds and unbundles, dissects, analyzes, and prices risk, and searches for the highest return. It explores all opportunities for risk/return sharing, in order to exploit the wedge between the real rate of return to assets and the real rate of interest, leading to a greater reliance on risk sharing.

Globalization is a multifaceted and multidimensional process of growing interconnectedness among nations and peoples of the world. Its main dimensions are cultural, socio-political, and economic. Its economic dimensions include growing trade flows, unhindered movements of finance, investment and production, accompanied by the standardization of processes, regulations, and institutions—all facilitated by the free flow of information and ideas. Globalization is the result of reduced information and transportation costs, and the liberalization of trade, finance, investment, capital flows, and factor movements.

As globalization gathers momentum and becomes pervasive, and as more economies liberalize in order to integrate into the global economy, the new finance will grow and so will risk sharing and asset-based securitization: both are at the core of Islamic finance. The present globalization is considered unfair because the risks and rewards of the process are not shared equitably. However, as equity-based and asset-backed financing grows, the fruits of globalization can be distributed more widely and more equitably among the participants than has been the case thus far, at least in terms of the financial linkages. There remains the question of protectionism in industrial countries, segmented labor markets and impediments to the transfer of technology, which require full international cooperation to be addressed and mitigated.

If the present globalization process is characterized as the free flow of trade, investment, and production, then it is possible to identify a similar episode of globalization—that of the Middle Ages. During the period referred to as "the age of the commercial revolution," from the middle of the eighth century to the latter part of the sixteenth century, trade flowed freely across the known world, supported by risk-sharing methods of finance, which were developed in the Muslim countries consistent with the *Shari'ah*. Information regarding the basic features of these methods was transmitted from the Muslim world via the intermediation of Jewish scholars and merchants, and from Spain, to Egypt, Europe, India, and North Africa. These new financial techniques were also transmitted by Muslim merchants to Eurasia, Russia, China and East Asia.

As globalization proceeds, its main engines—the new finance and advances in information technology—will shift the methods and instruments of financing trade, investment, and production in favor of more risk spreading and risk sharing, rather than risk shifting via fixed price debt contracts. This is the result of financial innovations that are dissecting, analyzing, and pricing risk better, so that—combined with efficient availability of information and the adoption of best international standards of transparency, accountability, and good governance in the public and private sectors—the raison d'être of fixed-price debt contracts will erode.

The current wave of globalization is here to stay and will change the financial landscape. As the new financial landscape emerges, risk-sharing and ultimately profit/loss-sharing contracts will become standardized, which will create opportunities for new financial systems to develop. Globalization and consequently the expansion of equity and risk-sharing modes of financing should pave the way for the further growth of Islamic finance. However, for this to happen Islamic finance has to overcome the several challenges that have been discussed in previous chapters and are summarized below.

CHALLENGES FOR ISLAMIC FINANCE

There are challenges on several fronts; theoretical, operational, and implementational. On the theoretical side, further work needs to be done on

developing core principles of Islamic economics, and understanding the functioning of a financial system operating on a profit/loss-sharing basis. On the operational side, issues relating to innovation, intermediation, and risk management are worthy of attention. Special attention should also be given to a system-wide implementation. Each of these challenges could take up a volume of its own, but for our purposes a brief discussion of some of these challenges will have to suffice.

Refining Islamic Economics

Whether Islamic economics is considered to be an entirely different discipline from traditional economics—a position justified by its world view, its view of rationality, its view on man's nature, its emphasis on the need for correspondence between behavior and prescribed rules, as well as its other specific dimensions—or as a special sub-field within that discipline, it has made considerable progress since its revival a little over three decades ago. This is remarkable, given that there is virtually no organized support for this effort, in sharp contrast to the multitude of private and public foundations providing financial support to research traditional economics. Despite the wealth of resources available in many Muslim societies, there is lamentably little support for scholarship in Islamic economics. Moreover, even the academic recognition of research activities in this field is, by and large, lacking and there is a lack of incentives for scholars to pursue their interest in furthering contemporary thinking in the discipline. Nevertheless, the personal dedication of scholars has produced a credible body of work that provides a sense of optimism regarding the future of Islamic economics.

There is no reason to doubt that scholarly activities in this field will continue and that, at some point in the future, it will develop a rigorous analytic foundation for policy analysis and prescription to achieve the objectives of Islam for the economy. Learning from the history of development of traditional economics—both its successes and failures—research in Islamic economics should anchor its progress on an interdisciplinary approach, paying due attention to historical, philosophical, psychological, and sociological dimensions of what Islam intends for individual and collective economic behavior. The immense scholarly works of Muslim philosophers, *fuqaha*, historians, and social critics provide a valuable legacy that will be extremely helpful in this process. Developments in traditional economics are also a fertile field for researchers in Islamic economics to harvest as a source of ideas. While the economic history of Muslim societies and thought can serve as a major source of ideas, special attention should also be directed at developing a proper language of discourse in Islamic economics, with the hope of the emergence of consensus-based, analytical, and operational definitions, and descriptions of major concepts that scholars need in order to further refine ideas and generate new insights. A common language, with its own "grammar" of Islamic economics, is fundamentally important. For this reason, a plea is made for the development of a coherent,

comprehensive, and systematic economic hermeneutics as a foundational structure that supports research, dialogue, and debate in Islamic economics, as well as in building the future edifice of theoretical, empirical, and policy structure of this discipline. The present generation of researchers is in a position to make an important contribution by focusing on activities that can draw economic meanings and inferences from terms, ideas, and concepts expounded in the sources of Islam. The hope is that at some point a collection similar to *Palgrave's Dictionary of Economics* is developed for Islamic economics. The momentum of these efforts will be greatly accelerated if financial resources, similar to those provided to investigations in traditional economics by major foundations, could be mobilized in Muslim societies to support such activities.

Trust, Institutions and Economic Development

Recent cross-country research indicates that the best-performing countries are those with relatively high trust levels and strong institutions. In poor-performing economies the level of trust is low, and institutions are either absent or weak. If trust is low, strong institutions should be established to protect property and investors' rights as well as to enforce contracts. While current Muslim societies have low levels of trust, they are adopting best practice and international standards of policy formulation and implementation, as well as legal institutions and practices that compensate for this weakness. Therefore, it is expected that risk-sharing methods of Islamic finance will expand rapidly in these countries.

As mentioned earlier, an important reason for the dominance of risk-sharing finance during the Middle Ages was mutual trust. It is possible that the breakdown in the general level of trust relationships may have led to the dominance of debt contracts beginning at the end of the Middle Ages. Economists, however, have been empirically investigating trust only recently after Fukuyama (1996) raised the possibility that it may be an important factor in explaining cross-country economic performance. Specifically, he asserted that the general level of trust, an important component of social capital, was a strong explanatory factor in the economic performance of industrial countries. Moreover, he indicated that a high level of general trust was reinforced in these societies by strong institutions. The last decade of the twentieth century had already witnessed a large volume of empirical research that focused on the existence (or the lack) of strong institutions explaining cross-country differences in economic performance. This literature isolated two specific institutions—those that protect property rights and those that enforce contracts—as the most important in explaining why some economies performed well and others did not.

As we saw in the previous chapter, the last decade has witnessed a growing literature on the importance of trust to the development of the financial system. There is growing evidence to suggest that low trust is a crucial factor in explaining the low level of stock market participation. If such research proves robust, trust may well become the long-awaited solution to the Equity Premium Puzzle (see following section). Trust may be defined

as the subjective probability that individuals attribute to the possibility of being cheated. Based on the analysis of cross-country data, where the level of trust is high, investment in equities in general, and in the stock market in particular, is also high. In low-trust countries, equity participation depends on observance of the rule of law and the existence of legal institutions that protect property and investor rights and those that enforce contracts. It suggests that in low-performing economies not only is the level of trust low, but property and investor rights are poorly protected, and legal enforcement of contracts is weak. Consequently, in these countries, corporations either do not form or, if they do, they resort to debt financing. The policy implications for these economies are that they should strengthen legal institutions, improve transparency, accountability, and governance—in both private and public sectors—and provide the public with a greater amount of information and education on risk/reward-sharing finance, particularly in equity markets.

The results of this recent research are a wake-up call for Muslim countries, since, as we have seen, trust is considered the most important element of social capital in Islam, and the cornerstone of the relationship of individuals with the Supreme Creator and with others in society. In short, Islam has made trust and trustworthiness obligatory—as well as keeping faith with contracts and promises—and has rendered them inviolable without explicitly permissible justification.

The reason for the poor economic performance of some countries is a low level of trust, combined with weak legal institutions protecting property and investor rights and poor contract enforcement. In the case of Muslim countries, Chapra (2000) has argued that this is attributable to weak adherence to the rules, norms, and values demanded by Islam. There is hope that as Muslim societies continue the process of strengthening legal institutions, their economic performance will improve. Efforts at reforming education, concentrating on adherence to Islamic values, norms and rules should strengthen the social capital—including, importantly, the level of trust—in these countries. One result of this will be the adoption of Islamic financial techniques of sharing risk/reward. Consequently, a global convergence process may be already at work toward risk sharing in the West and in the Islamic world. As the risks of globalization are shared more equitably, so will be its rewards, at least in respect of financial transactions and investment.

While the present low economic performance in Muslim societies, attributable to the low level of trust, is discouraging, signs are emerging that the future is more hopeful. The governments of these countries are implementing policies to strengthen the institutional structure of society, even if it is clear that the required level of trust will take a prolonged and sustained effort to achieve the strength commensurate with Islamic teachings. These policies include:

- Strengthening transparency, accountability, and good governance for public and private sectors

- Enacting fiscal responsibility and capital market laws
- Instituting legal structures that protect property and investor rights and enforce contracts
- Implementing financial-sector reforms that create a level playing field for all participants and deepen these markets
- Liberalizing trade and foreign direct investment.

Depending on the speed of such reforms, it is possible for Muslim countries to achieve much higher growth rates for their economies.

