CHAPTER 1

The Islamic Banking and Finance Industry

Potential global size of the Islamic financial services industry	US$ 4 trillion growing at 10% per annum
Actual global size of the Islamic financial services industry	US$ 1 trillion
The size gap	US$ 3 trillion
Growth rate	25%
Catch up parameter	11 years

1.1. Introduction

The ***real*** thing about Islamic finance is that it is not only about Islamic finance. Islamic finance is in reality a peaceful, non-political contribution to a wider set of efforts aimed at the renaissance of Islam as a modern religion that has to co-exist in the modern world, with a multitude of interdependence of communities and mutuality of faiths.

Islamic finance is certainly not an Islamist phenomenon, and has no political agenda of any kind at all. For suppliers of Islamic financial services - which include the likes of Al Rajhi Bank in Saudi Arabia, CIMB in Malaysia, Islamic windows operated by conventional banks like BNP Paribas, HSBC and many others - Islamic finance is nothing but a business opportunity.

For millions of Muslims around the globe, Islamic finance is not merely a fleet of products that follow a set of legal rules. The term 'Shari'a-compliant' is more comprehensive than what is presently understood in the current legalistic practice of Islamic banking and finance. The current size of the industry - **about US$ 1 trillion** - is small and far below its potential, because the real meaning of Shari'a compliance is either not understood properly or not implemented in its entirety. The consequent debate about Shari'a compliance is at best on nomenclature rather than on the substance of the matter. Terms like Shari'a compliant, Shari'a based, Shari'a observant and Shari'a friendly are smart inventions of the law firms and other service providers to the Islamic financial services industry; otherwise there is no significant difference between them if the nature of Shari'a is fully understood.

The growth prospects of Islamic banking and finance lie, inter alia, in proper understanding and implementation of Shari'a compliance. Shari'a represents much more than technicalities based on *riba* (interest in all its forms), gharar (contractual uncertainly in a legal context) and maysir (gambling). It is something deeper and higher, combining necessary conditions (like the aforementioned legal technicalities) with sufficient conditions (like requirements of moral correctness, equality of human beings and social justice). Further development of Islamic banking and finance depends very much on how the incumbent Islamic financial institutions and the new entrants implement conditions sufficiently.

Size & Growth

The Global Muslim population is estimated to be 1.6 billion.

The past and current growth in Islamic financial services industry (IFSI) can be attributed to strong growth in the Gulf Cooperation Council (GCC) countries and emerging markets and economies of Asia, coupled with an emerging youth-based demographic and rapidly growing population.

It is not a coincidence that Islamic banking and finance (IBF) grew rapidly during a period of high growth in the global economy. Exponential appreciation in the value of real estate all over the world created a class of 'the new rich' in many member countries of the Organization of Islamic Conference (OIC). The new Muslim rich brought a new demand pattern with them to the financial markets - seeking Shari'a compliant solutions on retail, investment and private banking financial services. This was distinctly different from the financial behaviour portrayed by the established class of the Muslim affluent and the rich.

Innovation and Growth

Although a number of political, economic, cultural, regulatory, environmental, ethical, market and tax related factors may play an important role in financial innovation, diversity of Shari'a views and opinions has been instrumental in Islamic financial innovation. This has led to a huge growth in some specific areas in Islamic finance.

Acceptance of murabaha as an Islamic financial contract has led to significant developments in retail, investment and treasury operations of Islamic banks.

The use of wa'ad as an acceptable financial tool led to the development of Islamic derivatives and structured products.

Most of the recent Islamic financial innovation stemmed from the mixing and matching of contracts. Shari'a compliant short-selling, for example, has been achieved by innovative uses of the contracts like salam, arbun and murabaha.

While there has been some opposition to what is perceived as excessive innovation in Islamic finance, the fact of the matter is that there is still insufficient innovation in the industry. It is true that most attempts to innovate in Islamic finance explicitly aim at replicating conventional products in a way that does not contravene Islamic law. While this in itself is important, it must be kept in mind that Islamic finance has other social dimensions as well, which ought to be considered when developing new products or assessing performance of the incumbent products in the market.

