The Dilemma Facing Islamic Finance and Lessons Learned from the Global Financial Crisis

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Abstract

In the aftermath of the recent global financial crisis, there has been an ongoing and renewed debate concerning the direction that the Islamic finance industry should be taking next. Amid the growth frenzy, the risk of noncompliance with Shariah is sometimes being ignored or underestimated, which has been tarnishing the industry's credibility, and may increase its vulnerability to ailments that have crippled the conventional financial sector.
Consequently, there has been a recent call for a "revolution", that is a speedy change, rather than a "slow-paced evolution" of Islamic finance, in light of the revelations of the crisis.
This paper examines ramifications of the crisis to Islamic finance in light of lessons learned by the conventional sector. An emphasis is placed on the area of managing and controlling Shariah risk. The role played by Shariah scholars in this respect is discussed.

Key Words: *Global Financial Crisis, Shariah Compliance, Islamic Finance*

I. Introduction

In the aftermath of the recent global financial crisis, there has been an ongoing and renewed debate concerning the direction that the Islamic finance industry should be taking next. Amid the growth frenzy, the risk of noncompliance with Shariah is sometimes being ignored or underestimated, which has been tarnishing the industry's credibility, and may increase its vulnerability to ailments that have crippled the conventional financial sector.

Some critics claim that "*Islamic finance has strayed from its roots*"; others view the industry as a "*copycat*" of conventional finance. One study by Haniffa and Hudaib (2007) found that some Islamic banks view *zakah* as a "tax burden" instead of treating it as a duty to fulfill one of Islam's five pillars; others were criticized for not being committed to maximizing "*halal returns*" specifically, while some were found to be using "*a combination of conventional and Islamic financing*".

There have been protests that Islamic finance has been taken over by large international finance institutions which are interested mainly in increasing their

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profits. Y-Sing and Richter (2010) quote Richard Thomas, chief executive of British Islamic lender Gatehouse Bank concerning threats which face Islamic finance in the wake of the global financial crisis *"the industry is in danger of dying in the cradle because it has taken poison in its food from conventional capital markets. If it's to thrive and prosper it has to do that on Islamic principles".*

Mirakhor, a former executive director of the International Monetary Fund and an influential industry expert has recently argued that if Islamic finance continues to rely on "*reverse engineered Islamic instruments*" it will become vulnerable to cycles and shocks that afflict conventional finance (Brown 2009).

The Islamic finance industry is being urged to develop products that are "*Shariah-based rather than Shariah-compliant*", and to pay more attention to "*substance rather than form*", in order to avoid being just a marketing fad. Such products would produce returns that are derived from the real economic performance of assets and should be based upon risk sharing.

Consequently, there has been a recent call for a "*revolution*", that is a speedy change, rather than a "*slow-paced evolution*" of Islamic finance, in light of the revelations of the financial crisis.

This paper examines ramifications of the crisis to Islamic finance in light of lessons learned by the conventional sector. **An emphasis is placed on the area of managing and controlling Shariah risk. The role played by Shariah scholars in this respect is discussed.**

II. Shariah Risk and Shariah -Compliance

2.1 The Key Objectives of Shariah

Justice and equity in society are key objectives of Shariah (Islamic law). A ban on earning interest (riba), selling debt, trading money, and speculation is meant to help fulfill those objectives.

Mufti Taqi Usmani cites Imam Al-Ghazali(1997) who had predicted nine hundred years ago, that earning interest on money without taking part in real economic activities would hamper the wellbeing of humanity which "*cannot be safeguarded without real trade skills, industry and construction.*"

Usmani also cites comments of the 1933 Report of Economic Crisis Committee, Southampton Chamber of Commerce, which discussed basic causes of that crisis and observed that "*it is desirable that [money] should cease to be traded as a commodity to ensure that it performs its true function of operating as a means of exchange and distribution*".

Thus Shariah's objectives and its prohibitions are consistent and above any doubt as the current crisis and past crises have demonstrated.

2.2 Shariah Risk

In recent years the Islamic finance industry has largely lost sight of the real reason for its existence, which is aiming to benefit society through abiding by God's laws, rather than "reverse engineering" or "Islamizing" conventional products that appear to be Shariah-compliant in form but have no actual Shariah-consistent substance.

