

Trends and Challenges in Islamic Finance

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I. Introduction

The Islamic finance industry is in the midst of a phenomenal expansionary phase, exhibiting average annual growth rates of about 15 percent in recent years. This rapid growth has been fueled not only by surging demand for *shari'ah* compliant products from financiers from the Middle East and other Muslim countries, but also by investors around the world, thus rendering the expansion of Islamic finance a global phenomenon.

In fact, there is currently more than US\$800 billion worth of deposits and investments lodged in Islamic banks, mutual funds, insurance schemes (known as *takaful*), and Islamic branches of conventional banks.¹ According to a recent study by McKinsey (2007), the value of Islamic banking assets and assets under management is expected to reach US\$1 trillion by 2010 with Islamic banks growing more rapidly than the average banking sector in most countries.

Besides its wide geographical scope, the rapid expansion of Islamic finance is also taking place across the whole spectrum of financial activities, ranging from retail banking to insurance and capital market investments. But perhaps the most striking has been the fast growth of *sukuk* or Islamic bonds, the most popular form of securitized credit finance within Islamic finance. Islamic bond issuance has soared over the last three years in response to growing demand for alternative investments (Jobst *et al.*,

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¹ There are currently more than 300 Islamic financial institutions spread across 51 countries, apart from 250 mutual funds that comply with Islamic principles. For a discussion of the ways in which Islamic banks are becoming increasingly involved in conventional financial systems and of the associated challenges, see Solé (2007).

2008). At the end of 2007, outstanding *sukuk* globally exceeded US\$90 billion (Moody's, 2007 and 2008). Gross issuance of *sukuk* has quadrupled over the past two years, rising from US\$7.2 billion in 2004 to close to US\$39 billion by the end of 2007. Although the current level of *sukuk* issuance by corporates and public sector entities remains a fraction of the global fixed income markets, total issuance in 2007 accounted for roughly a quarter of conventional securitization in emerging markets.

Sukuk have largely escaped the retrenchment of investment in structured finance on the heels of the global financial crisis triggered by the collapse of the US sub-prime mortgage market. Although the issuance of *sukuk* has slowed to US\$4 billion in the first quarter of 2008 (down by almost half from the first quarter in 2007), the number of deals brought to market has remained steady. That said, the prevailing market uncertainty and the retrenchment of real estate exposures worldwide has created a significant backlog of planned *sukuk* issues, which could see a restoration over the course of this year. On the assumption of a stable rate of growth, the volume of *sukuk* issued by governments and corporates will surpass the US\$150 billion mark by 2010, spurred by buoyant demand especially from banks, insurance companies and pension funds in both Islamic and non-Islamic countries.

The rapid evolution of Islamic finance activities points to the enormous profit opportunities that beckon. This in turn has prompted a vetting process among a number of jurisdictions around the world to establish themselves as leading Islamic financial centers. In this regard, the case of London is perhaps the most remarkable insofar as it has managed to extend its leading position in world financial markets to become a center for Islamic finance. Similarly, Hong Kong, New York, and Singapore are also making important advances to accommodate Islamic finance within their jurisdictions and aspire to join the ranks of the more established Islamic centers such as Bahrain, Dubai, Kuala Lumpur, and Labuan.

Islamic finance rests on the general idea of extending the tenets of Islamic religious beliefs to economic activity in a way that enhances social welfare. As one of the key features of Islamic finance, Islamic contracts are asset-based and transactions have to comply with *shari'ah* law, which prohibits (i) the trading of debt contracts to earn a profit (*riba*), (ii) profit taking without a real underlying economic activity, and (iii) activities that are not considered *halal* (*shari'ah* compliant). Moreover, the contractual

relationships between financiers and borrowers are governed not by capital-based investment gains arising from the time value of money but by shared business risk (and returns) from entrepreneurial investment in lawful activities.

In the authors' opinion, all these developments underscore the fact that Islamic finance has established itself as a permanent element within the global financial landscape. Nevertheless, despite the recent advances, important challenges lie ahead. This paper first provides a brief overview of the main Islamic finance principles, before discussing some of the challenges faced by Islamic finance and suggesting potential solutions. For expository purposes, we have adopted a two-pronged approach in considering these challenges through a discussion of key banking issues and then some capital market issues.

