Grant Thornton

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Islamic Finance

Insights from our specialists

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Whilst Islamic finance has emerged as an effective tool for financing development worldwide, including in non-Muslim countries, the industry does need to be mindful of key thematic issues and challenges which it faces.

Islamic Finance specialist, Samer Hijazi, shares a small selection of his insights in respect of the key trends and themes which the industry is being impacted by. The short excerpts cover the following themes:

- Islamic finance & oil prices: where to now?
- Islamic and Christian finance: A shared heritage
- Comparing Sharia'a governance frameworks.

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About the author:

Samer has extensive experience leading complex audit engagements for global investment banks, FTSE 100 banks, sovereign wealth funds, investment managers and international banks (including for the likes of Emirates NBD and NBAD). He has directed the audit of a number of financial services teams of clients that have multi-location operations, in Europe, Asia, Africa and the Middle East. This in turn has aided him to mastering the art of identifying issues and themes on the ground and converting these into insightful board feedback adding greater value.

He was instrumental in the formation of the UK Islamic finance practice and developed new products and solutions to deliver to all UK Islamic financial institutions, FTSE 100 banks and global investment banks, which saw him becoming de facto UK head of Islamic finance in 2009 and global head in 2013. As global head of Islamic finance, Samer played a key role in the industry lobbying of the British government which resulted in the launch of the UK government Sukuk which was oversubscribed 10 times. As a result of his integral role in the UK and global Islamic finance, he was awarded 'Global Islamic Finance Adviser of the Year – International 2014' by professional sector network.

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Islamic finance & oil prices: where to now?

Modern banks started offering Islamic finance in the mid-1970s. During that period, there were major developments in the Muslim world which included the oil boom, coupled with a greater sense of cultural awareness and pride as to the fact that the teachings of Islam encompass all aspects of life including how an individual conducts their financial and business affairs. Since then and as a result of which, Islamic finance begun maturing into a global industry, with total assets today believed to exceed $2 trillion and Islamic financial services available throughout most of the Islamic world as well as parts of Europe and North America given the prevalence and increase in demand.

Approximately 80% of these assets are concentrated in Islamic banks or Islamic divisions of other commercial banks (so-called “Islamic windows”). Sukuk (the Islamic equivalent of bonds) represent about 15% with Islamic investment funds and Takaful (Islamic insurance) making up the remainder.

Geographically, the vast majority of Sharia’a compliant assets are estimated to be concentrated in the Gulf Co-operation Council (GCC) countries and the wider MENA region. However, a significant amount is to be found in Asia and Malaysia, which has been a leading industry player since at least the 1980s.

Islamic finance really started to capture world headlines in the early years of the past decade as annual growth rates often exceeded 15-20% accompanied by rising commodity prices. Islamic finance started to attract the world’s attention as new institutions launched themselves to the market while global players like HSBC, Deutsche Bank, JP Morgan and others invested in Islamic Finance and the growth story.
In the last five years, Islamic finance assets have been growing at a double digit rate. However, with declining oil prices and the looming US interest rate rise, many market commentators are questioning how sustainable this can be over the next few years and whether the growth of Islamic finance is inevitably driven by the fortunes of oil prices.

Despite enviable recent growth rates, Islamic finance assets remain concentrated in the Gulf Co-operation Council (GCC) countries, Iran and Malaysia and still represent less than one percent of global financial services assets.
Oil-exporting countries are some of the key drivers of the global Islamic finance industry. As such, those countries’

public finances are likely to be most affected by the decline in the oil prices. Governments of those oil-exporting countries have often used Islamic finance to diversify their funding profiles but also to demonstrate their support for the growth and development of what is seen as an ‘indigenous’ industry with many local stakeholders. All six energy-exporting Arabian Gulf states have ambitious development plans and are likely to continue to spend to support overall growth, but if oil prices fall further they may rethink their investment strategy and policies, which will inevitably have an impact on Islamic finance.

Crude settled at $30.44 a barrel, on 12th January 2016, with the U.S. benchmark price dropping to its lowest level since December 2003. While prices now and 12 years ago are the same, the differences in the oil market fundamentals between the two periods are severe.