The above debate has brought to the surface the main risk that faces the Islamic finance industry today, namely Shariah risk, defined by Bälz (2008) as *"the chance that an Islamic financing transaction is challenged on [the] grounds that it does not comply with Islamic law."*

There is a common misconception that Shariah law governs Islamic financing transactions, when in reality they are governed by English common law. Bälz (2008) points out a curious fact which is that in conventional finance the law normally serves to make the transaction enforceable in court, and provides transaction security. In contrast, in Islamic finance, "the role of the Shariah is reversed; Shariah is a risk, which allows the transaction to be attacked on the basis that it did not conform to Islamic legal principles" (Bälz 2008).

Shariah risk is encountered in product development and investment screening.

According to Bin-Ibrahim (2009), Shariah risk in product development, which we focus on in this paper, entails issues such as*"improper structuring of products that did not meet the Shariah tenets, poor process of implementing the product in the market place, and miscommunication by people who are involved in the whole process from product initiation until the post implementation product review"*.

To deal with Shariah risk, Bin-Ibrahim (2009) points out that management is responsible for understanding the objectives of Shariah; reviewing business processes and activities to ensure full Shariah compliance; identifying, assessing, systematically monitoring and controlling Shariah risk

Several court cases have recently gained attention where the Shariah-compliance of Islamic financial deals was challenged. Chance (2010) advises clients who enter into Islamic financing arrangements with Islamic financial institutions to request a copy of the fatwa which confirms Shariah-compliance as well as ensuring that documents include "an express waiver of any Shariah-related defenses".

III. The Stamp of Shariah-Compliance is Subject to a Sudden Renunciation

The Islamic finance industry suffers from a major threat, namely the fact that the stamp of Shariah-compliance may be reversed. A contributor to this problem is the fact that this crucial ‘stamp’ is increasingly being transferred to “Shariah-Consulting institutions”, instead of being solely the responsibility of Shariah scholars. Next we discuss examples of this concern.

3.1 Sukuks

In 2007 Mufti Usmani shocked the Islamic finance industry by announcing that 85% of non-Ijarah sukuk issues were not Shariah-compliant and had gone too far in imitating conventional debt. The sukuk market took a serious hit and as a result Ijarah-based sukuks came to the forefront. Since then, product developers i.e. bankers and lawyers have had to abide by Shariah standards when structuring sukuks.

AAOIFI is the Accounting and Auditing Organization for Islamic Financial Institutions, based in Bahrain, it helps set standards in the Islamic finance industry. Y-Sing and Richter (2010) report that in 2008 sales of sukuks declined 50% partly due to an AAOIFI ruling that prohibited borrowers from making an upfront promise to pay back the face value at maturity in sukuk-Mudaraba and sukuk-Musharaka contracts. The authors also report criticisms of sukuks’ fixed-income cash flows.

3.2 Tawarruq Munazzam

Y-Sing and Richter (2010) point out that in 2009 the Fiqh Academy, which is based in Saudi Arabia, issued a ruling banning Tawarruq Munazzam as a "deception", which shook the $100 billion commodity-Murabaha market. The instrument is considered to be a “*paper shuffle devoid of real economic benefits despite giving a semblance of a chain of asset sales*”. Consequently, the industry is considering Mudarabah and Ijara (rental-based) sukuk alternative instruments to Tawarruq Munazzam.

3.3 Kuwait’s Investment Dar and BLOM’s Wakala

Y-Sing (2010) cites the recent court case involving Kuwait’s Investment Dar and Lebanon’s BLOM Bank. A Wakala (agency arrangement) for Dar to invest $10 million on behalf of BLOM was disputed. Dar argued that it is not Shariah-compliant; hence Dar refused to pay BLOM its money back. The deal had been approved by Dar’s own Shariah board; the case is making investors distrustful of Islamic finance since an investment company can find a ‘loophole’ to challenge the Shariah-compliance of an agreement. This issue is discussed further in the conclusion.

