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Innovations in Islamic Finance 2015: The great dilemma of Islamic finance

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International banks used to dominate Islamic finance. But their desire to innovate risked the market straying from its principles. Local and specialist firms have benefited from their withdrawal. But can they take **Shariah**-compliant finance to the next level without repeating the mistakes of the past?

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It's an industry where asset growth regularly nudges 20% a year, but one that has been all but abandoned by many of the world's biggest investment banks.

It's a market that fosters innovation to an extent seldom found in any other area of finance – but where that same innovation can mean accusations of compromise and even deceit.

It's a school of finance with exponential growth in the number of people seeking to study it. But one where bottlenecks in qualification and experience curtail its whole outlook.

Islamic finance is all of the above.

The next World **Islamic Banking** Conference, in Bahrain in December, will be the 22nd; the next Euromoney Islamic Finance Summit, the pioneer outside the Islamic world, will be the 14th. We have all been talking about Islamic finance long enough now for it to be fair to take stock. How far has it come? Has it realised its potential? What challenges remain? And what must its direction now be?

"Compared to 15, 20 years ago, when people said: 'Islamic what?', we have made enormous progress, particularly in banking," says Daud Vicary Abdullah, president and CEO of Inceif, the global university of Islamic finance based in Kuala Lumpur. "We've got standards, we've got education, we've got a better level of common understanding. If you'd asked me 20 years ago, I wouldn't have imagined we'd have come so far.

"But looking forward, personally, I feel we've still got an awful lot to do."

Everyone is quite obsessed with the fact that it's becoming a $1 trillion industry, but in reality, that's less than 1% of global assets. We should be tackling the 99% who don't use Islamic financeDaud Vicary Abdullah, Inceif

Numbers on Islamic finance can be somewhat treacherous to pin down. For example, should the assets of the Saudi Arabian Monetary Agency, in one of the most powerful and pious Muslim countries of all yet investing in interest-bearing T-bills, be considered Islamic? But there's no question the industry has grown at an impressive clip for many years now.

According to Ernst & Young, international **Islamic banking** assets among commercial banks passed $778 billion in 2014; it projects that assets in six core markets – Qatar, Indonesia, Saudi, Malaysia, the UAE and Turkey – will hit $1.8 trillion by 2019.

That's without counting the special case of Iran; in 2013, when Iran was included in the survey, Ernst & Young said total **Islamic banking** assets with commercial banks worldwide were $1.54 trillion.

Global **Islamic banking** assets witnessed a compound annual growth rate of 17% from 2009 to 2013; in Indonesia, the figure was 43.5%, in Pakistan 22%; and the combined profit of Islamic banks (Ernst & Young

uses the appellation “participation banks”, which is partly to get around problematic definitions and semantics in secular Turkey) crossed $10 billion in 2013.

These are big numbers, no question, with clear momentum, but there is much more to do. “Everyone is quite obsessed with the fact that it’s becoming a $1 trillion industry, but in reality, that’s less than 1% of global assets,” says Vicary. “We should be tackling the 99% who don’t use Islamic finance.”

Clearly, though, there is immense growth potential. Which prompts the question: why have so many multinationals abandoned the field?

Consider this. At any of the innumerable Islamic finance conferences in the mid-2000s, one could more or less be guaranteed to see a familiar cast of characters onstage. The most likely would be a man who was not actually a Muslim: Geert Bossuyt, a Belgian who was the head of structuring for the Middle East at Deutsche Bank, a man with an equity derivatives background, who had brought his expertise to the arcane world of Islamic finance.

He might well have been flanked by his colleague Harris Irfan. A well-regarded conference might have drawn Iqbal Khan, CEO of HSBC Amanah, or Afaq Khan, his equivalent figure at Standard Chartered Saadiq; Ismail Dadabhoy, executive director of Islamic finance at UBS, would likely have been a fixture too, and for a couple of years you would have got Arul Kandasamy, head of Islamic financing solutions at Barclays Capital.

Why mention this? Because not one of those men is in the same job now, nor at any western conventional bank, and in many cases, the jobs themselves don’t exist anymore. Deutsche was a pioneer in Islamic structuring, the first international investment bank to be trusted to come to the holy city of Mecca to offer Islamic financing advice; for a period of three years it was a dealmaker and structuring brains trust without compare, even if some of its ideas, culminating in the deeply technical double wa’d, really did stretch the spirit of Islamic finance.