II. Islamic finance principles²

Islamic finance principles ensure that contractual certainty and mutually beneficial balance are maintained between borrowers and lenders. Any financial transaction under Islamic law implies *direct participation in asset performance* ("asset layer") and assigns to financiers clearly identifiable rights and obligations for which they are entitled to receive commensurate return in the form of state-contingent payments. *Shari'ah* law prohibits the sale and purchase of debt contracts with the aim of obtaining an interest gain (*riba*),³ profit taking without real economic activity and asset transfer, as well as legal uncertainty surrounding the enforceability of contractual claims. Only interest-free forms of finance associated with activities that do not involve any association with pork, alcohol, fire arms, adult entertainment or gambling are considered permissible in Islamic finance. However, the *shari'ah* does not object to profit-taking and payment for the use of an asset as long as both lender and borrower share the investment risk together and profits are earned in line with *shari'ah* prescriptions. Moreover, returns cannot be guaranteed *ex ante* but accrue only if the investment itself yields income.

The permissibility of risky capital investment without explicit interest earning has spawned three basic forms of Islamic financing for both

² See Iqbal and Mirakhor (2007) and Wilson (2008) for an introduction to Islamic finance.

³ The trading of debt is allowed in some jurisdictions under the concept of *Bai al Dayn*.

investment and trade: (i) synthetic loans (*debt-based*) through a sale–repurchase agreement or back-to-back sale of borrower- or third party-held assets, (ii) lease contracts (*asset-based*) through a sale–leaseback agreement (operating lease) or the lease of third-party acquired assets with a purchase obligation (financing lease), and (iii) profit-sharing contracts (*equity-based*) of future assets. The appendix provides a short overview of these Islamic finance principles, which govern financial relationships and contracts in Islamic law jurisdictions.

These principles are best illustrated in Islamic banking, probably the oldest area of Islamic finance. For instance, Islamic banks determine the rate of return on deposits differently from commercial banks. In conventional banking, the rate of return is set contractually (fixed in advance or tied to a reference rate) and does not depend on the bank’s lending performance. In an Islamic bank, the rate of return on a deposit is directly dependent on the performance of the bank’s investments. If the bank records losses as a result of poor investments, depositors may lose some (or all) of their deposits. Thus, the contractual agreement between depositors and Islamic banks does not pre-determine any rates of return; it only sets the ratio according to which profits and losses are distributed between the parties to the deposit contract.

III. Islamic banking

Legal and regulatory issues

As mentioned above, Islamic banks have increased their presence in conventional financial systems. Typically, this process has taken place in one of two ways: either conventional banks have increasingly tested the waters of *shari’ah*-compliant banking activities by opening an Islamic *window* and/or offering specific Islamic financial products, or full-fledged Islamic banks have been licensed as such.⁴

Be that as it may, one of the first concerns that arise as Islamic banking emerges within a conventional system, is how to embed Islamic activities into the existing juridical and supervisory frameworks. To think about this issue, it is useful to adopt a two-tier perspective and address first the *legal*

⁴ See Solé (2007) for a discussion of this process.

aspects of Islamic contracts, and second, the *regulatory* aspects of Islamic financial transactions.

In other words, on the one hand there is the *legal* question of whether the existing laws in a secular jurisdiction allow financial transactions to be governed by *shari'ah* principles. On the other hand, there is the *regulatory* question of whether Islamic institutions require the same intensity and kind of prudential oversight as conventional institutions.

First, regarding the place of Islamic contractual arrangements within secular jurisdictions, it is likely that the existing legislation in conventional jurisdictions does not include all the *shari'ah* principles that should govern Islamic financial transactions. However, as DeLorenzo and McMillen (2007) point out, in most of the jurisdictions with modern legal systems the legal set-up is typically flexible enough to allow the parties involved to write their own contracts. Thus, in these contracts, the signing parties could explicitly specify the desired principles by which their transactions should be governed. By doing this, both parties would ensure that the principles to which they wish to adhere would be upheld in the jurisdiction where the contract is enforced.