The last time oil was at these levels, prices were on their way up, not down. China’s oil imports were rising at a double-digit-percentage pace to fuel a rapidly expanding economy while the Organization of the Petroleum Exporting Countries was limiting output to keep prices aloft. Iraq was repairing wells that were ravaged by the Second Gulf War and the Iranian economy was still closed off by sanctions. Fast forward to today, China’s energy demand could slow together with its economy. Saudi Arabia is pumping oil at a fast pace as it competes with the newfound U.S. producers, and investors will now be bracing for a possible flood of oil from Iran.

However, a recent report by the IMF studied the correlation between oil prices and bank profitability as a result of the global credit crunch in 2008/09. The research revealed that the impact of the last oil price shock on banking profitability was invariably indirect with direct implications for some institutions with weaker risk management frameworks, more aggressive business models and poorer quality asset books. The study's results suggested that the impact of oil price shocks was found to be greater with (non-Islamic) investment banks due to a variety of factors including a funding profile dependant on turbulent wholesale markets and revenues driven by trading income and transaction fees both of which are vulnerable to large market swings. Islamic banks typically have a more conservative business model and risk management framework while many source their funding from retail depositors making them less susceptible to fluctuations in the market.

It should be noted though that several Islamic investment banks suffered some of the same stresses of their conventional counterparts. Similarly, the reduction in oil prices is likely to impact conventional financial institutions as well as the Islamic ones.

As such, the decline in oil prices will be a challenge that the Islamic financial services industry needs to closely manage. However, while the industry is still 'young' compared to its conventional counterparts, it is far more experienced now having had to weather several economic crises over the years while its regulators and professionals are more seasoned now, having more risk management and diversification tools that they can utilise than perhaps was the case 20 or 30 years ago.

While many GCC states have been withdrawing global cash reserves from asset management institutions around the world, the need for this has often been driven by political developments as much as the impact of oil prices.

According to Standard & Poor's Ratings Services, growth in the Islamic finance industry may moderate in 2016, growing at a slower pace but will be to some extent counterbalanced by the opening up of Iran and more issuance from non-core markets such Europe, Russia, CIS countries and Africa. S&P, though, expects growth to pick up in the next decade. Iran could be a key market for growth as it emerges out of decades-old sanctions, thanks to the nuclear deal with the West (expected lifting of sanctions in 2016).

At the same time, Malaysia has always been a significant player in the global Islamic finance industry and often dominates global sukuk issuance volumes and yet it would be hard to argue that its economy is heavily dependent on oil prices. Many non-Muslim governments also continue to study Islamic finance as an avenue to diversify their budgets as they maintain their spending momentum in a low oil price environment but also to attract inward foreign investment from new sources. The British Government made a landmark sovereign sukuk issuance in 2014 to demonstrate its commitment to Islamic finance and the fact that the British economy was 'open for business' with Islamic finance.

As for the outlook for oil prices going forward, it seems difficult for the market to reach a consensus. Some local banks believe oil prices will reach $40-50 per barrel within 12 months. Other banks are more cautious and cannot see the price of oil exceeding $30 for 2016.

The variation of petrol prices also would not just affect the Islamic banking industry specifically, but have a systemic effect on the entire banking field. The way in which a particular bank is run, including its type of investment portfolio, will have a large role to play in its success, rather than whether it opts for Islamic or conventional banking. Hence, it would be difficult, from a legal standpoint, to conclude that the Islamic banking system is in a more vulnerable position compared to the conventional one should there be a continued decline in oil prices.

Most oil producing nations enjoy a stable legal structure that allows for the effective operation of Islamic banking structures side-by-side with conventional institutions. If the wider banking industry suffers from declining oil prices, presumably, policies of both legal and regulatory in nature would be formulated for the banking sector rather than just for conventional or Islamic banks specifically.

On the flip side, Islamic banks are by nature, risk averse. Given their prohibition against gambling, uncertainty and speculation, they are arguably better positioned to protect themselves against high risk and volatile investments.

To conclude, the global economy remains in a difficult place due to the steep fall in oil prices, challenging global equity markets, high regional political tensions and continued reform of global financial markets. Islamic banks only seem more affected by this drop solely due to the fact that the majority of the concentration of Islamic banking takes place in oil rich regions. Conversely however, the performance of Islamic banks in comparison to conventional banks during these times of crisis and as demonstrated historically, can be deemed more resilient due to more stable and conservative business models.

