

## THE FUTURE OF ISLAMIC FINANCE AFTER THE CREDIT CRUNCH

Writing articles about any form of finance, let alone Islamic finance, has been an unrewarding activity during the last quarter of 2008, as almost all statements have become out of date between finalising an article and seeing it printed. It has been a rollercoaster year for Islamic finance as it has for conventional finance. Islamic finance distinguishes itself from conventional finance in its compliance with the principles of Islamic commercial jurisprudence. Islamic finance techniques seek to promote ethical and socially responsible investment whilst providing an alternative to interest-based finance. The main tenets of Islamic commercial jurisprudence prohibit interest payments on monetary loans or securities, speculation, uncertainty in certain contractual terms and engaging in anti-social business activities (i.e. any activities involving alcohol and armaments amongst other things).

We started 2008 hoping to put the uncertainties caused by the crash in the securitisation market and Sheikh Taqi Usmani's statement that certain kinds of sukuk were not halal behind us. The year started well but the markets opened and closed during the first six months in line with the conventional markets and the idea that Islamic finance formed a separate market was shown to be illusory. We all went on holiday for the summer expecting deals on hold for much of the year to come to the markets after the Eid break in the second week of October. That expectation disappeared under the tsunami created by the banking crisis, particularly after the collapse of Lehman Brothers.

And yet...the feeling amongst many financial institutions in the Gulf, after the Eid holidays, was relatively sanguine, because they had made their profits for the year and could afford to sit out the credit crunch and return to business in January 2009. That view changed substantially during November 2008 as some property companies in the Gulf began to show their dependence on the frozen credit markets for funding by cancelling future projects and even announcing redundancies. This spectre is now moving into the financial sector, much of which, both Islamic and conventional, has been heavily exposed to the real estate market that is now tumbling in value. The property bubble has burst in Dubai just as it has in London and New York, central banks in the Gulf countries have been actively supporting banks through the provision of guarantees for deposits and liquidity, and the equity markets have taken a hammering. Confidence amongst the professional class in the Islamic finance industry has been shaken as never before and the same fears about job security and wealth erosion that stalk London and New York are now being felt in the powerhouse of Islamic finance that is the Gulf.

The confident statements at the beginning of the crisis that Islamic finance was immune to the contagion because it was based on ethical financing to support real activities rather than speculative structured products have proved hollow. Most Islamic financial institutions did not invest in sub-prime mortgages or other highly structured products because they were forbidden to do so since these products are usually based on interest or are highly speculative, thus limiting their losses in the early stages of the credit crisis. However, these same financial institutions were over exposed to property and equity and so have suffered from the collapse in confidence which has reduced asset values so substantially and swiftly. There is a recognition that both Islamic and conventional financial institutions will need to focus more on asset and risk management in the future.

It was also widely hoped by optimists that this crisis was an opportunity for Islamic finance to establish itself as the new model for the global financial system, based on a system of sharing risk and reward over a sustained period rather than relying on a short term fee for intermediation services. And so it may come to be since we are still in the early stages of the crisis but we haven't yet seen signs of the world acknowledging the superior values of the Islamic financing model.

What will 2009 bring us? Where will Islamic finance be and where should it seek to be?

If we assume no further global catastrophic events, financial or otherwise, then there is a hope that having recovered from our various religious and national holidays, we will return in January 2009 keen to do deals and so the markets will wake from the torpor that they are currently in, albeit slowly. Many believe that Islamic finance and the Gulf in general will be amongst the first to recover. This is based on the twin beliefs in the power of petrodollars and the fact that the Islamic finance market is small at present compared to the conventional market (for example, the Islamic banking market is reported to

account for just 13% of the total market in Malaysia, the most developed market) so that its capacity to increase is immense.

If the world sinks into the widely expected recession in 2009, the oil price is unlikely to increase substantially from its current levels and the liquidity that is available in the Gulf will be used to develop projects in home markets, as Saudi Arabia made clear at the G20 gathering. There is unlikely to be much cash left to bail out ailing Western firms looking for a white knight, unless they are able to offer extremely attractive terms (as the Barclays (non Islamic) capital raising showed). Similarly, if Islamic financial institutions, which attracted deposits at the start of the crisis, disclose that they too have suffered significant losses and, if they do not demonstrate a commitment to a truly ethical model of financing designed to promote the social and economic well being of society rather than providing Islamicised equivalents of conventional products, then we will quickly reach the limit to which the Islamic finance market will expand.