Emergence of a Risk Sharing Financial System

The question remains as to why greater use is not made of equity finance, with its risk-sharing characteristics. Prescott and Mehra (1985) demonstrated that, over many decades, there was a large differential between the real rate of return to equity and the real rate of return to a safe asset; that is, US Treasury bills. Furthermore, the differential was too large to be explained by existing theories of rational investor behavior. This result became known as the "Equity Premium Puzzle." It is a puzzle why rational investors, noting the differential, would not invest in equities until the point where the remaining differential could be explained as the risk premium on equities. Subsequent research demonstrated that the puzzle existed in other countries as well. A large body of literature has attempted to explain the puzzle but, as Mehra (2004) argued, all explanations failed, for one reason or another, to provide a satisfactory resolution.[2]

A major economic historical puzzle is why, after dominating the world of finance for eight centuries, risk sharing methods lost their supremacy to debt-based financing. One important reason may be that, since risk sharing is trust-intensive, a systemic breakdown of trust in Europe and elsewhere led to the emergence of debt-based financing. It is likely that this breakdown was a major factor for the decline of risk-sharing finance by the end of the Middle Ages.

While risk sharing techniques continued to be used in Europe until the mid-seventeenth century, interest-based debt financing began to be used more widely from the middle of the sixteenth century. There have been various explanations for this, including:

- The lifting of the scholastic prohibition on usury.
- The appearance and rapid growth of fractional-reserve banking that led to specialization of finance by intermediaries who preferred to provide financing to agent-entrepreneurs at fixed interest rates based on contracts enforceable by law in order to reduce monitoring and transaction cost.
- The inflow of gold and other riches into Europe from the European colonies in the Americas and elsewhere. This immense inflow reduced the incentive for the elite classes to continue financing trade on the basis of risk sharing. Instead, they preferred to turn their wealth over

to intermediaries, or to loan directly to merchant entrepreneurs on the basis of fixed-interest debt contracts.

- The emergence of nation-states whose governments were in need of finance for wars or other state activities, but could not raise resources except by means of fixed interest-rate contracts which paid an annuity in perpetuity without the need for governments to repay the principal.

However, this new system was inherently fragile.[3] Toward the end of the 1970s and the early 1980s, the existence of financial intermediaries in general, and banks in particular, was justified by their ability to reduce transaction and monitoring costs and to manage risk. However, little attention was paid to the reasons why banks operated on a fixed-interest system that rendered the system fragile and unstable and requiring a lender of last resort to regulate it. With the development and growth of information economics and agency literature, another explanation was added to the list of reasons for the existence of intermediaries: they served as delegated monitoring and signaling agents to resolve the informational problems, including asymmetric information that existed between principals and agents.

Based on the findings of the developing field of information economics, it is argued that adverse selection and moral hazard effects in a banking system operating on the basis of fixed-interest contracts in the presence of asymmetric information mean that some groups will be excluded from the credit market even when the expected rate of return for these groups may be higher than for those with access to credit. Furthermore, it is argued, in the case of risk/return sharing, contracts are not subject to these effects and that "the expected return to an equity investor would be exactly the same as the expected return of the project itself."

The fragility of a financial system operating on the basis of a fixed, predetermined interest rate was underlined by Stiglitz (1988: 312) who argued:

> *[I]nterest rate is not like a conventional price. It is a promise to pay an amount in the future. Promises are often broken. If they were not, there would be no issue in determining creditworthiness. Raising interest rates may not increase the expected return to a loan; at higher interest rates one obtains a lower quality set of applicants (adverse selection effect) and each one's applicants undertakes greater risks (the adverse incentive effect). These effects are sufficiently strong that the net return may be lowered as banks increase the interest rates charged: it does not pay to charge higher interest rates.*

The findings of the new field of information economics strengthened the arguments that a debt-based financial system with fractional-reserve banking operating with a fixed, predetermined interest-rate mechanism at its core is inherently fragile and prone to periodic instability. Stiglitz's findings underlined Minsky's argument that, as returns to banks declined, unable to

raise interest rates on their loans, they enter a liability management mode by increasing interest rates on their deposits. As this vicious circle continues to pick up momentum, the liability management transforms into Ponzi financing and eventually into runs on banks. The last two decades of the twentieth century witnessed a number of global bouts of financial instability and debt crises, with devastating consequences for a large segment of humanity, thus drawing attention to the vulnerabilities and fragilities of the financial system which originate, at their core, from fixed-price debt contracts. The risks of country-specific debt crises with potential risks of contagion have not diminished, particularly for a number of emerging economies, including some Muslim countries.

In the Middle Ages, Islamic modes of finance—based on mutual trust between agents and principals—dominated the known world. The breakdown of trust may have been crucial among the factors that explain the decline in risk sharing finance and the eventual dominance of fixed-price debt-contracting modes of finance. In modern financial markets, we observe a trend more favorable to risk sharing instruments. The rapid progress in development of risk sharing techniques and asset-backed instruments is evidence of this shift; in particular, there is already a perceptible shift of household portfolios toward equity and shareholding in a number of industrial countries. Risk sharing is also gaining momentum in discussions since the subprime financial crisis. As risk sharing financial instruments gain wide acceptance and the confidence of investors, it is possible to envisage a financial system founded on risk sharing as promoted by Islamic finance.

System-wide Implementation

The most important challenge facing the Islamic financial system is to secure system-wide acceptance and implementation. At present, many Islamic countries suffer from financial disequilibria that frustrate attempts at wholesale adoption of Islamic finance. Financial imbalances in the fiscal, monetary, and external sectors of these economies cannot provide a fertile ground for the efficient operation of Islamic finance. Major structural adjustments, particularly in fiscal and monetary areas, are needed to provide a level playing field for Islamic finance. The efficient operation of system-wide Islamic banking is presently severely constrained by distortions in the economy, such as:

- Pervasive government intervention and controls
- Inefficient and weak tax systems
- Financial repression
- A lack of capital markets and a strong supervisory and prudential regulatory framework
- The lack of a well-targeted and efficient social safety net
- A shortage of legal and institutional frameworks that provide *Shari'ah*-based definitions of property and contractual rights.

These distortions need to be eliminated to minimize waste and promote efficient resource allocation. Their removal prior to, or in conjunction with, the adoption of Islamic banking should create the dynamics necessary for non-inflationary and sustainable economic growth.

These distortions not only increase price instability but also aggravate the risk and uncertainty surrounding contracts that do not promise a fixed nominal return. Since Islamic modes of transaction shift more risks to the investor, the investor needs credible government policies to maintain stable prices. The choice of a monetary and fiscal policy regime determines the types of risks and uncertainty that the society bears. Individuals reduce the costs of risks and uncertainty by opting for safe assets with fixed nominal payoffs, rather than returns that are dependent on outcomes.

An Islamic financial system can be said to operate efficiently if the rates of return in the financial sector correspond to those in the real sector. In many Islamic countries, fiscal deficits are financed through the banking system. To lower the costs of this financing, the financial system is repressed by artificially maintaining limits on bank rates. Thus, financial repression is a form of taxation that provides governments with substantial revenues. To remove this burden, government expenditures have to be lowered and/or revenues raised. Massive involvement by governments in the economy makes it difficult for them to reduce their expenditures. Raising taxes is politically difficult. Thus, imposing controls on domestic financial markets becomes a relatively easy means of raising revenues. Under these circumstances, governments impose severe constraints on private financial operations that can provide higher returns to their shareholders and/or depositors. This makes it very difficult for Islamic banks and other financial institutions to fully realize their potential. For example, *mudarabah* companies that can provide higher returns than the banking system end up in direct competition with that system for deposits that are used for bank financing of fiscal deficits.

While it has been relatively easy to create a system in which deposits do not pay interest, the asset portfolios of Islamic banks do not contain sufficiently strong components that are based on profit sharing. This is because there is a lack of legal and institutional frameworks that facilitate appropriate contracts as well as mechanisms to enforce them. The banking system is a direct function of the returns to asset portfolios and, since assets are created in response to investment opportunities in the real economy, it is the real sector that determines the rate of return to the financial sector rather than the reverse. This is compounded by the limited range and variety of maturity structures of financial instruments currently available.

Consequently, there is a perception that profit sharing methods in particular and Islamic finance in general are high risk. This, in turn, has led to a concentration of the asset portfolios of the Islamic banks in short-term and trade-related assets. The problem is exacerbated by the fact that Muslim countries lack the deep and efficient capital and money markets that can provide the necessary liquidity and safety for existing assets. The absence of

suitable long-term instruments to support capital formation is mirrored in a lack of short-term financial instruments to provide liquidity.

Considerable efforts have been made recently to address issues of regulation and supervision of Islamic financial institutions and, as a result, a solid regulatory framework for Islamic financial institutions is emerging. However, challenges remain, the most immediate of which can be classified into two groups: (i) financial engineering and (ii) operational.

In the former category is the challenge to introduce new *Shari'ah*-compatible products that enhance market liquidity, offer risk-management tools and enable greater diversification of portfolios. Applying financial engineering techniques to Islamic banking requires the commitment of resources to gain an understanding of the risk/return characteristics of each building block of the system and to offer new products with different risk/return profiles to meet the demands of investors, financial intermediaries, and entrepreneurs for liquidity and safety. The process of securitization to enhance marketability, negotiability, and return on assets is a prime candidate for financial engineering. With increased globalization, integration and linkages have become critical to the success of capital markets. Such integration becomes seamless and transparent when financial markets are able to offer a wide array of instruments. Financial engineering in Islamic finance needs to focus on the development of products that foster market integration and attract investors and entrepreneurs to the risk/return characteristics of the product, irrespective of whether it is Islamic or non-Islamic. Innovation is also needed to satisfy market demand for both short- and long-term maturity structures. Money markets that are *Shari'ah*-compatible do not exist at present and there is no equivalent of an Islamic interbank market where banks can place overnight funds, or where they can borrow to satisfy temporary liquidity needs.

Another operational difficulty facing Islamic finance is the current lack of an equity-based benchmark or reference rate (reflecting the rate of return in the real sector) for pricing assets and evaluating portfolio performance, or comparing various investment alternatives. In the absence of such a benchmark, a common—if questionable—practice has been to use the London Inter-Bank Offered Rate (LIBOR) as a proxy. While this may be sanctioned by *Shari'ah* scholars as a temporary expedient, the system would operate more efficiently if an index representing returns on profit/loss-sharing instruments were developed for use as a benchmark.

ISLAMIC BANKING

Islamic financial institutions have performed well during the high growth period of the industry but, with a rapidly changing global landscape, maintaining sustainable growth is just one of many challenges. So far, Islamic banks have capitalized on a fast-growing, demand-driven niche market but,

with a large number of existing Islamic banks and growing interest from conventional institutions (both Western and non-Western) tapping into this emerging market, the industry is becoming highly competitive. IFIs have been able to maintain a competitive advantage in a market which was characterized until recently by high entry barriers for conventional institutions which were less knowledgeable in *Shari'ah*. However, increased awareness and recognition of Islamic financial instruments, advances in technology, globalization and market integration, and more experienced and professionally advanced conventional institutions will create tough competition in the future. Some of the major challenges facing Islamic financial institutions are set out below.