Islamic & Christian finance:

A shared heritage

Today, Islamic finance is widely accepted as a global USD 2 trillion industry offering banking, insurance and asset management services in over 75 countries around both the Islamic and non-Islamic world.

In recent years, it has captured headlines in the Financial Times and Wall Street Journal and some of its leading executives have been interviewed by the BBC, CNN and Bloomberg. Most people today have some knowledge of Islamic finance but how many people have heard of its counterpart, Christian Finance?

Like Islamic Finance, Christian Finance operates alongside modern-day conventional financial services which, with its recent history of governance, remuneration, Libor-rigging and other scandals, could not be more different to both of them. Islamic Finance comprises those institutions which seek to comply with Islamic law in all their operations. Similarly, Christian Finance represents a small collection of financial institutions which strive to conduct their business in accordance with the Holy Bible and the teachings of the Church.

An example of this is Reliance Bank in the UK which was founded by the Salvation Army in 1890. Reliance Bank offers loans and mortgages and a range of personal and business banking services. It is dedicated to ethical banking and uses its profits, not to pay huge bonuses to its senior staff, but to support the Salvation Army's evangelical and charitable work.

In fact, staff bonuses are capped at a GBP 2,000 maximum, and amongst its investment principles, it avoids dealings with any company whose main source of income is derived from sales of tobacco, alcohol, gambling, pornography and armaments. Sound familiar?

The last statement could have been lifted from the annual report of nearly every Islamic financial institution in the world. However, Reliance Bank does charge interest at market rates on its products and that is where the similarity ends to some extent.

Another example is JAK Bank which was officially founded in 1965 in Sweden on the then revolutionary principle that no interest would be charged on loans. JAK Bank founders believed that interest was harmful to society, damaging to the economy and akin to usury as described by the Catholic Church. JAK Bank instead fully matches loans up to the extent of its deposits and instead only charges an administrative cost per loan and supplements its income with membership fees from borrowers and depositors. Surplus funds are invested in assets which are deemed to help improve or sustain the wider good of the economy and society.

Other institutions include Kingdom Bank in the United Kingdom, Pax Bank and Liga Bank in Germany, the Catholic Family Federal Credit Union and Holy Rosary Credit Union in the United States and the Institute for the Works of Religion in Italy (more commonly known as the Vatican Bank). While global Islamic finance is believed to comprise 2-3% of global financial services, the share of modern-day Christian finance is even smaller. And yet, this was not always the case. Islam and Christianity share much in common when it comes to financial services. While an aversion to entities which are involved in areas such as tobacco, alcohol, gambling, pornography and armaments

would be expected from most religions, usury (or interest-based transactions) were historically, deemed to be as evil in Christianity as it is in Islam.

Today, Islamic finance is widely accepted as a global USD 2 trillion industry offering banking, insurance and asset management services in over 75 countries around both the Islamic and non-Islamic world.

As far back as 325 AD, the First Council of Nicaea forbade all clergy from practicing usury. In doing so, it quoted Psalm 15:5 from the Bible: "He does not put out his money at interest, nor does he take a bribe against the innocent. He who does these things will never be shaken." And that was only the beginning. The Third Council of the Lateran in 1179 excommunicated those engaged in usury while Pope clement V likened usury to heresy in 1311.

Usury was thus deemed to be a sin of the most extreme nature in most of Europe for more than a thousand years, earning Usurers a place in Dante's Seventh Circle of hell, alongside murderers and blasphemers. Going further back, both Plato and Aristotle argued passionately against the use of interest. Aristotle made the same argument against interest as Islam which is money is to be used as a medium of exchange and not to increase at interest.

Roman thinkers such as Cicero, Seneca, and Cato also disdained it, with the latter likening it to murder. In fact, the legal origins on the prohibition of usury can be traced back to the Code of Hammurabi in 1760 BC. While the Code did not prohibit usury it did seek to regulate it and fix the rates at which it took place. These trading practices and views then spread throughout the rest of the Middle East. So, if usury symbolised an abominable sin within Christian circles then, as it does within Islamic finance today, how did people access credit? There were several ways. Firstly, while usury was forbidden, lending was not and creditors could still charge a fee for costs incurred in administering the lending and collection process. Secondly, transaction structures were devised which made any return on capital provided linked to an underlying asset or service being provided.

