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JEEIR

Journal of Emerging Economies and Islamic Research

www.jeeir.com

Does Islamic Finance Industry Lack a Certain Degree of Credibility?

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Keywords – Islamic Finance, Islamic Banking.

Introduction

Islamic banking and finance sector risks losing a golden opportunity to demonstrate an alternative system that could prevent a future credit crunch and share risks. With the conventional banking sector slowly coming to terms with its high-profile collapses and bailouts, the Islamic sector has suffered only mild aftershocks. The question that comes to mind is: why are savers and investors not flocking to shariah-compliant banking? Could Islamic finance lack a certain degree of credibility? And if so, why?

The conventional banking sector has many years of experience, regulation and business culture behind it, whereas the Islamic sector without such a background, reached about $1.9 trillion in assets worldwide in only 25 years. That certainly looks impressive, but it still represents less than 1.2% of banking assets globally, which makes the question of why many investors are still lacking trust in the system all the more important.

The conventional financial system has evolved greatly over the last two centuries and has contributed a great deal to the development of not only the Western world but also to that of a substantial number of developing countries. The mention of Islamic finance raises the question of whether there is a strong rationale for the establishment of a parallel system. The rationale would exist only if it could be shown convincingly that the Islamic system is capable of addressing successfully some of the problems that the conventional system has been unable to address. There is general agreement that every system must ultimately lead to the well-being of all people. One of the measures that Islam has adopted for ensuring greater justice for all is to introduce the principle of risk-reward sharing instead of interest in financial intermediation.

While the conventional financial system has generally been considered to be superior with regard to efficiency, certain conventionally structured capital market products (derivatives products) led to the financial crisis of 2008–09. The introduction of the minimal-risk Islamic financial system over the past 10–15 years has added a healthy dimension to the international financial system. In addition to injecting greater justice into the system it has also helped make the financial system healthier and more stable by adding greater discipline into it.

A large number of Islamic financial institutions have been established worldwide and Islamic financial services are now available in most jurisdictions around the world. These institutions are playing an important role in catering to the financial needs of a wide spectrum of society. The innovative products they have provided have not only widened the coverage of financial services, but also deepened the financial markets. Nevertheless, the system is still in its initial phase and thus has a long way to go before it can optimize efficiency and enable Muslims to be confident that these institutions have made headway in the realization of the maqasid al-Shari'ah (the objectives of Islamic law).

The conventional financial system has a code of ethics and conduct to which all key personnel, including management, are accountable. Otherwise the system could not have survived and expanded to the level it has reached. It is therefore imperative for the Islamic financial system to become institutionalized and properly regulated not only by institutions' internal regulatory boards and authorities but also by external, accountable Shari'ah boards. This makes it necessary to evaluate the performance of modern Islamic banking and Islamic financial institutions regularly and have the Sharia board members transparent, accountable, and adequately qualified in terms of experience and ongoing education.

Sharia advisors who regulate Islamic banking are supposedly jurists specialising in Islamic law, modern finance and economics. Their job is to direct, review and supervise activities related to Islamic finance to ensure that they are in compliance with sharia principles. However, they are not accountable for their actions - that is the responsibility of the banks that employ them. Sharia board members' responsibilities, qualifications, ethos, commitment and social responsibility can therefore be unknown or questionable, when they should be identified, regulated and accountable, both to the organisation they represent and to those affected by their decisions, which ultimately shape the Islamic finance system. Anther problem is the opaque manner in which advisors are appointed. It is based largely on recommendations and friendships and there is little in the way of checks on qualifications or ability. But as they will rarely have to make an important decision, this hardly matters, as we shall see.

Corporate Governance in Islamic Banking and Finance

Islamic finance is a nascent industry, with a small share of the global market – about 1.2%. However, Islamic finance is benefiting from a number of favorable structural and cyclical drivers: strong growth in the GCC, Asia, and Africa; positive demographics of young and rapidly growing populations; and a growth in the preference of savers/investors towards Islamic finance in Muslim countries, partly due to a reawakening of cultural and religious identity. The rapid growth may have taken some by surprise, and the state of corporate governance might stand as evidence of this.

Corporate governance aims to provide institutions with a body of rules and principles to ensure that good practice, guides the overall management of an institution, covers incentive structures to address principal–agent issues, ensures that executive management serves the long-term best interests of the shareholders as well as the stakeholders and ensures sustainable value of the company in conformity with the laws and ethics of the country.