A second key aspect is whether Islamic institutions require similar levels of supervision as conventional institutions. In this regard, a somewhat common misunderstanding is that, since Islamic banking is largely based on profit-and-loss sharing agreements (PLS), Islamic institutions do not need to be supervised at the same level as conventional banks. In fact, as pointed out by Errico and Farrahbaksh (1998), El-Hawary *et al.* (2004), Solé (2007), and Čihák and Hesse (2008) among others, there are certain features of Islamic banks that warrant prudential regulation to a similar degree as traditional banks. These considerations include moral hazard considerations, safeguarding the interests of demand depositors, and systemic considerations.

But beyond the justification for the need to prudentially oversee Islamic institutions, one may wonder whether there are any specific modifications to the current regulatory frameworks that are necessary to ensure that the supervisory authorities can continue to fulfill the goals of prudential supervision vis-à-vis Islamic banks. In this regard, the cross-country experience has been varied: the options range from a minimal-alterations approach (e.g., the United Kingdom, where all deposit-taking institutions are required to comply with broadly the same set of regulations but with some

minor requirements for institutions offering Islamic products) to a dual approach where the authorities issue separate specific regulations for conventional and Islamic banks (e.g., Bahrain).

Although country approaches may vary, the fact is that Islamic banking activities entail specific risks that need to be taken into account both by financial institutions and regulators (see Bhambra, 2007, and Sundararajan, 2007, for a discussion). Recognizing the need for guidance on these issues, in 2002, a number of central banks and national monetary authorities of Islamic countries inaugurated the Islamic Financial Services Board (IFSB) in Malaysia as an international standard-setting body. The IFSB's mandate is to ensure the stability and soundness of the Islamic financial services industry by developing new, or adapting existing, international finance standards consistent with *shari'ah* principles and by harmonizing industry practices. In fact, parallel to the revision of the Basel Capital Accord in 2005, the IFSB issued two regulatory standards on capital adequacy and risk management for Islamic institutions.⁵ It has also issued additional standards in other important areas, such as corporate governance and the supervisory review, among others.

Finally, the regulatory authorities are also called to foster an environment where Islamic banking can offer a suitable response to investors' and depositors' demand for Islamic products. This is not to say that regulatory advantages should be given to Islamic institutions, but rather that a level playing field should be provided. In fact, it is possible that in the initial stages of the process, some Islamic transactions will fall into legal voids and thus may not be permitted by the existing legal framework or may be viewed with reticence by the general public.

Therefore, the authorities' attitude should be akin to the British Financial Services Authority's stated policy of "no obstacles, no special favours".⁶ It is in this spirit, for example, that the FSA closely collaborated with the Islamic Bank of Britain (IBB) to find a solution that would allow IBB to offer Islamic investment accounts while at the same time qualifying as a deposit taking institution, as mandated by the existing banking legislation. The solution reached was that the IBB would always offer its customers a choice between investment accounts (with a non-guaranteed

⁵ See the IFSB's guidelines "Capital Adequacy Standards for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services" and "Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services".

⁶ See the FSA's Briefing Note BN016/06, "Islamic Banking in the UK", available at www.fsa.gov.uk

principal due to religious considerations) and fully guaranteed accounts. Similarly, the FSA has also issued a regulation for Islamic mortgages.⁷ Under the new legislation, buyers of Islamic mortgages will enjoy the same degree of regulatory oversight as buyers of traditional mortgages.

Financial stability issues

Theoretical considerations

From a prudential perspective, given that Islamic banks are expanding their presence in conventional systems, it is relevant to know whether Islamic banks are more or less stable than conventional banks. As mentioned above, some authors have argued that the risks posed to the financial system by Islamic banks differ in many ways from those posed by conventional banks. Risks unique to Islamic banks may arise *directly* from the specific features of Islamic contracts, as well as *indirectly* from the overall legal, governance and liquidity-management infrastructure available to Islamic institutions. For example, PLS financing shifts the direct credit risk from banks to their investment depositors. But it also increases the overall degree of risk on the asset side of banks' balance sheets, because it makes Islamic banks vulnerable to risks normally borne by equity investors rather than holders of debt.

In addition, the absence of viable Islamic money markets could exacerbate liquidity risks. Similarly, prohibitions against the use of conventional derivatives limit Islamic banks' ability to hedge certain risks. Moreover, most Islamic banks have operated in environments with less developed or nonexistent interbank and money markets and government securities, and with limited availability of and access to lender-of-last-resort facilities operated by central banks. These differences have been reduced somewhat because of recent developments in Islamic money market instruments and Islamic lender-of-last resort modes, and the implicit commitment of most authorities to provide liquidity support to all banks during exceptional circumstances.

