

‘The Growth and Current Developments & Challenges for Global Islamic Finance’

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‘The Growth and Current Developments & Challenges for Global Islamic Finance’

I am going to focus on the four main areas implicit in the title.

These are:

- a) The Growth and Globalisation of Islamic Finance
- b) Current Developments and Future Trends
- c) Challenges Going Forward for the Islamic Finance Industry
- d) Opportunities for European Entities and Markets

a) The Growth and Globalisation of Islamic Finance

- The term ‘Islamic banking’ is a misnomer - just as it is an error to describe a niche of banking as Christian, Buddhist, Hindu or Jewish. Islamic banking is used as a generic term.
- Islamic banking is usually a form of fiduciary financial management – where the bank acts as a manager (or Mudarib) of investors’ and depositors’ funds. This is based on the investment or financing guidelines as required, which in turn dictates the financial contract used.

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- It is a faith-based system of banking. Not all ethical banking is necessarily Shariah-compliant. While Islamic banking is an ethical system of financial management.
- Islamic banking essentially a faith-based system of financial management, which derives its principles from the Shariah, the Islamic Canon Law being derived from three sources – the Quran, (the revealed Muslim holy book); the Hadith (sayings of the Prophet Muhammed); and the Sunnah (the practices of the traditions of the Prophet Muhammed).
- It is further reinforced by three features – Ijma (consensus), Qiyas (Analogy) and Ijtihad (discourse).
- It is characterised by a prohibition of Riba (usury, interest); Gharar (deception and uncertainty in contracts); Maisir (gambling or speculation)

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- Islamic finance is essentially a contract-based system of financing governed by a body of laws relating to financial transactions called Fiqh Al-Muamalat.
- The theological roots of Muamalat can be traced to the concept of Islam as a faith, with its three basic components - Aqidah (faith and belief in God (Allah) and in His commands (Ahkam); Shariah which governs the day-to-day life of Muslims; and Akhlaq (the framework of etiquette and work ethics in which a Muslim conducts his or her actions).
- The Shariah further comprises Ibadat (worship and man's relationship with God) and Muamalat (concerned with the practicalities of mundane daily life, of which a significant part is a Muslim's economic activities, especially banking and financial activities).
- Given that the Islamic economic system essentially comprises a public sector (Siasi); a private sector (Tijari); and a social welfare sector (Ijtima'i), there has been an on-going debate amongst Islamic bankers, economists, legal experts and academics whether such a system should be financed through debt or equity-based instruments.

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- The Shariah objection to interest that is fixed and pre-determined; borrower or partner liable to pay interest no matter what his or the business performance.
- If you lend a man money, you don't get any interest; but if you are prepared to go into business with him and share in the risks, then you are entitled to a share of the reward and return from that business
- Prohibition of financing certain sectors – Riba banks, casinos, pork production, breweries, pornography, industries or activities that wantonly destroy the environment
- Concept of money – money alone cannot be used to make more money, i.e. interest cannot be charged on loans. Investors and users of capital share in the risk and reward of an enterprise. Money cannot be hoarded and must be used for productive purposes in the economy

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- Wealth creation and profit maximisation is allowed – but is both for the benefit of the individual and for the improvement of society as a whole.
- Extra Tier of compliance – ethical compliance through the use or presence of Shariah Board
- Spectacular growth over the last 10 years – Islamic finance products now offered on all the five continents in various forms – some advanced, some nascent

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- **Growth Statistics** – *(Source: Official and Islamic Banker estimates)*
(Caveat)
- Estimated number of Islamic financial Institutions – 600
- Estimated funds under management – US\$750bn – US\$1.2 trillion
- Estimated size of Sukuk Market – papers outstanding – US\$150bn
- Estimated size of Islamic funds – US\$40bn
- Global Gross Takaful Contributions US\$5.318bn (at end 2008); US\$6.876bn (forecast for 2009) US\$8.907bn (forecast for 2010) – World Takaful Report 2010
- According to the SCM, at end 31 December 2009, Sukuk issuances in Malaysia totalled RM31.7bn. Malaysia accounts for 47 per cent of the Sukuk issuances in the world.

