# Islamic Economics and Finance: Challenges and Opportunities for Dubai

## Abstract

This study examines the characteristics of Dubai market for Islamic finance and financial services and analyse the activities of the major institutions involved. In this context, the study addresses some regulatory issues that present a particular challenge in an environment where little account has been taken of the needs and preferences of clients, especially with regard to those who want to respect the Shari'ah, which prohibits interest, based transactions. In addition, the analysis explores the challenges Islamic financial institutions are facing globally and particularly in Dubai. Then, in the same way opportunities are addressed and analyzed. It is found that Islamic finance has indeed some internal challenges, in the form of weak corporate governance practices, lack of products for liquidity risk management, lack of standardization in the products, and the relative small size of the majority of Islamic financial institutions compared to conventional institutions. It is suggested that some institutional changes have to be taken into consideration by major Islamic banking and finance organizations in Dubai to make Islamic finance attractive to Muslims and non-Muslim consumers and compatible with the conventional financial system.

**Keywords:** corporate governance, regulations, Dubai, institutions, products, Shari'ah

## Introduction and Background

Islamic banking and finance has shown progressive development all over the world since mid-1970s. Many potential markets, however, still not much familiar with the progress and development in Islamic Economics & Finance. His Highness Sheikh Mohammad Bin Rashid Al Maktoum, Vice President and Prime Minister of the UAE and Ruler of Dubai, has launched the "Dubai: Capital of Islamic Economy" initiative which envisions setting up integral platform for an "Islamic Economy". This initiative requires innovative instruments such as liquidity management to create a proper environment for Islamic financial product initiation and innovation in the UAE. The strategic plan relies on seven main pillars and 46 initiatives; which include:

i. the establishment of Dubai as global reference and economic engine of Islamic Finance;

ii. a trusted name and solutions provider for the halal industry;
iii. a destination of choice for family tourism;
iv. a pioneer of the Islamic digital economy;
v. a capital of Islamic fashion, arts and design;
vi. a global network of information and education on Islamic economy; and
vii. a world class centre for Islamic economy standard and certification.

Many of these initiatives have already been launched, such as the Dubai Global Sukuk Centre, the Dubai Centre for Islamic Finance, the Global Islamic Economy Summit and Islamic Economy Award.

In the context of above-mentioned initiative, a comprehensive long-term strategy is needed to accomplish the important initiatives. Dubai is emerging as the major center for Islamic banking and finance in the region. Dubai has created and attracted massive investments in both hard and soft infrastructure. The next step is to move from an investment-driven economy to an innovation-driven economy. The strategy, in this regard, need to address the challenges, opportunities and policy options for Dubai to be a global center of Islamic Economy & Finance.

The objective of this study is to examine the characteristics of Dubai market for Islamic finance and financial services and analyse the activities of the major institutions involved. In this context, the purpose is to cover some regulatory issues which present a particular challenge in an environment where little account has been taken of the needs and preferences of clients, especially with regard to those who want to respect the Shari'ah which prohibits interest based transactions. There are continuous discussions and debate to build a robust institutional investor base for Islamic finance, Sharia governance of Islamic product offerings and the convergence of Islamic finance with the ethical and socially responsible investment industry. The initial challenge about introducing Islamic finance and shari'ah compliance products requires some amendments in the financial regulatory frameworks. This study tries to look closer at the measures to be taken and changes to be made from both, the regulatory authorities and Islamic financial institutions, in order to come up with suggestions on how this problem could be solved, paving the way for the establishment and growth of Islamic finance in Dubai. In this context, the objective is to explore and analyse the challenges Islamic financial institutions are facing globally and particularly in Dubai. Then, in the same way opportunities are addressed and analyzed. The purpose is to see that Islamic finance has indeed some internal challenges, in the form of weak corporate governance practices, lack of products for liquidity risk management, lack of standardization in the products, and the relative small size of the majority of Islamic financial institutions compared to conventional institutions.

The majority of the literature related to Islamic finance in the Western world is country related. They only examine the role of Islamic finance in a respective country according to its Muslim population. The objective of our study is to provide a comprehensive overview of opportunities and challenges that Islamic financial institutions (IFIs) face in the world. One problem here is non-compatibility of Islamic banking with the established financial order of many countries in the world. The other is the limited effort of these countries to encourage the introduction of Islamic finance.

The above mentioned led us following problem statement:

*What regulatory measures do Dubai must take, and what institutional changes IFIs must make, in order for Islamic finance to thrive and prosper in the region, not only for Muslim but also non-Muslim consumers?*

To provide a basis for concluding on this problem statement, the following research questions will be answered:

- *Which fundamental changes (both regulatory and non-regulatory) have to be taken into consideration by policy makers in the world for encouraging and integrating IFIs into the prevailing system?*
- *Which institutional changes have to be taken into consideration by major Islamic banking and finance organizations, in order to make Islamic finance attractive to Muslims and non-Muslim consumers and compatible with the conventional financial system in the Western world?*
- *To answer the above mentioned research questions, the structure of proposed study is as follows:*
- **Part 1** presents an outline of the Islamic finance, its theory, products and institutions, in order to provide the reader with fundamental theoretical background of the Islamic finance and financial institutions, and to gain an understanding of the terms and services that Islamic finance provide. The challenges and opportunities facing the Islamic finance globally, and particularly in Dubai, are discussed and analyzed in **Part 2**. The challenges and their possible solutions have been explored in the context of issues related to corporate governance, risk management, the role of central banks, regulations and public policies. In addition, the opportunities are being addressed in terms of market development and product development. The final part deals

with the questions “what should be done, from both the Western legislators’ side and Islamic financial organizations’ side, in order for Islamic financial services to thrive and prosper in the region and particularly in Dubai, the emerging global center of Islamic Economics and Finance.