On the other hand, there are features of Islamic banks that could render them less vulnerable than conventional banks. For example, Islamic banks are able to pass through a negative shock from the asset side (such as a worsened economic situation that causes lower cash flow from PLS

⁷ See the FSA's PN041/2006, "Home reversions and Islamic mortgages get new consumer protections", available at www.fsa.gov.uk

transactions) to the investment depositors. The risk-sharing arrangements on the deposit side thus arguably provide another layer of protection to the bank, in addition to its book capital. Also, it could be argued that the need to provide a stable and competitive return to investors, the shareholders' responsibility for negligence or misconduct (operational risk) and the more difficult access to liquidity put pressure on Islamic banks to be more conservative. Furthermore, because investors (depositors) share in the risks (and typically do not have deposit insurance), they have more incentive to exercise tight oversight over bank management.

Finally, and partly due to the lack of short-term investment opportunities, Islamic banks have traditionally held a larger proportion of their assets than commercial banks in reserve accounts with central banks or in correspondent accounts with other banks. Thus, even if Islamic investments were more risky than conventional investments, from a financial stability perspective the question is whether or not these higher risks are offset by bigger buffers. In sum, whether Islamic banks are more or less stable than conventional banks depends on the relative sizes of the effects discussed above, and it may in principle differ from country to country and even bank from bank.

Some empirical evidence

Čihák and Hesse (2008) find, based on a sample comprising 18 countries, that larger Islamic banks tend to be riskier than smaller Islamic banks and similar large commercial banks, while smaller Islamic banks tend to be more stable than small commercial banks. Furthermore, as the presence of Islamic banks grows in a country's financial system, there is no significant impact on the soundness of other banks. This suggests that Islamic and commercial banks can co-exist in the same system without substantial "crowding out" effects through competition and deteriorating soundness.

A plausible explanation of the contrast between the high stability in small Islamic banks and the relatively lower stability in larger ones is that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger. For example, the PLS modes, used by Islamic banks, are more diverse and more difficult to standardize than loans used by commercial banks. As a result, as the scale of the banking operation grows, monitoring of credit risk becomes rapidly much more complex. That results in greater prominence of problems relating to

adverse selection and moral hazard. Another explanation is that small banks concentrate on low-risk investments and fee income, while large banks do more PLS business.

IV. Islamic capital markets

Amid a growing demand for alternative investments, there has been a surge in recent years in the issuance of Islamic capital market securities by corporates and public sector entities across the world. Asset securitization plays a special role in this regard. Although the concept of asset-backing is inherent to Islamic finance, very few structured credit transactions have been executed following the precepts of the *shari'ah*. Since asset backing, entrepreneurial investment and specific credit participation in identified business risk are fundamental to any Islamic transaction, *shari'ah*-compliant securitization represents a straightforward capital market-based form of Islamic finance.

This section reviews the current state of market development, examines some pertinent economic and legal implications of *shari'ah* compliance on the configuration of securitization transactions, and informs a preliminary outlook on the prospects for Islamic securitization in light of the ongoing regulatory consolidation.

Market situation

In the wake of the rapid growth of the Islamic finance sector, Muslim investors are flocking to the growing number of competing Islamic investment products. In particular, structured finance instruments are receiving increasing attention owing in large part to enabling capital market regulations, a favorable macroeconomic environment, and financial innovation aimed at establishing *shari'ah* compliance.

While *sukuk* are structured in a similar way to conventional asset-backed securities (ABS) or covered bonds, they can have significantly different underlying structures and provisions. *Sukuk* are tantamount to Islamic securitization, which, through a *shari'ah*-compliant lending transaction or trust-based investment in existing or future assets, transforms bilateral risk sharing between borrowers and lenders into the market-based refinancing of asset performance. They commoditize the capital gains from asset transfer in either one of the three basic forms of Islamic finance (i.e., debt-based

contracts, for example, synthetic loans/purchase orders (*mudharabah*); asset-based contracts, e.g., sale-leasebacks (*ijara*), or equity-based contracts, e.g., profit-sharing arrangements and trusts (*musharakah* or *murabahah*). To this end, *sukuk* are akin to mortgage pass-throughs, except investors own a portion of the underlying assets, which fund unsecured debtor repayments from profitable and direct investment in religiously-sanctioned and real economic activity.

