

Questions & Answers session with the experts



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Has the financial crisis affected Islamic finance?

I agree with Fajr Capital's CEO, who said that "when crises happen they impact all financial institutions – Islamic or conventional, to the extent of their exposure to those underlying markets." However, while quantitative impact of financial crisis was negative, its qualitative impact is quite opposite. Financial crisis had only reinforced those calling for ethical financial system and I am particularly happy to observe a growing consensus that Islamic finance deserves to be considered as a viable alternative to replace the current system.

Unlike many Western financial institutions, Islamic banks have remained relatively unharmed during the current global financial crisis. In fact, Islamic finance has gained a greater acceptance and more widespread recognition in recent years, as more and more Muslims and non-Muslims worldwide have taken an interest in Sharia-compliant banking products and services due to its more prudent investment and risk philosophy. In response, Islamic Banks are starting to open up in many countries across the globe, helping this segment of the financial industry to continue to flourish.

Islamic finance remained steady in this tough global economy primarily due to the nature of the industry. According to the laws of Sharia, the buying or selling of debt is strictly prohibited, as well as insurance and investment gains and excessive risk-taking. In other words, Sharia-law does not allow individuals or companies to borrow money that does not exist – it must be invested into productive enterprises. It is this more cautious attitude towards money that has kept Islamic banks relatively safer from the effects of the global financial crisis today compared to their conventional banking counterparts.

What are the advantages and disadvantages of working within the framework of Islamic rules?

When discussing the advantages of working within the framework of Islamic rules, I would like to detail them into systemic as well as individual ones.

When considering the systemic ones, I would like to recall Dr. Minsky – Nobel prize-winning economist, who argued that the modern finance was far from the stabilizing force that mainstream economics portrayed: rather, it was a system that created the illusion of stability while simultaneously creating the conditions for an inevitable and dramatic collapse. In this regard, I found particularly interesting results of a recent study conducted by two scholars from Ajman University, who concluded that Islamic banks outperformed their conventional rivals in terms of profitability, liquidity and earnings per share. Hence, application of Islamic rules may offer greater systemic/ macroeconomic stability.

When discussing the individual advantages, I find no better way than quoting from official Vatican's March 4, 2009 statement (published by Bloomberg) that "the ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service".

As for disadvantages, I would like to highlight the severe shortage of academic research as well as the industry-lead R&D, which only promotes further difference in (Shariah) interpretation and subsequently wrong application of various products. Both factors, when combined, lead to greater confusion among investors, which may be considered as the biggest industry impediment.

As seen by the continued growth of Islamic banking today, working within the framework of Islamic law can be extremely beneficial to financial institutions. The market's built in protection system and ethical form of banking are among the many advantages of complying with Islamic law. Unlike conventional banks, financing in Islamic banks is restricted to useful goods and services and debt is not incurred without true collateral behind it.

Islamic banks are also subject to greater scrutiny than conventional banks – needing to follow governmental regulations as well as the tenants of Sharia law. Not only are Islamic financial institutions monitored by the same regulatory bodies as conventional banks, but they are also under the watchful eye of their own Sharia Board, which must approve all products, policies and procedures as well as the bank's ethical banking principles. Obviously these checks and balances create additional work for the bank's operations. Additionally the restrictions on Islamic banks against investment in many sectors available to conventional banks, and against utilization of many investment vehicles may reduce profits short-term. However, these disadvantages are also advantages as they have prevented Islamic banks from venturing down the path that has recently brought many conventional financial institutions to ruin.

What needs to be done to improve the knowledge?

In my view, the knowledge of Islamic finance requires greater convergence among the various schools of thought. This can be achieved through dramatic increase in industry-lead R&D, which will also promote the depth within the subject of Islamic finance. More R&D will help in developing new products (beyond Tawarruq) and reducing confusion about their compliance with Shariah requirements.

I believe that academia has a special role to play in advancing the knowledge of Islamic finance, eradicating illiteracy within the industry players and educating the future members of Shariah boards. Designing more robust undergraduate, graduate and post-graduate level academic curriculums, including elements of Shariah law, will help.