**PART I:**

**Islamic Finance: Theory, Institutions & Products**

The philosophy or subject matter of finance deals with the management, creation of money, banking, credit investment, assets and liabilities. The public and private financial systems contain financial instruments that can be related to countless assets and liabilities. The study of finance is divided into three broad categories: Public Finance, Private Finance and Personal Finance. The public financial sector include government taxes, spending, budgeting and debt issuing policies. Private Finance is a method of providing funds for major capital investments where private firms are contracted to complete and manage the projects. Personal finance is the financial management which an individual or a family unit performs to budget, save, and spend monetary resources over time, taking into account various financial risks and future life events.

Islamic finance refers to the means by which corporations in the Muslim world, including banks and other lending institutions, manage and raise capital in accordance with *Sharia*, or Islamic law. It also refers to the types of investments that are permissible under *Shariah* law. Financial system encompasses financial institutions, borrowers and lenders within the regional and global economy. Islamic financial system operates according to Islamic law (sharia) and is, therefore, sharia-compliant. Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies like the conventional financial system. However, Islamic law, rules and regulations that apply to their conventional counterparts, govern these entities. The main principle of Islamic finance is its adherence to interest or riba-free financial transactions, while other principles are: prohibition of fixed return, profit-and-loss sharing and hence risk sharing, participatory financing; prohibition of gharar (uncertainty), speculation and gambling; money not having any inherent value in itself; and also equity-based financing.

The proponents of Islamic Finance argue that Islamic finance is relatively less prone to crisis because its risk-sharing feature reduces leverage and encourages better risk management on the part of both financial institutions and their customers. Furthermore, it is argued that Islamic finance is more stable than conventional finance, because: (i) Islamic finance involves prohibitions against speculation; (ii) financing is asset-based and thus fully collateralized; and (iii) it is founded on strong ethical precepts. Moreover, Islamic financial institutions (IFIs) are considered good platform(s) for increasing access to financial inclusion, including access to finance for SMEs, thereby supporting growth and economic development.

Islamic finance emerged in the early 1960s with the objective of developing and providing alternative financial contracts in conformity with Sharia principles as necessitated by Islam.[1] Previously, various Islamic modes of financing were used in different parts of the Muslim world but the institutionalisation of Islamic finance in the modern form of banks and financial

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[1] Shari'ah or Islamic jurisprudence is based on primary and secondary sources of law. The first primary source is the Quran, the divine revelation that contains legal injunctions, and the second primary source is the Sunna, which relates the practice or code of conduct of the Prophet. Secondary sources of law are Ijma' or consensus, Qiyas or analogical deductions, and Ijtihad or interpretations to explain the law, with differences among various school of thoughts (such as the Sunni and the Shia).

institutions started with the pioneering experiments in the early 1960s in Egypt. The Mit Ghamr Islamic Bank (MGISA) in Egypt in 1963, mobilized the savings of Muslim investors and attracted a flood of deposits, which grew at the rate of more than 100 percent per year in the first three years of operations. The first major Islamic commercial bank-the Dubai Islamic Bank (DIB)-was established in the UAE in 1975 and success of the DIB led to the establishment of similar banks like Faisal Islamic Bank (Sudan) and Kuwait Finance House (Kuwait) in 1977. The Shari'ah-compliant profit sharing financing companies were allowed to operate in 1980 after required amendments in the legal framework to initiate bank finance through Islamic instruments. The financial infrastructure, including standards setting and regulatory institutions, has also been catching up with the rapid growth of Islamic financing. International standard-setting institutions were established to guide the operations of the industry around the world, although standardization of Islamic products across different countries remains a challenge.

Since 1991, the Accounting and Auditing Organization for Islamic Financial Institutions

(AAOIFI), based in Bahrain, has been issuing accounting, auditing, and Shari’ah standards for financial reporting at Islamic financial institutions. The Islamic Financial Services Board (IFSB), established in 2002 in Malaysia, is responsible for issuing supervisory and regulatory standards and guidelines. In 2001, the International Islamic Financial Market (IIFM) in Bahrain was mandated to develop guidelines for the issuance of Islamic financial instruments and to encourage active secondary market trading. Most recently in 2010, the Malaysia-based International Islamic Liquidity Management Corporation (IILM) started issuing short-term Shari'ah-compliant financial instruments to facilitate cross-border Islamic liquidity management.

Islamic finance assets grew at double-digit rates during the past decade, from about US$200 billion in 2003 to an estimated US$1.8 trillion at the end of 2013 (Ernst & Young 2014; IFSB 2014; and Oliver Wyman 2011). However, despite this growth, Islamic finance assets are still concentrated in the Gulf Cooperation Council (GCC) countries, Iran, and Malaysia, and represent less than 1 percent of global financial assets.

**Key Instruments of Islamic Finance**

The concept of loan in Islamic Finance is benevolent loan (qard al hasan), a form of financial assistance to the needy to be repaid free of charge. The other modes of financing in Islamic Finance are not referred to as "loan" rather fall under one of three categories:

i) Profit-loss sharing (PLS);
ii) Non-PLS contracts; and
iii) Fee-Based products.