Economic and legal challenges

Despite considerable, and growing, demand for *shari'ah*-compliant assets, the further development of Islamic securitization depends on essential economic, regulatory, and infrastructural conditions.

Amid weak reliance on capital market financing in many Islamic countries, issuers of *sukuk* are first and foremost faced with several critical economic impediments that pertain to (i) the identification of reference assets that meet *shari'ah* requirements and offer attractive returns, and (ii) the substitution of standard structural features in conventional securitization structures, such as credit enhancement and liquidity support, which are not permissible in an Islamic context.⁸ Given the limited sourcing and structuring of eligible asset portfolios, Islamic issuers have begun to originate their own Islamically acceptable assets (rather than buy asset pools in the market).

The absence of practical and definitive guidance on *shari'ah* compliance for securitization structures affects the legal integrity restitution interest of investors in *sukuk*. Islamic investors are not only concerned with the compliance of both securitized assets and the transaction structure with the *shari'ah* but also with legal enforceability of asset claims under contract law. So from an investor's perspective, both the underlying reference assets and the transaction structure need to satisfy two legal regimes: the applicable commercial law as well as Islamic law.

In this context, the question whether Islamic law governs a securitization transaction by *substance* or *form* determines the degree to which pronouncements by *shari'ah* scholars encroach upon the legal enforceability of commercial interests. While the conclusion of financial transactions under

⁸ In some emerging markets, potential *sukuk* issuers may also be faced with legal uncertainties regarding the tax and accounting treatment to be given to the Special Purpose Vehicles (SPVs) needed for *sukuk* issuance (Solé, 2008).

different legal regimes can lead to the same outcome (*substance*), the legal process (and possibly the associated rights and obligations of the contractual parties) (*form*) might vary considerably.

If *shari'ah* compliance is treated (only) as a *matter of substance* and upholds in spirit what was created in form, such as the issuance of asset-backed securities (ABSs), (defined by commercial law), the violation of the *shari'ah* would probably temper investor interest in a transaction, but would not preclude legal enforceability of investor claims. However, if the transaction is governed solely by *shari'ah* law as a *matter of form*, the opinion of *shari'ah* courts could override commercial legal concepts and re-qualify the legal nature of a securitization transaction. For instance, the legal separation of securitized assets from the bankruptcy estate of the originator in a true sale securitization carries the possibility of bankruptcy courts or insolvency officials in Islamic jurisdictions to invalidate the substantive non-consolidation and “re-characterize” an asset sale as an unsecured loan.

Regulatory consolidation and market harmonization

Recent efforts to achieve regulatory consolidation and standard setting have addressed economic constraints and the legal uncertainty imposed by Islamic jurisprudence and poorly developed uniformity of market practices. Therefore, market inefficiencies caused by heterogeneous prudential norms and diverse interpretations of *shari'ah* compliance are expected to wane in the near future. Leading international organizations in Islamic finance, such as the Accounting and Auditing Organization of Islamic Finance Institutions (AAOIFI), have been working on aligning *shari'ah* principles on a consistent basis. In this regard, a fine balance is required between collective initiatives and regulatory revisions, so as to ensure that standardization is achieved without staving off financial innovation. In 2008, a Task Force of the IFSB is due to publish recommendations for standard *sukuk* structures in response to efforts by professional organizations towards greater uniformity of such structures.

Outlook

Since conventional securitization is virtually absent in Islamic countries, considerable demand for *shari'ah*-compliant investment assets provides an untapped market for structured finance. Islamic securitization also

complements the conventional ABS universe as an alternative and more diversified funding option that broadens the pricing spectrum and asset supply as high demand for alternative investment products causes greater lending width. Thus, it is hardly surprising that the current process of regulatory harmonization coincides with institutional competition for capital market leadership in the development of Islamic capital market assets and structured finance. Several Islamic jurisdictions, such as Bahrain, Malaysia, and Dubai are encouraging *shari'ah*-compliant debt issuance in a bid to promote themselves as centers for Islamic finance.

V. General challenges

What are the current challenges for Islamic finance and its continued above-average growth rates in the different regions, across banks and products? Below, we list a few key challenges that were partly touched upon in the above discussion.