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- Number of Islamic Mutual Funds in Saudi Arabia – 147 - total volume of just under US\$30bn NCB Capital is the largest with 24 funds under the Al-Ahli Label
- Number of Islamic unit trusts and mutual funds in Malaysia -155 – total volume of about RM22.692bn
- Market penetration of Islamic finance in total banking sector – Brunei (40%); Malaysia (19.5%); GCC countries (12%); Turkey (5.5%)
- Number of Muslim countries (member countries of the Islamic Development Bank (IDB) – 56
- Global Muslim population – 1.5 billion
- Most Populous Muslim country – Indonesia – 205m
- Huge potential – harnessing of SWFs; other investment agencies – GOSI (Saudi Arabia), Public Investment Fund (Saudi Arabia) , Employees Provident Fund (Malaysia)

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- **Malaysia Islamic Banking Statistics**
- Total Islamic Banking Deposits end March 2009 is RM156,580.5m compared with RM192,141.m at end March 2010
- Total Islamic Financing end March 2009 is Rm110,281.7m compared with RM141,253.3m at end March 2010
- Total Capital Base of Islamic Banking at end March 2009 is RM16,910.9m compared with RM20,785.5m at end March 2010

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Muslim Sovereign Wealth Funds – Assets Under Management – 1 January 2010

| Country | Fund | Assets \$bn (US Dollars) | Year of Establishment | Origin | SWF/Forex Reserve Ratio | LMTI |
|-------------------------|--|-------------------------------------|----------------------------------|---------------|--|-------------|
| Abu Dhabi | Abu Dhabi Investment Authority | \$627 | 1976 | Oil | 13.9 | 3 |
| Saudi Arabia | SAMA Foreign Holdings | \$431 | n/a | Oil | 1.1 | 2 |
| Kuwait | Kuwait Investment Authority | \$202.8 | 1953 | Oil | 10.6 | 6 |
| Dubai | Investment Corporation of Dubai | \$82 | 2006 | Oil | 1.8 | 4 |

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Muslim Sovereign Wealth Funds – Assets Under Management - October 2009

| | | | | | | |
|------------------|-------------------------------------|---------------|-------------|------------|------------|-----------|
| Libya | Libyan Investment Authority | \$65 | 2006 | Oil | 0.8 | 2 |
| Qatar | Qatar Investment Authority | \$65 | 2003 | Oil | 8.6 | 5 |
| Algeria | Revenue Regulation Fund | \$47 | 2000 | Oil | 0.3 | 1 |
| Abu Dhabi | Mubadala Development Company | \$14.7 | 2002 | Oil | 0.3 | 10 |
| Bahrain | Mumtalakat Holding Company | \$14 | 2006 | Oil | 2.9 | 7 |

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Muslim Sovereign Wealth Funds – Assets Under Management - October 2009

| | | | | | | |
|----------------------------|---|--------------|-------------|----------------------|------------|----------|
| Oman | State General Reserve Fund | \$8.2 | 1980 | Oil & Gas | 0.3 | 1 |
| Saudi Arabia | Public Investment Fund | \$5.3 | 2008 | Oil | Nil | 3 |
| Ras Al- Khaimah | RAK Investment Authority | \$1.2 | 2005 | Oil | X | 3 |
| UAE Federal | Emirates Investment Authority | n/a | 2007 | Oil | X | 2 |

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Muslim Sovereign Wealth Funds – Assets under Management - October 2009

| | | | | | | |
|-------------------|---|---------------|-------------|------------|------------|------------|
| Abu Dhabi | International Petroleum Investment Company | \$14 | 1984 | Oil | 0.3 | 10 |
| Kazakhstan | Kazakhstan National Fund | \$.38 | 2000 | Oil | 1.1 | 6 |
| Brunei | Brunei Investment Agency | \$30bn | 1883 | Oil | n/a | 1 |
| Oman | Oman Investment Fund | n/a | 2006 | Oil | X | n/a |
| Dubai | Dubai World | n/a | 2006 | Oil | X | n/a |

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Muslim Sovereign Wealth Funds – Assets under Management – October 2009