Despite the easy attractions of cynicism, I believe that the current crisis does provide Islamic finance with a rare opportunity to reinvent itself and to appeal not just to the 1.5 billion Muslims in the world but also to the rest of humanity, which is suffering as a whole from the collapse of free market capitalism and for whom the pain is likely to intensify next year, as the effects of the financial crisis are fully felt in the real economy in the form of higher costs and fewer jobs. These people are likely to be attracted by a system of financing which celebrates the ethical spirit behind the Grameen model of banking rather than the synthetic derivatives market. Islamic finance needs to focus less on complying with each rule and more on reflecting the principles which underlie those rules so that transactions are no longer Sharia compliant but are Sharia based. The AAOIFI Statement on Sukuk issued in February 2008 (which stated that purchase undertakings, where the exercise price was fixed at issuance, were not Sharia compliant for sukuk based on musharaka, mudaraba and wakala structures) reflected the frustration of scholars at the manipulation of Sharia rules by clever bankers and lawyers wanting to create products that did not reflect the underlying principles of Islamic finance but that do fit into a model that is easily understood by conventional investors who thus far have tended to be the main investors in sukuk. This may change as Islamic investors are attracted by the more predictable returns offered by sukuk in an attempt to diversify their asset pool from the more volatile property and equity markets.

Tougher business conditions and a reduced deal flow next year will also give market participants an opportunity to respond to the demands of the market for increased harmonisation of Islamic principles, products, documentation and processes both markets and across markets. This process has already started with the launch of the IIFM/ISDA Commodity Murabaha form and with the creation of working groups to consider how best to structure sukuk in order to address AAOIFI's concerns. It is possible to argue that the market reaction to the AAOIFI Statement on Sukuk has demonstrated the importance of AAOIFI as an institution to the Islamic financial markets and so the need for a central decision making body is also being addressed in response to the current crisis.

The non-Islamic world's increasing interest in understanding Islamic finance is likely to continue as cash strapped companies look to the Gulf as a possible source of funding and begin to explore Sharia compliant structures for the first time. Their governments are responding by following the UK model to create a level playing field through removing tax and regulatory obstacles. Non-Muslim majority countries in Europe, such as the United Kingdom, France and Italy are ensuring that their legal systems create a level playing field for Sharia compliant structures. In Asia, Singapore and Hong Kong are vying to be the hub for Islamic finance, despite Malaysia's traditional dominance. Even if the hoped for liquidity does not materialise for many of these companies and their advisers, their research into Islamic finance as a source of possible funding will be valuable in consolidating the position of Islamic finance as a form of finance available to all. This process could help to realise the 'New Silk Road' of financial flows linking Asia and the Middle East that Dr Zeti Akhtar Aziz, Governor of Bank Negara Malaysia (the central bank), has discussed.

It is possible that this time next year we will find that the world has converted to Islamic financing although I think it is unlikely. It is sometimes forgotten that even in the Middle East and the Islamic world the majority of funds are managed conventionally. Most of the sovereign wealth funds in the Muslim-majority world are conventional funds although some of their wealth is required to be managed along Sharia principles. It is the conventional funds that are able to buy equity in Western banks

seeking additional capital rather than the Islamic institutions which are forbidden to invest in banks that generate profits from products that charge interest.

2009 is, nevertheless, likely to be a milestone in the development of Islamic finance since it will address its first global crisis and is likely to respond by consolidating its principles and procedures, developed in the very short time period that it has formed part of the global financial industry. Islamic finance is a very young industry despite relying on principles established fourteen hundred years ago. It was only used in the West in the 1970s when Sharia compliant trades were carried out on the London Metal Exchange. The pace of innovation that Islamic finance has shown in the last four years demonstrates that it is a fast learner and that it is likely to respond to the challenges of 2009 by emerging as a stronger and larger part of the global finance industry.