Two-way Intermediation

As impressive as the record of growth of individual Islamic banks may be, the fact is that these banks have served mostly as intermediaries between Muslim financial resources and major commercial banks in the West. In this context, this has been a one-way relationship. There is still no major Islamic bank that has developed methods of intermediating between Western financial resources and demand for them in Muslim countries. While there is considerable room for competition and expansion in this field, the long-term survival of individual Islamic banks will depend on how rapidly, aggressively, and effectively they can develop techniques and instruments that allow them to carry on a two-way intermediation function. They need to find methods of developing marketable *Shari'ah*-based instruments by which asset portfolios generated in Muslim countries can be marketed in the West, as well as marketing *Shari'ah*-based Western portfolios in Muslim communities.

Risk Management

Financial markets are becoming more integrated and interdependent, thus increasing the probability of rapid contagion between them. Further, insufficient understanding of the new environment creates a greater risk perception even if the objective level of risk in the system is unchanged or reduced. The current wave of capital market liberalization and globalization may prompt the need for enhanced risk management measures, especially for the developing economies and the emerging Islamic financial markets. Whereas financial risk management is widely practiced in conventional financial markets, it is grossly underdeveloped in Islamic financial markets. IFIs need to take immediate steps to devise an infrastructure for implementing proper risk measurements, controls and management, and to produce instruments to share, transfer and mitigate financial risk so that entrepreneurs can concentrate on what they do best—manage exposure to business risk in which they have a competitive advantage.

This requires Islamic financial intermediaries to adopt appropriate risk management, not only for their own portfolio but to offer such services

to their clients. A financial institution which can offer guarantees, enhance liquidity, underwrite insurance against risks, and develop hedging tools for a fee, can and should be established. If the basic building blocks of the Islamic financial system are viewed as a set of "asset-backed" securities, derivatives can be created synthetically and can be used to share, transfer or mitigate financial risk. Both on- and off-balance-sheet hedging instruments should be developed using these building blocks by applying the techniques of financial engineering.

IFIs need to realize the importance of operational risk that arises from the failure of controls and processes. Currently, there is a serious lack of a risk-management culture and of enterprise-level sponsorship of active risk management. Formulating a strategy for risk management in Islamic financial markets will require a comprehensive and detailed discussion of the scope and role of derivatives within the *Shari'ah* framework; an expanded role for financial intermediaries with special emphasis on facilitating risk sharing; the application of *takaful* insurance against financial risk; and the use of financial engineering to develop synthetic derivatives and off-balance-sheet instruments.

Standardization

Another operational challenge for Islamic banks is to standardize the process for introducing new products into the market. Currently, each Islamic bank has its own religious board to examine and evaluate each new product. Each religious board may have its preferences or adherence to a particular school of thought. This process needs to be streamlined and standardized to minimize time, effort and confusion. Some banks have already instituted a post-product audit process by audit committees to ensure compliance with the *Shari'ah* guidelines defined by the religious board. However, this needs to be applied across the industry as a whole.

Consolidation

Given the large number of small institutions, Islamic banks do not enjoy economies of scale. Indeed, many banks use the facilities of conventional banks as intermediaries for treasury management, foreign exchange, portfolio services and investment banking, which reduces their profit margins. It is time, perhaps, for Islamic banks to seriously consider merging into large financial institutions in order to benefit from economies of scale and reduced overhead costs through efficiency gains.

Governance

In principle, the governance model in the Islamic financial system—with its *Shari'ah* boards, public-policy institutions, regulatory and supervisory institutions to monitor the performance of IFIs, and its commitment to

contracts that protect the interests of all stakeholders—is similar to that of a stakeholder-based incentive system. The governance issues of IFIs are similar to those experienced in an "insider" system of governance, where the institutional investor plays an active role in the governance process.

While increased monitoring by investment account holders as a result of increased transparency is highly desirable, their representation in the organs of governance raises several operational and implementation concerns. As the majority of investment account holders are individuals, who may not organize themselves collectively to perform the necessary monitoring, this places greater responsibility on regulators and *Shari'ah* boards to ensure that an adequate monitoring mechanism is in place to protect their rights. As the custodian and manager of investment accounts, the financial institution itself becomes an institutional investor with a vested interest in the governance of the institutions with which it places funds. This issue is not generally highlighted in current discussions of corporate governance.

Finally, the role of the *Shari'ah* boards in providing sound governance is also critical. The current practice of each institution maintaining a *Shari'ah* board or adviser leads to inefficient decision-making arising from a duplication of effort and a lack of standardization. As discussed earlier, a system-wide *Shari'ah* board comprising religious scholars who are also trained in Islamic economic and financial principles would be more efficient and cost-effective.

This system could work closely with the regulators and supervisors to ensure that effective monitoring and supervisory controls are devised to protect the rights of all stakeholders with whom the financial institution has explicit or implicit contracts.

ENDNOTES

1. Raghuram (2005).
2. Interestingly, in the same paper Mehra reported that one dollar invested in equity in 1802 would have been worth nearly $560,000 in 1997, whereas the real worth of the same dollar invested in Treasury bills over the same period would have been $276.
3. For further details, see Minsky (1982) and Khan (1987).

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CHAPTER 17
Issues and Challenges

As is invariably the case in any emerging market, the Islamic financial industry faces several challenges. The nature of these challenges is diverse, as there are numerous issues concerning its theoretical foundation, infrastructure development, systemic implementation, integration with external systems, and enhancing operational efficiency. There are challenges at both macro and at micro levels and the approach taken to these will determine the future success or failure of the industry. Although the industry has enjoyed handsome growth, its sustainability and future growth will largely depend on how successful it is in addressing these challenges. If due attention is not paid to addressing these issues, Islamic finance will fail to achieve its full potential and to deliver on its promise. Therefore, the stakes are very high and demand serious discussion of the issues.

There is no shortage of literature pointing out the deficits in the current state of the industry and what needs to be done. Table 17.1 summarizes some of the prescriptions given for enhancing different segments of the industry. The next logical step would be to prioritize the steps to be taken and then prepare an action plan. A complete coverage of all the issues and challenges would be a lengthy and voluminous academic exercise. However, in this chapter we attempt to provide a brief overview of some of the major challenges.

DEVELOPMENT OF THEORETICAL FOUNDATION

Conventional economics is the result of decades of rigorous theoretical and empirical research, debate and analytical argument and has gone through many iterations. This has led to solid and time-tested development of models that provide a foundation for further analytical work. This is evident in all aspects of economics, whether micro or macro issues or in fields such as economic development or international trade and finance. This collective understanding is evolving every day, and has become a valuable asset in understanding the economic behavior of individuals as well as of societies. Similar rigorous analytical work, especially in areas of core economics, is seriously lacking in the case of Islamic economics. The research in Islamic

TABLE 17.1 Suggestions for enhancing the Islamic financial industry

Islamic Banking	Money, Capital Markets	Legal/Regulatory Issues	Others
Consolidation	Develop liquidity-enhancing mechanisms	Enhance and harmonize standards	Social sector financing. Institutionalization of Islam's redistributive instruments
Expand scope, services, products	Develop asset-linked, rather asset-based, products	Enhance corporate governance	Develop non-bank financial intermediation
Enhance risk management	Develop *sukuk* based on intangible assets such as services, rights, working capital, etc.	Enhance *Shari'ah* governance	Reputational risk
Lessen reliance on commodity/fixed-income-like products	Develop partnership and risk-sharing products	Supervision and monitoring	Financial engineering. Ease of product development
Reduce exposure to operational risk	Develop *Shari'ah*-compliant securities/stock markets	Financial Sector development	Hedging with or without derivatives
Liquidity-enhancing products	Develop Islamic benchmarks	Investor/creditor rights	Public finance
Hedging products	Public finance instruments	Insolvency laws	Monetary policy management

Source: Iqbal (2010)

finance has primarily been driven by business needs to establish an Islamic banking and financial system, and less attention has been paid to developing a comprehensive analytical framework based on Islamic economic principles. The progress in understanding and describing economic behavior as envisioned by Islam is slow and needs more attention. Without a solid foundation and rigorous analytical work, it would be difficult to present viable solutions to economic and social problems.

The development of a theoretical foundation of finance in Islam also needs attention. Several areas—such as asset pricing, corporate finance, derivatives, and hedging—require further research. For example, in the absence of a risk-free asset, how will the Capital Asset Pricing Model (CAPM) behave, or how will Black's zero-beta model behave with restrictions on short selling?[1] Several such issues have not been researched. In the development of conventional economics, finance was not seen as a separate field until relatively recently. In conventional economics the importance of investment has been long recognized. Financial markets were seen as important in attracting savings, and as a channel to allocate savings to investors and to do this in the most efficient way. The health of financial markets was appreciated largely in accommodating the financing of the real economy. The importance of finance was perceived from this very narrow perspective. Thus, earlier finance was not treated as an important and separate field of endeavor.

The appreciation of risk was a crucial building block in the development of modern conventional finance. Early in the twentieth century, Irving Fisher, one of the giants of economics, was the first to appreciate the importance of risk in the functioning of financial markets. In the 1930s a number of renowned economists, most notably Keynes, saw the importance of risk in the selection of a portfolio. But in their analysis and discussion, the role of risk was largely limited to affecting expected capital gains and speculative and hedging activities. This strain of analysis led to results covering the relationship of futures prices and expected spot prices (normal backwardation), the price-stabilizing effect of speculation, the impact of risk on assessing the value of future streams of income and, eventually, to the development of portfolio theory.

These developments in turn led to the realization that arbitrage was one of the two fundamental features of conventional finance; this is supported by the Black-Scholes-Merton option-pricing model and by the Modigliani-Miller Theorem. In the case of option pricing, if a portfolio of other assets can reproduce the return from an option, then the price of the option must be equal to the value of the portfolio; if not, there will be arbitrage opportunities. The Modigliani-Miller Theorem also uses arbitrage reasoning to examine the impact of corporate financial structures for arriving at a market value for a firm. If the production outlook of two firms (with differing financial structures) is the same, then the market value of the firms must be the same; if not, there is opportunity for arbitrage.