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|-------------------|-----------------------------------|---------------|-------------|----------------------|------------|-----------|
| Malaysia | Khazanah Nasional Berhad | \$25 | 1993 | Non-commodity | 0.3 | 4 |
| Malaysia | 1Malaysia Development BHD | \$3.1 | 2008 | Oil | nil | 5 |
| Indonesia | Government Investment Unit | \$0.3 | 2006 | Non-commodity | x | x |
| Iran | Oil Stabilisation Fund | \$13 | 1999 | Oil | 0.2 | 1 |
| Azerbaijan | State Oil Fund | \$11.9 | 1999 | Oil | 0.6 | 10 |

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Current Developments – primarily in 2009

- **A) Prudential**
- **B) Regulatory & Legal**
- **C) Shariah Governance**
- **D) Product Innovation**

Prudential

- a) Taskforce on “Islamic Finance and Global Financial Stability” – set up by IDB, IFSB – recommendation to set up Islamic financial stability forum to recommend ways of further strengthening the Islamic financial infrastructure to boost its resilience and ability to meet future challenges.
- b) The IDB and IFSB in addition also set up a Liquidity Management Task Force earlier this year whose mandate is to enhance the efficiency of Islamic financial institutions in managing liquidity at both national and across borders.

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Regulatory & Legal

The Irish Revenue Service, the tax authorities, outlined in detail the tax treatment of Shariah-compliant products and structures for the funds, leasing and Takaful (Islamic insurance) industries – October 2009

a) Adoption in late September 2009 by the French National Assembly to amend Article 2011 of the French Civil Code relating to the formation of trusts. The amendment is generally regarded as a positive step towards facilitating the origination of Sukuk (Islamic securities) out of France.

c) Malaysia Financial Liberalisation Measures – April 2009

Under the new liberalisation measures Bank Negara Malaysia will issue:

- up to two new Islamic banking licences in 2009 under the Islamic banking Act 1983 to world class foreign players to establish new Islamic banks
- these banks can be 100 percent foreign owned
- they must have a paid-up capital of at least US\$1 billion, and

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- up to two new family Takaful (Islamic insurance) licences in 2009 to players that can offer significant value proposition to Malaysia to spur the development of the Takaful industry.
- November 2009 – New Central Bank Act – strengthens position of Shariah Advisory Council (SAC) of Bank Negara as the Shariah Authority of Last Resort or the Apex Shariah Authority
- April 2010 – New Capital Markets Act – similarly SAC of Securities Commission of Malaysia as the Apex Shariah Authority in relation to Islamic capital markets issues
- Luxembourg Director of Contributions issued Tax Circular outlining tax treatment neutrality for Islamic products including Murabaha, Ijara and Sukuk, which is seen as debt instrument
- UK – the Financial Services and Markets Act 2000 Order 2010, was sent to the House of Commons in mid-January 2010, aimed at reducing compliance and legal costs for Islamic financial instruments, and facilitate the issuance of corporate Sukuk in the UK.

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Further extensions announced to incentives by Malaysia in October 2009. The incentives that will be extended until 2015 for

the Malaysian Islamic finance sector include:

- Stamp duty exemption of 20 percent on Islamic financing instruments
- Tax exemption on banking profits derived from overseas operations. The exemption is also extended to profits of Takaful (Islamic insurance) companies derived from overseas operations, and
- Double deduction on expenditure incurred in promoting Malaysia as an International Islamic Financial Centre.

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The incentives that will be extended until 2015 for the Malaysian Islamic capital market include:

- Deduction on expenditure incurred on the issuance of Islamic securities (Sukuk and Islamic private debt securities) approved by the Securities Commission Malaysia (SC), the securities regulator. The incentive is also extended to expenditure incurred on the issuance of Islamic securities (Sukuk and Islamic private debt securities) approved by the Labuan Offshore Financial Services Authority (LOFSA)
- The tax treatment accorded to Special Purpose Vehicle (SPV) established under the Companies Act 1965 to be extended to SPV provisions established under the Offshore Companies Act 1990 electing to be taxed under the Income Tax Act 1967
- Tax exemption on profits received from non-Ringgit Sukuk originating from Malaysia approved by the SC be extended to profits received from non-Ringgit sukuk originating from Malaysia approved by LOFSA; and
- Deduction on expenditure incurred in the establishment of stock broking companies.