PLS Financing Products

PLS financing is based on the principles of equity and participation, closest to spirit of Islamic Finance and have strong links to real economic activities. *Musharkah* and *Mudarbah* are two main types of Islamic Finance.

*Musharakah* means the act or contract of striking up a partnership and considered as a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. The exact meaning of this term is limited in comparison to the term *Shirkah,* which is more commonly used in classical Islamic law. *Musharkah* partnership is considered as the most authentic form of Islamic financing where two or more partners provide capital to finance a project or own real estate or movable assets, either on permanent or diminishing basis. Diminishing Musharkah (*Musharkah mutanaiqisa*) is mostly used in home financing where ownership of the equity is gradually transferred completely to the buyer. The partners in musharkah have a right to take part in the management of business. *Musharkah* can be limited (*shirkat-ul-inan*) or unlimited (*mufawadah*) where *shirkat-ul-inan* gives different rights to different partners and is limited in scope in the sense that each partner is the agent only and not the guarantor of other partner. In case of *mufawadah*, an unlimited partnership, every partner ranked equally and is both the agent and the guarantor of the other.

*Mudarbah* is a profit-sharing and loss-bearing contract where funding is supplied by the financier (*mustasmir* or bank) and effort and management expertise are provided by the entrepreneur as agent (*mudarib*). The share in profit is determined by an agreed ratio but losses are borne entirely by the financier with certain conditions such as there is no misconduct, negligence or breach of contract by the *mudarib*. It is sort of "sleeping partnership" where mudarib runs the business without any interference by the financier. *Mudarabah* contracts are generally used for mutual funds and Islamic banks mainly make use of *mudarbah* financing to raise funds.

**Non-PLS Financing Products**

Non-PLS financing products are generally used to finance consumer credit, corporate credit, asset rentals and manufacturing. In practice, the most common non-PLS instruments include *murabahah, ijarah, salam* and *istisna*.

*Murabahah* transactions are generally used in trade and asset financing where bank purchases the goods and delivers them to the customers with the condition of deferred payment agreed by the two parties. This is usually aligned with interest payments, but *murabahah* facilitate the acquisition of goods and not to exchange money for money over a period.

*Ijarah* is a lease contract of sale of the right to use an asset for a period of time whereby the leaser own the leased asset for the entire lease period. Since the ownership remains with the leaser, the lessee can repossess the asset in case of nonpayment. The leaser is also responsible for the maintenance of the asset provided that the damage is from lessee side. Generally, *Ijarah* is based on hire-purchase agreement whereby the leaser agrees to sell the asset to the lessee at the end of lease agreement.

*Salam* is a form of forward agreement where delivery occurs at a future date in exchange for spot payment. The agreement is based on the principle that commodity cannot be sold before it is produced. *Istisna* is another form of forward contract between the end user and the manufacturer where under the first *istisna*, the bank agrees to receive payments from a client on a longere-term schedule and under the second contract, the bank (as a buyer) makes progress installment payments to the producer over a shorter period of time.

*Istisna* involves the sale of unique manufactured goods while slam can be used in standardized goods. Istisna allows for spot, deferred or even installments' payments, but *salam* requires spot payment of full price. Salam contract cannot be cancelled once it is signed as compared to *istisna* contract which can be cancelled unilaterally until the date that manufacturers starts working on the goods. The delivery time of goods is fixed in *salam*, whereas a maximum time for delivery can be specified in *istisna* after which the buyer is no longer bound to accept the goods.

In addition to above mentioned Islamic Finance products, Islamic banks offer a variety of fee-based services using three types of contracts: *wakalah, kafalah, ju`ala*. These are mainly the supplementary instruments to the main *murabahah* and *mudarbah* transactions such as bank transfers, LoCs, guarantees, credit cards, collection and safe custody services, generating various types of fees and commission.

In *wakalah* based trade transactions, the bank acts as the agent or *wakeel* of customer in a trade transaction or issuing a letter of credit facility. The Islamic banks, generally, raise demand deposits (*wadi`a*) using *wakalah* contracts.

*Kafalah* is a form of financial guarantee by the bank to a creditor on behalf of the debtor to cover fines or any other personal liability. Guarantees are typically used to secure the import of goods, in which case a bank issues a guarantee when the exporter discharges the liability for the goods on behalf of a third party. Each party, whether an exporter or importer, can be assured that the transaction will end up in receiving his dues (the price, for an exporter, and the goods for an importer) as agreed upon. The importer may be asked by his banker to post some form of collateral as surety, and typically pay a fee (*ujrah*) for this service. *Kafalah* is not an actual transaction, but is rather used to facilitate transactions such as international trade.

**Islamic Finance Institutions**

Islamic finance is now serving more than seventy countries and expanding in both the Muslim and non-Muslim communities such as the United Kingdom and wider Europe, Japan, South Africa and Kenya. Africa is appearing as a new emerging market for the Islamic Finance industry as it is gaining increasing regulatory support in North Africa, specifically Tunisia, Morocco and Kenya. Kenya plans to issue its debt *sukuk* in financial year 2015/16. Islamic banking in the East and North African region are set to finance infrastructure developments and gaining momentum across the continent.

