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Islamic Finance Gears Up

[Mohammed El Qorchi](#)

While gaining ground, the industry faces unique regulatory challenges

Islamic finance is developing at a remarkable pace. Since its inception three decades ago, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries. They are concentrated in the Middle East and Southeast Asia (with Bahrain and Malaysia the biggest hubs), but are also appearing in Europe and the United States. Total assets worldwide are estimated to exceed \$250 billion, and are growing at an estimated 15 percent a year (although cross-border data remain scarce).

Islamic financial products are aimed at investors who want to comply with the Islamic laws (Sharia) that govern a Muslim's daily life. These laws forbid giving or receiving interest (because earning profit from an exchange of money for money is considered immoral); mandate that all financial transactions be based on real economic activity; and prohibit investment in sectors such as tobacco, alcohol, gambling, and armaments. Islamic financial institutions are providing an increasingly broad range of many financial services, such as fund mobilization, asset allocation, payment and exchange settlement services, and risk transformation and mitigation. But these specialized financial intermediaries perform transactions using financial instruments compliant with Sharia principles.

What are the reasons behind the recent growth in Islamic finance? One is the strong demand from a large number of immigrant and nonimmigrant Muslims for Sharia-compliant financial services and transactions. A second is growing oil wealth, with demand for suitable investments soaring in the Gulf region. And a third is the competitiveness of many of the products, attracting Muslim and non-Muslim investors. Yet despite this rapid growth, Islamic banking remains quite limited in most countries and is tiny compared with the global financial system. For it to take off and play a bigger role, especially in the Middle East, policymakers must tackle enormous hurdles—notably on the regulatory front. Islamic banking has so far been spared from a serious financial crisis, with the exception of a few small cases (such as the Dubai Islamic Bank in 1998 and Ihlas Finans in Turkey in 2001). Nevertheless, building confidence in a new industry is fundamental for the development of Islamic finance.

What is Islamic financing?

The fact that Islamic laws prohibit paying and receiving interest does not imply that they frown on making money or encourage reverting to an all-cash or barter economy. They encourage all parties in a financial transaction to share the risk and profit or loss of the venture. Depositors in Islamic banking can be compared to investors or shareholders, who earn dividends when the bank makes a profit or lose part of their savings if the bank posts a loss. The rationale is to link the return in an Islamic contract to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth.

Islamic financial instruments take the form of contracts between providers and users of funds to manage risk. On the asset side, Islamic banks engage in investment and trading activities according to the various contracts available (see box). On the deposit side, funds are mainly mobilized on the basis of a *Mudaraba* contract or an interest-free loan contract (*Qard Al Hasan*). Overall, Islamic banks offer their depositors four classes of accounts: current, savings, investment, and special purpose investment accounts.

A range of Islamic financial instruments

While the main types of Islamic financial instruments are

conceptually simple, they may become complicated in practice as some banks combine aspects of two or more types of instruments to suit customer requirements.

Debt instruments include *Murabaha*, a purchase and resale contract in which a tangible asset is purchased by a bank at the request of its customer from a supplier, with the resale price determined based on cost plus profit markup; *Salam*, a purchase contract with deferred delivery of goods (opposite to *Murabaha*), which is mostly used in agricultural finance; *Istisna*, a predelivery financing and leasing instrument used to finance long-term projects; and *Qard al-Hasan* (benevolent loan), an interest-free loan contract that is usually collateralized.

Quasi-debt instruments include *Ijara*, a leasing contract whereby a party leases an asset for a specified rent and term. The owner of the asset (the bank) bears all risks associated with ownership. The asset can be sold at a negotiated market price, effectively resulting in the sale of the *Ijara* contract. The *Ijara* contract can be structured as a lease-purchase contract whereby each lease payment includes a portion of the agreed asset price and can be made for a term covering the asset's expected life.

Profit-and-loss-sharing instruments include *Musharaka*, an equity participation contract under which a bank and its client contribute jointly to finance a project. Ownership is distributed according to each party's share in the financing. They also include *Mudaraba*, a trustee-type finance contract under which one party provides the capital for a project and the other party provides the labor. Profit sharing is agreed between the two parties to the *Mudaraba* contract and the losses are borne by the provider of funds except in the case of misconduct, negligence, or violation of the conditions agreed upon by the bank.