Thirdly, the Crusaders actually brought back to Europe some Islamic financial techniques such as Mudaraba risk and reward sharing contracts (or known as 'Commenda' to the Europeans). Indeed, some historians believe that it was the use of the Commenda contract which helped Venice become a European trading superpower.

Fourthly, they found ways around it. There were large Jewish communities throughout Europe who had their own teachings to follow, some of which permitted them to engage in interest based transactions with people outside their community but not within their community. Finally, every now and then, the Church seems to have been prepared to turn a blind eye. Enter the Knights Templars who were set up by the Crusaders as a humble monastic order to protect the surge of European pilgrims going to the Holy Land after the capture of Jerusalem in 1099. The Order had about nine knights and had few financial resources, relying on donations to survive. They soon received the blessing and support of some of the most powerful people in the Catholic Church and became a favoured charity throughout Christendom, receiving money, land, businesses and sons from noble families who were eager to fight in the Crusades.

In 1139, Pope Innocent II exempted them from all authority other than that of the Pope and they were well on their way to becoming one of the most powerful financial groups in Christendom with a network throughout Europe and the Middle East. Apart from charitable donations; wealthy crusaders, pilgrims and other travellers would deposit their wealth with a local Templar office and withdraw it on arrival in the Holy Land, this being the precursor to the modern cheque. Using similar methods, they established a flourishing letter of credit business, acquired real estate, factories and ships. At one point they owned the Island of Cyprus - indeed, they were the medieval version of a multi-national company and many of their financial techniques are still in use today.

With all this wealth, they began lending vast sums of money to other crusaders, businessmen and European royals. Much of this lending was with interest but at a time when there was no greater priority than the struggle against Islam. Ultimately, their downfall came in a reverse form of the 2008 banking crisis. Operating effectively as a bank, the French King Philip IV found himself heavily indebted to the Templars as a result of wars with the English. Philip, for this and other reasons, determined the Templars were 'too big not to fail' and ordered many of them to be arrested, charged and executed.

Ironically, usury was not one of the crimes they were accused of - still, it remains one interesting way of how a state dealt with troublesome bankers. After the Templars, interest based lending continued in Europe but at lower levels until the 17th century when a comeback was driven by various factors such as the Protestant Reformation and the Industrial Revolution. To understand what changed, we need to take a closer look at interpretations of the words usury and interest.

Many modern Christian financial thinkers view them to be different. The former is akin to 'loan-sharking', exploitation or charging someone for something that has no value. Interest, on the other hand, is deemed to be a reasonable, market driven return for the use of capital and which compensates the provider for the opportunity cost of not investing this capital elsewhere. The Catholic Church continues to condemn usury but even the Vatican Bank participates in the global interest based financial services system.

Islamic and Christian finance have ultimately evolved from the same roots and a shared history. They share much in common and divergent views on interest and usury will probably remain the key difference for the near future.

Comparing Sharia'a governance frameworks

Islamic financial products and services are distinguished from their conventional counterparts by their compliance with Sharia'a precepts and principles. Sharia'a compliance risk to an Islamic financial institution (IFI) is the risk that a financial service or product is not or will not be in compliance with established Sharia'a principles and standards as interpreted by the Sharia'a advisors to the IFI. The consequences of non-compliance with Sharia'a principles can be significant and pervasive – with the worst case scenario being that it could lead to depositors withdrawing their funds; loss of income; voiding of contracts; litigation; and ultimately lead to a diminished reputation and long-term damage to the IFI's business franchise.

The risk of Sharia'a non-compliance is present in all stages of the development and launch of an Islamic product, including the conceptualisation and structuring of Islamic instruments; legal documentation; contract terms governing default and late payment charges; sale and market conduct; execution and implementation; and accounting and disclosure.

In order to be able to address these risks, an IFI should establish a rigorous and comprehensive Sharia'a governance system. In this article, we discuss a number of governance models in place around the world based on a survey of reporting practices of IFIs in the UK, the Middle East and Malaysia. Typically, these comprise of internal and/or external assurance arrangements.