According to *The Banker* survey data, the banks and financial institutions offering *shariah* compliant services adapting their business models to a new set of market conditions.[2] The Banker report 2015 indicated 360 institutions reported sharia-compliant activities. Out of these 360 institutions, 111 are conventional banks operating semi-separated sharia windows, while 248 are wholly compliant independent organizations. The ranking of year 2015 shows that 198 institutions are commercial banks, 32 are foreign owned subsidiaries and 90 are insurance companies. According to the Banker`s 2015 Islamic Financial institutions survey, the industry`s total assets moved into the negative territory after years of double-digit growth from 2007 to year-end 2013. The compound annual growth rate of assets in Islamic Financial institutions was recorded as 15.73 % from 2007-2013 and single digit growth reported as 9.81% in 2014 and in the 2015 ranking total assets fell 8.48%. Despite a decline in the overall assets of Islamic Finance market, it still commands assets annual compound growth rate of 12.68% from 2007-2015. The decline in

[2] Top Islamic Financial Institutions, the Banker Report (November 2015).

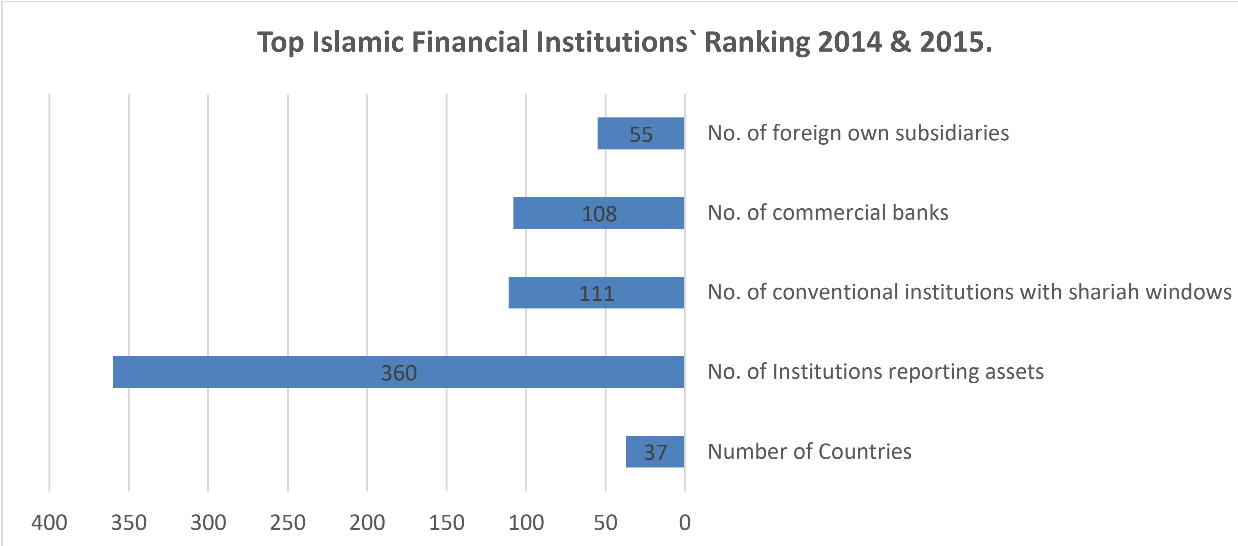
assets growth in the last two years can be attributed to new market regulations, exchange rate differentials, market saturation in highly banked economies and consolidation in some markets. The *Shariah* compliant assets in the Islamic Finance industry declined from $1.391bn in 2014 to $1.273bn in 2015. The most significant decline in the assets was recorded in Iran where assets contracted by 38.79% due to exchange rate changes against the US dollar. Furthermore, the Banker`s survey reveals that 360 institutions reported shariah-compliant activities and are adapting their business models to a new set of market conditions. Out of these 360 institutions, 111 are conventional banks operating semi-separated *shariah* windows, while 248 are wholly *shariah* compliant independent organizations. The ranking in 2015 shows that 198 institutions are commercial banks, 32 are foreign owned subsidiaries and 90 are the insurance companies.

The Banker`s survey Report 2015 reveals that out of 360 Islamic Finance Institutions, 282 (78.55%) institutions reported an increase in assets while 77(21.44%) reported decline in total assets. Ranking the profitability of the industry indicates that 294 institutions reported positive profits from the previous years and 52 institutions reported a decline in profits from the previous year.

**Highlights of the Top Islamic Financial Institutions Ranking 2014 & 2015**

| **Institutions** | **Numbers** |
|---|---|
| Number of Countries | 37 |
| No. of Institutions reporting assets | 360 |
| No. of conventional institutions with *shariah* windows | 111 |
| No. of commercial banks | 108 |
| No. of foreign own subsidiaries | 55 |

Source: The Bankers Report: 2015.




**Regional Asset Growth ($bn)**

| | 2014 | 2015 | % Growth |
|---|---|---|---|
| **GCC** | $561 | $640 | 14.19 % |
| **Non-GCC MENA** | $537 | $339 | -36.97 % |
| **MENA Total** | $1098 | $979 | -10.83 % |
| **Sub-Saharan Africa** | $11 | $8 | -22.11 % |
| **Asia** | $259 | $269 | 3.69 % |
| **Australia/Europe/America** | $24 | $17 | -26.52 % |
| **Global Total** | $1392 | $1273 | -8.48% |
| **% of MENA total to global total** | 78.9% | 76.87% | |

**Source:** Top Islamic Financial Institutions: The Bankers` Report 2015.

**In numbers:**

| | |
|---|---|
| Total shariah assets in ranking | $1,273bn |
| Total shariah assets of standalone banks (exc widows) | $946bn |
| Total shariah profits of standalone banks | $12.53bn |
| Average return on assets of standalone banks | 1.10 % |