Recent regulatory changes concerning the structure of *sukuk* warrant careful consideration and might mute some of the recent enthusiasm for Islamic capital market products. In February 2008, the *shari'ah* committee of AAOIFI issued new recommendations regarding the role of asset ownership, investment guarantees, and the *shari'ah* advisory and approval process in *sukuk* origination and trading. These proposed rules attracted significant attention prior to their release, following a statement by the chairman of the *shari'ah* committee in November 2007 indicating that 85 percent of *sukuk* issues in the GCC do not concur with *shari'ah* principles. Most *sukuk* issued in the GCC have explicit repurchase agreements that guarantee the repayment of principal but violate the profit–loss sharing (PLS) features of *shari'ah* law. There are currently discussions underway between the various stakeholders and some market participants to gauge the potential of these recommendations to cause permanent damage to the *sukuk* market.

The *sukuk* market is also still plagued by illiquidity due to limited depth and breadth, mainly because Middle Eastern banks, which are the most likely securitizers/sellers of risk, are flush with liquidity and capital, so there is no strong funding or balance sheet rationale for *sukuk*. Although the commoditization of illiquid asset exposures through securitization facilitates the disciplining effect of capital markets, the lack of information

from private sources about securitized assets in many *sukuk* and the prevalence of “buy-and-hold” investments inhibit efficient price discovery and information dissemination. Moreover, *sukuk* are available at maturities of 3, 5, and 10 years but not for short-term maturities, which significantly limits their application for money markets. Although Islamic banks are currently one of the largest buyers of *shari’ah*-compliant products (at long maturities), they would benefit most from issues at shorter tenors. There is some hope that the launch of different *sukuk* funds in the near future might potentially unlock liquidity constraints, but this might only create new demand without sufficiently alleviating supply constraints. It is currently also difficult to set up *sukuk* funds with sufficient diversification. Notwithstanding the compelling value proposition of *sukuk*, without efficient and transparent capital markets and appropriate legal frameworks to operate within, Islamic capital markets will not continue to grow meaningfully in the near future.

Liquidity risk management of Islamic banks is an important challenge and is constrained due to limited availability of tradable Islamic money market instruments and weak systemic liquidity infrastructure. At the moment, there is no *shari’ah*-compliant short-term Islamic money market (less than one week maturity) in local currency or in US dollars, and Islamic repo markets have not yet developed. Islamic money markets with longer maturities, which are based on commodity *murabaha* transactions (mark-up financing), sometimes suffer from unreliable brokers with low credit-worthiness. Islamic banks also have a competitive disadvantage with conventional banks, as they deposit their overnight money with their domestic central bank interest free. The lack of liquidity and viable alternatives, combined with the competitive disadvantage, hamper the local Islamic banks and can even create a liquidity crisis. Many investment banks are currently designing new complex products, compliant with *shari’ah* law, that attempt to overcome the shortcomings of the Islamic money market. It remains to be seen whether these new solutions will obtain widespread *shari’ah* compliance in the Islamic finance community and generate enough demand for a functional Islamic money market to develop.

Business models and products of Islamic banks are still rather homogeneous, while *shari’ah* compliance amplifies risks stemming from product configuration and process implementation. The success of Islamic banking

in recent years has produced too many Islamic banks with the same business models. There is a lack of “bread and butter” lending, and the current excess liquidity has led to too much complacency among the Islamic banks. In addition, there is a large and diverse set of accounting standard differences across the different jurisdictions. The development and setting of simple standard legal contracts is necessary in order to overcome the complexity and heterogeneity of current contracts. Furthermore, the deployment of IT systems that help monitor the fulfillment and visibility of processes on an end-to-end basis are crucial to facilitate the continuous monitoring of activities by *shari’ah* scholars while eliminating the possibilities of non-compliance, which in some cases might render transactions invalid.