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Still in Progress:

- 1. Saudi Arabian Mortgage Law
- 2. UAE new mortgage lending rules
- 3. Hong Kong Review of Legislation to facilitate tax neutrality for Islamic transactions
- 4. The UK banking regulator, the Financial Services Authority (FSA) published its long-awaited policy statement on ‘Strengthening Liquidity Standards’ for authorised financial institutions in the UK on 4 October 2009. The provisions stress that the FSA takes a “no obstacles, no special favours” approach to regulating Islamic banks in the UK.
- 5. South Korea review and possible adoption of legislation to facilitate issuance of Sukuk

Shariah Governance

- a) Malaysia Dual Banking Model enshrined in Law

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- b) Malaysia Central Bank Act 2009 (Amended) – Bank Negara Malaysia National Shariah Council is enshrined in law as the Shariah Authority of Last Resort
- c) Saudi Arabia - Resolution 179 (19/5) on Tawarruq issued by the International Council of Fiqh Academy in Makkah in April 2009
- d) The fallout of the statement issued by the Shariah Committee of the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) in Bahrain in February 2008 relating to Musharaka and Mudaraba Sukuk
- e) The judgement of the Malaysian Appeal Court in April 2009 that the Al-Bai Bithaman Ajil (BBA) deferred payment contract as practiced in Malaysia is a valid Islamic sale contract – thus overturning an earlier ruling by a lower court.

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Product Launch & Innovation

1. RHB Islamic Bank Tawarruq (commodity Murabaha transaction) for personal financing & cash management based on mobile phone airtime as the underlying commodity.
2. Bursa Malaysia - Bursa Suq Al-Sila' platform under the concept of commodity Murabahah. This multi-currency and multi-commodity facility is an electronic exchange traded platform to facilitate the trading and settlement of commodity using crude palm oil (CPO) for liquidity management between Islamic financial centres.
3. Istisna-based Mortgages – Housing development & finance – CIMB Islamic Bank – 2009
4. Dubai Electricity and Water Authority raised US\$2.2bn through an Islamic term facility syndication
5. ICD – Affordable Housing Fund; Tamweel Africa – JV with Asya Bank in Turkey
6. IDB/ADB Asia Infrastructure Fund - US\$1bn -

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7. Sukuk – sovereign & quasi sovereign –
 - a) Bahrain US\$750m sovereign Sukuk
 - b) US\$650m Indonesia International Sukuk
 - c) 45bn Rupee Islamic Securities programme for the State Bank of Pakistan to facilitate Islamic banks to place their reserve requirements in Shariah-compliant instruments
 - d) US\$850m IDB Sukuk under its US\$1.5bn MTN Programme
 - e) Singapore Reverse Enquiry Sukuk
 - f) Indonesia Rupiah Sukuk
 - g) Malaysian RM5bn Simpanan Nasional Retail Sukuk
 - h) IFC Hilal US\$100m Sukuk
 - i) Dubai Government US\$2bn Sukuk Programme
 - j) Dar Al Arkan III Sukuk – SR750m
 - k) Saudi Electricity Company SR5bn Sukuk

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- Very Latest Sukuk Developments
- i) 1Malaysia Global Sukuk Berhad – second sovereign issuance by Ministry of Finance – announced last week by Malaysian Prime Minister
- ii) RM3bn 1Malaysia Sukuk – local currency Sukuk – May 2010
- Cagamas Berhad (National Mortgage Corporation of Malaysia): a) joint issuance of a “first-of-its kind” Sukuk with Saudi-owned Alrajhi Bank Malaysia Berhad, which is aimed at attracting investors from the Gulf Cooperation Council (GCC) countries and elsewhere - up to RM2bn;
- b) a RM300 million 5-year Sukuk, which will be redeemed at their full nominal value on maturity, and which will be listed and tradable under the Scripless Securities Trading System;
- c) Cagamas issued a RM1.06 billion Cagamas Debts Securities comprising RM1 billion 1, 2 & 3-year Sukuk and RM60 million 3-month Conventional Commercial Paper (CCP). May 2010;
- d) a RM500 million 5-year Sukuk in April 2010;
- e) RM500 million Cagamas Debt Securities comprising RM120 million Islamic Commercial Papers (ICP) and RM380 million Islamic Medium Term Notes (IMTN) – all on the same basis as above.