But in 2009, Deutsche shut the business down, though it remains a mainstay as an arranger on sukuk.

Bossuyt went on to the part-Deutsche-owned thinktank advisory group Dar Al Istithmar, which itself folded in 2013, and is now at a group called Khalij Islamic (tagline: 'Innovative Islamic finance').

Irfan, after Deutsche, wrote an outstanding book, Heaven’s Bankers, which chronicled the boom and decline of investment-banking fervour for Islamic finance, and recounted with considerable guilt the cheapening of its principles that sometimes took place, while remaining utterly convinced that there was a wonderful role that Islamic finance could play (which is just as well, since he’s now managing director of the European Islamic Investment Bank in London).

Iqbal Khan left HSBC, then run by Michael Geoghegan, who, it is said, couldn’t really see the merit in Islamic finance; some time after Khan’s departure, in 2012 HSBC dramatically slimmed its presence in Islamic finance in most markets, shutting down everything bar Malaysia and Saudi Arabia, though it remains the clear leader in sukuk issuance.

Afaq Khan saw through the good times and the bad and built probably the pre-eminent remaining international **Islamic banking** franchise at Standard Chartered, but announced his own departure, for undisclosed pastures, in March.

Dadabhoy left UBS in 2012, setting up his own Islamic finance advisory company, AIMS, in Dubai last year.

And Kandasamy, like many others, went local in the Islamic world after Barclays scaled back its Islamic business, at Abu Dhabi Commercial Bank and later 1Malaysia Development.

So they all left the western bulge-bracket investment banks to either go local, or boutique, or both. The big investment banks decided, typically during the financial crisis, that the business was non-core, or that not enough money could be made from it, and so they left. But why, if the prospects were so good?

HSBC Amanah had seemed the most committed, but Khan, who founded and built that business, and is now CEO of the private equity and advisory firm Fajr Capital, whose backers include Khazanah and the Abu Dhabi Investment Council, is sanguine about its exit today.

“The financial crisis, and the resulting regulatory framework that emerged, has made it very difficult for large global institutions to function in an unfettered way in areas that require a higher amount of capital,” he tells Euromoney. “When you talk about Islamic finance in its purest form, it is a hybrid structure between debt and equity instruments, and the more the hybrid shifts towards equity, the more the capital required by the conventional banks.”

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The geographical spread away from OECD markets is an added burden. “Each institution has its own journey in coming to Islamic finance, and each had to make rational decisions based on its internal priorities,” Khan says.

The biggest single challenge for Islamic finance is the lack of an **enabling** environment. We could have seen a young industry growing at 1,000% per annum if it had been properly enabledBadlisyah Abdul Ghani, CIMB Islamic

He continues to believe that international banks “have contributed hugely through the history of Islamic finance, and will continue to,” and argues that their exit was not about Islamic finance per se but a broader retrenchment.

“The model of large international banks flag-planting across 100 countries is being penalised by the market. The market is rewarding those banks making prudent use of their capital, and in that focused business Islamic finance will always be an addendum, an appendix, an add-on; never the core for most of the large conventional banks.”

But there’s a case to be made that the departure of westerners is to Islamic finance’s long-term good. Khan points to the opportunity for local banks, noting Abu Dhabi Islamic Bank picking up Barclays’ Islamic businesses in the UAE, and Meezan Bank buying HSBC’s in Pakistan. But there’s also a question of approach.

In Heaven’s Bankers, Irfan reflects on a crisis of confidence that perhaps beset many Muslims in the profession over the last decade.

“Although their skill base is critical to the industry, non-Muslim conventional bankers dominate the industry, and they care little for the essence of **Shariah**,” he writes. “The more the industry grows, the more it does so by an increasing compromise of its once core principles.”

One can make a reasonable case that Islamic finance, having flown in some troubling directions in the run up to the financial crisis, is ready to settle back into more familiar and conservative territory now that the rocket-scientist western structuring teams have retreated.

This might be just as well. Everyone can identify the moment when, for them, they realised the industry had just gone too far from its roots and principles.

Perhaps it was the Aston Martin financing in 2009, when Islamic finance embraced the leveraged buy-out? Maybe it came back in 2006 when Bahrain’s Khaleej Finance and Investment launched a capital protected (despite guarantees being unIslamic) fund called Optimum? For some, it was the arrival of the Islamic hedge fund – to many, a contradiction in terms, since one can’t sell something one doesn’t own in Islam – through **Shariah** Capital in 2008.