Financial innovation in Islamic finance is still hampered by the need for harmonized financial regulation. As discussed before, governance issues, especially the *shari’ah* compliance of products and activities, constitute a major challenge for the Islamic finance industry. Although *shari’ah* rulings (*fatwas*) by legal scholars are disclosed, there are currently no unified principles on which *shari’ah* scholars decide on the *shari’ah* compliance of new products. Fatwas are not consolidated, which inhibits the dissemination, adoption, and cross-fertilization of jurisprudence across different countries and schools of thought. Moreover, there is still considerable heterogeneity of scholastic opinion about *shari’ah* compliance, which undermines the creation of a consistent regulatory framework and corporate governance principles. The fragmented opinion of *shari’ah* boards, which act as quasi-regulatory bodies, remains a source of continued divergence of legal opinion. Since Islamic law itself is divided between different juristic schools of thought (*madhahib*), which provide guidance on the analytical reasoning (*ijtihad*) or interpretative analogy (*qiyas*) of the general principles of the *shari’ah*, there is no consensus (*ijma*) on the religious compliance of certain products and transaction structures. Given the rising global integration of the Islamic financial services industry, greater supervisory harmonization across national boundaries is essential.

There is also regulatory disparity among national supervisors, with each regulator working independently and refusing to recognize the validity of judgments made by foreign counterparts. A greater role for the AAOIFI, the *General Council for Islamic Banking and Finance Institutions* (GCIBFI), and the *Islamic International Rating Agency* (IIRA) in this regard has added

consistency to *shari'ah* rulings, while the retention of conventional finance market practice and the supremacy of a governing law as a matter of form remain essential to maintain investor confidence in the rapidly growing Islamic banking system and capital markets. Also, national solutions are gaining traction. Various Islamic countries have teamed up in a bid to create more liquidity and enhance market transparency with a view to becoming a center of Islamic finance, while more specific regional initiatives provide a valuable platform for drawing further attention to structured finance as an important element of local capital market development.

VI. Conclusion

Despite a number of challenges that we outlined in the previous sections, the future looks bright for Islamic finance. Financial institutions in countries such as Bahrain, the UAE, and Malaysia have been gearing up for more *shari'ah*-compliant financial instruments and structured finance—both on the asset and liability side. In addition, financial innovation will contribute to further development and refinement of *shari'ah* compliant derivative contracts. For instance, the development of Islamic derivatives bodes well for the Islamic insurance (*takaful*) industry, whose *shari'ah* compliance has traditionally resulted in overdependence on equity and real-estate investment, restricting the potential of risk diversification from a wider spectrum of available assets.

At the same time, the leading financial centers, e.g. Hong Kong, London, New York and Singapore, are making significant progress in establishing the legal and prudential foundations to accommodate Islamic finance side-by-side with the conventional financial system. Many of the largest western banks through their Islamic windows have become active and sometimes leading players in financial innovation and new *shari'ah*-compliant financial instruments that attempt to alleviate many of the current constraints such as a weak systemic liquidity infrastructure. More conventional banks are expected to offer Islamic products, enticed by enormous profit opportunities and also ample liquidity especially across the Middle East.

New product innovation is also driven by domestic banks' interest in risk diversification. With a large number of new Islamic banks across the

Middle East and Asia especially, diversification of products enables banks to offer the right product mix to more sophisticated clients. A few banks are already active across different jurisdictions, and this trend is certainly going to continue in the near future with possibly some consolidation.

On the regulatory front, the IFSB has moved ahead with its standardization efforts of the Islamic financial services industry that will foster the soundness and stability of the system. Globally accepted prudential standards have been adopted by the IFSB that smoothly integrate Islamic finance with the conventional financial system. For instance, the adoption of the IFSB Standards (somewhat akin to Basel II) which take into account the specificities of Islamic finance, ensures a level playing field between Islamic and conventional banks.

Finally, the shining example of the growth and potential of Islamic finance are *sukuk* bonds. Defying the ramifications from the US subprime crisis so far, the *sukuk* market has been growing rapidly and will surpass the US\$150 billion mark by 2010, driven by demand from financial institutions, insurance companies and pension funds across Islamic and non-Islamic countries. Many challenges still lie ahead, but the banks' search for profitable opportunities and the ensuing financial innovation process in tandem with favorable regulatory developments at domestic and international levels as well as growing capital market sophistication, will ensure that the Islamic finance industry will continue to develop at a steady pace.