IV. Concerns About Growth and Expediency Taking Precedence Over Shariah-Compliance

Alarabiya (2009) reports concerns about *“commercial expediency taking precedence over Islamic principles*”, as opposed to views that if Shariah scholars go in the direction of “*the most pure market*” there might be no market to speak of. We report two more opposing views about this debate.

Hawser (2010) quotes Abdel-Karim, Secretary-General of the Islamic Financial Services Board (IFSB), "*those Islamic financial institutions that pursued aggressive expansion may have neglected fundamental and sound risk management standards and violated their fiduciary responsibility toward investors*."

In contrast, Pavoni (2010) quotes Abdul-Malek, Chief Executive of HSBC Amanah who worries about being too strict in applying Shariah, "*there is no point in producing very strict shariah-compliant products if there isn't much demand for them*".

Saleem (2010) has the right answer about this controversy, he points out that Shariah-compliance should not be seen by Shariah scholars and Islamic banks as an end in itself; instead *“it should be understood as a supervisory process which also provides a moral compass for Islamic banks to increase their benefit to society.”*

V. Case Study of Growth superseding Shariah-Compliance: Recent Sukuk Defaults

Next we present recent cases of sukuk defaults to demonstrate concerns about growth superseding Shariah-compliance.

5.1 Sukuk Statistics

Asiamoney(2010) reports Zawya Research Group’s findings concerning the period December 1996-September 2009. There were 747 sukuk issues for a total amount of US$106.6 billion, most of them since 2002.

Benyon(2010) quotes Hussain, a partner at global law firm Eversheds *"of the big sukuk issuances in general, for which we can track ownership, about 40% of sukuk-holders are conventional institutions and not Islamic institutions,”*

5.2 Recent Sukuk Defaults

Siddiqui(2010) describes the sukuk market as having been the engine of the growth of Islamic finance during the petro-liquidity spike; he reports that the Western media viewed the recent sukuk market bankruptcies, defaults, and restructuring exercises as "*the beginning of the end of Islamic finance*".

Until recently the sukuk market had not been tested, since over 90% of issued sukuks are still outstanding. The recent defaults of some sukuk issues, such as Kuwait's Investment Dar and the restructuring of Nakheel sukuk issues in Dubai, have been a wake-up call mostly for investors i.e. sukuk holders.

The defaults have revealed that regulators, lawyers, and most disappointingly Shariah scholars, have not been able to keep up with the sector's fast growth rate, which has been driven mostly by abundant liquidity, thus they are all currently scrambling to answer questions by anxious sukuk investors.

5.3 Are Sukuks Certificates Of Ownership Or Debt Instruments?

Benyon(2010) quotes Eversheds' Hussain_"*there has been an inconsistent application of the principles of shariah*" in the case of sukuks.

Generally two types of sukuks exist, an asset-backed sukuk gives the investor fractional ownership and rights to an underlying asset, whereas an asset-based sukuk is linked to an asset and is backed only by the issuer's credit not the asset.

There is confusion among investors in asset-based sukuks concerning their rights to the asset in the case of default, as well as confusion concerning the identity of sukuks whether they are considered as **certificates of ownership or debt instruments**, the latter would obviously be preferred by investors in cases of default.

Asiamoney(2010) points out that in asset-based sukuks "*unless it's specifically stated in the documentation, a creditor's right is not typically to that cash-generating asset which is there chiefly to ensure Shariah-compliance but to the obligor's balance sheet, which can be a very different proposition*".

Asiamoney adds that while sukuks are supposed to be a tool for sharing profits and risks, there is currently an ambiguity concerning the obligation of a distressed "borrower" to continue to pay a "dividend" to an investor, i.e. the sukuk holder.

This is a clear example of a sector growing faster than scholars' ability to scrutinize its Shariah-compliance (we are not questioning scholars' willingness!). The current confusion highlights the fact that speed and expediency appear to be more important than accuracy and transparency in structuring Islamic products.

Some believe that recent sukuk defaults have been blown out of proportion. They see a bright side to these defaults, because creditors are getting a chance to discover any rights they may have to the underlying assets.