And for many the final straw was Goldman Sach’s attempt to launch a $2 billion sukuk, using an unloved structure called the tawarruq (a simultaneous purchase and resale of commodities on a metals exchange) and without any specification that the money raised would serve an ostensibly Islamic function.

Every scholar at some point found themselves either at odds with another scholar about a particular structure, or troubled about it themselves; it all came to a head with the Pakistan scholar **Taqi Usmani**’s 2007 comment (later clarified and amended) that as many as 85% of Gulf sukuk did not really comply with Islamic law.

Many feel the scales began to tip the other way when Malaysia’s $1 billion sukuk in 2010 would not be passed by its **Shariah** scholars – led by Nizam Yaquby, the most prevalent scholar of them all – until changes were made to documentation that in most previous years would have been passed without concern.

So are we now in a new age when innovation isn’t the point anymore? Where everything that needs to be done Islamically, can be done, and the focus is instead on bedding down what’s already there?

“When it comes to innovation, I don’t think it has stopped in the conventional space, so why should it in Islamic? It will always be a mainstay,” says Badlisyah Abdul Ghani, CEO of CIMB Islamic. “But in Islamic finance there is a lot of talk in regards to innovation, and sometimes that can cause us to lose the plot.”

That plot, he says, should be simple: making sure Islamic finance products are available for consumers, be they individual, corporate or institutional.

“So perhaps there is now a need to have the bigger emphasis on market penetration," says Abdul Ghani. "But you can’t forget about innovation, because without it you can’t penetrate the market.”

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Abdul Ghani has little truck with the idea that Islamic finance has come to be nothing more than a mirroring of conventional structures, cheapening the industry's principles. "My view is fairly straightforward," he says. "When the consumer asks for a particular financial solution, be it a savings account, a financing facility to buy a house or car or whatever, we will be required to provide that service in a way that is consistent with **Shariah**. If it appears, when it comes out, to be mirroring a conventional financial solution, to my mind it is completely a coincidence.

"The debate," he says, "is a waste of time. It doesn't serve society, and it provides a disservice to Islamic finance because it distracts Islamic finance from doing what is needed. The customer is king, and the customer gets what the customer wants, as long as it is consistent with **Shariah**."

Still, some believe there is scope to branch out in new directions.

"I don't think we should blindly follow what the conventional world does," says Vicary, who before Inceif was head of Islamic finance for Deloitte. "If it clicks and makes sense we should do it; we are mature enough as an industry now to make our own decisions based on our own research."

Vicary's mantra – he comes back to it several times in the interview – is the principle of risk sharing, and he believes more can be done to develop products that are "more about risk sharing than risk shifting. What instruments do we need to support that?"

In his view, thinking this way is essential to avoid being vulnerable to systemic shocks. "If we are doing things on the basis of: everything's debt-based so let's do the same and the next debt crisis will never happen, then we're being naïve."

In the absence of standards or guidelines, each central bank would go under its own interpretation to cater for Islamic banks. IFSB provided a reference for the industryRifaat Ahmed Abdel Karim, IILM

And where there is debt, **Shariah** requires that it remain anchored to the real world – the source of the sector's resilience through the financial crisis.

"**Shariah**-compliant banks have targeted businesses that are connected to the real economy: trade, development, housing programmes, infrastructure," says Tirad Al Mahmoud, CEO of Abu Dhabi Islamic Bank. "Given the events of recent years, it would seem debt that is linked to real assets and the real economy would be a more appealing structure if we are serious about avoiding another financial crisis."

But if Islamic finance is to go its own way, what, in practice, does that mean?

Ijlal Alvi is the long-serving leader of the Bahrain-based multilateral the International Islamic Financial Market, which seeks to standardize contracts and product templates for the Islamic capital and money markets. Necessarily, much of his work has involved some mirroring of conventional structures, to help the Islamic markets live with the conventional: published standards have included Islamic equivalents of swaps, hedging, repo and derivatives.

But not everything. "There are a number of transactions that are truly unique to Islamic finance, and there is a need to have more products with unique features," he says, citing wakalah and mudarabah as examples.

Others, too, think it's time to get past products that are technically compliant but with a certain lingering unease, to ones that are truly consistent with **Shariah** ideals.

