Islamic finance: Challenges and opportunities

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Islam prohibits the charging and payment of interest on financial transactions and advocates social justice and equality through distribution of wealth within the society. Following these principles, the Islamic banking and finance sector has experienced rapid global acceptance since the establishment of the first commercial Islamic bank in 1975. With annual growth rates of between 15 per cent and 20 per cent, the assets of the Islamic finance sector are expected to reach the US\$2 trillion mark by the year 2015.¹ The strong performance of the Islamic financial institutions during the global financial crisis has further enhanced the reputation of the sector as a legitimate alternative to the conventional financing system. However, the sector faces many challenges as it continues to expand globally. These challenges include the regulatory environment in some countries that limit the ability of Islamic financial institutions to offer certain financing products, and a lack of consumer knowledge about the system.²

The current Special Issue 'Islamic Finance: Challenges and Opportunities' provides practical insights into the operations of the Islamic financial sector. The papers are written by authors from Africa, Asia and Europe and provide an international perspective covering the markets for Islamic financial products in the Gulf countries, Malaysia, Pakistan and Europe.

The issue opens with a contribution by Volk and Pudenko that identifies the major challenges and opportunities for Islamic retail banking in Europe. The authors compare

two European markets of Britain and Germany and propose a framework that aids in determining the evolution of a domestic market for Islamic Banking. The framework consists of four attributes: demand conditions, supply conditions, regulatory conditions and societal conditions. The paper suggests that further expansion of Islamic Banking in Europe would require changes in the regulatory environment to allow implementation of Islamic banking schemes and comparable tax treatment to conventional banking. The role of the customers is also identified in the paper which concludes that the consumers need to play a proactive role in aiding the growth of Islamic banking in Europe.

Among the criticisms of the Islamic financing system is the claim by some observers that the system, like the conventional option, focuses on the economic outcomes rather than the social concerns. The paper by Dusuki addresses this issue and advocates the importance of understanding the *Maqasid al-Shariah* (objectives of *Shariah*). Dusuki analyses the equity-based *Sukuk* financial structures and explains that in order to distinguish itself from the conventional system, Islamic financial agreements should go beyond the economic outcomes of the contracts, and focus on the spirit of the system that emphasizes social justice and equality.

The next paper by Kaleem and Ahmad looks at the *Shariah* compliant agriculture financing options in Pakistan. With Pakistan attempting to increase the market share of Islamic banking to 12 per cent by 2011, the

range of Islamic financial products offerings has increased. The authors study the bank staffs' perception and understanding of the forward sale agreement on crops (*Bai Salam*) in Pakistan. On the basis of the sample of 173 respondents, the paper concludes that the application of *Bai Salam* contracts has been limited owing to poorly kept land records, wide spread illiteracy and restrictive government policies.

The ability of the Islamic financial sector to withstand the economic downturn during the global financial crisis is analysed in the next paper by Alam and Rajjaque. The paper compares the performance of *Shariah* compliant equities with equities in the wider general market. The authors construct three portfolios based on the constituents of S&P Europe 350 that represent overall market, the market without the financial firms and the market of *Shariah* compliant equities. The findings of the study reveal that the portfolio of *Shariah* compliant equities outperforms the other two portfolios and shows less variability, and is therefore considered less risky.

Sufian's paper titled 'Productivity, Technology, and Efficiency of De Novo Islamic Banks: Empirical Evidence from Malaysia' looks at the impact of entry of foreign banks on the Islamic banking sector in Malaysia. Using the Malmquist Productivity Index (MPI) methods, the paper analyses the performance of the De Novo bank in Malaysia over the last decade and compares the operational performance with those of other foreign and domestic Islamic banks in Malaysia. The findings of the study indicate that the change in technology and technological know-how has resulted in foreign Islamic banks outperforming their domestic counterparts in Malaysia. The findings also show that the De Novo banks have been more efficient and productive than the other banks operating in Malaysia

and have therefore outperformed their domestic and foreign Islamic bank counterparts. Sufian concludes that the entry of the De Novo bank as a subsidiary changed the structure of the Islamic banking sector in Malaysia where foreign banks had previously offered their products via Islamic windows.

The special issue concludes with the final paper by Hussein that examines the behaviour of key bank-level stability factors of liquidity, capital, risk-taking and consumer confidence in Islamic and conventional banks operating in the same market. Using a sample of 194 banks from the Gulf Cooperating Countries between 2000 and 2007, Hussein finds that liquidity is not determined by a bank's product mix but rather attributed to systematic factors. The findings also reveal that Islamic banks generally tend to provide higher consumer confidence levels due to the fact that they are more capitalized than conventional banks, have positive and significant relationship with liquidity and tend to follow stringent risk strategies compared to conventional banks.

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