The second important development in the modern theory of finance was initiated by the empirical finding that commodities and asset prices behaved randomly. Paul Samuelson came up with an ingenious explanation for this observation that asset prices had to behave randomly; if this was not the case then arbitrageurs could exploit the opportunity to make a profit. For asset prices to behave randomly, all available and relevant information would have to be immediately translated into price changes in markets that behaved "efficiently." Thus the Efficient Market Hypothesis was born. In

sum, an appreciation of the importance of risk, arbitrage pricing, and efficient markets are the relatively recent foundations of conventional finance. At its core, conventional finance is seen today as the management of risks.

In Islam, the importance of risk is clearly acknowledged. While conventional finance, with its roots in economic theory, has developed instruments to identify and trade risk to those willing to assume it, in Islam risk cannot be sold in any manner. The study of finance in Islam is built on the foundation that risk must be *shared* between parties in any endeavor (as opposed to being assumed entirely by one party or the other). Finance in Islam can benefit from the same theoretical developments but with two important constraints: Islam prohibits the notion of a risk-free rate of interest; and instruments that partition risk contrary to Islamic teachings cannot be allowed. Finance can be developed in Islam along conventional lines but with these two important constraints. On the face of it, modern finance should provide practitioners of Islamic finance with added tools to achieve their central goal of better risk sharing. Moreover, as Islam prohibits financial gain without the assumption of some measure of risk it would appear that efficient markets and the random-walk behavior of financial assets and commodities are implicitly, if not explicitly, subsumed in Islamic teachings.

In short, for Islamic finance to make further progress it needs to devote resources and effort to develop analytical models and a theoretical foundation which distinguishes it from conventional economics and finance. Without this, there is a danger that it will be marginalized as a small subset of the conventional system.

DEVELOPMENT OF ECONOMIC INSTITUTIONS

The optimal functioning of an Islamic financial system (or indeed of any system) requires that underlying economic and legal institutions are in place. The Islamic economic system is a rules-based system governing property rights, contracts, the behavior of economic agents, and social capital in accordance with the teachings of Islam. As a result of several years of inactivity in developing such economic institutions, any effort to build a financial system to comply with partial aspects of Islam is bound to face difficulties and result in sub-optimal performance.

Fergusson (2006) undertook a detailed survey of the literature concerning the development of institutions and legal frameworks, and of their linkage with financial development. A condensed version of his main arguments and relevant empirical evidence is given in Table 17.2.

However, these economic institutions are notable for their absence in many, if not all, Muslim countries. In the Middle East and North Africa (MENA) region, for example, Abed and Davoodi (2003) found that the rates of economic growth since the 1970s were not only lower than those of developing countries as a whole, but were, on average, twice as volatile. They attribute this poor performance to several factors: high population

TABLE 17.2 Importance of institutions and legal framework for financial systems

	Main Theoretical Arguments	Empirical Research
Institutions	Better protection of creditor rights increases the breadth and depth of capital markets. Laws and their enforcement influence the extent to which insiders can expropriate outside investors who finance firms. Credibly pledging collateral reduces asymmetric information problems.	Shareholder and creditor-rights indices (for 49 countries with publicly traded companies) increase opportunities for external finance (La Porta *et al.* 1997a, 1998). Creditor rights and law enforcement are also positively correlated with bank development (Levine 1998, 1999), firms' ability to raise capital (Kumar *et al.* 2001; Beck *et al.* 2003), efficiency of equity markets (Morck *et al.* 2000), efficiency of capital re-allocation (Beck and Levine 2002; Wurgler 2000), corporate and bank valuations (Claessens *et al.* 2000, 2003; La Porta *et al.* 2000) and ability to fund faster-growing firms (Demirgüc-Kunt and Maksimovic 1998), and firms with less collateral (Claessens and Laeven 2003). Law enforcement and creditor protection also reduces credit cycles and currency and banking crises (Johnson *et al.* 2000; Galindo *et al.* 2001, 2004; Boucher 2004).
Legal framework	Alternative view: strict protection of creditor rights (e.g. right to repossess collateral) might be inefficient and may impede continuation of efficient projects. Pro-creditor rights reduce risk-taking incentives for entrepreneurs. Protection of creditors reduces their incentives to screen projects and to discourage investment by overconfident entrepreneurs. Legal framework and corporate governance: by shaping firms' incentives, a weak protection of creditor rights and weak law enforcement might encourage adoption of remedial rules, higher ownership concentration, and excessive reliance on tangible and liquid assets.	Extending La Porta *et al.*'s (2000) exercise by including additional macroeconomic controls, Padilla and Requejo (2000) find that, although an efficient judicial system improves the size and efficiency of the credit market, the effect of creditor protection is inconclusive. By extending the sample (15 additional developing countries), Galindo and Micco (2001) find that the positive effect of creditor protection does hold, even after controlling for macroeconomic variables. Countries with weak laws and enforcement tend to introduce remedial rules such as mandatory dividends and reserve requirements (La Porta *et al.* 1998), display more ownership concentration (Zingales 1994; La Porta *et al.* 1998; Claessens *et al.* 2000; Himmelberg *et al.* 2000; Roe 2000; Caprio *et al.* 2003; Dyck and Zingales 2004), and invest more in tangible assets (Claessens and Laeven 2003) and liquid assets (Pinkowitz *et al.* 2003).
Other institutions (trust or social capital)	Trust: increasing the perception that others will cooperate facilitates cooperation in large and impersonal markets.	Social capital and financial development are strongly connected in Italy, according to household data (Guiso *et al.* 2000). Beyond Italy (in a sample of 48 countries), trust is positively correlated with the size and activity of financial intermediaries, bank efficiency, and stock and bond market development (Calderón *et al.* 2001).

Source: Fergusson (2006).

growth and low productivity; lagging political and institutional reforms; large and costly public sectors; inefficient and inequitable educational systems; underdeveloped financial markets; high trade restrictions; and inappropriate exchange rate policies.

Many of the ills that contributed to the region's poor growth performance could be treated with the legal and institutional developments prescribed by Islam. While there is as yet no great impetus for this process, a number of Muslim countries have recently implemented macroeconomic and structural reform policies and have adopted international best-practice standards and codes. This, together with an increase in oil revenues, has resulted in a marked improvement in the economic performance of these countries. The implementation of international best practice in the areas of transparency and accountability, the development of an independent judiciary and the reform of the legal system, and the development of the financial sector could increase investment, employment and income, and lead to a reduction in poverty.

RELUCTANCE TO PROMOTE RISK SHARING

Risk sharing is the objective of Islamic finance. To foster the development of Islamic finance, there must be a sustained effort to remove the bias against equity finance; to reduce the transaction costs associated with participation in the stock market; to create a market-based incentive structure to minimize speculative behavior; and to develop long-term financing instruments and low-cost, efficient secondary markets for trading equity shares. These secondary markets would enable better distribution of risk and achieve reduced risk with expected payoffs in line with the overall stock market portfolio. Without true risk sharing, Islamic finance may provide a false impression of being all about developing debt-like, short-term, low-risk and highly liquid financing without manifesting the most important dimension of Islamic finance: its ability to facilitate high growth of employment and income with relatively low risk to individual investors and market participants.

In the long run, the Islamic financial system requires institutions that support risk sharing, partnership-based, equity-style financing and investment. The instruments they use will require close monitoring by the financial intermediary. To reduce the costs involved in this process, there will need to be mechanisms to perform collective monitoring of economic agents. Also, the trading of equity-based securities should be encouraged; this will be done in a stock market that operates according to *Shari'ah* principles, and thus prohibits the use of leverage (through margin accounts) and excessive speculation (including short sales).

One of the major criticisms of Islamic banks is their reluctance to hold risk sharing assets, despite the fact that Islam's economic principles demand that they should engage in partnerships and equity-sharing financial assets. For example, from Figure 17.1 it is evident that their first preference is for

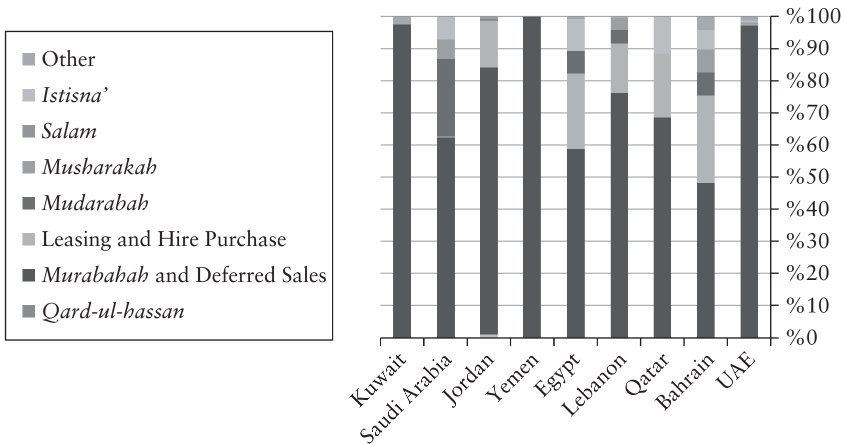

FIGURE 17.1 Asset composition of select Islamic banks by country, 2008
Source: MENA Flagship Report (2010)

financing instruments that are generated through sale contracts and leasing instruments. Informal observation of more recent balance sheets shows a similar picture. The banks' heavy usage of sale-based financing has earned this practice the title of the "*murabahah* syndrome."[2]

The reluctance of Islamic banks to use risk-sharing instruments such as *musharakah* and *mudarabah* contracts is problematic for achieving the true potential and promise of the system. The reason for shying away from such instruments is a lack of appetite for risky assets, which is the result of trying to emulate conventional commercial banks, where the preservation of depositors' principal is the foremost objective. By investing in financing and trade-related instruments, Islamic banks are able to provide low-risk and safe investment opportunities. They should change this business model and expand their portfolio to include risk-sharing instruments. The banks often claim that their reluctance is a direct reflection of the reluctance of depositors for risk-sharing instruments. However, it is possible that the depositors' low appetite for such instruments arises from a lack of transparency and confidence in the ability of the financial intermediary. There is a lesson here that Islamic banks would do well to heed when it comes to selecting and monitoring risk sharing assets and enhance the transparency of the investment process by informing the depositors with good estimates of exposure to risks taken by the financial intermediary in investing in risk-sharing instruments.