APPENDIX

Islamic Banking—Basic Terminology

Term	Explanation
<i>Amana</i> (Demand deposits)	Deposits held at the bank for safekeeping purpose. They are guaranteed in capital value, and earn no return.
<i>Bay mu'ajal</i> or <i>bay bithaman ajil</i> (BBA) (Pre-delivery, deferred payment)	The seller can sell a product on the basis of a deferred payment, in installments or in a lump sum. The price of the product is agreed upon between the buyer and the seller at the time of the sale, and cannot include any charges for deferring payment. In a BBA contract, the lender is not compelled to disclose the profit margin.
<i>Salam</i> (Pre-payment, deferred delivery)	The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date.
<i>Ijara</i> (Lease, lease purchase)	A party leases a particular product for a specific sum and a specific time period. In the case of a lease purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.
<i>Istisna</i> (Deferred payment and delivery)	A manufacturer (contractor) agrees to produce (build) and to deliver a certain good (or premise) at a given price on a given date in the future. The price does not have to be paid in advance (in contrast to <i>bay salam</i>). It may be paid in installments or part may be paid in advance with the balance to be paid later on, based on the preferences of the parties.
<i>Ju'ala</i> (Service charge)	A party pays another a specified amount of money as a fee for rendering a specific service in accordance with the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.
<i>Kifala</i>	It is a pledge given to a creditor that the debtor will pay the debt, fine or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.
<i>Mudaraba</i> (Trust-based contract)	<i>Rabb -ul- mal</i> (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers his labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by <i>rabb -ul- mal</i> . The liability of the entrepreneur is limited only to his time and effort.
<i>Murabaha</i> (Mark-up financing)	The seller informs the buyer of his cost of acquiring or producing a specified product. The profit margin is then negotiated between them. The total cost is usually paid in installments.
<i>Musharaka</i> (Equity participation or "sweat capital finance")	The bank enters into an equity partnership agreement with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.
<i>Qard Hassana</i> (Beneficence loans)	These are zero-return loans that the <i>Qur'an</i> encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.

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Islamic Finance And ESG: The Missing Link™. 34. Banks. Turkey and Iran lead this decline under a trend that we expect will continue in the next 12-24 months. As the economic cycle might turn at some stage, we believe a low-single-digit growth rate over the next two years is a fair assumption. We see three potential accelerators that could get the industry back to the days of strong growth: Inclusive standardization, financial technology (fintech), and environmental, social and governance (ESG) opportunities. 4 Islamic Finance Outlook 2020 Edition. challenges related to sukuk issuance and management. These include the traceability of underlying assets to understand better the risk, the traceability of cash flows for prompt corrective action in case of underperformance, and the traceability of investors. Islamic finance, which was a niche market not long ago, is on the rise and has attracted increasing interest in both predominantly Muslim countries and the West alike. Major international financial institutions are already active in this industry. Various contractual types and structures derived from classical Islamic legal and commercial concepts have emerged, based upon the principle of prohibition of *riba*, which is generally interpreted as a prohibition of interest, as well as other principles of the Sharia (Islamic law) as interpreted by religious scholars. The paper first discusses the current trends in Islamic finance, which has become mainstream with currently more than US\$800 billion of assets worldwide and a buoyant market for sukuk bonds. However, this exorbitant growth raises many challenges, particularly in the areas of banking, capital markets and regulation. Thus, the paper then considers these challenges, notably the economic and legal bottlenecks of sukuk, banking-specific issues, such as liquidity risk management and business models, as well as disharmonized financial regulation. Despite the challenges, the paper concludes that the I... We believe that Islamic Finance is ideally placed to take advantage of these trends, especially in light of the fact that our analysis indicates that by 2030, more than 95% of the world's Muslim population will be located in Asia and Africa. Speculation around the future of Islamic Finance is over. Doing so will be challenging, especially since Islamic banks will need to focus on innovation and on improving their cost efficiency relative to their conventional counterparts. We look forward to the opportunity of serving you and would be delighted to address any of your ongoing questions or concerns about the Islamic Finance industry in general or any other specific business related issues. Ashruff Jamall Global Islamic Finance Leader. PwC - Islamic Finance 3. The paper first discusses the current trends in Islamic finance, which has become mainstream with currently more than US\$800 billion of assets worldwide and a buoyant market for sukuk bonds. However, this exorbitant growth raises many challenges, particularly in the areas of banking, capital markets and regulation. Thus, the paper then considers these challenges, notably the economic and legal bottlenecks of sukuk, banking-specific issues, such as liquidity risk management and business models, as well as disharmonized financial regulation. Despite the challenges, the paper concludes that the I...