Hawser(2010) quotes IIFM's CEO Alvi (International Islamic Financial Markets, a market standardization body), that defaults in the sukuk market are good because they "*will give clarity to the market for the future, the defaults are unlikely to stop people [from]investing in sukuk and will in fact improve the product's sophistication level".*

Interestingly, some companies' credit risk is being confused with Shariah risk. Harris Irfan, Barclays Capital's Head of Islamic products, commented on worries over some defaults on Sukuk issues in 2009 and their impact on the Islamic finance industry. Irfan opines that although confidence was shaken, this was not because these products were Shariah-based instruments, but because "the credit of the companies that issued them was not very good, this was a commercial issue not a Shari'ah issue," (cited by Corbett 2010).

VI. Islamic Finance Amid the Global Financial Crisis

Prior to the current global financial crisis the conventional financial sector had expanded beyond the real economy as a result of *"indiscriminate lending, excessive risk-taking and overzealous financial innovation",* (Aziz 2009).

Alternatively, Yeoh (2010) believes that "*adverse macro-economic conditions, bad corporate governance and loose* regulatory *oversight*" caused the crisis. Both the public and private sectors have been accused of imperfect governance practices.

Islamic finance which prohibits interest, speculation, and debt trading has managed to escape the worst consequences of the crisis. Consequently it has been in the spotlight as a possible alternative financial system, particularly due to its emphasis on linking every financial transaction with an underlying productive economic activity, which promotes stability and job creation.

6.1 Recent Growth Statistics of Islamic Finance

A survey conducted by The Banker (2009) showed a healthy 28.6% asset growth rate at the top 500 Islamic banks in 2009 ($822bn), compared to a meager 6.8% in the top 1000 world banks.

The Statistical Economic and Social Research and Training Centre for Islamic Countries (SESRIC) reports that the Muslim world accounts for 7.6% of nominal

GDP. Recent figures indicate that Islamic finance represents only 1% of the global financial system, which predicts future growth potential for the industry.

6.2 How Was Islamic Finance Affected By The Crisis?

IFSL (2010) reports that while Islamic banks had a limited exposure to losses from investment in toxic assets they have not been insulated from the effects of the crisis and the subsequent economic downturn. The exposure to the bursting bubble of the real estate sector has resulted in some Islamic banks suffering a higher rate of non-performing loans than conventional banks. In addition, revenue, profitability, and liquidity were negatively affected in 2008 and 2009.

Some believe that Islamic finance did not totally avoid the crisis. Brown (2009) quotes Rushdi Siddiqui, Global Head of Islamic Finance for Thomson Reuters, he said in November 2009 that the credit crisis has "*flushed out the false premises and assertions of disconnect between Islamic banking and finance and conventional finance*"*.* Siddiqui points out that Islamic finance has been hurt by the crisis due to

"a series of financial setbacks among Gulf-based Islamic financial institutions(IFI's); the limited availability *of risk and liquidity management tools; excessive reliance on property and commodity assets" .*

Abdullah (2010) believes that "*Islamic finance's conservatism did not fully shield it from the ills of the economic crisis*", she quotes Ali, President of Jeddah-based Islamic Development Bank(IDB), "*the word immune is inappropriate here".*

Three factors have increased Islamic finance's exposure to losses suffered in the property and the commodity markets as a result of the crisis:

a. The limited universe of Shariah-compliant investment vehicles; a significant proportion of funds is allocated to real estate properties and commodities in Islamic investment portfolios.

b. Islamic finance requires transactions to be backed by real assets.

c. Heavy reliance on internationally-based mutual funds in Islamic wealth management.

Additionally, Islamic finance suffers from weak liquidity management tools; just as in the Western case, there were cases of intervention by commercial banks and central banks to limit the negative impact of declining liquidity, caused partly by the economic slowdown.

VII. Lessons from the Crisis

In this section we review lessons learned by the conventional financial sector from the crisis and we extrapolate these lessons to the Islamic finance industry.