FINANCIAL SYSTEM, ARCHITECTURE AND INFRASTRUCTURE

There is well-documented research suggesting strong positive linkages between financial development and the economic development of the real sector of a country. In addition, the existence of a robust financial system

infrastructure leads to the development of financial markets and financial stability. The development of a robust financial sector is essential for any country, but the rapid growth of institutions offering *Shari'ah*-compliant financial products and services is posing challenges to the policymakers to develop a financial system supportive of such institutions. Other factors that will influence the design of such a system include continuing globalization, a growing emphasis on market discipline based on a regulatory environment, a shift towards a risk-focused supervisory approach, and increased competition from conventional financial institutions. The unique risk/reward characteristics of Islamic financial intermediation must also be incorporated into the design of financial architecture to promote a sound regulatory environment and to develop seamless integrations with the broader financial landscape.

The infrastructure of the financial system can be classified into three categories:

- *Systemic liquidity infrastructure*, which covers institutional arrangements for money and government securities markets, settlement systems, monetary and foreign exchange operations, and liquidity risk management
- *Information and governance infrastructure*, which includes accounting and disclosure standards and corporate governance arrangements for financial institutions
- *Insolvency regime and safety-net infrastructure*, which includes lender-of-last-resort arrangements, deposit insurance, and the legal framework governing bank insolvency, loan recovery, and creditors' rights.[3]

Financial architecture refers to the legal and institutional arrangements for a sound and well-functioning financial services industry. Financial infrastructure is a subset of the architecture and is often referred to as the underlying foundation to facilitate the preconditions for the functioning of the industry and the effectiveness of supervision and regulation of different segments.

At the national level, financial architecture includes legal and institutional arrangements for the regulation and supervision of the Islamic financial services industry. A robust legal infrastructure to define and enforce contracts, insolvency, and financial safety nets is essential. It should also include a framework for macro prudential surveillance, arrangements for efficient systemic liquidity, and a transparent and information-rich governance infrastructure.[4] At the international level, financial architecture improves coordination among various national policies and promotes financial and technical cooperation. This includes institutions such as the International Monetary Fund, the World Bank, the Bank for International Settlements, regional development banks such as the Asian Development Bank and Islamic Development Bank, international standards-setting institutions such as International Accounting Standards, and international

associations of market players for self-regulation and industry promotion such as the International Capital Markets Association.

Sundararajan (2006), Marston and Sundararajan (2006), and IDB/IFSB (2006) provide a detailed discussion of the issues and the missing elements in developing architecture and infrastructure for the Islamic financial industry, which we summarize below:

- While there are distinct differences in conventional and Islamic financial systems, significant elements of conventional infrastructure are equally applicable and accessible to Islamic finance. Therefore, there is no need to duplicate components of infrastructure that can be shared with some adjustments to accommodate specific operational requirements of Islamic finance.
- Financial architecture should be aligned with a vision for the industry, and it should start with a detailed policy designed to address issues of aligning financial sector laws—such as insolvency laws—with *Shari'ah* Law, strengthening the environment for risk sharing—that is, equity-based financial instruments and intermediation—and enhancing the corporate governance of institutions offering Islamic products and services.
- At the national level, the financial architecture for Islamic finance is exposed to the same weaknesses as the conventional financial sector in many developing countries. Inadequate or non-existent legal frameworks for regulation, weak observance of core principles (such as a lack of independence, weak risk management, weaknesses in disclosure), and ill-defined consolidated supervision affect both conventional and Islamic banks. In addition, there is a need for special treatment of the legal and institutional framework for the insolvency regime, investor rights, creditor rights, securitization and judicial enforcement.
- As part of the systemic liquidity infrastructure, the micro-structure of money and exchange and securities markets, payment settlement systems, and monetary and debt management operations are not yet well adapted to accommodate and integrate Islamic financial institutions into the broader financial system. These factors limit the development of securities markets, which is critical for promoting product innovations, risk management and effective supervision of Islamic finance generally. *Shari'ah*-compatible money and capital markets are essential for the implementation of monetary and fiscal policies.
- There is a need for strengthening the international architecture of Islamic finance, as there are still gaps and overlaps in the support structure provided by international infrastructure institutions. These institutions can and should, therefore, play a key catalytic role in promoting the industry at the national level. In this respect, the IFSB is expected to play the leading role in setting standards and to coordinate with the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the International Accounting Standards Board (IASB). The AAOIFI should continue to realign work

programs and promote greater adoption of its standards at the national level. The IIFM should focus on market practices and contract standards and strengthen its role as an association of market players. The LMC can play a role in promoting national and regional strategy for money-market development. The IIRA can play an important role in enhancing disclosure and transparency.

Compared with the conventional system, the current form of Islamic finance offers very limited functionality. Table 17.3 provides a functional assessment of Islamic financial markets as they exist today.

The design of financial infrastructure and architecture to promote Islamic finance is a challenge and demands serious commitment from stakeholders. Some of these challenges are discussed below.

TABLE 17.3 Functional assessments of Islamic financial markets

Function	Assessment
Capital mobilization	Limited set of instruments; concentration in short-term maturities; low depth and breadth of markets; and lack of liquidity.
Managing risk	No derivative markets or organized mechanism for risk mitigation. High geographic and sector concentration. Limited diversification opportunities.
Pooling and diverse ownership	No or limited stock markets in Islamic countries. Where they do exist, they are illiquid and poorly supervised, offering limited opportunities for the pooling and diversity of ownership. In non-Islamic countries, limited *Shari'ah*-compliant stocks available to Islamic investors.
Efficient contracting	Lack of civil and commercial law based on Islamic law in several Islamic countries where the legal system is predominantly conventional limits efficient contracting. In non-Islamic countries, it may not be possible to replicate *Shari'ah* law in its intended form, which hinders efficient contracting.
Transparency and price discovery	Illiquid, shallow, and poorly supervised capital markets inhibit the process of price discovery and limit opportunities for arbitrage.
Governance and control	Not all stakeholders participate in the governance of financial institutions offering Islamic financial services. Lack of transparency in governance of *Shari'ah* boards.
Operational efficiency	High perception of operational risk resulting from a lack of proper accounting standards, clearing and settlement processes, and training personnel.

Source: Adapted for Islamic financial markets based on Ul-Haque (2002).

Liquidity

Financial market efficiency and resilience are determined by the depth (indicated by the volume and frequency of transactions) and breadth (measured by the array of financial instruments and services available) of the market. Islamic financial markets are still small when compared to conventional markets. A large share of Islamic financial markets is dominated by commercial banking activities, but even this is still less than one percent of total conventional banking. Although there is growth in other areas of finance, such as capital markets and insurance, these are also very small. For example, the total size of outstanding *sukuk* as of 2007 was US$140 billon, which was only 0.47 percent of a total outstanding debt of US$29,728 billion in US markets.[5]

Integration with Global Financial Landscape

Increasing globalization has spread Islamic finance to many different geographical locations where the infrastructure does not support Islamic finance-friendly institutions. This poses a problem for policymakers and regulators and can create an obstacle to the growth of Islamic finance. For Islamic finance to integrate well with the conventional system there is a need to develop international institutions and standard-setting agencies that can provide the necessary support to local authorities and develop procedures and standards which can be adopted with ease.

Liquidity Risk and Lender of Last Resort

Several studies have highlighted the issue of liquidity risk associated with Islamic financial instruments and the resulting exposure to Islamic banks.[6] In addition, the lack of a lender-of-last-resort facility based on Islamic instruments further complicates the problem of liquidity risk. Although this facility is usually available to Islamic banks, such arrangements are based on interest—a prohibited element. For a fully functional financial system, a lender of last resort that complies with Islamic Law is another essential requirement. Very limited work has been done in this area and further research is required.[7]

Development of Benchmarks

The practice of measuring the performance of an asset by comparing its return and risk to a well-defined benchmark is now standard in a market-centered financial system. Markets are good at offering an efficient, measurable, and consistent benchmark for different asset classes and securities. The dearth of transparent benchmarks that can be used to compare risk-adjusted returns complicates the task of evaluating the efficiency of financial institutions. Such benchmarks are valuable tools for measuring the relative

performance of different asset classes and, ultimately, the performance of the financial intermediary. The economic system in Islam suggests the use of return in the real sector as a benchmark for the return in the financial sector. However, the current practice of using interest-based benchmarks such as the LIBOR is certainly in direct conflict with Islamic principles. Although this practice has been accepted on an ad hoc basis under the law of necessity and in the absence of better benchmarks, several researchers have correctly raised the need to develop benchmarks that reflect Islamic modes of finance.

LIMITED MARKET-BASED FINANCIAL INTERMEDIATION

Banks and financial markets play complementary roles. More transactions are now done in markets and by institutions that have an arm's-length relationship with their clients. This has not, however, marginalized traditional institutions such as banks and their relationships. The changes have allowed such institutions to focus on their core business of intermediation, customization, and financial innovation, as well as risk management. Financial institutions are able to perform their core functionality more efficiently if there are supporting markets to provide liquidity, risk transfer, and insurance. As the "plain vanilla" transaction becomes more liquid and amenable to being transacted in the market, banks wishing to be competitive will embrace more illiquid transactions.[8]

Institutions specializing in *Shari'ah*-compliant products have been operating on the same business model for some time and without much innovation. Given the lack of supporting money, capital, and derivative markets, financial intermediations are retaining excessive exposure, especially to liquidity risk, and are missing out on opportunities to diversify. For the Islamic financial system to function properly, financial intermediaries will need to specialize in mobilizing deposits, identifying investment opportunities, originating, structuring, and packaging securities, and managing risks, while allowing the complementary financial and capital markets to fill the remaining gaps and provide liquidity and risk sharing.

Allen and Gale (2007) suggest that a successful, deep, and active stock market requires that information, enforcement, and governance costs are eliminated or at least minimized. Once this happens, the cost of entry into the equity market is lowered and "there is full participation in the market. All investors enter the market, the average amount of liquidity in the market is high, and asset prices are not excessively high" (p.115). As mentioned earlier, where Islamic rules of market behavior are in place, the informational problems, transaction costs, and governance and enforcement issues would be non-existent or at such low levels that there would be little or no deterrence to entering the stock market.