Islamic banks are subject to an additional layer of governance since the suitability of their investment and financing must be in strict conformity with Islamic Law. For this purpose, Islamic banks employ an additional layer of governance, the Sharia advisory board. All the complex factors involved in balancing power between the CEO, the board, the shareholders and the Sharia board members can be considered parts of the corporate governance framework. Tasks include auditing, ensuring Sharia compliance, selecting officers and advisors, remuneration of management and advisors, balance sheet and off-balance disclosure and ensuring transparency.

Shari'ah Board Accountability and the Need for a New Breed of Scholars

The Islamic finance system was created by a group of Muslim intellectuals, who in good faith developed an Islamic financial structure that can withstand turbulences in global economic systems, but they never thought that profiteering scholars many of whom now sit on numerous Sharia boards across the region and the world would hijack the system. This exclusive membership with its stringent rules has stalled across association with traditional investors looking to diversify their portfolios. An organized reform of Sharia boards will open the doors for contemporary scholars to bring about modern change in Islamic finance and reveal its true identity and excellent safety net against financial crisis.

One of the areas needing closer inspection is Sharia board accountability. Firstly, it is not accurate to say there is shortage of qualified Sharia board members. Graduates of 'Islamic Studies' may attain the qualifications necessary to sit on Sharia boards, but they ultimately find it difficult to crack that door open because the 'Old Guard' is protecting their personal interests under the self-propagated pretext of having the proper experience and qualifications. But ironically, it is they who most need to gain experience in the workings of a complex world economy; new blood is and remains the only hope for Islamic finance to become an alternative to the conventional system.

Education and Corporate Governance

It has also become clear that there is no program in place for educating and training the new generation of Sharia board members. Shareholders and clients of IFIs expect their investment to be protected by professionals adhering to strict standards of corporate governance. To protect the system from abuse and fraud there must be corporate governance in which the IFIs are directed, controlled, and forced to adopt structures and processes which incorporate the values of fairness, transparency and accountability.

The practical function of corporate governance is to put in place a system which will deliver a company's business objectives to increase shareholder value and offer efficient, accountable services to clients and the public at large, whilst managing risk. IFIs share the same practical and business objectives, but are subject to an additional layer of compliance with Shari'ah rules and principles. IFI objectives are not only to seek to offer Islamic finance services, but also to make a profit, but only in a socially responsible manner.

Sitting on a board demands competence and an understanding of both complex mathematic concepts and immutable Quranic tenets. With the current generation of board members ageing, education of the next is therefore a vital and urgent step in the process. The current system must be changed; there are enough brilliant minds throughout the Islamic world and global finance to make a difference. First, the most pressing remedial measure is to limit the number of boards a member can sit on to one, and attendance should be part of the deal. Second, board membership should not be a guaranteed job for life; members' continued employment should be dependent on biennial elections. Third, board members must have a noticeable effect on the bank's organisation; this can include product development and training. Fourth, corporate governance should be strengthened to include sharia board members' accountability, just as boards of directors are accountable. And finally, the veil of secrecy needs to be lifted on members' appointment, qualifications, activity and performance; relevant information must all be openly accessible and transparent.

Spread too Thin

Another problem with existing Sharia board membership is that such a small number of Sharia advisors are expected to serve an expanding sector. Instead of training new, young talent, the existing members are spreading themselves thinly around the world's sharia boards: more than 70 board each in several cases. Financial institutions use these 'celebrity' names in their marketing materials to boost the self-importance and supposed credibility of both parties. Inevitably, the decision-making process is being squeezed in terms of time and commitment because it would be impossible to give a reasonable amount of time to so many boards. Important decisions will go on being rubber-stamped until a major change takes place, and it will not happen from within as long as board membership is such a lucrative business.

So who has the power to change the system? Corporate governance of Islamic banking is torn between the Islamic banks' national central banks, and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Islamic Finance Services Board (IFSB) on the appointment of the Sharia board members. The IFSB recently produced a detailed draft on governance that has no mention of accountability, which sums up the state the sector is in and explains why many Western bankers see Islamic institutions as a risk too far.