**Source:** Top Islamic Financial Institutions: The Bankers` Report 2015.

**Top 25 fully shariah-compliant institutions by pre-tax profits (including all institution types)**

| Rank | Institution | Country | Pre-Tax Profits $m | % change |
|---|---|---|---|---|
| 1 | Al Rajhi Bank | Saudi Arabia | 1,822.98 | -8.09 |
| 2 | Mellat Bank | Iran | 947.01 | 51.34 |
| 3 | Dubai Islamic Bank | UAE | 768.00 | 64.10 |
| 4 | Pasrgad Bank | Iran | 663.00 | -42.70 |
| 5 | Kuwait Finance House | Kuwait | 633.00 | 18.32 |
| 6 | Bank Rakyat | Malaysia | 613.00 | -5.26 |
| 7 | The Company for Co-operative Insurance (NCCI) | Saudi Arabia | 560.12 | n/a |
| 8 | Masraf Al Rayan Bank | Qatar | 554.00 | 16.14 |
| 9 | Abu Dhabi Islamic Bank | UAE | 476.00 | 20.81 |
| 10 | Qatar Islamic Bank | Qatar | 469.00 | 30.64 |
| 11 | Bank Sederat Iran | Iran | 446.00 | -10.44 |
| 12 | Tejarat Bank | Iran | 434.42 | 57.09 |
| 13 | Al Barka Banking Group | Bahrain | 375.00 | 5.93 |
| 14 | Parsian Bank | Iran | 348.00 | -47.75 |
| 15 | Alinma Bank | Saudi Arabia | 337.00 | 26.22 |
| 16 | BOPA Arabia for Co-operative Insurance | Saudi Arabia | 301.28 | 104.48 |
| 17 | Eghtesad Novin Bank | Iran | 236.00 | -41.37 |
| 18 | Bank Albilad | Saudi Arabia | 230.00 | 18.56 |
| 19 | BIMP Holdings | Malaysia | 229.00 | -6.53 |
| 20 | Qatar International Islamic Bank, Doha | Qatar | 226.00 | 9.71 |
| 21 | Sina Bank | Iran | 203.00 | 14.69 |
| 22 | Barwa Bank | Qatar | 195.00 | 41.30 |
| 23 | Faisal Islamic bank of Egypt | Egypt | 178.90 | -1.16 |
| 24 | Karfarin Bank | Iran | 170.00 | -37.73 |
| 25 | Bank Al Jazira | Saudi Arabia | 152.00 | -12.14 |

**Source:** Top Islamic Financial Institutions: The Bankers` Report 2015.

**Top 10 Fastest Growing Fully Shariah-Compliant Institutions**

| Rank | Institution | Country | Shariah-Compliant Assets $m | % change |
|---|---|---|---|---|
| 1 | Al Salam Bank | Bahrain | 5,200.00 | 79.68 |
| 2 | Al Rayan Bank | Uk | 1,012.46 | 76.09 |

| | | | | |
|---|---|---|---|---|
| 3 | BUPA Arabia for Co-operative insurance | Saudi Arabia | 1,261.02 | 70.53 |
| 4 | City Bank (Bank Shahr) | Iran | 5,107.13 | 63.89 |
| 5 | Tourism Bank | Iran | 2,969.80 | 62.94 |
| 6 | Ajman Bank | UAE | 3,058.21 | 58.35 |
| 7 | Bank of Industry & Mine | Iran | 8,900.56 | 57.76 |
| 8 | Saman Bank | Iran | 7,886.18 | 52.18 |
| 9 | Sarmayeh (Capital) Bank | Iran | 4,785.91 | 48.88 |
| 10 | Day Bank | Iran | 3,978.84 | 48.59 |

**Source:** Top Islamic Financial Institutions: The Bankers` Report 2015.

**Top 10 Fastest Growing Islamic Windows**

| **Rank** | **Institution** | **Country** | **Shariah-Compliant Assets $m** | **% change** |
|---|---|---|---|---|
| 1 | Habib Bank Limited | Pakistan | 1,159.67 | 127.31 |
| 2 | Export-Import Bank of Malaysia (EXIM) | Malaysia | 781.14 | 52.38 |
| 3 | Bank Muscat | Oman | 1,122.63 | 43.01 |
| 4 | National Commercial Bank | Saudi Arabia | 46,365.61 | 38.92 |
| 5 | Saudi Hollandi Bank | Saudi Arabia | 8,560.00 | 31.99 |
| 6 | Saudi Investment Bank | Saudi Arabia | 8,158.13 | 31.55 |
| 7 | Dev. Bank of Malaysia | Malaysia | 2,105.15 | 26.80 |
| 8 | Samba Financial Group | Saudi Arabia | 18,393.87 | 25.77 |
| 9 | Arab National Bank | Saudi Arabia | 17,626.67 | 25.19 |
| 10 | RHB Capital | Malaysia | 10,347.61 | 23.96 |

