

KEY ISLAMIC BANK

Zaher Barakat and Allen Merhej examine the major issues confronting the growth of the Islamic Banking sector

This year has marked another successful year in the record books for the Islamic finance industry. Islamic financial assets currently stand at between US \$600 and US \$700 billion and have been growing at 20 to 30 per cent per year over the past decade. Many industry experts estimate that the industry will exceed US \$1 trillion by 2010.

With fast expansion comes big risks and challenges. Due to its religious underpinning, the Islamic finance industry faces a unique set of challenges. As such, practitioners should be increasingly vigilant in order for the industry to stay on the right track and prevent it from derailing.

In this article, we shall highlight six broad challenges which in our view impede growth and have implications for different areas of the Islamic finance industry. We will focus on: 1) the new challenges in structuring the *sukuk* (Islamic bonds) which have suffered a setback after the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) issued a statement in this respect, 2) the alarming issue of fatwa shopping, 3) the importance of Shari'a auditing, 4) the shortage of Islamic finance experts able to handle the growing number of transactions while keeping the required high standards, 5) the lack of liquidity which can dramatically increase risks and 6) the challenges facing the Islamic structured products.

Sukuk Structuring

Prior to 2008, the *sukuk* market had been experiencing explosive growth. In fact, in 2007, the global market for *sukuk* had more than doubled and was on track to continue posting impressive growth.

However, this growth has noticeably slowed since the beginning of the year especially when it comes to the US dollar denominated *sukuk* and the primary market *sukuk*.

Many blame the slowed growth on the troubles in the world economy and the unfavourable credit market conditions, while others refer this setback to the recent statement on *sukuk* which was issued on 14 February 2008 by the AAOIFI. It is not a secret to say that the AAOIFI statement was driven by an article written by the Chairman of AAOIFI, Justice Taqi Usmani, who considered that most *sukuk* in the market are not Shari'a-compliant.

The AAOIFI scholars are trying to shift the *sukuk* industry from the asset-backed *sukuk* to the asset-based *sukuk* where the return of the *sukuk* holders is linked to the performance of the underlying asset rather than to the contractual arrangement in place between the *sukuk* issuer and the originator. Now, the main dilemma for the originators of *sukuk* is to find a low-risk high-yield asset which can be used in *sukuk* transactions. Moreover, the above-mentioned AAOIFI statement has declared the impermissibility of the purchase undertaking in the *sukuk* based on the *musharaka* (partnership), the *wakala* (agency) and the *mudaraba* (limited partnership) whenever such purchase undertaking consists of a promise to buy the *sukuk* at their face value¹.

Islamic finance practitioners are invited to consider *sukuk* structures which differ from previous structures and they should adhere more to the core concepts of the *fiqh al muamalat* (Islamic law of

transactions). This is getting more difficult as it is expected that the Islamic scholars are likely, prior to giving their fatwa, to scrutinize in much more care the structure of any potential *sukuk* in order to avoid any criticism from their peers. This is important and vital for the *sukuk*'s originator due to the fact that issuing a fatwa by Islamic scholars is the cornerstone of any Islamic banking or capital market product.

Fatwa Shopping

The fatwa issue leads us to discuss another key challenge facing the Islamic finance industry, which can be termed as 'fatwa shopping' and the harmonization of fatwas.

At present, there is no ultimate authority or a single organization that governs the Islamic finance industry globally, nor is there a set of universal rules and guidelines regarding Shari'a interpretation. As such, each Islamic bank has its own Shari'a board which oversees and verifies conformity of the banks practices with Shari'a law. These boards can consist of a number of Shari'a scholars; however, due to the limited number of scholars who are well versed in both finance and religion, the Shari'a boards tend to be overburdened and the approval process unpredictable.

From this backdrop, the fatwa shopping can be described as the procedure by which a financial institution seeking a fatwa on a financial product contacts the scholar whom they assume will consider such a product as Shari'a-compliant and subsequently grants them the fatwa. This is similar to what is known in legal terms as 'forum shopping', where an individual tries to get its legal case heard in the court thought most likely to provide a favourable

¹ The full text of this statement can be accessed on the AAOIFI Web site www.aaofii.org.

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judgement without taking into consideration the rule of conflict of laws which says that the litigation should be heard by the jurisdiction that has the most ties with such litigation.

Fatwa shopping is a threat to the Islamic finance industry because it works against the harmonization of the fatwas. Such harmonization is required in order to minimize complexities and execution difficulties and to decrease the cost of structuring Islamic financial products thus providing more people with access to such products.

Furthermore, fatwa shopping increases the inconsistency between Islamic financial products, leading consumers and investors to be uncertain regarding the Shari'a compliance of the offered products and gradually leading them to lose faith in Islamic finance as a whole.