There is, however, a gap between what Islam teaches and actual market behavior. For this reason, the actions governments take and the institutions

they create to remedy this behavior and to reduce the cost of market participation have to be stronger and more comprehensive than they are today if they are to replicate the behavior expected of market participants who act in compliance with Islamic rules. Such actions, policies and institutions would include:

i. Enabling equities to compete fairly with debt-based instruments; this means removing all legal, administrative, economic, financial and regulatory biases that favor debt and place equity holding at a disadvantage
ii. Creating positive incentives for risk sharing via the stock market
iii. Investing in a massive campaign to educate the public on the benefits of stock market participation (the kind of campaign that the Thatcher Government ran in the UK, which increased stock market participation substantially in a short span of time)
iv. Investing in human capital to produce competent, well-educated and trained intermediaries—lawyers, accountants, financial journalists and *Shari'ah* scholars—which would entail creating world-class business and law schools
v. Limiting the leverage (including margin operations) of non-bank financial institutions and the credit-creation ability of banks through prudential rules that effectively cap the total credit the banking system can create
vi. Developing a strong, dynamic regulatory and supervisory system for the stock exchanges to continuously monitor the behavior of markets and participants while staying a few steps ahead of those with a penchant and motivation to use regulatory arbitrage to get around rules and regulations
vii. Finding ways and means of regulating and supervising intermediaries or, at least, mandating that they become self-regulating in order to minimize false reporting or misreporting
viii. Ensuring transparent and accurate reporting of the day's trade by all exchanges
ix. Establishing legal requirements for the protection of the rights of minority shareholders.

While this list is by no means exhaustive, implementing its recommendations will help reduce the cost of market participation, invest the market with greater credibility, and reduce reliance on debt financing. Black (2001) asserts that enshrining the legal protection of minority shareholders' rights alone would give countries large stock market capitalization, larger minority shareholder participation, more publically listed firms relative to the total population, less concentrated ownership, higher dividend payouts and lower costs of capital. Black also believes the potential for developing a vibrant stock market is greatly increased if minority shareholders can be assured of receiving good information concerning the true value of

businesses in which the listing companies are engaged, and that there is sufficient legal, regulatory and supervisory protection against such things as insider-trading transactions.

Where these things are lacking, the problems of moral hazard and adverse selection raise their ugly heads. Having enforceable laws and credible institutions in place can serve to assure investors of the honesty of publicly listed firms and of the full transparency and accuracy of their reporting and information. These laws governing financial disclosure and securities, for example, would be backed up by strong sanctions for anyone tempted to defraud investors through false or misleading information. Sanctions imposing risk of liability (to investors) on accountants, lawyers, traders or investment bankers in retaliation for false reporting, fraudulent, misleading information or faulty endorsements can be powerful tools for dissuading all concerned from defrauding investors. Requiring intermediaries to be licensed—with the attendant threat that licenses can be revoked—is another powerful regulatory tool, particularly when this is backed by the additional threat of heavy fines or criminal proceedings for abusing the system. Stock exchanges, too, have a critical role to play through implementing and enforcing stringent listing standards, again backed by the threat of heavy fines or the delisting of companies that violate disclosure rules. An active, dynamic, well-informed financial press can be valuable in creating a culture of disclosure, which would be closely monitored by a strong, independent regulatory agency.

While the above policies and institutions are crucial in reducing the cost of participation in stock markets and thus promoting widespread risk sharing, governments need to do more: they must lead by example. They could become active in markets for risk sharing. Generally, governments do share risks with their people through, for example, their tax and social expenditure policies. They are silent partners. They share the risks of the financial system through monetary policy and deposit guarantees. They could choose to finance part of their budget, at least their development spending, through risk sharing and direct ownership of development projects with their citizens. In this way, they would reduce the debt burden on the budget. This reduction in government borrowing reduces the burden on monetary policy as well. Governments undertake public-goods projects because the characteristics of these goods—indivisibility and non-exclusivity—prohibit their production by the private sector and therefore are undertaken by governments. However, their social rate of return is substantial and much higher than private rates of return. A recent popular proposal suggests that these projects should be undertaken jointly with the private sector, hence the "public–private partnership" (PPP) label. However, this proposal has a number of problems—market distortion, and informational and governance problems being just three.

EXPANDING SCOPE OF FINANCIAL INTERMEDIATION

A financial intermediary transforms savings into investment and, in the process, creates additional value by reducing search, monitoring, and transaction costs, as well as diversifying and/or hedging risks, thereby allowing more efficient utilization of resources. A financial intermediary performs these functions through the design and utilization of instruments or products intended to achieve a specific objective. The nature of financial intermediation in Islamic finance is distinct from conventional finance in several ways, the most critical being that a financial intermediary in the Islamic system plays multiple roles. Whereas organized markets—such as money, capital, and derivative markets—complement the role of a conventional financial intermediary, in the Islamic system an intermediary is expected to undertake some of these functions. In other words, an Islamic financial system has more common features with "bank-centered" financial systems such as those of Japan and Germany than with the "market-centered" systems of the US and the UK (Iqbal 2005; Iqbal and Mirakhor 2007).

At present, financial intermediation in Islamic markets is very restricted. It is limited mainly to commercial banking activities, with the gradual introduction of investment banking services. Within commercial banking, there is more emphasis on trade financing and some leasing-based assets that are of short-term maturity and often illiquid. In the case of investment banking, the menu of products and services is even more limited and is often targeted at high-net-worth individuals.

IFIs have to expand the scope of their activities to provide a wider range of products and services in the areas of corporate finance, risk management, SME financing, and wealth management. Research has shown that during early phases of development where capital markets are not well developed, financial intermediaries play a critical role in providing financial services to the corporate sector. In the absence of liquid Islamic capital markets, they will have to become the main source of financing. Furthermore, the simple availability of financing will not serve this purpose; the mode of the service will have to be improved. The financing would have to be cost-effective, flexible, and client-oriented. Financial intermediaries must understand the needs of corporate sector clients to develop customized solutions that can make them competitive in the market.

Major structural changes in the role of financial intermediaries are required in the area of risk management. Their role in developing a risk management infrastructure should be twofold: first, to develop and apply risk management techniques for their own portfolios; and, second, to offer risk management services to their clients. Risk management tools expand the role of a financial intermediary that can offer innovative products and risk management services to the client, and can also manage its own exposure more efficiently and in a cost-effective manner. Managing financial risk also creates profitable opportunities for financial intermediaries in several

ways. For example, a bank's risk experts are likely to provide more effective advice to clients and more effectively differentiate their products. The fees associated with supplying risk management transactions can be an important source of revenue, and since these transactions increase customers' profits by lowering the probability of financial distress, they also indirectly lower the intermediary's loss exposure.[9]

Consumer and retail banking is another area where there are gaps. The question is often raised about the potential for developing financing instruments that are not based on a tangible asset; for example, an instrument to provide financial assistance for student loans. Education loans do not create any tangible asset and do not have any collateral other than personal guarantees. Another case is the area of consumer services, such as credit cards. An original purchase on a credit card may not conflict with *Shari'ah* principles, but once it becomes an interest-bearing loan, the same transaction is in conflict. In such cases, it becomes incumbent on IFIs to find workable solutions. If they are unable to supply a complete set of services, consumers wishing to comply with *Shari'ah* will be at a disadvantage.

Another area requiring attention is financial products and services for small and medium-size enterprises (SME). A vibrant SME sector plays a critical role in the economic development of any country. Proponents of Islamic finance advocate that Islamic finance encourages entrepreneurship and is friendly to grassroots entrepreneurship. However, in reality, the majority of IFIs do not have any systematic program to promote SMEs. This will be discussed further later in the chapter.

Advances in information technology and financial engineering have obviated the need for "bricks and mortar" banking and financial markets. As Bill Gates once remarked, "banking is essential, banks are not." Now, consumer and mortgage financing, corporate credit, all depository asset management, and investment banking services—which not long ago would have required considerable investment in physical infrastructure—are offered by means of global e-commerce trading systems that can easily accommodate different languages across borders. Importantly, these systems are defined by their product rather than by their geographical location. Islamic financial institutions are scattered over different geographical regions and, therefore, are overexposed to credit and market risk in domestic markets and regions. The availability of services through the internet will expand their client base and will help them diversify their portfolios.

Although Islamic banks have grown in number, the average size of their assets is still small by comparison with conventional banks. The majority of Islamic banks are below the benchmark asset size of US$500 million considered to be the minimum for an efficient conventional bank. In Table 17.4 we listed the top 10 Islamic banks. As of 2010 Top Islamic Banks' asset size is only 1.5 percent of top conventional bank in the World and only 26 percent of conventional bank ranked number 100 in the world. Whereas as of early 2000, there was no Islamic bank in the list of top 500 world banks, at least one Islamic bank, as of 2010, was included in the list of top 1,000 banks

TABLE 17.4 Top Islamic Banks and Islamic Windows as of 2010

	Name	Country	*Shari'ah* Compliant Assets ($m)	Return on Assets (RoA)
Islamic Banks				
1	Al-Rajhi Bank	Saudi Arabia	45,528	4.03
2	Kuwait Finance House	Kuwait	40,318	0.27
3	Dubai Islamic Bank	U.A.E.	22,835	0.59
4	Abu Dhabi Islamic Bank	U.A.E.	18,620	0.94
5	HSBC Amanah (Global)	U.K.	16,700	n/a
6	Bank Rakayat	Malaysia	14,785	3.36
7	Al Baraka Banking Group	Bahrain	13,623	0.99
8	Maybank Islamic Berhad	Malaysia	12,402	1.02
9	Qatar Islamic Bank	Qatar	10,789	4.93
10	Bank Islam Malaysia Berhad	Malaysia	9,268	0.27
Islamic Windows				
1	National Commercial Bank (Jeddah)	Saudi Arabia	17,113	1.72
2	Riyadh Bank	Saudi Arabia	11,913	1.8
3	Saudi British Bank	Saudi Arabia	11,198	n/a
4	Arab National Bank	Saudi Arabia	8,507	2.05
5	Banque Saudddi Fransi	Saudi Arabia	8,125	2.00

Source: Banker (2010)—This list excludes banks based in Islamic Republic of Iran.
The Banker, Top 500 Islamic Financial Institutions, The Banker, Special Supplement, Nov. 2010, p. 34.
http://www.thebanker.com/Banker-Data/Banker-Rankings/Top-500-Islamic-Financial-Institutions

in the world as compiled by *Banker* (2010). Ranking of Al-Rajhi Bank, Kuwait Finance House, and Dubai Islamic Bank Ranks were 242, 270, and 383 respectively. Large institutions have significant potential for efficiency gains from economies of scale and scope, organizational efficiency, and a lower cost of funding. Given their size, Islamic banks are unable to reap these benefits.[10]

In the absence of debt and derivatives markets and in light of the underdevelopment of equities markets, financial intermediaries will be required to take up the slack. In the changing global financial landscape, Islamic banks will have to go beyond their traditional role as commercial banks and develop areas such as securities, risk management, retail banking, asset management, and insurance that are currently absent or inadequate.