7.1 The Need for a Uniform System of International Regulation

Evanoff and Moeller(2010) quote University of Chicago's Rajan, who believes that the origins of financial crises often lie in areas where regulators have little information or authority, thus *"the financial system and regulators must prepare for the worst-case scenario during good times".*

Greenberg (2010) believes that the world needs policies that target problems that have led to financial collapse. He adds that the SEC should regulate the creation of new financial products and hire regulators who are very knowledgeable about finance; hence higher compensation and continuing education of regulators are essential.

In parallel, Brown (2009) cites Mirakhor's opinion that "**the most important lesson**" of the global crisis for the Islamic sector is that *"it is in urgent need of a uniform system of international regulation, including a single Shariah authority, to remove the threat of potential instability"*. Mirakhor adds that the regulatory challenge is far more serious within the framework of Islamic finance than in the conventional system. Some believe that the influential Fiqh Academy is currently the closest thing Islamic finance has to a Shariah-regulatory body.

7.2 The Need for a Formal Risk Assessment Process

7.2.1 Systemic Risk Regulation in the Conventional Market

Greenberg (2010) believes that stabilizing the financial system in the long-term requires responsible risk-management mechanisms.

In the West there are current calls for creating a regulatory framework which would be responsible for a formal assessment process of systemic risk in order to foresee problems earlier and develop suitable measures that would prevent future crises.

According to Bennett (2010) there is a need for a new federal **systemic-risk regulator** who "*must work in tandem with the functional regulators of each segment of the financial services industry*". Bennett lists examples of **systemic risk** such as the risks created by excessive or rapidly increasing leverage, illiquidity and concentration.

Bennett also points out the regulator's supervisory responsibility over all segments of the financial services industry, and the need to "*eliminate regulatory arbitrage through the shifting of risk to unregulated or less-regulated segments*".

Managing risk requires forward-looking risk analysis and being proactive rather than reactive. Bennett (2010) recommends that risk management should involve discouraging the escalation of current minor risks, reducing the possibility of larger risks materializing, containing the impact of such risks and increasing the immunity of the system against harm. For risks that have already materialized the focus would be on containing the extent of losses.

7.2.2 Capital Markets Safety Board in the Conventional Market

Lo(2010) recommends the creation of a "Capital Markets Safety Board" (CMSB) which would investigate, report, and archive "accidents" of the financial industry. CMSB would be manned by forensic accountants, lawyers, and financial engineers who work together "*on a regular basis over the course of many investigations, a number of new insights, common threads and key issues would emerge from their analysis*". Lo believes that if CMSB makes its findings public, then investors would gain better insights when choosing investments and firms would be forced to improve their '*safety records'*.

7.2.3 Managing Shariah Risk in Islamic finance

In re-evaluating its regulatory infrastructure, the Islamic finance industry can use a '**Shariah-risk regulator' whose responsibility is to identify, measure, monitor and manage Shariah risk that impacts the whole industry.** One should recall the major negative impact of Usmani's ruling about sukuks in 2007, discussed elsewhere in this paper. Coming up with an equivalent to CMSB would be a good idea.

7.2.4 Managing Systemic Risk in Islamic finance

One area which has been ignored so far in Islamic finance is **systemic risk**; the interconnectedness of financial firms means that what goes wrong at one firm can harm the whole industry, as in the case of some firms' default on sukuk payments which has tarnished and slowed-down the sukuk market.

Goud quotes IDB's Ali "*the trend in the past was to focus on regulating financial institutions, individually, without sufficient attention to* ***systemic risk*** *and macro-level complications*". IFSB's Abdel-Karim supports this view "*we don't see the whole picture, and we need to see who's connected with what".*

7.2.5 Synergy between Risk Management and Other Divisions

Davis(2009) reports that in many [conventional] organizations, the divisions of " *risk [management], compliance [with regulations] and internal audit don't so much work together as compete - for resources, prestige and the attention of senior executives.* ”

Islamic finance needs to promote cooperation and synergy between **risk management** and the various other divisions, particularly external Shariah supervisory boards and internal auditors. Y-Sing(2010) reports that Malaysia’s Central Bank Negara(BNM) in its 2009 annual report required Islamic banks to set up Shariah review, audit and risk management control functions to reinforce compliance. According to BNM “*the framework aims essentially to strengthen the Shariah governance process, decision-making, accountability and independence*”.