Shari'a Auditing

Shari'a auditing is another challenge facing the Islamic finance industry. This subject is still largely underdeveloped and its importance is not fully recognized by industry players whether Islamic banks, Islamic finance professionals or Islamic investors.

Institutions involved in the Islamic finance industry are required, according to their by-laws and the AAOIFI standards, to conduct at least on an annual basis Shari'a auditing. However, as the subject is still not fully developed the problem arises when trying to see what Shari'a auditing entails. Recognizing this problem, last year the AAOIFI launched a certificate entitled the 'Certified Shari'a Advisor and Auditor Certificate' in order to enhance Shari'a auditing knowledge and encourage Islamic

banks and other institutions involved in this industry to use the services of professional Shari'a auditors. However, the courses and materials are in Arabic, thus limiting its benefits to Arabic speaking persons only. Nevertheless, it is important to note that the majority of scholars have excellent command of the Arabic language.

Shari'a auditing can be divided into two types of auditing, the first type is financial Shari'a auditing and the second type is the procedural Shari'a auditing.

- 'Financial Shari'a auditing' is auditing conducted by professional accountants to ensure that the entries of financial operations in the books of the Islamic financial institutions were performed correctly and according to the Islamic accounting standards (and the relevant GAAP). This auditing is in many ways similar to conventional auditing in terms of giving a historical 'snapshot' of the financial situation of the relevant Islamic financial institution. The AAOIFI have issued Islamic accounting standards in order to guide Islamic financial institutions and their accountants on conducting the book entries of Islamic financial operations.
- 'Procedural Shari'a auditing' is the auditing conducted by the Shari'a auditors to ensure that the financial operations performed by the Islamic financial institution are Shari'a-compliant and that they have been performed in accordance with the fatwas and the directions of the SSB (Shari'a supervisory board). For example, in the event that an Islamic bank is offering a *murabaha* product to its customers for the purpose of buying cars, the Islamic

bank should, in order to be in compliance with Shari'a, purchase the car (from a dealer) before it can sell it to the customer. An employee of the bank may, deliberately or accidentally, sell the car to the client before such car has been purchased by the bank. The mission of the procedural Shari'a auditor is to find similar procedural Shari'a mistakes, to instruct on their prevention and to supervise the effective implementation of the fatwas issues by the SSB.

Procedural Shari'a auditing is a new type of auditing which can be assimilated to the scope of work of the 'compliance officer' in a conventional bank. This type of auditing is required in order for Islamic financial institutions to ensure that their operations are conducted in compliance with the Shari'a principles (or more accurately in accordance with the directions of their SSB). This compliance is audited and certified by the Shari'a auditor who in turn should report to the SSB.

Procedural Shari'a auditing should be conducted at an internal and an external level. These two levels of Shari'a auditing are essential to ensure that it is properly conducted. It should be mentioned that the two levels of Shari'a auditing are parallel and similar to the two levels of auditing in conventional auditing.

Internal Shari'a auditing can be conducted by an employee of the Islamic financial institution or by an independent Shari'a auditor requested to perform this task. External Shari'a auditing is conducted by an independent external Shari'a auditor who can also be the one who is conducting the internal Shari'a auditing. ▶

At present, there are no codified rules, issued by a governmental or non-governmental body, detailing how the procedural Shari'a auditor should proceed. This is a challenge facing institutions operating in the Islamic finance industry and Shari'a auditors. In fact, the procedural Shari'a auditing is still a profession 'in the course of making'. In 2007, the AAOIFI launched the 'Certified Shari'a Accounting and Auditor' course to encourage faster development of the procedural Shari'a auditing.

Procedural Shari'a auditing should exist at the pre-financing and post-financing levels. It should exist during the lifetime of any Islamic financial operation. Procedural Shari'a auditing is required in order to ensure that Islamic funds are being invested in and profits are generated from a *halal* project.

In our opinion, procedural Shari'a auditing holds more reputational risk than financial Shari'a auditing as it confirms that the operations that consumers are usually aware of (ie, mainly the retail operations) are being performed in compliance with Shari'a.

In the event an audited transaction was found by the Shari'a auditor to be not fully compliant with Shari'a, then profits from such a transaction would be given to charity as they cannot be kept by the Islamic financial institution, or distributed to its shareholders as dividends. Poor internal Shari'a auditing would not only affect profits of Islamic financial institutions but would also increase reputation risk and ultimately destroy shareholder value.

Shortage of Experts in Islamic Banking

The rapid growth of Islamic banking has meant that the industry has not been able to produce enough experts needed to support this growth. At present, many professionals interested in working in this industry have not had enough time to gain the required experience to enable them to competently manage or advise on Islamic financial transactions. The shortage of Islamic finance experts is affecting, at different levels, the growth of the industry.