The nature of financial intermediation and the style of financial products and services offered make Islamic banks a hybrid between commercial and investment banking, similar to a universal bank. A universal bank benefits from economies of scope because of its close relationship with an established client base and the access this provides to private information. Combining different product lines (such as banking and insurance products) or commercial and investment banking lines may increase the relationship value of banking at a much lower average cost of marketing.

For example, by expanding the scope of their services, Islamic banks could spread the fixed costs (both physical and human capital) of managing a client relationship over a wider set of products, leading to a more efficient use of resources. They could use their branch networks and other channels to distribute additional products at low marginal costs. As universal banks, they would be able to capitalize on their good reputation established in one product or service area to market other products and services with relatively little effort. This would also benefit consumers by enabling them to purchase a bundle of financial services from a single provider, rather than having to expend time and money acquiring them from different providers.

WEALTH MANAGEMENT

Wealth management entails offering financial planning and management to high-net-worth individuals and private and public institutions, with the goal of sustaining long-term wealth. With the current wave of petro-dollars being earned by GCC countries, the demand for such services from public-sector institutions is bound to increase. Although several GCC countries are currently using conventional investment vehicles, the increasing demand for *Shari'ah*-compatible products is likely to mean that some portions of this wealth may be available for Islamic financial markets. Similarly, there are increasing numbers of institutional investors who will be interested in *Shari'ah*-compatible wealth management. These include central banks with excess foreign-exchange reserves, state pension funds, future funds (such as the oil funds established by some countries), and sovereign wealth managers.

Several prominent economists have argued that the foreign-exchange reserves held by the central banks, and some sovereign wealth funds should consider investing a portion of these reserves in riskier assets such as the equity markets. This should be encouraging for Islamic finance, which is based on the principle of risk sharing and is friendly to equity sharing investments.

However, offering robust wealth management in Islamic finance presents serious challenges. Any wealth management process begins with defining investment objectives and goals. This is followed by a rigorous strategic asset-allocation (SAA) process which determines the optimal mix of asset classes to achieve the desired goals and objectives. In conventional finance, the SAA process has become a science, with the aid of sophisticated

statistical and quantitative models. The analysis is well supported by considerable historical data for each asset class to assist in understanding past behavior and to forecast future performance. Such models are driven by comparable benchmarks, arbitrage-free strategies, hedging mechanisms, and—most importantly—reference points for returns for different maturity structures in the debt market. With these tools, the SAA process helps in constructing an optimal portfolio of different asset classes to achieve target investment objectives at acceptable levels of risk.

Constructing a meaningful SAA framework in Islamic finance is a challenge. First, a fixed-income debt market—other than the limited and illiquid *sukuk* market—does not exist. Therefore, the SAA framework would have to resort to using proxies from conventional debt markets, which may not be an ideal situation. Second, there are no *Shari'ah*-compliant benchmarks against which an SAA strategy can be devised. Although a number of such benchmarks are available in the equity asset class, they have yet to be developed for fixed-income markets. Third, given the prohibition of interest, and thus of pure debt security, an SAA framework would have to work with other asset classes with distinct risk/return profiles. For example, it would require the development of *mudarabah* arrangements where the manager can deploy funds in a customized fashion, which are hard to model. The highly customized nature of financial assets adds to the complexity of modeling.

All of these factors mean that the SAA framework will require a more complex design and therefore extensive quantitative modeling. In the absence of a meaningful SAA framework, the investor will be exposed to unknown risks and, as a result of potentially inappropriate asset allocations, may not be successful in achieving long-term goals.

RISK MANAGEMENT FRAMEWORK

Given their 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, which means that their risk exposure is high. IFIs need to adopt appropriate risk management, not only for their own portfolio but 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 than the investors for whom they act.

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.

REGULATORY AND GOVERNANCE ISSUES

Several studies have identified weaknesses and vulnerabilities among Islamic banks in the areas of risk management and governance.[11] Operational risk, which arises from the failure of systems, processes, and procedures, is one area of concern. Weak internal control processes may present operational risks and expose an Islamic bank to potential losses. Governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. As we saw in earlier chapters, the role of *Shari'ah* 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 the subject of considerable debate.

Implementing a risk management framework requires close collaboration between the management of IFIs, regulators and supervisors. At the institutional level, implementation is the responsibility of management, which should identify clear objectives and strategies and establish internal systems for identifying, measuring, monitoring, and managing various risk exposures. Although the general principles of risk management are the same for conventional and Islamic financial institutions, there are specific challenges in the management of risk in Islamic financial institutions.

Corporate governance in Islamic finance entails implementation of a rules-based incentive system that preserves social justice and order among all members of society. Governance processes and structures inside and outside the firm are needed to protect the ethical and pecuniary interests of shareholders and stakeholders. Iqbal and Mirakhor (2002) present a stakeholder-centered model of corporate governance based on the principles of Islam and suggest that an institution operating within an Islamic system is expected to protect the rights of all stakeholders in the firm as well as in the society. At the operational level, there are serious issues relating to the rights of investment account holders (IAHs)—that is, the depositors—as their participation in the governance structure is non-existent. Similarly, Islamic banks maintain several reserves to smooth income and to compensate IAHs in times when actual profits are below market expectations. However, there are no clear rules relating to the governance of such reserves.

Implementation of financial disclosure is another priority. Ideally, jurisdictions within which Islamic banks operate should implement accounting and reporting practices in line with accepted international standards. This could be accomplished by adopting the official AAOIFI standards, using

them as a basis for national standards, or integrating them into existing accounting and auditing standards. AAOIFI standards ensure that only the best accounting and auditing practices are used. They allow comparability across Islamic banks in different jurisdictions, although they may limit comparability between Islamic and conventional banks. Stakeholders involved in Islamic finance will find it easier to gain familiarity with a single accounting framework, rather than having to deal with multiple national standards. Simply extending International Financial Reporting Standards (IFRS) or national conventional standards is not likely to bring the same clarity, because it may not allow the disclosure of relevant information.

Poor corporate governance imposes heavy costs, but the mere extension of international standards to Islamic banks may not be sufficient to combat this. The principles and practices of Islamic financial services require a thorough review: sound corporate governance requires the formulation of principles and enforcement (for more, see van Greuning and Iqbal 2007). In many countries where Islamic finance is developing, regulators often lack the power to enforce rules, private actors are non-existent, and courts are "underfinanced, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt" (Fremond and Capaul 2002). Furthermore, a "law habit" culture—that is, a propensity to abide by the law—must be rooted in society. While the ability to enforce regulations is inextricably coupled with the overall process of development, legislation enabling transparency, private monitoring initiatives, and investments in the rule of law by willing authorities can pave the way to the emergence of regulatory frameworks.

The regulation of Islamic financial institutions is one area in which there have been substantial developments in recent years and the progress in this respect is worth appreciating. Credit for this goes to the collective efforts in setting up such organizations as the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), with the help of multilaterals such as the IMF and Islamic Development Bank (IDB). In its short life, the IFSB has made a noticeable mark on international financial circles in promoting Islamic finance and developing standards and regulatory frameworks. If this trend continues, there is reason for optimism about the further globalization of Islamic finance. However, more work needs to be done.

Whereas the current financial crisis has highlighted vulnerabilities in financial systems, it has also recognized new challenges facing the regulation of cross-border and highly integrated financial markets. Prior to the crisis, the emphasis was on market discipline and on promoting standardization and harmonization of rules and practices. International financial intermediation was subject to a growing set of standards and codes, such as the Basel Core Principles on Banking Supervision, transparency and monetary management guidelines, IOSCO capital markets standards, corporate-governance rules, anti-money laundering (AML), and combatting the financing of terrorism (CFT). The objective was to enhance the efficiency of

the system by delivering the best services at the lowest cost to the consumer. However, the financial crisis has exposed the need to strengthen the stability of the system, which has led to a consensus on the need for more regulation.

The current situation offers both opportunities and challenges for the Islamic financial industry. Industry stakeholders can influence policy formulation at early stages to ensure that the new regulatory environment is more "friendly" to Islamic finance and addresses some of the key issues in regulating IFIs. These issues include the treatment of IAHs as stakeholders, enhancing transparency in financial disclosure, and standardization. This will require active participation in the debate and the formulation of the new regulatory environment at local and international forums.

The real challenge will be the enforceability of new rules and standards. Currently, IFIs operate for the most part in dual-system set-ups, which impose additional responsibilities on the regulators to maintain regulatory and supervisory standards for both conventional and Islamic institutions. This practice is both resource-intensive and expensive. With stricter standards, the challenge will be to ensure that Islamic financial institutions receive due attention and priority in this process. At present, regulatory and supervisory standards, including compliance with Basel II, are being developed for IFIs, though their enforceability is in question. Since the majority of IFIs operate in developing economies, it requires extra effort to enforce the standards irrespective of how good the standards may be.

Islamic financial institutions are perceived to have higher exposure to operational risk because of the lack of proper risk systems and trained staff. In the new financial environment, there will be more reliance on risk monitoring and management. New techniques for monitoring credit and liquidity risk will be introduced and old techniques such as VaR will be refined to reflect better exposures. IFIs should start addressing this issue by updating their risk systems. At the same time, regulatory bodies should ensure proper training for their staff as well as for financial institutions. Regulators and supervisors should also develop a better understanding of certain practices of the financial institutions in assessing and monitoring risks.

Going Beyond Banking

The distinction between traditional commercial banking and investment banking is becoming 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, an IMF study in 2003 ranked several countries in the Middle East according to their level of financial development and found that countries throughout the region had a weak institutional environment and a poorly developed non-bank financial sector.[12] There has not been much progress since then. Islamic finance has been dominated by commercial banking, and the amount of investment banking, insurance, asset management, SME financing, and microfinance is very small.

Islamic finance that claims to promote social justice and advocates equal opportunity for less-fortunate segments of society needs to develop an SME and microfinance industry. A well-developed microfinance industry will promote economic development in underdeveloped Islamic countries. As poor segments of society become economically empowered, they will expand the base of depositors and investors. While microfinance institutions have been successful in conventional markets, there are only a few cases of such institutions operating on Islamic finance principles. Their phenomenal success within conventional finance has forced even private investors to regard microfinance as a potential and viable asset class. In an Islamic system, instruments such as *qard-ul-hassan*, *sadaqat,* and *zakah* can play a vital role in serving the poor, and the role each instrument can play needs to be reviewed.