This report is divided into 10 SECTIONS, which are distributed over 27 chapters. Each SECTION visits an integral part of the industry, and gives the reader a snap shot of where this market segment is at the time of writing this report.

Following this introduction is **SECTION 2**, which contains a current exposition on Islamic retail banking, both from a common as well as a corporate perspective. **Chapter 2** starts with the basic principles of Islamic retail banking, and the early initiatives that were taken in countries such as Pakistan, Egypt and Malaysia. It elucidates the size of the Islamic banking market today and its projected expansion, while exploring what the principal drivers of growth are, and how much of the expansion in the market is accounted for by retail as opposed to commercial banking. Moving from an institutional focus to a product focus, this chapter then analyses the historical evolution of the market from simple deposits and loans, through to the development of takaful and investment products such as equity-based mutual funds, and the emergence of Shari'a compliant mortgage products. A comparison of Islamic and conventional products is made, with the evaluation that the absence in Islamic markets of excessively speculative products or those open to abuse safeguard investors, and may therefore become more attractive to non-Muslim as well as Muslim investors. **Chapter 3** focuses on the Islamic retail banking products in the GCC region. It has three subsections that cover asset and liability products, telephone banking and the website quality assessment of selected banks from the GCC countries.

The research in the chapter maintains that key players in the market are still relying on the few financial products which have traditionally been available to Islamic banking customers. Subsequently, a detailed assessment of features has been made in major product segments offered by the banks. This assessment is comparative in nature and provides a vivid description of the competitive position of Islamic banks in the region.

The section on telephone banking offering broadly covers the experience of customers during their interaction with the targeted Islamic banks. Finally the chapter provides a survey based assessment of the websites of different bank websites. It evaluates various aspects of website design and functionality and rates the banks in the sample group.

SECTION 3 covers Chapters 4, 5, 6, 7, 8, 9, 10 and 11 on Islamic Capital Markets. Chapter 4 gives an overview of the Islamic Capital Market, tracing its historical roots to the present day market operations. Chapter 5 starts with coverage of the size, drivers and history of the industry, and then looks at some of its centres of excellence, including Bahrain, Ireland, Malaysia and Saudi Arabia. Other areas include Shari'a compliant fund products, legal and regulatory issues (distribution, availability of scholars, interpretation of Shari'a boards and costs) and finally a comparison and contrast of Islamic and conventional finance products. This is followed by a critical review in Chapter 6 in the gap between the actual and potential size of Islamic asset management showing the disparity between what is and what could be in terms of total assets under management. For the first time ever the survey of the Islamic mutual fund industry provides an insight into managed Shari'a-compliant assets, and where it could go in the coming years.

The departure of Islamic asset management vis-à-vis its conventional counterpart is its adherence to Shari'a parameters of investing. The tools and latest developments that provide Shari'a compliant portfolios will be discussed in Chapter 7. Chapter 8 discusses the legal structures of Islamic funds in an important domicile for Islamic finance, which is Luxembourg. Chapter 9 and 10 deal with sukuk products. This is followed by a review of the sukuk industry and its important components. Chapter 11 deals with the major consideration applicable to Islamic Capital Markets products. This includes the legal form of investment vehicles, suitability of exchange, Shari'a and tax related issues.

SECTION 4 is the beginning of a discussion on Islamic

Investment banking, with an exposition of both Islamic project finance and Islamic private equity. While describing the size, growth and regional trends of Islamic project finance in Chapter 12, it also sheds light on the Shari'a and legal issues surrounding project finance. The following quote in the chapter, "It is now virtually inconceivable that a mega-project in the [GCC] region would be structured without a Shari'a-compliant component", gives the reader a taste of the massive progress this market segment has made in the last decade.