Hawser (2010) cites IFSB Karim’s call for adapting existing international standards such as the Basel Accord to accommodate unique risks that face Islamic finance.

7.3 Re-evaluation of the Product Design and Structuring Processes

The conventional sector has been re-evaluating mistakes made in designing “weapons of mass destruction” such as CDO’s and CDS’s. Similarly, the Islamic finance industry needs to re-evaluate its product design and structuring processes to eliminate Shariah-noncompliance.

Critics believe that many Islamic financial instruments bear a strong resemblance with conventional instruments. They call for products to be Shariah-based i.e. abiding by the Islamic principles of risk-sharing and linking every transaction to the real economy.

Y-Sing and Richter (2010) point out that the crisis has intensified a push for Islamic finance to "*return to its roots*" and separate itself from conventional banking. However, they express concerns that radical reforms to the industry could make products less attractive to investors who have become less risk-tolerant.

The same authors quote Alam, JPMorgan's Bahrain-based Islamic Structuring Head, who cautions that a major shift in the industry might create uncertainty at this very time:

"the industry's move back to its roots will lead to a different approach to risk by the investor base. This shift to a different approach will change the landscape of Islamic banking. It will make it more challenging initially”.

Oakley (2009) believes that the crisis is already helping bankers to become more reasonable when adapting conventional into Islamic financial products. This is evidenced by the fading of "*excitable pre-credit-crunch talk of Islamic hedge funds*", having observed speculation's worldwide losses.

7.4 Re-Writing/Clarifying Islamic Contracts' Fine Print

Full disclosure and transparency are being emphasized in the conventional sector, with many stakeholders suffering huge losses mostly because of ambiguity and complexity of the products that have led to the crisis, and which have fooled even 'savvy' regulators.

This calls for re-writing the fine print in Islamic contracts. The Banker (2009) points out those creditors in some Islamic products such as sukuks are just now discovering their "privileges" as legal battles heat up over ownership and rights, with some issuers experiencing financial distress.

7.5 Calls for Consolidation among IFI's and/ or Acquisitions of Conventional Financial Institutions

There are current calls for consolidation in the Islamic finance industry, both intra-regionally and eventually internationally (Iqbal Khan, Fajr Capital CEO and a former head of HSBC Amanah, the British bank's Islamic arm, (cited by Wigglesworth 2009a). The reason is to benefit from economies of scale and to be able to compete with international players who dominate the industry with huge resources and divert it away from its objectives.

Others are calling for acquisitions of conventional institutions by IFI's in order to benefit from their know-how and distribution channels. However, Siddiqui (2010) expresses concerns that an Islamic mega-bank might pose *"systemic and confidence risk in the home country [due to] concentrated exposure without many compliant-hedging mechanisms"*

7.6 Regaining Control from Blemished Conventional Banks

Critics of Islamic finance's evolution to date believe that IFI's should be less passive in order to regain control from large conventional banks whose credibility and integrity have been blemished by the crisis.

Wigglesworth (2009b) believes that large international banks such as HSBC and Citigroup, have increasingly become the driving force behind Islamic finance. Western bankers and lawyers are often designing and structuring Islamic financial products, motivated by tapping into the petrodollar boom and gaining market share, with little if any genuine concern about meeting the objectives of Shariah.

The same source quotes Ricaud, head of Islamic finance at Rothschild as saying that because Islamic finance tried to imitate the conventional system too much, it has " *lost a bit of its originality and peculiarity, and is paying the price right now for having been taken over by conventional banks* ".

Shariah scholars and "**indigenous**" Islamic banks or IFI's should be proactive, in order to correct the recent trend which has resulted in the hasty development of some products that "*bend certain key precepts of Muslim jurisprudence to breaking point*", (Wigglesworth 2009c).

7.7 Re-Evaluation of Shariah Scholars' and Islamic Bankers' Compensation

According to Lemieux(2010) the compensation practices at conventional financial institutions have encouraged bankers to tolerate excessive risk-taking.

Lemieux adds that as a result of the global financial crisis, G20 countries have introduced measures "*to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking"*. Others recommend structuring management compensation such that ethics and long-term performance rather than risk-taking are rewarded.