Recent trends

In countries where Islamic banking is operating, its coverage and extent vary significantly from situations where the sector is entirely Islamic (Iran and Sudan), to others where conventional and Islamic systems coexist (Indonesia, Malaysia, Pakistan, and the United Arab Emirates), to countries where there are one or two Islamic banks. The current trend seems

to be toward separation between Islamic and conventional banks. Some countries have opted for a clear separation between these banks, while others have allowed conventional banks to set up Islamic windows, opening the way for some of the largest multinational banks to participate. Even large conventional banks in the United States and Europe have opened Islamic financing windows.

The Islamic debt market—both foreign and domestic—has been the most rapidly growing segment of Islamic finance. In Malaysia, for example, Islamic securities accounted for 42 percent of total outstanding private debt securities by end-2004, and Islamic securities accounted for 25 percent of total outstanding bonds.

The international Islamic bond market is divided into sovereign (and quasi-sovereign) and corporate *Sukuk* (or Islamic note) markets—a particularly innovative, rapidly growing area. These asset-based bonds of medium-term maturity have been issued internationally by sovereign and corporate entities. *Sukuk* paper has the advantage of competitive pricing as a risk-mitigation structure. In 2001, the Bahrain Monetary Agency was among the first central banks to issue this paper, in its case in three- and five-year maturities, with most issues oversubscribed. Qatar issued Qatar Global *Sukuk* with a seven-year maturity (the largest issue ever at \$700 million).

The German State of Saxony-Anhalt became the first non-Muslim issuer to tap the global Islamic debt market in 2004, raising some 100 million euros via a *Sukuk* issue in an innovative effort to appeal to a broader range of investors. More recently, the Islamic Development Bank created the first program for repeat issues of *Sukuk*. Widespread *Sukuk* paper issuance could lay the groundwork for the emergence of Islamic capital markets. But while the *Sukuk* market is developing rapidly, it remains primarily a market where holders keep bonds to maturity with limited secondary market trading.

On the equity side, two indices were launched in 1999 to provide a benchmark for equity prices for investment by Islamic financial institutions: the Dow Jones Islamic Market (DJIM) Index in Bahrain and the Financial Times Stock Exchange Global Islamic Index Series (GIIS). Although these indices have since been published worldwide, Islamic indices remain in their infancy and play a limited role in Islamic

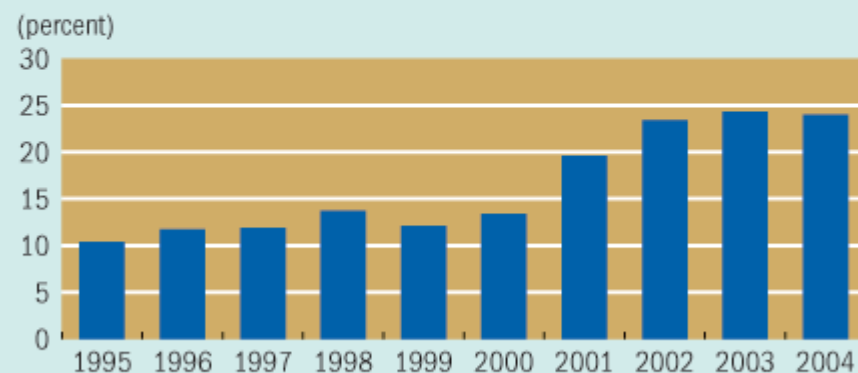
financial markets.

Many Islamic financial institutions, particularly in Bahrain, Malaysia, and Sudan, have been gearing up for further expansion by continuing to develop, refine, and market innovative Islamic financial instruments, on both the asset and liability sides. In recent years, many new Islamic financial products have been developed and are increasingly used in financial market activities, including equity and bond trading and investment, Islamic insurance and reinsurance (*Takaful/re-Takaful*), Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products.