**Source:** Top Islamic Financial Institutions: The Bankers` Report 2015.

**20 Largest Countries ranked by total shariah-compliant assets 2015**

| |
|---|
| **IRAN** RANK 1<br>Total Shariah-compliant assets $m: $316,423<br>No. of Institutions offering shariah services: 28<br>Muslim population: 77,685,520<br>Percentage of total population: 99% |
| **SAUDI ARABIA** RANK 2<br>Total Shariah-compliant assets $m: $306,807 |

| |
|---|
| No. of Institutions offering shariah services: 42<br>Muslim population: 27,225,460<br>Percentage of total population: 92.7% |
| **MALAYSIA** RANK 3<br>Total Shariah-compliant assets $m: $206,309<br>No. of Institutions offering shariah services: 37<br>Muslim population: 19,954,199<br>Percentage of total population: 66.1% |
| **UNITED ARAB EMIRATES (UAE)** RANK 4<br>Total Shariah-compliant assets $m: $111,294<br>No. of Institutions offering shariah services: 20<br>Muslim population: 7,084218<br>Percentage of total population: 75% |
| **KUWAIT** RANK 5<br>Total Shariah-compliant assets $m: $84,448<br>No. of Institutions offering shariah services: 27<br>Muslim population: 2,459,915<br>Percentage of total population: 70.7% |
| **QATAR** RANK 6<br>Total Shariah-compliant assets $m: $70,898<br>No. of Institutions offering shariah services: 10<br>Muslim population: 1,478,681<br>Percentage of total population: 65.2% |
| **BAHRAIN** RANK 7<br>Total Shariah-compliant assets $m: $65,068<br>No. of Institutions offering shariah services: 30<br>Muslim population: 944,910<br>Percentage of total population: 70.3% |
| **BANGLADESH** RANK 8<br>Total Shariah-compliant assets $m: $22,298<br>No. of Institutions offering shariah services: 24<br>Muslim population: 143,929,414<br>Percentage of total population: 90.8% |
| **INDONESIA** RANK 9<br>Total Shariah-compliant assets $m: $21,044<br>No. of Institutions offering shariah services: 56<br>Muslim population: 219,946,653<br>Percentage of total population: 87% |
| **PAKISTAN** RANK 10<br>Total Shariah-compliant assets $m: $10,101<br>No. of Institutions offering shariah services: 19<br>Muslim population: 178,653,274<br>Percentage of total population: 96.5% |
| **SUDAN** RANK 11<br>Total Shariah-compliant assets $m: $7,467<br>No. of Institutions offering shariah services: 9<br>Muslim population: 35,159,030 |

| |
|---|
| Percentage of total population: 90.7% |
| **EGYPT** RANK 12<br>Total Shariah-compliant assets $m: $7,015<br>No. of Institutions offering shariah services: 1<br>Muslim population: 79,467,562<br>Percentage of total population: 95.3% |
| **SWITZERLAND** RANK 13<br>Total Shariah-compliant assets $m: $6,879<br>No. of Institutions offering shariah services: 1<br>Muslim population: 401,321<br>Percentage of total population: 4.9% |
| **TURKEY** RANK 14<br>Total Shariah-compliant assets $m: $5,950<br>No. of Institutions offering shariah services: 1<br>Muslim population: 74,320,280<br>Percentage of total population: 98% |
| **BRUNEI** RANK 15<br>Total Shariah-compliant assets $m: $5,025<br>No. of Institutions offering shariah services: 1<br>Muslim population: 317,827<br>Percentage of total population: 75.1% |
| **UK** RANK 16<br>Total Shariah-compliant assets $m: $3,811<br>No. of Institutions offering shariah services: 4<br>Muslim population: 3,096,498<br>Percentage of total population: 4.8% |
| **THAILAND** RANK 17<br>Total Shariah-compliant assets $m: $84,448<br>No. of Institutions offering shariah services: 27<br>Muslim population: 2,459,915<br>Percentage of total population: 70.7% |
| **YEMEN** RANK 18<br>Total Shariah-compliant assets $m: $3,549<br>No. of Institutions offering shariah services: 3<br>Muslim population: 24,718,823<br>Percentage of total population: 99% |
| **SYRIA** RANK 19<br>Total Shariah-compliant assets $m: $2,881<br>No. of Institutions offering shariah services: 3<br>Muslim population: 21,623,085<br>Percentage of total population: 92.8% |
| **ALGERIA** RANK 20<br>Total Shariah-compliant assets $m: $2,516<br>No. of Institutions offering shariah services: 2<br>Muslim population: 39,529,658<br>Percentage of total population: 99% |

**Source:** Top Islamic Financial Institutions: The Bankers` Report 2015.

As mentioned above, Islamic Finance industry`s global growth remained significant in the last ten years except in 2015 when industry`s total asset growth became negative. An exchange rate differential in a number of markets and specifically in Iran has substantially affected the overall growth of Islamic Financial assets. The collapse of Iranian Rial since 2013 eroded the value of Iranian market`s contributions to global *shariah* assets as Iran is the world`s largest Islamic banking market-due to fully *shariah*-compliant nature of its financial system.

Except Iran, the Islamic Financial Institutions appeared strong with continuous annual cumulative growth rate of 12.68% of their assets between 2007 and 2014. The continued growth has largely been driven by the dominant markets of the GCC and Malaysia. The GCC registered a CAGR of 17.49% between 2007 to 2014 as compared to CAGR of 10.55% in Asia and 10.46% in sub-Saharan Africa. Qatari Banks dominated the CAGR of GCC`s Islamic Financial Institution posting a CAGR of 21.09% between 2009 and 2014. These achievements were mirrored, to a lesser extent, elsewhere in the Gulf as fully *shariah*-compliant lenders in the United Arab Emirates achieved a CAGR of 10.64% over this period.