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- **VTB Capital working on possible Sukuk issuance**
- **DAAR issued US\$350m Sukuk earlier this year**
- **Saudi Electricity Company (SEC) permission from the CMA to issue another Sukuk – May 2010**

- **Other Major Developments:**
- **Rescheduling of Dubai World, Nakheel etc debt and repayment of latest obligations due on the Sukuk**
- **Successful redemption on time of DAAR Sukuk in April 2010 – US\$600m issued in 2007**
- **New Funds by Oasis Group Holdings of South Africa – 63 funds by June 2010 – South Income Fund; Balanced Funds; UK Fund – US\$4.5bn under management**
- **Reliance Capital Asset Management of India – India Fund BRIC fund**
- **AmanaRaya/Capital Partners Holdings – Al-Harameen Fund – Makkah and Madina as new investment centres; and the Halal Ventures Fund**
- **New IB licences – Kuveyt Turk Beteiligungsbank in Germany; Deutsche IIB in Malaysia;**

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Recent Innovations in the Malaysian Islamic Finance Market May 2010

| Institution | Date | Type | Application |
|-----------------------------|--------------------|--------------------------|---|
| AIBIM | April 2009 | Master Agreements | Standard Interbank Murabaha Master Agreement (IMMA) & Master Agency Agreement (MAA) |
| Malaysian Government | July 2009 | Legal | Institutionalising National Shariah Council of Bank Negara Malaysia in law as the Shariah Authority of Last Resort |
| Malaysian Government | August 2009 | Legal | Central Bank Act 2009 Amendment – Malaysia's Dual Banking Model recognised in law |

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Recent Innovations in the Malaysian Islamic Finance Market October 2009

| Institution | Date | Type | Application |
|-----------------------------|--------------------|---------------------------|---|
| AIBIM | August 2009 | Master Agreements | Corporate Murabaha Master Agreement (CMMA) – a standard document for deposit taking between financial institutions and corporate customers |
| Bank Negara Malaysia | August 2009 | Product Guidelines | Shariah Parameter Reference on Murabaha (SPR1) – defines essential feature of the Murabaha based on the underlying Shariah contract |
| RHB Islamic Bank | August 2009 | Product | Classical Tawarruq – underlying commodity is mobile phone airtime |

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Recent Innovations in the Malaysian Islamic Finance Market October 2009

| Institution | Date | Type | Application |
|-----------------------|-----------------------|-----------------------------|---|
| Petronas Bhd | August 2009 | Sukuk Branding | Petronas \$1.5bn Sukuk – first to be designated the EMAS (Gold) brand – all foreign currency issues from Malaysia to be afforded this symbol |
| Bursa Malaysia | September 2009 | Liquidity Management | First international trade on Bursa Suq Al-Sila’ commodity trading platform – in London between CIMB Islamic Bank and Gatehouse Bank plc |

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Challenges Going Forward

- a) Post 9/11 and Post-Subprime – global financial market dynamics have changed. Islamic finance not immune. Financial market stability is just as important for Islamic finance although fewer risks because of Shariah proscription on certain speculative activities.
- b) There is a need for a more comprehensive legal, regulatory and supervisory framework infrastructure to meet the present challenges, and its regular adaptation to keep pace with the evolution and transformation of the financial system.
- c) There is a need for an integrated crisis management framework to ensure that any emerging crisis in the Islamic financial system will be promptly and efficiently managed.
- d) There is a need for institutional arrangements for resolution of troubled international Islamic financial institutions.
- e) There is a need to enhance the risk management capability of IFIs, through additional capital requirements to cushion the inventory risks of underlying assets and equity positions that are embedded in partnership contracts, therefore bringing the capital requirements closer to the true economic risks in the portfolio of the IFIs.