Compensation in Islamic finance has also been a concern for a while now, with recent calls for paying Shariah scholars from a central pool rather than by financial institutions that retain them, in an effort to promote independence (Abozaid 2010).

As for Islamic bankers' remuneration, it is worth evaluating the impact of internal compensation systems on their risk-taking activities, particularly leniency in enforcing Shariah-compliance.

VIII. Is Islamic Finance A Viable Alternative to Conventional Finance?

Some believe that the global crisis is a golden opportunity for Islamic finance to present itself as a complement, if not an substitute, to conventional finance.

Warde and Gresh(2010) recently recommended that the USA administration should support the rise of Islamic banking and finance(IBF) in the USA as an alternative framework for finance to replace the broken financial system. They believe that IBF would bring greater transparency and accountability to financial regulation. They suggest measures that would promote IBF in the USA, *"tax incentives, new banking legislation that equalizes the playing field between conventional and Islamic banks*". They recommend more training initiatives within government regulatory agencies that improve knowledge about IBF.

Farooq (2009) in contrast believes that IBF largely overlooks the real sector; hence it is susceptible to problems that afflict conventional finance. IBF presently relies more on non-PLS modes, such as *murabaha*, *salam*, and *ijarah*, that are fixed- return-based and are structured in a virtually risk-free manner, instead of promoting transactions which are based on risk and profit-loss sharing (PLS) such as *mudarabah* or *musharakah*. Farooq suggests that IBF can better benefit humanity if it is "*appropriately linked to the real sector and embedded in an economy that is also based on Islamic values and principles and by being part of a mapped-out national approach and strategy*".

IX. Future Growth Outlook

Remarkably, the Archbishop of Canterbury recently opined that the spread of Shariah finance, if not Shariah law, now "seems *unavoidable*" (Hasan 2008), while Iqbal Khan believes that "*the gold mine for Islamic finance is at the lower end of clients, the growing masses of underserved Muslim customers*" (Wigglesworth 2009a).

Recent surveys show that only 14% of Muslims worldwide currently use banks, compared to 92% of US households, and 95% in the UK, hence a huge growth potential is projected for the Islamic finance industry if it succeeds in reaching the average Muslim client (Oakley 2009).

Hawser(2010) reports that as a result of the crisis, Islamic finance has spread to non-Muslim countries such as Sweden; in addition, a number of banks in Kuwait are converting from conventional to fully Islamic banks.

Pavoni (2010) discusses growing interest by non-Muslim investors in Islamic products, quoting Ayer, chief executive of CIMB-Principal Islamic Asset Management "i*n some of our funds, up to 35% of investors are non-Muslims and in others it's even 50%.".* Pavoni speculates that this interest may have been stimulated by Islamic funds' performance which have been negatively correlated with conventional funds, and he ponders about Islamic funds *"will [they] be used purely as an anti-cyclical measure or whether interest from the wider investment community will stick".*

However, one cannot safely generalize that there is a long-term negative correlation between Islamic and conventional mutual funds' performance. Interestingly, Ayer reports rising investor interest in Islamic products that provide capital protection (Pavoni 2010).

X. Final Recommendations

In this section we re-emphasize some of the aforementioned lessons and make additional recommendations.

10.1 Return to Shariah's Objectives

The expansion of Islamic finance beyond the Middle East and Malaysia will not happen as long as some people view it as a "*copycat*" of conventional finance.

Y-Sing and Richter (2010) quote Muneer Khan, Dubai-based partner at lawyers Simmons & Simmons *"according to some scholars, [Islamic finance] has moved too far in the direction of conventional debt, and equity-based financing has been left behind -- it's like a pendulum they want to swing back".*

However, some believe that the current uncertain environment may not be ideal for a drastic change.

10.2 Regulation

The Islamic finance industry is currently governed by a mélange of national regulators and standard-setting bodies. There have been recent calls for establishing an Islamic global regulatory body that presides over IFIs' operations. It would help issuers of securities cope with having "*to manage different taxation and regulatory regimes which limit economies of scale*" (El-Said and Ziemba 2009). It would facilitate cross-border acquisitions and marketing. However, Sheikh Delorenzo(2000) suggests that what is really needed is '*more specialized Shari'a supervision, or supervision geared toward specific sectors within the Islamic finance industry instead of a single central Shariah Supervisory Board'* .

