

## Examining the prerequisites of becoming the hub for Islamic finance

Jan 31 2008 Hari Bhambra

This article provides a brief examination of the Islamic financial services industry including the perceptions, misconceptions and the current questions of integrity that it faces. It will also explore the issues which face jurisdictions that have joined the race to become the hub for Islamic finance.

### The Islamic finance industry

When major financial centres hold numerous conferences on one common subject, one quickly acknowledges the significance of the subject matter concerned — in today's context that subject matter is Islamic finance. Across the globe at conferences hosted by practitioners, regulators and governments the topic of Islamic finance is high on the agenda, although the motivations for the drive and focus on this relatively new industry differs.

The drive to become part of the Islamic finance industry is heavily driven by the desire to penetrate a financial sector with a potential which has yet to be fully uncovered. The global Islamic banking industry is estimated at between \$800 to \$1trn with an estimated growth potential of 15 to 20 per cent per annum. No major financial centre should be seen without a significant Islamic finance market. From this perspective, the race is now on for a jurisdiction to become the global hub for Islamic finance.

There is a demand to penetrate this industry, although there is still a gap in terms of the knowledge and understanding of Islamic finance. There are a number of broad and generalised analogies with ethical finance and interest-free finance, both of which are too wide generalisations to provide a clear and accurate picture of the industry. In certain jurisdictions, such perspectives may lead to a distorted, almost artificial perception of Islamic finance, even in those jurisdictions that are part of the race to become the hub for Islamic finance.

### The race to become the hub for Islamic finance

Motivations behind the drive to become the hub can be summarised from two perspectives. One perspective is to provide another financial option in the form of a range of financial products that are structured to meet the underlying principles of Islam. The second perspective is that Islamic finance is, at this point, an industry based on Islamic wrappers for conventional products held together by mere semantics, as is the view expressed at conferences held in some established international financial centres. Given the pace of growth of the Islamic financial services industry, however, it is clearly a market segment that must be captured. The

perspective which is held clearly will influence the strategy of the relevant market to develop into an Islamic finance hub.

The main question to consider is whether the jurisdiction and the market leaders that will drive the creation of this Islamic hub need to believe in the legitimacy and purpose of Islamic finance. Considered in a different manner — can a jurisdiction which considers Islamic finance to be an industry based on Islamic wrappers and semantics provide a conducive infrastructure for the next period of growth in Islamic finance? It could take Islamic finance into a different direction which will eventually result in the removal of the association with the religion itself, i.e., with emphasis on the underlying features of the products rather than their basis in Islam, such as marketing the products as "ethical or moral" financial products which may lead to greater market penetration than is currently the case.

Indications of the growing appetite for Islamic finance among non-Muslims can be seen in other international markets, such as the US, where Islamic finance has been attracting nuns who are drawn to the ethical underpinnings of Islamic finance, i.e., investments denoted as "Halal". This initial appeal of Islamic finance has in some markets facilitated the growth of "Catholic" funds, i.e., funds which are consistent with Catholic principles, as seen in the US where a "Catholic Advisory Board" analogously supervises such funds. Greater market penetration and greater inclusion could be achieved through the emphasis on the ethical or moral aspects of Islamic finance.

### **Is Islamic finance real?**

Among some practitioners the question of whether Islamic finance is a real and legitimate industry is frequently asked. The perspectives of Islamic finance, particularly the negative perceptions, can often be linked back to the limited understanding of the underlying principles upon which Islamic finance is based. Many practitioners tend to focus on Islamic finance as representing emulations of conventional financial products. This is often a perception which has resulted from the overuse of conventional analogies to describe Islamic financial products, for example references to Murabaha and Ijara as Islamic mortgages.

These structures differ from each other and from a conventional mortgage. A conventional analogy is often the most efficient manner to describe Islamic financial products to a layperson and is often a starting point in explaining the Islamic financial services industry, however, a conventional analogy which is not entirely accurate may lead to a misunderstanding of the industry. The problem with Islamic finance at this point in time is not the purpose of this industry but the lack of understanding of it.

Some of these misunderstandings have emerged as a result of practitioners examining Islamic finance from a top-down perspective rather than a bottom-up approach, i.e., without understanding the root or underlying basis and principles which underpin this industry.

Islamic finance is drawn from the principles of Islam or Shari'a which prescribe a series of prohibitions and permissions in respect of dealings in financial matters. The core basis of Islamic finance is fairness, equity, transparency and social responsibility. These principles were introduced to prevent, inter alia, the exploitation through the imposition of penal repayment terms for lending practices, hence the prohibition on Riba (which has been generalised as a prohibition against giving and receiving interest, although it is much wider than just interest). The prohibition was introduced to prevent unfair indebtedness, i.e., to prevent borrowers facing ongoing repayment terms which would enslave borrowers to debt. Investments and trade are encouraged with emphasis on profit and loss sharing among participants — drawing upon principles of equity and fairness. Participants in ventures are equally entitled to profits but must also be equally exposed to potential losses.