Islamic Banks of the GCC featured top 10 ranking of the Banker`s Survey Report 2015 by Tier 1 capital growth.[3] The *shariah*-compliant banks in Bahrain posted a significant assets` growth rate of 21%

[3] Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable non-cumulative preferred stock. Tier 1 capital is a bank's core capital, whereas tier 2 capital is a bank's supplementary capital. A bank's total capital is calculated by adding its tier 1 and tier 2 capital together. Regulators use the capital ratio to determine and rank a bank's capital adequacy.

between 2013 and 2014. The similar growth was observed in Qatar, Suadi Arabia and the UAE where standalone lenders increased their assets by 38%, 20% and 14% respectively.

## PART II: CHALLENGES AND OPPORTUNITIES IN ISLAMIC FINANCE

Islamic Finance appeared as an emerging sector in the 1970s and evolved to offer a wide-ranging financial system incorporating banking, capital market and *takaful* sectors. Though there is continued growth in *sukuk* and other *shariah*-compliant assets such as *takaful*, yet Islamic banks dominate the Islamic financial industry. Despite the promising development of Islamic banking, empirical evidence on the stability of Islamic banks, however, is so far mixed. Islamic banks functioning tends to be comparable with that of conventional banks in terms of efficiency. However, recent studies show that the profitability of Islamic banks decreased more than the conventional banks during the financial crisis. The instability may be attributed to weaker risk management practices, regulations and financial crisis spillover to the real economy (Rashwan, 2012; Hassan and Dridi, 2011). The countries with well-established regulatory framework are less prone to instability of Islamic banks during the financial crisis as compared to Islamic banks in countries of weak regulatory framework. In addition, the growing Islamic Financial industry is facing considerable challenges in terms of human capital issues, standardization and harmonization, *shariah* requirements and existing legal framework, public awareness, market competition, macroeconomic fluctuations, regulatory variations, the emergence of non-traditional provider of financial services, geopolitics and the advance of technology are influencing the direction of Islamic finance.

The training and education of Islamic finance is vital for the development of dedicated and qualified human capital, as Islamic financial industry needs a specific set of competencies and skills, such as *shariah* understanding and market insight. However, there is still lack of educated and skilled human capital in the Islamic financial services areas such as *Shariah* and Takaful. The existing serving cadre of Islamic finance professionals require additional training and development. The shortage of qualified *shariah* experts and Islamic finance talent poses a significant impact on the growth of Islamic finance.[4]

The differential interpretation of Islamic law generating different interpretation of Islamic finance, which lead to different practices and use of concepts across jurisdiction. This lack of harmonization, standardization and legal uncertainty may get in the way of the growth and internationalization of Islamic finance. A mutual recognition of *Shariah* views on Islamic finance may mitigate the legal uncertainty and the degree of *shariah* non-compliance risk. Another major challenge of Islamic finance is related to public awareness and perception towards Islamic financial product and services. There are some misconceptions about Islamic finance in terms of its limitations as guided by shariah. However, Islamic finance is not limited to Muslims only and is available commercially to both Muslims and non-Muslims. There is fear that Islamic financing is subject to high judicial risk as clients can approach *shariah* courts that rule on case-by-case basis, as well as seek redress in regular courts. The variable rate of return and equity risk arises when Islamic financial institutions enter into *musharkah* and *mudarbah* partnerships as providers of funds. The mark-up on murabahah transactions, which is usually detrmined in relation to a benchmark like LIBOR, cannot

[4] http://www.faa.org.my

be altered (even in the event of prepayment) and Islamic Banks, in this context, face more mark-up (interest rate) risk in fixed-income instruments like *istisna`* and *murabahah*. Mark-up risk results from changes in the benchmark rate that could pose risk to the fixed assets income of the bank. To mitigate the risk, Islamic banks generally use a variety of prudential reserves along with using conventional risk management measures. However, some additional risk mitigating tools are required to address their unique risk exposure. Having a unique nature of Islamic financing, Islamic banks need to develop new techniques, processes, institutional setup and procedure to further enhance risk management practices. Conventional tools used by Islamic banks comprises internal rating system, internal control system, external audits, maturity matching, risk reports and GAP analysis[5].

The Islamic Financial Services Board (IFSB) is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.[6] The major role of ISFB is to set rules on disclosure requirements on displaced commercial risks and smoothing practices. The Islamic codes of corporate governance with further standardization for *Shariah* compliance would benefit Islamic financial institutions. Though it seems challenging to standardize different interpretation of certain religious matters across jurisdictions and *Shaiah* scholars, harmonizing differences

[5] In management literature, gap analysis involves the comparison of actual performance with potential or desired performance.
[6] http://www.ifsb.org/

in the *Shariah* compliance of different instruments would reduce uncertainty and foster industry growth.[7]

**Opportunities in Islamic Finance**

Despite lack of expertise and services tailored to *shariah*-compliance finance, Islamic finance is still making great progresses into mainstream banking. Islamic financial institutions, especially the banks, are now introducing new ways in new markets such as China and North African regions are two targeted destinations for shariah-compliant institutions. This poses opportunities for the exportation of shariah-compliant finance in different parts of the world. A large number of international development agencies such as World Bank, International Finance Corporation (IFC), Islamic Development Bank (IDB) and Asian Development Bank (ADB) exploring the sukuk market to diversify sources to fund their operations.