The issue in Islamic finance is that Islamic bankers need to be experts in conventional finance and also well versed in physical trading of commodities and different aspects of Shari'a. In order to be an expert in the field, practitioners should be expert in their field of business from the conventional side and should also have strong knowledge of Shari'a and particularly of Islamic law of transactions (*Fiqh al muamalat*). Professionals with this dual qualification are hard to find, although the number of 'newcomers' in Islamic finance is steadily growing. It is certain that with time the industry will self-feed itself but until this time comes we will keep seeing movement of professionals from conventional finance to Islamic finance. However, there is a big risk that newcomers, with only basic knowledge in Shari'a and Islamic finance, may threaten the industry as they will tend to 'bend' the rules and overmarket themselves.

Moreover, a common mistake that newcomers to the industry make is that they either try to outsmart Shari'a scholars by replicating, in a Shari'a-

compliant package, the conventional products or by 'recycling' the structure and the documentation of the conventional products, thinking that labelling the products as Shari'a-compliant will render such products Shari'a-compliant. Others think that they can work in Islamic banking because they have good Shari'a knowledge forgetting that *fiqh al muamalat* is something that you only know by specifically studying it, as *fiqh al muamalat* forms only a small part of Shari'a rules (where the remaining Shari'a rules are rules relating to non-commercial practises).

Liquidity Risks

One of the main principles in Islamic finance is the concept of profit and loss sharing². Under Islamic banking, financing activities must always be backed by tangible assets, whereas in conventional banking, the financing activities can be carried out back-to-back without being backed by assets.

In general, Islamic assets are predominantly long-term and relatively illiquid. At present, this does not present a problem as the majority of the Muslim countries are flush with cash. However, under normal market conditions, the mismatch between the duration of assets which are long-term and illiquid and the liabilities which are short-term can present serious challenges as was evident from the liquidity squeeze that faces western banks and has resulted in serious failings and near global financial meltdown.

This liquidity risk is especially serious for the Islamic finance industry as the Shari'a-compliant repo market is virtually non-existent and Islamic banks may face numerous restrictions when tapping inter-bank instruments. In addition, this challenge causes banks to run an overly liquid balance sheet, thereby sacrificing profitability and ultimately destroying shareholder value.

Islamic Structured Products

Where conventionally structured products are relatively straightforward, similar Islamic financial products tend to be more complex. Shari'a compliance often leads to additional requirements in the structuring process which in turn leads to higher transactions costs. However, a combination of ingenuity and persistence has enabled the industry to conquer many inherent obstacles. This has created an industry that is growing steadily and products that are in constant evolution.

Nevertheless, the industry is still facing a shortage in short-term investment products. In the GCC and Europe, the commodity *murabaha* financing (also known as *tawarruq*) is the most widely used short-term financing instrument. Some Islamic banks have tried to structure alternative products, but they were faced by their inability to generate assets caused by credit ratings and liquidity issues relating to their balance sheet.

The market has recently seen some Islamic structured products which artificially incorporate more than one Shari'a-compliant mechanism into one single Islamic product in order to replicate

² The principle of profit and loss sharing can be found in the legal maxims of the *Majalah Al Ahkam Al Adliyah*.

the economic effect of a conventionally structured product. For example, the market has seen a swap mechanism which was incorporated into an Islamic structured product in order for the Islamic investor to swap its return deriving from a Shari'a-compliant underlying investment by a return deriving from an investment which is not Shari'a-compliant. From the face of it, the underlying transaction of these Islamic products are Shari'a-compliant when taken separately, but when looking at their economic effect one can see that they are not Shari'a-compliant. These so-called Islamic products are Shari'a-compliant in their form but not in their spirit. Such products should be severely reprehended by the scholars and industry practitioners in order for the market to evolve in the right direction at all times. Such direction should be guided by the spirit of Islam and the values behind Islamic finance.

Maxim number 2 of *Majalah Al Ahkam Al Adliyah*, which is the first written codification of the *fiqh al muamalat* considers that meaning should be given to the purposes and spirit of the text and not for its wordings.

Conclusion

Due to its religious underpinnings, the Islamic finance industry faces a set of unique challenges. The above-mentioned points are only a handful. As more experts join the ranks, the industry players should carefully consider the challenges and develop processes to consciously improve every aspect of the industry.

Unlike conventional finance, the success of Islamic finance depends on satisfying both faith and economics. As such, industry stakeholders are invited to share their knowledge between each other and to have a better communication with the scholars. In addition, it is crucial to remember at all times that the purpose of Islamic finance practitioners is not to 'replicate' in an Islamic way, the conventional finance products but to 'create' new financial products which appeal to Islamic banks and investors, even if this means slower growth. ■

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