Internal assurance arrangements to achieve/demonstrate Sharia'a Compliance

Internal assurance arrangements are clearly the most prevalent governance model currently in place. An IFI's internal assurance framework to ensure Sharia'a compliance will usually consist of a Sharia'a Supervisory Boards (SSB) often supported by the IFI's internal audit function and, sometimes, by an internal Sharia'a Review Unit, however, other hybrid arrangements are also common.

The SSB is responsible for ensuring that an IFI has complied in all its activities with Sharia'a, as well as for directing, supervising and reviewing its activities. The SSB consists of scholars and industry best practice is for the members of the SSB to be elected by the shareholders of the IFI, in order to establish their independence from management who they are required to challenge.

However, we have noted some inconsistencies in the application of this model around the world. Firstly, while industry standards around Sharia'a governance have been developed and issued by the likes of AAOIFI and the IFSB, these standards are mandatory in only a few jurisdictions and barely referred to as best practice in other jurisdictions.

As such, some SSBs comprise several recognised scholars while others only include one or two. How each of these SSBs oversee the activities of their respective IFIs also varies with the members of some SSBs choosing to directly sample the IFIs transactions themselves on a periodic basis. Other SSBs make use of the services of the internal audit function and issue them with work programmes, however a handful of IFIs also employ their own internal Sharia'a review unit consisting of more junior scholars who perform compliance testing directly for the SSB.

To make matters even more perplexed, we have noted that the nature and scope of the assurance opinions issued by the various SSBs also differ. Most SSBs issue Sharia'a compliance opinions on the activities of the IFI for the year then ended based on the transactions sampling they would have carried out over the period. Most of these opinions give positive assurance on the compliance of the IFI. However, some SSBs state that they have reviewed all transactions and activities of the IFI as opposed to a sample while a minority of SSBs issue negative assurance opinions.

All of this is also compounded by the fact that there seems to be no industry accepted definition of the experience and qualifications needed to work as a scholar. This is obviously less of an issue when it comes to the big industry names such as Sheikh Nizam Yaqoubi and Dr Mohamed El Gari to name a few, who are practically household names now. However, arguably, this is potentially a barrier to entry for the next generation of leading scholars.

This leads us on to the next challenge, which sees many IFIs being advised by the same scholars. As one senior Islamic banker stated: "if you want to establish a high quality Islamic finance business with zero tolerance for compliance issues then there is a select group of scholars you have to use". Some industry commentators respond that this is no different to the Big 4 accounting firms being auditors to 99% of the FTSE 100, however, the Big 4 are subject to independent oversight by industry regulators around the world. With a few exceptions, there is little independent regulation of Sharia'a scholars currently in place.

External assurance arrangements to achieve/demonstrate Sharia'a Compliance

As noted, some jurisdictions (especially those that follow AAOIFI standards) require some form of external assurance around the IFIs' Sharia'a compliance arrangements and this is typically the responsibility of the IFI's external auditor.

As such, an external audit of an IFI may entail not only a statutory financial audit, but also an audit of the Sharia'a compliance of the entity. Since IFIs are required to adhere to Sharia'a principles in all their business activities and operations, external auditors in some jurisdictions express an opinion as to whether all transactions and products entered into during the financial year are in compliance with the Islamic Sharia'a rules and principles, and fulfill the specific directives, rulings and guidelines issued by the SSB of the entity.

In addition, some jurisdictions, such as Malaysia, Pakistan, Oman and Nigeria, have set up a Centralised Sharia'a Board (CSB). The advantage of a CSB is that it brings consistency to financial products and services offered by IFIs. The disadvantage of a centralised structure is that it can inhibit the SSB's ability to provide solutions and innovations that are relevant to that particular IFI. Further to this, an IFI operating across different jurisdictions may find it difficult to adhere to guidelines set by different CSBs. Nevertheless, it seems that a CSB can complement the SSB function by providing clarification at a regional level over Islamic investment and accounting issues.