"If product development is done on a cyclical basis, you give the low-hanging fruit priority over transformational products," says Iqbal Khan.

He uses the example of hedging. There's nothing unIslamic about wanting to mitigate the volatility created by risk, provided one doesn't veer into speculation. But the standard approach – creating a derivative product and overlaying it with a commodity programme to give it some link to the real economy – has always seemed a loose fit with **Shariah** principles.

"To me, there is another solution: risk sharing through takaful," the Islamic version of insurance, "creating less speculative products where risk and reward can be shared," says Khan. "It would be a great innovation but requires a huge amount of work, education and effort. The mindset has to be how can we transform the thinking to create products that are better and fairer."

One area of tension between what the industry needs, and what the industry can do without compromising its principles is in liquidity management.

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“The industry has always had surplus liquidity,” says Iqbal Khan. “The issue is the authenticity and integrity of liquidity management products. How can you make these products much more conducive and effective for economic growth in the real economy?”

The standard approach has been to use commodity murabaha, which have always caused a certain queasiness among scholars; in Khan’s view, these were approved by scholars as a temporary fix to managing liquidity, and “they were always expected to migrate eventually to an asset-backed, trade and commerce-backed form of paper, where the force of the surplus liquidity becomes a force of economic growth in the underlying economy.”

Alvi, too, notes “the issue of overreliance on murabaha, especially for liquidity management,” and would like to see it reduced. His favoured method is an instrument called the inter-bank unrestricted wakalah.

And the message may be getting through. In IIFM’s home base of Bahrain, the central bank in April launched a new liquidity management product based on the IIFM’s unrestricted wakalah standard document. It allows retail Islamic banks to deposit excess liquidity with the Central Bank of Bahrain, which is appointed as wakil (or agent) to invest the cash on behalf of the bank in a sukuk portfolio. At launch, the instruments will have a one-week duration, meeting a need for short-term placement of funds, and they may yet be followed by an overnight version.

This has a number of advantages.

“Commodity murabaha needs three parties: there is an actual sale and purchase of a commodity, so you need a commodity broker in the middle,” says Shaikh Salman Bin Isa Al Khalifa, executive director of banking operations at the Central Bank of Bahrain. “That can be cumbersome, and very difficult to manage in short-term contracts of one week or less. Wakalah is more flexible and involves no third party.” It’s also more palatable to scholars. “Commodity murabaha was developed in the 1970s as a means to invest excess liquidity, but it was not necessarily the best instrument," Al Khalifa continues. "In light of nothing else being available, scholars approved it, but did not necessarily like it. With the wakalah structure, feedback from the scholars has been much better.”

Probably the most ambitious multi-party initiative in Islamic finance to date has been the International Islamic Liquidity Management Corporation, envisaged in the wake of the global financial crisis in 2008 and launched in 2010. It has 10 shareholders – a host of central banks from Nigeria to Kuwait, Luxembourg to Indonesia, plus the Islamic Development Bank – which represents a degree of cooperation difficult to achieve in the diverse Islamic economies.

It, too, was invented partly as a way to wean the industry off commodity murabaha – which, in addition to its **compliance** questions, is not a tradable instrument – but mainly to provide an avenue for cross-border short-term paper. Even though the **Islamic banking** industry survived the financial crisis well, the smarter members of the profession – Bank Negara Malaysia governor Zeti Akhtar Aziz among them – recognised that this should not be mistaken for resilience, because Islamic banks could find it hard to liquidate assets in a hurry when they need to.

“Tradability is a very important issue,” says Rifaat Ahmed Abdel Karim, CEO of IILM. A $990 million issue in February was typical of a continuing programme of short-term Islamic paper from IILM, the closest equivalent to commercial paper in the Islamic world. “Because banks can offload them from their balance sheet when they need to, that helps with financial stability,” says Karim.

Yet IILM, for all that it represents the sort of foresight, preparation and cooperation that Islamic finance needs, demonstrates challenges too. Saudi Arabia, having been a founder, dropped from the IILM shareholders before its inaugural issue in 2013; no Saudi institution appears on the list of primary dealers anymore, and when asked if the paper is bought by Saudi institutions, Rifaat says: “I don’t know, to be honest.”

One leading Islamic banker, while acknowledging that IILM has fulfilled its mandate to provide liquid instruments for cross-border markets, adds: “It’s all about volume at the end of the day, and I don’t yet see much demand for IILM liquid assets.”