In recent years, Islamic investment funds have prospered in the Gulf countries and Malaysia. Among the different categories are equity funds, real estate and property funds, Murabaha funds, commodity funds, and leasing funds. Islamic equity funds are the most common, and total assets worldwide grew more than 25 percent over the 1997–2003 period. In Malaysia, the number of Islamic investment funds reached 71 in 2004, up from 7 in 1995, and their share of net asset value as a percentage of total funds more than doubled over this 10-year period (see chart).

A rapid rise

The net asset value of Islamic investment funds as a share of all Malaysian investment funds more than doubled over the past decade.



Source: International Organization of Securities Commissions.

A range of Islamic instruments is also in use in several countries for financing specific government projects and procurement of goods and services. In recent years, several

countries, such as Sudan and Iran, have introduced short-term government securities based mainly on participation principles for funding government operations and liquidity sterilization.

Developing money markets

Designing Islamic instruments for monetary operations has proven conceptually difficult. In countries with a dual banking system, the lack of noninterest-bearing securities has limited the scope of monetary management. The liquid nature of banks' liabilities, related to the predominance of deposits of short-term maturities, predisposes the system to hold substantial liquid assets and excess reserves. This, in turn, inhibits financial intermediation and market deepening. Difficulties in defining rates of return on these instruments have also constrained the development of money and interbank markets.

Developing these markets is indispensable for the conduct of monetary policy and financial market deepening. The inadequate development or absence of these markets in many countries constrains central bank intervention through indirect instruments and has occasionally encouraged the use of direct controls on credit. The absence of well-organized, liquid interbank markets—that can accept banks' overnight deposits and offer them lending to cover short-term financial needs—has exacerbated banks' tendencies to concentrate on short-term assets.

Progress in effective liquidity management calls for adopting a comprehensive, integrated approach to developing money and securities markets. It would also require establishing an efficient lender of last resort facility; developing well-suited interbank instruments for active interbank trading or for monetary operations; actively utilizing securitization techniques to manage the maturity and risk spectrum of assets and liabilities; and making available risk management and hedging instruments, which presupposes the resolution of various legal, institutional, and accounting issues.

Regulating and supervising Islamic finance

Undoubtedly, one of the biggest challenges is developing a framework for governing, supervising, and regulating Islamic banks. To begin with, there is no common approach among countries where Islamic banking exists. One of the two main

views—held by regulators in Malaysia and Yemen, for example—is that Islamic banks should be subject to a supervisory and regulatory regime of central banks that is entirely different from that of conventional banks. The second main view recognizes the uniqueness of Islamic banks' activities, but favors putting them under the same central bank supervision and regulatory regime as that for conventional banks, with slight modifications and special guidelines that are usually formalized in occasional central bank circulars. Bahrain and Qatar are examples of countries that practice this latter form of central bank supervision and regulation.

Since the late 1990s, however, the Islamic banking world has stepped up efforts to standardize regulation and supervision. The Islamic Development Bank is playing a key role in developing internationally acceptable standards and procedures and strengthening the sector's architecture in different countries. Several other international institutions are working to set Sharia-compliant standards and harmonize them across countries. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Finance Service Board (IFSB), the International Islamic Financial Market, the Liquidity Management Center, and the International Islamic Rating Agency.

A number of countries and institutions have adopted accounting standards developed by the AAOIFI, which complement the International Financial Reporting Standards. The IFSB aims to promote the development of a prudent and transparent Islamic financial services industry and provides guidance on the effective supervision and regulation of institutions offering Islamic financial products. The IFSB has recently finalized standards on capital adequacy and risk management, and has made progress in developing standards on corporate governance. Once developed and accepted, these international standards will assist supervisors in pursuing soundness, stability, and integrity in the world of Islamic finance.

