THE FUTURE OF ISLAMIC FINANCE IN THE MIDDLE EAST

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Introduction

While conventional financial markets in Western Europe and North America are in turmoil, there is a refreshing burst of optimism in the world of Islamic finance. Largely shielded from the financial crisis, although not entirely immune, there is a significant opportunity for the Islamic financial system to provide an attractive alternative to conventional financing.

The continued potential for growth of Islamic finance means that investors are increasingly looking to tap into the various opportunities it offers. Nevertheless, Islamic finance has its challenges as well. This article provides an overview of the key principles that underlie Islamic finance and highlights issues that need to be addressed to bring it to greater heights.

Key Principles of Islamic Finance

There is no formally accepted definition of Islamic finance. Islamic finance transactions are based on Islamic principles and jurisprudence (together, the “Shari’ah”), which are derived from the primary sources of the Qu’ran and the Sunna. A fundamental principle of Shari’ah is that a physical asset or tradable commodity should underpin each transaction. As a result, Islamic finance transactions are either asset-based or asset-backed. In contrast, conventional banking generally relies on a contractual liability to recover monies exchanged as loans and deposits, together with an interest margin for the lender.

While Islamic and conventional financing may initially appear incompatible, the structural issues involved are not insurmountable. One of the major differences between conventional and Islamic finance systems is the notion of interest, which is prohibited under the principles of Shari’ah law. This, however, does not suggest that an Islamic bank acts as a charity institution. In Islamic finance, financing of industries deemed unlawful by Shari’ah law such as alcohol, tobacco, weapons, pork and gambling are also prohibited.

Contracts in which one party is regarded as having gained unjustly at the expense of another are also considered invalid. Contracts which contain uncertainty, particularly in regard to one of the fundamental terms of the contract such as the subject matter, price or time for delivery, are also considered invalid. The test is whether something has been gained by chance rather than by productive effort. To ensure adherence to these underlying Islamic principles, most Islamic institutions are governed by a supervisory board of Muslim scholars who analyze the institution's methods and operations.

Islamic Finance Challenges

A significant challenge affecting Islamic finance is the diversity of opinion as to whether particular practices or products are Shari’ah compliant. This means that some products and services may be approved as being Shari’ah compliant by some Shari’ah scholars but not by others. On a global level, the approval of an Islamic firm’s products and services may also depend on the jurisdiction in which they are to be offered. This can add another layer of complication for regulators.

A second obstacle for Islamic finance has been the risks associated with the shortage of qualified Shari’ah scholars in the Islamic financial industry. Currently, financial advisors, Islamic financial institutions and their Shari’ah committees are grappling with how to structure Islamic finance to properly integrate with conventional finance. The end result has been the development of a cumbersome and document-heavy structure that in many respects mimics conventional financing. There is clearly opportunity for more education and training and some positive steps are now being taken, including university degrees and professional training courses in Islamic financing.

There is a lack of a legal and regulatory framework for dispute resolution, especially in cross-border transactions. In contracts for Islamic transactions, the enforceability of terms and conditions depends on the governing law. In the case of a dispute, it is unlikely that a court located in a commonwealth country will determine a verdict based on Shari’ah law. To mitigate this risk, contracts have to be written carefully to minimize potential disputes.

Another challenge is the lack of tax framework for Islamic products leading to uncertain tax outcomes and sometimes even double taxation, as well as the prohibition of certain Islamic products. A number of countries are revising their tax, legal, and regulatory frameworks to attract Islamic finance. For example, several countries that are encouraging an Islamic financial market are working to address issues in the taxation of Islamic products.

Lastly, Islamic finance also presents an unusual problem because there is neither any specific legislation regulating it, nor is there sufficient relevant case law to address these issues. Shari’ah law is not a codified body of law, but rather a set of practices based on various interpretations. Furthermore, Islamic finance in some countries and their various business models have not yet been tested in a severe economic or market downturn.

The Future of Islamic Finance

Notwithstanding these challenges, many Islamic institutions are expected to undergo a positive transformation in their approach and strategy towards Islamic finance, and more importantly in their business models. With the development of Islamic financing techniques, it is clear that there are increasing opportunities for its use. Increased product sophistication and market awareness-building would also need to go hand-in-hand with the advancement of the financial and legal infrastructure in Islamic finance. Indeed, Islamic banking can incorporate lessons from the global financial crisis and emerge as a role model in the future.