At the other end of the spectrum is the UK, which is typically accepted as the leading hub for Islamic finance in the Western world given the number of institutions (including stand-alone) offering Islamic financial products there together with the recent UK Government Sukuk issuance. However, the regulators over the years have taken a strictly secular approach to Sharia'a governance, preferring to let the industry itself arrive at what the right framework might look like. While this approach is understandable, it is also a little risky given that Sharia'a compliance is a fundamental aspect of operational risk in an Islamic financial institution. The result is that Sharia'a governance models range fairly widely across Islamic financial institutions in the UK.

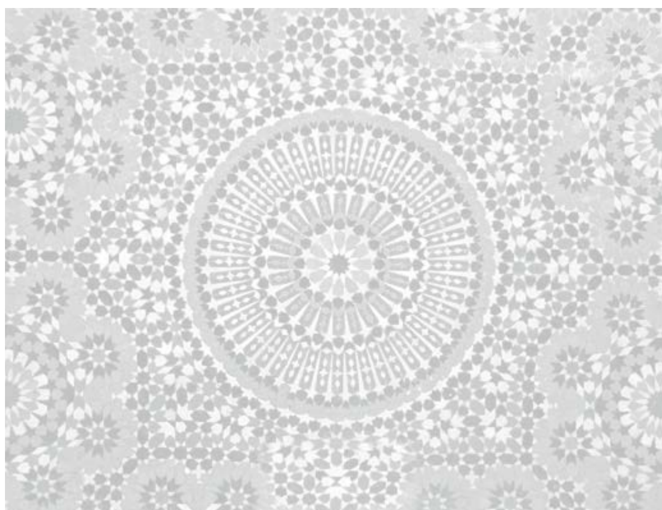
Recent developments

It always needs to be remembered that while the wider conventional financial markets have been in place for hundreds of years, modern Islamic finance only really emerged on to the scene in the 1970s. As such, it has had a whole suite of issues to address as it developed over the past forty years from product development to convincing skeptical customers of the validity of its offering and Sharia'a governance has been only one of many challenges.

However, there is recent evidence to suggest that more and more stakeholders within the industry are recognizing the need for more regulation and standardization around forms of Sharia'a governance frameworks within the Islamic world.

In May 2016, the UAE Cabinet approved the launch of a new Sharia'a Authority, a national regulator to set standards for Islamic finance products, oversee the Islamic financial sector, approve financial products and set rules and principles for banking transactions in accordance with Islamic jurisprudence. Members of the new board will be selected by the UAE Central Bank and subject to its oversight. The UAE Sharia'a Authority will be modeled on the Malaysian version and will effectively act as a higher level of approval for products approved by individual Islamic finance SSBs which will continue to exist.

The Central Bank of Bahrain (CBB), in the meantime, has proposed new governance rules that would require Islamic banks in the Kingdom to conduct annual external Sharia'a audits of their operations which will be a significant shift away from the existing internal assurance arrangements. It is understood that this move is partially to placate concerns of some market participants and customers that the activities of some Islamic finance houses are sailing too close to the wind of conventional finance.



Conclusion

There does not seem to be a single accepted model of achieving and demonstrating 'Sharia'a compliance' to the market and the stakeholders of the IFI. The current structures and processes established within IFIs for monitoring and evaluating Sharia'a compliance consist of internal and, in some cases, external features. One of the defining lessons of the recent financial crisis has been around the need for better and more transparent corporate governance. We believe this should also apply to developing more consistent and rigorous Sharia'a governance models across the Islamic finance industry around the world and we welcome some of the recent moves to greater standardization around Sharia'a governance frameworks within the region, which will further fortify governance frameworks overall.

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Our global Islamic Financial Services team consists of country, regional and service line leaders with expertise in helping clients in over 90 countries. Having the perspective of industry experts from a range of assurance, tax and advisory service lines, as well as the major global financial centers, places us in an excellent position to help leading financial institutions, including banks, drive and manage their growth, specifically within Islamic Finance.

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Helping you unlock the challenges

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- Taxation advice
- Regulatory authorisation and compliance
- Testing Sharia'a compliance
- Conversion advisory services
- Issue and placement of Islamic products
- Forensics and anti-money laundering compliance
- Corporate governance advice
- Financial risk management
- Strategy development and implementation
- Market feasibility studies
- IT risk management and governance
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