There is an ongoing debate over the fact that Islamic banks do not separate fund management and investment activities from commercial banking. From a supervisory perspective, Islamic banks are often compared with universal banks and mutual funds, which may cause technical difficulties for regulators and supervisors. For instance, an Islamic bank

acting as a *Mudarib*—an agent in Mudaraba, a type of profit-and-loss-sharing (PLS) instrument—might be considered more a fund manager than a bank. Consequently, in these cases, some supervisors support taking the supervisory approaches applied to conventional fund managers. There are instances in which various risks are aggregated into a single Islamic instrument and offered within a single institution (for example, *Salam*) and the principle of pooled savings and risk sharing in the outcome applies. Closer examination of the character of the underlying transaction is needed for effective supervision, however.

Because of the risks associated with the activities carried out by these institutions and the contracts that govern their mobilization of funds, some argue that their supervision and regulation require a much broader coverage extending beyond the banking sector. Moreover, the risk-sharing nature of liability contracts has raised issues concerning the definition of capital and the capital adequacy ratio.

Some analysts also argue that an appropriate regulatory framework for Islamic banking must place greater emphasis on operational risk management and information disclosure than is normally the case in conventional banking. This argument is based on the specific nature of the risk profile in Islamic financial intermediation, relating to both PLS and non-PLS modes of financing. Investment risk is considered the most critical operational risk affecting Islamic banks' PLS activities. While PLS modes may shift the direct risk to investment depositors, they may also expose Islamic banks to risks normally borne by equity investors rather than holders of debt. PLS modes involve banks in activities that go beyond conventional banking, such as the determination of profit-and-loss-sharing ratios on investment projects. Moreover, banks' exposure is heightened because of the lack of recognizable default on the part of the agent-entrepreneur in PLS contracts, except in cases of negligence or mismanagement.

If a project posts a loss under a Mudaraba contract, for instance, the bank would not be able to recover its loan since it would bear all the financial losses. This situation would not constitute a default on the part of the entrepreneur whose liability is limited to his time and efforts. Furthermore, there is no legal means allowing banks to control the agent-entrepreneur who manages the business financed through Mudaraba contracts, and banks cannot reduce risk by

requiring a collateral or other guarantee in PLS modes of financing.

Additional hurdles

Besides developing money markets and sorting out regulation and supervision, policymakers will need to tackle two other big hurdles.

Data collection. The lack of aggregate data makes it virtually impossible to compare Islamic banks across countries, which, together with the absence of common reporting and accounting standards, complicates the work of supervisors. No data are available on cross-border Islamic banking, the amount of cross-border Islamic financial transactions, and real-estate investment based on Islamic principles for developed countries. Some central banks, including those in Bahrain, Malaysia, and Turkey, have begun to produce a chapter in their annual reports on Islamic banks, putting them in a separate group, with aggregated data that provide information on the size and growth of Islamic banking at the country level. Nevertheless, a multilateral effort is needed to collect and consolidate cross-country data.

Capital markets. The markets for Islamic instruments and government securities remain shallow and an organized international Islamic financial market is still nascent. The sector must improve the range and sophistication of asset and liability classes and develop new instruments and financial techniques that would enable Islamic banks to diversify their balance sheets.

Adoption of a common position on certain financial instruments would help develop Islamic finance and improve its competitiveness globally. For example, a number of issues relating to speculation and the use of derivatives must be resolved before a fully functioning Islamic stock market can evolve. While arbitrage and short selling are not acceptable under Sharia, other financial transactions appear to be, in practice, subject to varying interpretations. For instance, transactions involving the purchase and sale of debt contracts in secondary markets are permissible only in Malaysia.

In sum

Resolving these important issues, as well as adopting best practices for supervision and accounting, are critical for future

market and industry development. For the foreseeable future, supervisory authorities will continue to face the dual challenges of understanding the industry and striking a balance between providing effective supervision and facilitating the industry's legitimate aspirations for further growth and development.

These challenges can be overcome if the concerned central banks and institutions enhance their multilateral cooperation, and create the appropriate environment and conditions. These conditions would create a level playing field and provide the infrastructure needed for the industry's market-driven development. A sound, well-functioning Islamic financial system can pave the way for the regional financial integration of the countries involved. It can also contribute to their economic and social development, by financing the economic infrastructure and creating job opportunities.

For further reading on Islamic finance:

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