Chapter 13 looks to demystify Islamic private equity, and provide an overview of the traditional western GP-LP model and the "sell-down" approach employed in the Gulf. It also examines the leverage issue currently challenging the PE model. With the continued growth in the broader Islamic finance arena, coupled with the continued stock market volatility, the Islamic private equity market is also anticipated to grow.

SECTION 5 continues the theme of Islamic investment banking, with a study of derivatives and Islamic risk management products covered extensively in Chapters 14 and 15 respectively.

SECTION 6 gives an exposition of the Islamic insurance industry with its current size, growth and regional trend. It also details all the prevalent models currently used in the market.

SECTION 7 covers Islamic financial systems and Shari'a governance respectively. The banking industry has traditionally been a leader in adopting technology, and there are now hundreds, possibly even thousands, of pre-packaged software systems available to conventional banks to help provide efficient processing infrastructures. The introduction of Shari'a-compliant banking has changed some of the fundamental processing rules. Just how the banking software industry has responded and what are the characteristics of software packages that can meet the needs of Islamic banking will be discussed in Chapter 17 under Islamic financial systems. Chapter 18 begins with a review of the Shari'a governance structure in Islamic financial Institutions, and identifies necessary Shari'a requirements for the industry. It also records the growing pains in the area of human capital development, particularly in the training and preparation of Shari'a scholars. Scholars have quite unfairly been subject to serious criticisms, such as the high number of Shari'a board that some serve on; allegations of a lack of independence from firms that retain scholars; their very high compensation; the lack of consensus opinion among scholars leading to a divergence of interpretations; as well as hasty certifications of products. Rather than dwell on these allegations, the chapter presents pragmatic solutions to improve this facet of Shari'a governance in the industry.

SECTION 8 covers taxation aspects from both a micro and macro perspective. Chapter 19 tackles the taxation issues pertaining to Islamic products, while Chapter 20 takes into account cross-border Islamic finance transactions and their respective tax implications.

SECTION 9 covers important aspects of regulation in the industry. Chapter 21 looks at some of the regulatory challenges faced when introducing Islamic financial techniques into the highly regulated environment of the United Kingdom. This is a story of challenges that first had to be identified and then overcome. Using jargon-free language, the chapter explains some of the regulatory issues and discusses the solutions adopted to resolve them. It also makes some brief observations about the role of financial regulators in secular jurisdictions determining whether or not products are Shari'a compliant before spending a significant amount of time seeking to explain the role of English law in Islamic finance. The chapter recognizes that whilst English law may not be an appropriate choice of governing law in every instance, there are many cases where its historic flexibility and reliability do make it the sensible choice. In these cases, practitioners need to know how to make sure its application is ensured.

Chapter 22 focuses on the regulatory challenge for Islamic finance firms in North America, with comparisons made between the nuances in Canada, the United States, the Cayman islands off the coast of North America and non-American jurisdictions like Hong Kong. The greatest need in the North American retail market remains home financing. This chapter examines the challenges for home finance providers in Canada and the United States from a regulatory perspective, namely that banks are not allowed to own real estate unless it is under power of sale and that from a Shari'a perspective a murabaha-based product, which would not require ongoing title, cannot be refinanced due to prevailing market conditions. Given the regulatory challenges, the chapter also discusses some of the developments in "soft law": namely, the Shari'a guidelines that apply to mutual funds, which have been followed with great success, pre-and post-crisis, by the Amana family of mutual funds. Finally, the chapter alludes to what may pose the greatest challenge to Islamic finance firms in the future: national security scrutiny that runs parallel with the recent yearning for Middle Eastern capital.

SECTION 10 finally completes the report with an overview of Islamic banking related activities worldwide. Africa is covered in some depth, with sketches of those countries that would be well placed to start Islamic financial operations based on their current GDP and Muslim population. Similar sketches have been made of Islamic financial operations in Europe, North America and Asia.