These are some of the basic elements of Islamic finance that are often overlooked and a rather simplistic focus or common reference to conventional analogies are made in order to understand the relatively new Islamic structures. These conventional analogies can be correct, but often they are not which may further result in the Islamic financial services industry being misunderstood.

### **The emergence of Islamic finance**

Some of the current misunderstandings in respect of Islamic finance can be traced back to the manner in which Islamic finance emerged approximately 40 years ago. There was a reliance on and emulation of conventional products to form the basis of Islamic financial structures, and it is important that researchers, analyst and practitioners understand why this was the case. During the inception of the Islamic financial

services industry there was limited understanding or infrastructure to support Islamic finance. In the absence of an economic system which was based on or consistent with Islamic principles, limited understanding and know-how, much of the Islamic financial services industry emerged within conventional financial systems which led to the emulation of conventional financial products rather than the origination of "indigenous" Islamic products.

This position has recently led to debates about whether Islamic finance should be more accurately described as Shari'a-enabled rather than Shari'a-compliant given the dispensations, under the concept of Law of Necessity, permitted by the scholars to enable the products to be offered into the market from the perspective that a Shari'a-enabled product may be better than no Shari'a alternative product at all. Over the past four decades, however, there has been a steady drive by practitioners, such as RHT and certain lawyers in the Middle East, to move Islamic finance closer to the letter and *spirit* of Shari'a, by creating Islamic finance structures which are based on the core underlying principles of Islam. This includes greater focus on the social aspects of Islam as the growing demand for Shari'a-compliant microfinance has indicated.

### **The direction of Islamic finance**

In terms of the future direction of Islamic finance and the credibility of the industry, some eminent scholars have now raised concerns over the legitimacy of certain structures that have previously been offered as Shari'a-compliant structures in many markets, such as certain sukuk structures and the overuse of certain Shari'a-compliant liquidity management tools. Given such public pronouncements, those new to Islamic finance might be perplexed by such scholars' proclamations, in particular, those that may have been involved in the fatwa issuance process further raising questions of authenticity or the validity of Islamic finance.

Such public proclamations, however, should not be seen as casting doubt over the legitimacy of the Islamic financial services industry. In fact such pronouncements are demonstrative of the strong drive to move Islamic finance into a new era of legitimacy and raise greater and more accurate understanding of it. Scholars as well as certain practitioners are seeking to align Islamic finance more closely with its underlying principles, to widen the impact and benefit of Islamic finance to society, and to emphasise charity and social responsibility by those involved in the industry.

### **Critical success factors to become the hub for Islamic finance**

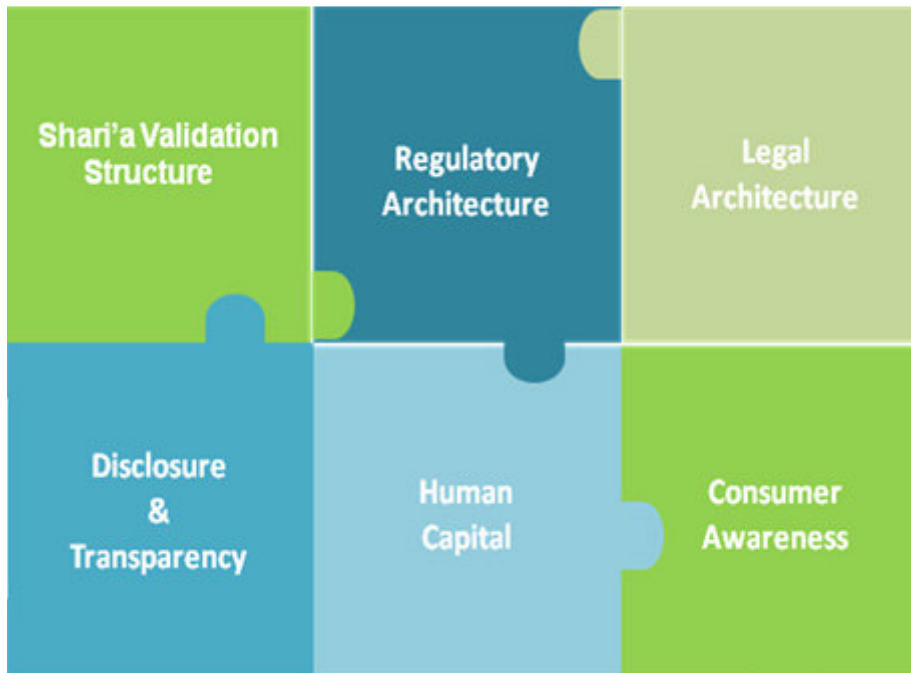
Returning to the issue of the jurisdiction seeking to become the hub for Islamic finance, there are a number of critical success factors that should be in place:

1. **Shari'a validation process.** Clear, well defined Shari'a validation/authentication process. To ensure customer confidence is maintained in the Islamic financial services industry, there must be a process for seeking and providing Shari'a approvals before products can be held out as being Shari'a-compliant and going forward to provide a conducive environment to develop a pool of Shari'a scholars.
2. **Regulatory infrastructure.** Clear, transparent regulatory framework for the regulation of Islamic finance which provides a level playing field across all participants, but also provides an appropriate regulatory model which successfully merges international standards with specific regulations to reflect the specific risks in Islamic finance.
3. **Disclosure and transparency.** Appropriate levels of disclosure and transparency of the Islamic financial products and services and clear disclosure of rights, obligations, risks and rewards, and appropriate levels of disclosure of the related fatwa.

4. **Legal infrastructure.** A sound legal framework including clear enforcement structure to address disputes that pertain to Islamic finance noting the case law and conventions on the use of Shari'a as a governing law provision. Such a framework should also be clear as to when a dispute will be dealt with as a commercial dispute and when finite issues of Shari'a become the subject of review.

5. **Human capital.** Practitioners involved in the industry must be appropriately trained to engage in the Islamic financial services industry. The jurisdiction concerned should therefore provide an appropriate infrastructure for the development of human talent in the field of Islamic finance.

6. **Consumer awareness.** To raise understanding and awareness of the Islamic finance industry is also a major component of any jurisdiction that wishes to become the hub for Islamic finance. Information about the products, the Shari'a process, the similarities and differences with conventional finance will all help to clarify the purpose, rights, obligations and risks associated with Islamic financial products.



#### So where is the 'hub for Islamic finance'?

Each jurisdiction which is part of the race to become the hub for Islamic finance will need to have a number of the critical success factors stated above. One such jurisdiction which already possesses a number of these critical success factors is a jurisdiction based in the Middle East, the Dubai International Financial Centre.

The DIFC has implemented an entire legal architecture based on a familiar Common Law system, with its own supporting court system. The DIFC also boosts the unique Shari'a Systems Model which incorporates a comprehensive regulatory system, as well as a Shari'a oversight structure, applicable across all types of financial institution (fully Islamic institutions or Islamic windows) thus ensuring a level playing field. The Shari'a Systems Model is based on international standards such as those of the International Organisation of Securities Commission, Basel, the Financial Action Task Force and the International Association of Insurance Supervisors, but has been modified to reflect the specific issues and risks in Islamic finance. The regulatory model is both transparent and promotes a level playing field, and avoids the complexities

associated with a "case-by-case" approach to the regulation of Islamic finance.

This unique model is based on the careful collaboration between international standards familiar to many financial institutions across the globe, and well defined Shari'a oversight or "authentication and validation" requirements which are familiar to those operating in Islamic financial systems, although easy to integrate into conventional compliance and business operations of international institutions. This will provide a truly global solution to Islamic finance.

The overall infrastructure of the DIFC including its legal, tax and regulatory architecture is conducive to Islamic finance. Significant initiatives are also underway to develop human capital in the field. The DIFC's position as the potential hub for Islamic finance is further strengthened by geographical and demographic fundamentals which may not exist in other jurisdictions.

## **Conclusion**

The motivations of each jurisdiction concerned will differ and will drive the development of Islamic finance in the relevant market. Arguably, the appetite for protecting the authenticity of Shari'a-compliant finance is more pronounced in Islamic jurisdictions and will continue to be the case. Strong regional hubs of Islamic finance in the Middle East, therefore, will continue to emerge, while other markets will focus on streamlining and standardising the Islamic finance structures to a position where the role of Shari'a scholars may become less integral to the structures.

There is clearly a demand for faith-based financial products, and among non-Muslims, the ethical basis of Islamic finance will continue to drive the growth of the industry. At this significant crossroad, however, Islamic finance must evolve more closely to its basis in Islam or face the potential that the Shari'a elements may become diluted and it will merely become another alternative form of ethical or moral finance. The cost of penetrating the global financial system may be that the very component of Shari'a becomes irrelevant.

The future of Islamic finance if developed more in line with the letter and *spirit* of Shari'a could provide social benefits to communities across the world, by providing Shari'a-compliant microfinance and even social development projects, to name a few. As to whether the jurisdiction which seeks to become the hub for Islamic finance needs to believe in the underlying legitimacy as opposed to just the growth potential of Islamic finance — it would certainly be a significant advantage in the race to become the hub for Islamic finance.

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