Nevertheless, progress has clearly been made, and it may prove to be just a question of time until the IILM becomes the true benchmark it really needs to be.

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At those Islamic finance conferences over the years, the handful of people who have not been talking about innovation or market size have usually been talking about harmonization or standardization. The dream is a simple unified set of values and standards to govern the whole Islamic finance industry.

“The biggest single challenge for Islamic finance is the lack of an **enabling** environment,” Abdul Ghani says. “We could have seen a young industry growing at 1,000% per annum if it had been properly enabled.”

This has always been supremely difficult, partly because of the need to keep pace with structural innovation in the industry, partly because the sophistication of individual markets varies dramatically, and because different Muslim countries have quite different views on **compliance**, with Malaysia and Saudi Arabia particularly distant from one another.

But is this still an issue?

“Some differences of opinion are extremely healthy,” says Vicary. He recalls in his Deloitte days about seven years ago studying the available outstanding fatwas and finding that 95% of all schools of thought were in complete agreement. “The lack of convergence is blown up out of any reasonable proportion," he says. "The debate is about the fine turning now.”

Vicary’s issue, instead, is with the starting point of the frameworks themselves. “We have made progress. But the crux of the issue is that the existing regulatory framework is based on a risk transfer scenario where banks act as intermediaries and lay risk off somewhere else. We need some fundamental changes in terms of regulatory understanding that there is an alternative method of risk sharing.”

For Iqbal Khan, the issue is not the formation of standards but coordination among the numerous institutions tasked with developing them. In addition to IIFM, there is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which develops standards around auditing, accounting, governance and **Shariah**; the Islamic Financial Services Board (IFSB), another standard-setting body, tasked with enhancing the soundness and stability of the Islamic finance industry worldwide; and then various other multilaterals and individual central banks that have an influence on the way frameworks are shaped, particularly in Malaysia, Bahrain and Saudi Arabia.

“How do we make sure these institutions work in a coordinated manner so we can create a framework that works in conjunction with the international framework?” asks Khan, who says the problem is made harder by central banks and regulators becoming increasingly parochial. “A lot of effort has been made by these groups but more needs to be done. There has to be a sense of urgency.”

As one banker puts it: “There is no global unified **Islamic banking** framework. It doesn’t exist.”

Those who have been at the coalface of Islamic regulation and standards see things differently. “I always look at it this way: without IFSB, what would have happened?” says Rifaat, its former secretary-general. “In the absence of standards or guidelines, each central bank would go under its own interpretation to cater for Islamic banks. IFSB provided a reference for the industry.”

The idea of an Islamic finance market trying to grapple with Basel II or III at an individual level without these principles is potentially chaotic, and certainly not conducive to cross-border activity.

Rifaat thinks IFSB is “far ahead on the curve”, and points out that it simultaneously serves as an equivalent of IOSCO, the BIS and an international supervisory group for insurance; he says it has “issued the fundamental core standards” and now needs to focus on specific issues, though he believes AAOIFI “will have to catch up if banks are to adopt a full set of accounts”.

The other unarguable obstacle the industry faces is over human resources.

“The biggest challenge, to me, has always been about people,” Iqbal Khan says. Inceif is a strong institution doing important work: not yet 10 years old, it has produced 830 graduates from over 70 countries at a masters or PhD level and has over 2,000 students on its books, the majority of them from outside Malaysia. But there’s only one Inceif and there need to be more.

“What we need is not one but many Inceifs across the world,” Khan says.

The biggest issue remains the shortage of **Shariah** scholars who not only have enough qualification in Islamic jurisprudence but the right experience of business and finance. As Abdul Ghani puts it: “We don’t just need someone who is qualified in **Shariah**. We need an experienced adviser with **Shariah** qualifications to provide us with immediate advisory capacity.”

A decade ago, six scholars appeared on such an overwhelming dominance of **Shariah** supervisory boards that it had the uncomfortable appearance of a cartel; 10 years on, the same names are just as important, but

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has a new bench of suitably experienced talent emerged? Perhaps in Malaysia, where it was forced to happen by limiting the number of roles scholars could perform, but not much elsewhere.

The verdict? For all of its momentous growth, Islamic finance today shows the same opportunities and challenges it did at the turn of the century. Great asset growth, but with so much further potential; a permanent tension between the innovative and the impure; a yearning for a unified framework; and just not enough people to get it where it needs to go – yet.

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