Over the past few years, Islamic banking has increased dramatically; however, much more can be done in order to improve the knowledge of Islamic finance around the world. The first place to start is in financial institutions themselves. Islamic banks must invest in greater education of staff and management to allow them to become emissaries of Islamic banking to their customers. Having knowledgeable personnel familiar with Sharia-compliant banking products and services will provide reassurance to customers, and keep them returning to the Bank and spreading the word themselves to bring greater market share to those institutions. The best way to make sure that all employees are well-informed is to provide comprehensive training on standard banking policies and procedures, as well as the tenants of Islamic law.



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The Islamic finance along with its inherent structural framework which strongly establishes a link between over all economic activity, focuses lending on the basis of asset backing and higher transparency under the contracts indicate that financial crisis did not directly affect the Islamic finance however; it had indirectly affected Islamic financial institutions with varying degrees across the globe. The indirect effect of financial crisis is there since Islamic finance itself is an integral part of the global financial system. Islamic banking is the only banking system which has an inbuilt risk mitigation system which is not available with the conventional banking. Resultantly conventional banks primarily bear higher costs in identifying exposure related risks, risk mitigation and on resulting follow ups. On the other hand, Islamic banking minimizes different risks even at the initial stages of different financial transactions. We can have an easy and parallel comparison of three products namely Murabaha, Ijarah and Musharaka which may be typically employed for working capital and capital expenditure requirements. These involve an asset which reduces the underlying risks to a certain degree and makes the transactions acceptable and better rewarding for both parties


On the basis of my experience, I would like to make a point that working within the framework Islamic rules has different advantages without having any disadvantage. Rather it indicates few challenges which need to be resolved. Advantages would be:

- 1) Reference to banking activities, working within the framework of Islamic rules provides comfort for complying shariah as well as a frame work of unity.
- 2) Reduced risk of financial crisis in the financial markets due to better structural framework of Islamic finance. This will benefit the economic activity at large.
- 3) Increasing popularity of Islamic finance and Islamic banks being powerful means in mobilizing resources especially after recent financial crisis will reduce the chances of liquidity crunch for Islamic financial institutions all over the globe.
- 4) Islamic finance encourages development of sectors which are beneficial for humanity at large and discourages sectors which are destructive in nature for the society.

Disadvantages and challenges:

- 1) Islamic finance lacks financially engineered developed shariah compliant banking products which have resulted in tough competition with conventional banks on different frontal lines.
- 2) Lack of regulatory & legal frame work and prudential regulations for assuming risks with different Islamic banking transactions.
- 3) Lack of Shariah compliant techniques & products and marketing strategy which will allow financial institutions to operate in a two way financial intermediation functions.
- 4) Islamic finance lacks integrated marketing strategy to place a highly positive perception across the globe.
- 5) Unified consensus of different shariah scholars regarding acceptability of different financial instruments.

Followings can improve the knowledge regarding Islamic finance:

1. A paradigm shift regarding developing firm belief in Islamic Finance.
2. Bankers should be encouraged to develop structural framework know how of Islamic finance and different financial instruments.
3. Professionally designed integrated marketing campaigns to spread general know how about Islamic finance globally.
4. Allocation of certain portion of annual budget for research & development and interactive training courses for the staff.
5. Involving shariah division at the initial stages of structuring facilities which will result in improved knowledge base as well as shariah compliant banking.
6. Financial institutions should encourage their staff across all functional divisions to participate in annual dissertation competition backed by monetary benefits.
7. Islamic banking should be made part of university and college education which will help the next generations having concrete knowledge grounds. Further, Islamic financial institutions should finance different world renowned universities like Harvard University, LSC, Oxford and University of Pennsylvania for developing Islamic banking educational programmes which will provide an expanded avenue for marketing & acceptability in those regions as well as highly developed human capital for Islamic finance. 

Do you know what will happen
tomorrow?