Basel III Regulations and Islamic Banks

Many Islamic financial institutions are finding they already exceed the requirements with above-average Tier 1 capital (13% capital adequacy), strong customer deposits and much lower levels of leverage Islamic banks will not be looking for additional capital. In fact Islamic banks experience excess liquid cash that due to absences of suitable Shari'ah compliant products globally either long or short term investment. Basel III regulations will affect Islamic banks in the same way as with conventional banks. Basel III struggles to define liquid assets. The liquidity coverage and net stable funding ratios are intended to ensure that Basel III fills the gaps left by the previous Basel accord. But defining suitable liquid assets is proving difficult.

Islamic finance finds liquidity management solutions the launch of an International Islamic Liquidity Management Corporation is a step to resolving a long-standing weakness of Islamic finance, but there is still much work to be done. The issue of liquidity, Sukuk issuance popular liquidity instrument, to fulfill part of the gap in the market make Basil III compliance possible.

Islamic banks have not been spared by the global financial crisis; many were exposed to risky expansion plans and high-risk concentrations, in particular in the real-estate sector. Islamic Banks have limited exposure to the Global banking avoiding excessive risk in high-risk derivative products traded in the conventional banks. Most Sharia-compliant institutions have considerably higher capital adequacy ratios than conventional banks, which create credit risk problem. Islamic finance offers limited options to raise alternative forms of capital and so results in a lack of subordinated debt in Sharia-compliant form, as well as fewer preference shares. Islamic banks have limited use of derivatives and securitised structures affect their levels of capital adequacy, also, the lack of leverage in most Islamic banks means they will not be obstructed by the leverage ratio of Basel III.

The Basel III Committee's package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand periods of stress, bringing the total common equity requirement to 7%, Islamic banks are among the best capitalised banks in the world, and historically comply with inflexible standards of capitalisation. The structure of Islamic banking is simpler, more tangible and easier to understand in many ways, these attributes are strengthened by sharia boards headed by scholars who only approve new deal structures and business activities if they comply with sharia principles. Basel III is unlikely to fundamentally change the way Islamic banks operate, they have more immediate challenges, such as consolidation and increasing profits. However, for some Islamic banks, the regulatory framework will offer an opportunity to prosper and strengthen their position.

The Necessity to Find the Right Islamic Banking Model

The steady growth of sharia-compliant assets implies banks believe in the future of the sector. The steady growth of Islamic assets that The Banker's Top Islamic Financial Institutions survey has recorded is demonstration to the confidence that banks have in the future of the sector, but growth does not guarantee profitability. For local banks in Muslim-majority countries such as the Gulf States and Malaysia, Islamic banking has cultural and political imperatives which proved in many instances to be a positive variable both from the supply and demand side.

In that context, recent developments at HSBC, the largest global player in Islamic finance, are inauspicious. In October 2012, HSBC effectively shut down its subsidiary HSBC Amanah, which had been the second largest Islamic window in the world, with sharia-compliant assets of $16.7bn. The bank will continue to provide universal Sharia-compliant banking for clients in Malaysia, Indonesia, and in Saudi Arabia through Saudi British Bank, in which HSBC owns a 40% stake. Global Islamic wholesale banking and Sukuk capital markets, in which HSBC is the market leader, will still be offered through subsidiary HSBC Saudi Arabia. HSBC will retain majority of Islamic finance revenues at group level.

Conventional banking may have taken a battering recently, but it remains years ahead in terms of transparency, due diligence and legal adherence. Excessive and inappropriate activities do of course take place in conventional banks but if they are detected, the result to individuals and institutions can be dire. Islamic board members, accountable to no one, can continue with impunity so long as they remain within the laws of the lands in which they operate. As well as the economic impact of such a relaxed attitude, there is the risk that devout Muslims are being misled when they are told that their accounts are run with strict sharia adherence at the forefront.

In conclusion, does the Islamic banking sector have the nerve and the will to enact the massive changes necessary, given that the existing system is of immense benefit to the sector's narrowly based leadership? If enough serious thinkers begin to make them selves heard, perhaps the bankers will realise that the party is over. They will have to choose whether to be part of the change or to move on before the pace of change overtakes them. Malaysia sets Islamic finance example. Malaysia leads the world in providing a Sharia-compliant environment for savings and investment and in all other spheres of Islamic finance including best practices that of corporate governance and board membership. Certainly there is still a lot of room for improvement even in Malaysia, but the Islamic finance industry in the rest of the world needs to buck up before it misses that golden opportunity to be a real alternative to the conventional finance industry.