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- *f) There is a need for a mechanism for cooperation between regulators across jurisdictions for resolution and for containing potential systemic risks beyond the national boundaries, and for the Financial Stability Board (FSB) of the International Monetary Fund (IMF) to engage with the prudential standard setting entities for Islamic finance, not only to raise awareness of whether the new standards being introduced can be applied to Islamic finance and whether modifications need to be made, but also to see whether there are any unintended consequences.*
- *g) There is a need for mutual recognition of financial standards and products across jurisdictions.*

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- h) *"The growing role and relevance of Islamic finance in the global financial system will not only increase its potential to contribute to global financial stability, but also towards strengthening global economic growth. As the world seeks solutions to the current global financial crisis, a general consensus is emerging that financial services needs to return to its basic functions – to provide financial services that adds value to the real economy.*

"These are the very elements that are espoused in the Shariah principles that underpin Islamic finance and which explains its resilience during this international financial crisis. The challenge before us is to build a new financial architecture that would allow for the more efficient functioning of not only financial intermediation within national economies but also across borders. Islamic finance, with its emphasis on a strong linkage to productive economic activity, its inbuilt check and balances and its high level of disclosure and transparency offers this prospect" – Dr Zeti Akhtar Aziz, Governor Bank Negara Malaysia October 2009 Istanbul World Bank Group Annual Meeting

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- i) Corporate Governance – a major issue
- *j) Conflict of Interest – Shariah advisories on more than one Board; ministers and regulators also chairmen of private banks and companies*
- k) Product Innovation – although there is a natural retrenchment to Back to Basics and vanilla products in the current financial climate, innovation is the mainstay of the future development of Islamic finance.
- *l) Adopting a modern scientific approach to Shariah Governance process, especially in the formulation, articulation and adoption of Fatwas (Islamic legal opinions) – there needs to be more market consultation and transparency.*
- m) Uniform Shariah interpretations a red herring – it is not going to happen – nature of Islamic law – ‘Unity and Strength in Diversity’ – same in conventional finance – Rule 144A (US) – Institutions need to navigate through this through market education, due diligence and a clear product development and marketing strategy

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- *n) Human capital development – a major bottleneck especially to cope with the rapid growth of the sector and the number of new institutions being authorised worldwide. Result is poaching of staff.*
- o) Harmonisation and standardisation of documentation – good progress by AIBIM; IIFM – problem of voluntary adoption because of under-developed governance culture
- *p) Regulation of Shariah advisories*
- q) Shariah Authority of Last Resort
- *p) Consumer Awareness and Education*
- r) Consumer Protection
- *s) Shariah-compliant Deposit Insurance Scheme – only two Malaysia and Turkey*
- t) Marketing to Muslims and Ethical Investors

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- *u) Impact of IT and Banking Automation*
- v) Research & Development – very under-developed
- *w) Islamic Banking and the common good – measuring performance; wealth creation potential; contribution to the real economy; social impact; carbon footprint; and maintaining its social justice and welfare ethic*

These are some of the challenges. It is important to note that various jurisdictions have made excellent progress in meeting some the challenges. The notable example is Malaysia with its systemic approach to Islamic finance. Malaysia is the most advanced Islamic finance model and market in the world. If you wish to learn about a modern thriving scientific approach to Islamic finance, a trip to Kuala Lumpur is worth the money. You will be pleasantly surprised.

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Conclusion

Islamic finance is here to stay. It is fast becoming part of the global financial system. Europe will ignore it at its disadvantage. Look at it as An alternative system of financial management.

Do not get bogged down with the semantics of polemics – Shariah compliance; religious versus secular financing; Shariah interpretations. These can easily be overcome through the right approaches and advice. An example in practice is Malaysia.

Emerging giants such as China, Korea, India, Brazil and Russia will eventually embrace it because of its intrinsic values and market opportunities and financial inclusion aspects.

My advice is follow the ‘UK Model, but not the UK Bureaucracy’.

Do not enter this market half-heartedly. The UK for instance is a graveyard of ill-thought out Islamic equity funds which failed miserably. A sector worth pursuing – estimated market size of US\$1.2 trillion with a potential to rise to US\$4 trillion over the next few years.

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Thank You for Listening

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