10.3 Standardization

Some are calling for globally standardized documentation of financial products, although they warn of the risk of reducing creativity through over-standardization (Ghoul 2008, Hawser 2010).

There have been several recent examples of standardization efforts which are discussed next.

10.3.1 Tahawwut (Hedging) Master Agreement

In the area of **risk management**, IIFM recently drafted standard master agreements for Islamic finance structures such as murabahah and Tahawwut. In March 2010, IIFM and ISDA (International Swaps and Derivatives Association) launched a

Tahawwut Master Agreement; a news release announced that the agreement is a breakthrough in Islamic finance and risk management, and "*marks the introduction of the first globally standardized documentation for privately negotiated Islamic hedging products*", (News Release 2010).

10.3.2 Shariah Parameter Reference

Malaysia's BNM started an effort in August 2009 towards standardization and harmonization of the Islamic finance industry (Parker 2009). BNM issued the first in a series of Shariah references which are meant as guidance and reference to all IFI's, named "Shariah Parameter Reference 1" or *Murabaha* Parameter (SPR1), outlines the main Shariah requirements in the contracts and provides examples, methods and models for practical application of the contract.

10.3.3 AAOIFI Screening of Islamic Products

AAOIFI announced In February 2010 plans to shift its role and start screening Islamic finance products, "*product by product*" in the second half of 2010, in order to verify Shariah-compliance. Efforts will be made to balance harmonization of Shariah interpretation and banks' commercial interests. A committee of eight people including Islamic scholars, auditors, bankers and lawyers will conduct the screening (Reuters 2010).

10.3.4 Scientific Methodology in Shariah Discussions

As an alternative to standardization, Shariah scholar Elgari recommends adopting the scientific methodology in scholars' deliberations "*Shariah is a science. It requires methodology, and resolutions require peer review and market consultation.*" (Parker 2009)

XI. Conclusion

The financial crisis has served to expose weaknesses in IBF such as the issue of growth and expediency taking precedence over shariah-compliance when developing products. The lessons learned in the conventional sector were discussed and extrapolated to serve as a guideline for rectifying the roadmap currently followed by IBF. The "Islamic Finance and Global Financial Stability" report which came out in April, 2010 recommended that product development in IBF must be done within Shariah parameters and should aim to fulfill Shariah's main objective, which is "the realization of benefits to the people" (IFSB-IRTI-IDB2010).

Y-Sing (2010) reports allegations by lawyers that some banks may be sabotaging IBF by disclosing insufficient and selective information to Shariah advisers in order to *"speed up the approval process for products or push these experts for an endorsement within a short time after supplying them with complicated financial documents"*.

In what appears to be a response to the above issue, there was a recent announcement by Bank Negara in its 2009 annual report that it is tightening governance rules for IFI's which operate in Malaysia, by requiring them to have review functions that continuously monitor operations' Shariah-compliance(Y-Sing 2010). IFI's must have *"annual Shariah audits which would provide an independent assessment of compliance with established policies. The senior management is also responsible for ensuring that all submissions to the Shariah committee are adequately researched and supported by a* thorough *study on the Shariah issues, product structuring and documentation"*.

As for the question of Islamic finance serving as an alternative financial system, Hassan and Rasem (2009) opine that "Islamic finance has a built-in risk management mechanism that enables the global financial system to perform in an orderly manner and avoid such crises", however, the authors argue that in the absence of enabling institutions and lack of political will, "the main challenge facing the Islamic financial services industry is developing a mechanism that allows the salient values and merits of Islamic finance to be revealed to a global economy dominated by banking and finance".

We conclude with the aspiration that the next stage of development in Islamic finance will involve creating Shariah-based products that have no conventional equivalents. The acid test of Islamic finance's success and universality will be reaching a point when conventional institutions "conventionalize" indigenous Shariah-based financial products, as opposed to IFI's "Islamizing" conventional products.

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