Living in perfect harmony

Despite its substantial growth in recent years, Islamic banking is facing challenges when it comes to deeper global market penetration. The solution, say these authors, is more consistency and harmonization.

The growth of Islamic banking has outstripped that of conventional banking in recent years with total Islamic banking assets crossing the US$1.5 trillion mark in 2013. The widely held expectation that this superior growth record will continue is understandable given that approximately one-sixth of the world's population is Muslim–most of which is based in the Middle East and Asia. Taking note of the demand, a number of western countries have recently started allowing Islamic banks to operate in their respective jurisdictions. The UK became the first leading western country to issue a government Sukuk (Islamic bond.) The first full-fledged Islamic bank in Germany was launched earlier this year; while Japanese regulators are considering issuing regulations that will allow Japanese banks to provide Islamic finance products in Japan.

Yet, despite the increased interest, Islamic banking penetration in non-Muslim countries has been slow as Islamic banks find it difficult to expand into different jurisdictions and face regulatory and Shari'a complications in terms of approvals. Islamic banks are also finding it challenging to cope with the evolving global banking environment and making appropriate rules and regulations to cope with these changes while still remaining competitive with their conventional counterparts. Additionally, the industry lacks consistency in product structures and investment practices that adversely affects its credibility, reputation, perception and regulation capabilities.

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The challenge

Islamic banks are essentially governed by their Shari'a boards–the religious scholars that deem a product Shari'a-compliant, or not. But the challenge is that there is no central authority promulgating Shari'a law, and the understanding of what is hence permissible and what is not varies among Islamic scholars and jurisdictions. The rapid growth of Islamic banking over the years has resulted in the introduction of complex banking products and structures, which now require Shari'a harmonization at a global level. At present, that harmonization is lacking. For example, the Islamic contract of *Tawwaruq* or Commodity *Murabaha* is only allowed by certain scholars. Similarly *Bai-al-dain*, or sale of debt, although disallowed by the majority of Muslim scholars, is allowed by some scholars in Malaysia. Recently a prominent Shari'a scholar concluded that approximately 85 percent of Sukuks in the market fall short of basic Shari'a principles.

While conventional banks have harmonized and approved regulatory standards that banks around the world follow, making it easier for them to expand and conduct operations in different countries, there are no approved standards *per se* for Islamic banks; they follow the conventional banking regulations.

But because Islamic banking differs from conventional banking, it is difficult for Islamic banks to completely follow these global conventional standards. For instance, the capital structure in Islamic banks is different from that of conventional banks. Because of the prohibition of interest, Islamic banks mobilize and utilize funds using Shari'a-compliant instruments or contracts that are not used by conventional banks and hence their capital structure primarily consists of Tier 1 capital only, while only a handful of Islamic banks have Tier 2 capital. Another differentiation between the two banking models is the bank's ownership of the asset: in Islamic banking contracts like *Murabaha*, Islamic banks have to own the asset for a period of time, a practice that is not required in conventional banking practices.

Industry response

The industry realizes this challenge and certain countries and governments have fostered the development of the Islamic banking sector. Countries like Malaysia, Bahrain, and Oman have developed separate legal and regulatory frameworks for Islamic banks to follow, while Qatar has aimed to separate Islamic banking from conventional banking by banning Islamic windows within conventional branches in the country. Other countries, like the United Arab Emirates (UAE) and Turkey, have been focusing on promoting the Islamic banking industry and are becoming centers of excellence. Yet despite these improvements, these countries have been working in isolation rather than collectively to address these issues. As a result, the industry still lacks a clear strategy and direction to help achieve its potential.

Nevertheless, the industry has taken certain steps; the Islamic Development Bank (IDB) recently echoed the need for a Global Shari'a advisory board that offers greater uniformity to the Islamic finance industry. Also, the Association of Shari'a Advisors in Islamic Finance (ASAS) was officially registered in 2011 with the objective of establishing a global entity to ensure professionalism among Shari'a advisors and experts in Islamic Finance. The aim of the Association is to "develop Malaysia as a reference center for Islamic financial transactions" and the country is working on the development of human capital in Islamic finance and is establishing the necessary Shari'a, legal, regulatory and supervisory frameworks. The success of such associations will rest heavily on individual governments and local regulators to enforce the standards within their jurisdictions.

Conclusion

It is imperative for the Islamic banking industry to focus on the development of products that foster market integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than concentrating only on its Shari'a compliance. Islamic banks need to invest in the research and the development of new products that are acceptable by a "Global Shari'a Board." At the moment, there is a

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dilemma as Shari'a opinion is diversified, leading to situations where one school of thought may approve a product or service as being Shari'a-compliant only for it to be rejected by another school of thought. A big step towards achieving harmony would be to set up a central board at a global level with representation from all different schools of thought.

For harmonizing standards and structures, the industry does encourage *ijtihad* in the global community through international conferences and convocations. Organizations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisations for Islamic Financial Institutions (AAOIFI) have been formed to recommend principles and industry best practices at global levels. However, these organizations unfortunately have no binding powers to implement their standards on the industry and they merely develop recommendations. If Islamic banking is to achieve its potential, it needs to be supported by governments and regulators. Most importantly, all aspects of Shari'a compliance need to be properly defined; ultimately the harmonization of Shari'a compliance is a critically important component to ensuring the stability, which is intrinsic to the Islamic finance model.

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