China`s ambitious infrastructure programme 'One belt, One Road' is beginning to have an impact on the Islamic Finance industry as China has signed currency swap agreements with Indonesia, Kazakhstan, Malaysia, Pakistan, Qatar, Turkey and the United Arab Emirates.[8] Emerging Asian financial institutions are making their presence in Islamic finance markets as Chinese banks such as Bank of China, Industrial and Commercial Bank of China and Agricultural Bank of China now approaching Southern Asia and the Gulf regions. Furthermore, Hong Kong Monetary Authority received orders from 49 global institutions issuing two types of government *sukuk*. China also approached the Arab States especially Qatar and the United

[7] Hussain Mumtaz, Shahmoradi and Rima Turk (2015), " An Overview of Islamic Finance", IMF Working Paper WP/15/120.

[8] The Banker (November 2015), "Top Islamic Financial Institutions Report 2015".

Arab Emirates to establish Islamic financial centres to develop economic cooperation between China and the Arab States.

The introduction of regulatory reforms such as Islamic Finance Services Act in Malaysia in July 2014 and offering of *shariah*-compliant investment options for pension funds in the future are progressive steps to achieve government`s target of pushing Islamic financing to 40% of the domestic total by 2020.

The recent advancements in technology and digital banking also opening many avenues for Islamic financial institutions to turn to digital innovations as most *shariah*-compliant institutions are relatively young, so they have a unique opportunity to harness and benefit from digital innovation in a way that more established conventional institutions do not.

Small and Medium Enterprise (SME) financing by banks has been gradually increasing in most of countries where Islamic Banks operate. However, SME Islamic financing still lacks behind the conventional lending as it comprises only 8.75% of total private sector lending. There are opportunities for Islamic financial institutions to collaborate with international agencies and financial institutions to establish a global SME Islamic fund. The best way for banks to pursue these opportunities is to better understand their SME clients, from their business operations to their financing needs and then the institutions can offer them the right products. In that way the banks can build robust SME banking operations with the right business model and skill. The volatile nature of SME business aligns more closely to Islamic finance as profit and loss-sharing principle encourage the investors to manage the risk through partnership opportunities. The need is to develop further the existing products to be more sophisticated so that they can address the needs of SMEs keeping in view the volatile nature of SME businesses.

**Part III: Challenges and Opportunities for Dubai as Global Islamic Finance Centre**

Given the geographical proximity of Dubai as well as the Emirates religious and cultural links, Dubai is emerging as the global hub of Islamic asset management center. The establishment of Dubai Islamic Economic Development Centre (DIEDC) initiated a strategic plan introducing seven main pillars and forty-six initiatives focusing on promoting and nurturing a culture of ethical and responsible in an Islamic economy ecosystem that ensures sustainable growth and prosperity.[9] The projected potential market for halal industry is estimated around $2600bn in 2020 and the same is the case with financial services, retail, tourism, telecommunications and research & development. Dubai can emerge as a global hub of Islamic asset management having the facility of Dubai International Financial Centre (DIFC) hosting Islamic Banks, Islamic re-takaful (reinsurance) products and Islamic funds. The DIFC emerged as promoting Islamic finance globally through the creation of DIFC Islamic Finance Advisory Council (IFAC), which is developing, and implementing the necessary laws and regulations needed to host Islamic finance within its operations.

According to a new report by the European Islamic Investment Bank, entitled "Dubai as the Global Hub of Islamic Asset Management", the Islamic asset management sector remains largely underdeveloped despite its sizeable international potential and appeal.[10] In addition, Islamic finance is described in different

[9] http://www.iedcdubai.ae/

[10] Top Islamic Financial Institutions, Report by "The Bankers" (2015); pp-17.

interpretations due to different practices and uses of concepts according to different Islamic Laws jurisdictions. The requirement is to develop a middle ground in terms of consensus on standards which are mutually acceptable as guiding shariah standards. There is still lack of multi asset Islamic funds and Islamic financial institutions need to identify ways of incentivizing the creation of multi-asset class funds. Most of the Islamic financial institutions are disintegrated and there is a major challenge of developing new financial instruments based on *shariah* principles to increase investments through convergence between Islamic economy sectors. There is need to develop right infrastructure for the establishment of a financial system that can become a global model to tackle the issues of poverty, unemployment, brain drain, inequality and economic slowdown. Although Dubai overtook other international financial centres to become the World`s leading hub for the multi-billion dollar sukuk trade, yet the requirement is to transform Dubai into a world class centre for the standards and certification needs of the Islamic economy. Dubai has the advantage having advanced infrastructure, economic dynamism and legislative & regulatory flexibility to facilitate the objective and goal of making it as Capital of Islamic Economy.

In the context of opportunities for Dubai to be a hub of Islamic economy, Dubai can maintain its place as a leading market for sukuk having increased the total sukuk value in its market to US$36.7 billion in 2015.[11] The development of an efficient, shariah-compliant platform offering diverse Islamic solutions in the form of various products and services will open the doors to get the top position of global hub for Islamic finance. The brand name Dubai as having the status of the world`s largest sukuk trading platform can fulfil the vision of becoming the global capital of

[11] Top Islamic Financial Institutions, Report by "The Bankers" (2015).

Islamic economy. The exponential growth of Chinese interest in MENA regions infrastructure projects has led Chinese companies, banks, trading houses and big conglomerates to setup their regional offices in Dubai and can be approached to finance the variety of Chinese projects through Islamic financial products and services.

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