The emergence of Islamic finance in modern times began with non-bank financial institutions such as Tabung Haji in Malaysia, and Mitghamr and Nasser Social Bank in Egypt. The objective of these institutions was to fill the gap left by conventional banking institutions. Research over the last couple of decades shows how significant are the contributions of non-bank financial institutions that complement the activities of banks by providing various services to different segments of the economy. Research also documents the diversification benefits of non-bank financial institutions, adding to the stability of the financial services.

Conventional non-banking financial institutions have grown to cover a wide range of activities such as private equity, joint venture, credit unions, advisory services, and specialized finance houses. In addition, specialized forms of financing are in practice as well, including trust finance, endowment funds, and cooperatives. Such institutions have special relevance to Islamic finance. For example, today's trust financing or endowment funds have their roots in the Islamic institution of *waqf* (endowments), which has made enormous contributions to the economic development of Muslim societies throughout their history. In addition, the Islamic system offers unique instruments which do not have any direct points of comparison in conventional finance. *Qard-ul-hassan* (interest-free loans), for instance, have proved to be effective in promoting economic development and a means of alleviating poverty.

The objectives of socioeconomic justice and the equitable distribution of wealth separate Islamic economic principles from others. As we have seen, the *Qur'an* places great emphasis on the redistribution of income and wealth, and mandates institutions for this purpose. The most important of these are the institutions of inheritance—*sadaqat*, *zakah*, *waqf* and *qard-ul-hassan*, which all have wide-ranging implications for economic development and are necessary for the welfare of society. These instruments are vehicles for ensuring just conduct and maintaining a healthy level of wealth distribution. A major reason for the inadequate levels of economic growth and the existence of widespread poverty in many Muslim societies is non-compliance with the rules of just conduct in the economic sphere. It is also

clear that this state of affairs, in turn, stems from a general lack of familiarity with these rules among Muslims.

In an Islamic economic system, various levies are imposed on production or income to redeem property rights accrued by different members of the society. It is important to realize that in no way are these levies to be considered as charity, a common misunderstanding among laymen and scholars alike.

According to some estimates, the assets of the non-bank financial sector will make up around 8–10 percent of total Islamic assets.[13] Given the size of the Muslim population and the GDP of Islamic countries, this estimate appears to be on the low side. Actual potential is much more, as these institutions have to be expanded to cover wider segments of society.

The following steps are suggested to strengthen this sector:

- Develop institutions to formalize the implementation of redistributive instruments of Islam. Formal institutions to channel these flows in the most effective fashion need to be developed. These could be dedicated institutions specializing in the distribution of funds in the most cost-effective and most beneficial manner. If there are well-functioning Islamic financial intermediaries, these can become a distribution channel for these social welfare services as part of their customer services. A reputation of positive contributions to social welfare could serve as an asset for the institution in attracting or retaining customers.
- Develop a legal framework to encourage and protect non-banking financial institutions to enable them to operate in a friendly environment.
- Design and implement a prudent regulatory and policy framework for a broad-based and efficient non-bank financial sector. Some regulatory overview may also be needed to instill confidence and protect stakeholders and to ensure the healthy growth of the industry. Furthermore, tax neutrality can play an important role in further growth of this sector.[14]

Promotion of SME Financing

The Islamic financial industry and policymakers should develop ways to promote SMEs and their access to the formal financial sector. In developing appropriate products, *mudarabah* contracts based on principal/agent principles would be well suited for the purpose. However, this type of contract has yet to be institutionalized in most Muslim countries. While conventional banks are constrained by their conservative approach to risky assets and by protective regulatory regimes from extending credit to SMEs, this need not be the case for Islamic banks, which can hold *mudarabah*-based assets with no regulatory constraints. Furthermore, IFIs are encouraged to enter into equity partnerships, which can be used to promote the SME sector. These

instruments should be developed through the banking or non-banking sectors to promote SME financing.

To facilitate operation of the SME sector, the SME report (2006) makes the following suggestions, which are equally applicable to the Islamic financial industry:

- Government measures to promote SMEs should be carefully focused, aiming at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance.
- Public policy should improve awareness among entrepreneurs of the range of financing options available from official programs, private investors, and banks.
- The principles of risk sharing should be observed, committing official funds only in partnership with those of entrepreneurs, banks, businesses or universities.
- The tax system should not inadvertently place SMEs at a disadvantage.
- The legal, tax and regulatory framework should be reviewed in order to ensure that the business environment encourages the development of venture capital, including opportunities for exit.

Economic Development

In addition to all the critical issues outlined above, the growth of Islamic finance will be determined by the growth and development of the real sector of Muslim economies. By this we do not mean growth of GDP alone. Growth in GDP can be accompanied by little or no financial development as, for example, would be the case if a country sells its oil abroad and imports all its needs. Broad-based economic development requires higher savings and investment, a more-educated and better-trained labor force, the adoption of modern technology and best practices, efficient institutions (especially the rule of law), consistent economic policies, and an environment where a vibrant private sector can grow and develop. The synergy between the real and financial sectors has been readily acknowledged. Economic growth in the real sector in such a setting will stimulate the financial sector, and the financial sector will in turn provide financing for the growing real economy. The largest and most-developed economies tend to have the largest and most-efficient financial sectors.

While Islamic finance continues to receive considerable attention, no attempt has been made for a system-wide implementation of the economic tenets of Islam. The challenge for Muslim countries wishing to embrace Islamic finance would be to understand the linkage between Islam's economic tenets and economic growth. Islam's notions of justice in exchange and distribution, the role of society and the state, instruments to promote social welfare, inclusiveness, and promotion of mutual and collective help can lead to an equitable and just economic system.

Public Finance

One of the key elements for sustained growth and development in any modern economy is sound public finances; that is, adequate public revenues and prudent public expenditures that promote economic growth and social welfare. An overbearing government that runs large budgetary deficits and finances wasteful expenditures does significant harm to both economic growth and social welfare. An overbearing public sector crowds out private sector investment and growth. A government that runs large deficits reduces resources for the private sector, damages macroeconomic stability and reduces available policy options. Wasteful government expenditures, such as harmful subsidies and excessive military expenditure, reduce economic growth and adversely affect social welfare.

On the revenue side, efforts aimed at improving the elasticity and efficiency of the tax system need to be supported by improvements in administrative efficiency and tax enforcement. On the expenditure side, an improvement in the quality of public-expenditure programs, especially the elimination of indiscriminate subsidies and the adoption of a fair and just social safety net, would enhance their contribution to economic growth. However, while not all Muslim countries have warmed to the concept of the market economy and broad-based reforms, nearly all—to varying degrees—have taken timid steps to reduce fiscal costs and improve efficiency by tackling a variety of complex and politically sensitive issues. Such issues include the need to broaden the tax base and to reduce budget deficits; to address spending on subsidies, public-sector employment, pensions, and health; to use taxation and income transfers to achieve a fairer distribution of income and wealth; and to introduce greater transparency as part of governance reform. The attendant benefits of the improved fiscal conditions are also evident in lower inflation, smaller balance of payments deficits, more resources for private sector investment, and, quite recently, better growth rates.

Social Safety Net

While over the last few decades the international community has adopted the position that broad-based economic growth is necessary for stemming the effects of systemic poverty, a growing consensus has emerged that social safety nets and social protection are also essential elements of any comprehensive framework for poverty alleviation. Not only are resources that provide basic services, such as health and education, important in their own right, they are also critical drivers for economic growth and development and essential to achieving an equitable distribution of income and wealth. An adequate social safety net is a central feature of Islamic economic doctrines and it is acknowledged to have a positive impact on economic growth and development.

In the early 1980s, the general prescription for growth in developing countries was economic reform, focusing on developing a prudent

combination of policies to enhance stabilization and adjustment. Little attention was given to the potential social costs of such reforms; reform was largely for reform's sake and did not incorporate the particular conditions of individual countries. However, by the late 1990s the pendulum had gradually shifted towards a model of economic growth that included more attention to relieving constraints that were binding to individual countries, including specific provisions for social welfare and protection. It has also been recognized that safety nets alone cannot serve effectively as an instrument for alleviating poverty without sound macroeconomic policies that enhance sustainable growth. While restructuring efforts may create economic efficiency gains over the long term, they often also lead to social dislocation, particularly over the short term. As Muslim countries adopt much-needed economic reforms to promote fiscal discipline (eliminating government waste, reducing harmful subsidies), build effective institutions (rule of law, reducing corruption), and promote economic justice in an effort to stimulate long-term growth, the development of a comprehensive structure to protect the vulnerable from falling deeper into poverty and to improve and broaden income distribution becomes even more pressing.

Developing Human Resources

Education is today seen as a major, if not the major, input for sustained economic growth and development. A modern financial sector is dependent on having highly educated professionals in the fields of economics, finance, accounting, and IT. At the same time, effective and prudent supervision and regulation of the financial sector requires highly trained specialists. Unfortunately, all of these specialists are in high demand the world over and are highly mobile. High-quality university education, a good working environment and appropriate remuneration are key factors. Efforts should also be made to develop a multitude of customized research and training programs, with appropriate certification, in areas such as financial engineering and risk management. The need for cross-discipline activities to train *Shari'ah* scholars in economics and to train economists in the basics of *Shari'ah* principles cannot be overemphasized.

ENDNOTES

1. Iqbal (2002).
2. Ali and Ahmed (2006).
3. Martson and Sundararajan (2006).
4. Macro prudential surveillance refers to monitoring the impact of plausible macroeconomic shocks on financial soundness and of the implications of financial soundness on the macro economy, and adjusting macro and financial policies, as needed.
5. US debt includes US Treasury, mortgage-related debt, corporate, and agency debt. Source: Securities Industry and Financial Markets Association (SIFMA), http://www.sifma.org

6. See Ali (2004) and Chapra (2006).
7. Chapra (2006) puts forward the idea of creating a common pool at the central banks to provide mutual accommodation to banks in case of need. All banks may be required to contribute a certain mutually agreed percentage of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (that is, drawings do not exceed contributions) over a given period of time. In a crisis situation the central banks may allow a bank to exceed the limit, with appropriate penalties, warning, and a suitable corrective program.
8. Rajan (2006).
9. Smith (1993).
10. Iqbal (2005).
11. See Chapra (2000); Khan and Habib Ahmed (2001); El-Hawary, Grais and Iqbal (2004); and Grais and Iqbal (2006).
12. Creane *et al.* (2003).
13. IRTI and IFSB (2006).
14. Ibid.

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