The Role of Islamic Finance in Shaping the New Financial Order

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Abstract

The global financial crisis provided an opportunity to test the strength of the Islamic financial system and to discuss the question of whether it represents an alternative to the conventional financial system. Such a crisis would have avoided under an Islamic financial system because most, if not all, of the factors that caused it were absent in the Islamic financial system. Islamic finance is among the fastest growing segments in international financial systems in recent years with an estimated annual growth rate of 20 percent and total assets of more than $1 trillion. Global finance is at a crossroads now. As the existing international financial system experiences its worst crisis since the Great Depression, it is the correct time to look for alternatives. Islamic economics and finance offer a more efficient alternative to the Western approach with its emphasis on equity, risk-sharing, and participatory economic growth. There is no room for excessive leverage and speculation in the Islamic financial system. Also, there exists a close link between finance and real economic activity. This paper argues that Islamic finance entered a new era after the global financial crisis and that it could play an important role in redesigning the global financial order. However, at its current stage of development it is difficult for the Islamic financial system to assume a significant role in ensuring the health and strength of the international financial system in the near future.

Keywords: Islamic finance, Islamic banking, the global financial crisis, new financial architecture.

JEL Codes: F5, F65

1. Introduction

In the early 2000s, the United States (US), and indeed the world, experienced the worst financial crisis since the 1930s and the Great Depression. Events preceding and associated with the financial crisis impacted financial markets and institutions and the way they did business. There is general agreement among economists, politicians, and financial professionals on the causes and consequences of the global financial crisis. However, the search for a solution to the crisis thus far has remained a continuing debate. Global finance is at a crossroads and it is now timely to start looking at alternatives. The question is whether it will be possible to create a new international financial order based on the principles of Islamic finance such as equity, mutuality, and sustainability, instead of speculation and the appetite for short-term profit-making. The crisis brought about enormous challenges for the conventional system but at the same time created an abundance of opportunities for the Islamic financial system.

The purpose of this article is to evaluate the role of Islamic finance in shaping the new financial order as it is one of the fastest growing segments of international financial markets. While Islamic finance challenges the Western dominance of the international financial system, it cannot play a significant role in ensuring the soundness and stability of the international financial system with its present status. This paper is organized as follows. Section 2 gives a brief account of the global financial crisis with a focus on the main causes of the crisis from an Islamic perspective. Section 3 provides an overview of Islamic finance. This section explains the basic concepts and principles of Islamic finance, discusses the roles of money, credit, and banking in the Islamic financial system, and emphasizes the direct connection between Islamic finance and real economic activity.

Section 4 tries to establish a conceptual link between Islamic finance and the global financial crisis, stressing that such a crisis could have been avoided if Islamic financial principles had been prevalent in the international financial system. Section 5 presents the challenges and opportunities ahead of Islamic finance and its potential for redesigning a new financial order.

2. A Brief Account of the Global Financial Crisis

The global financial crisis has stimulated extensive policy debate on the reforms that are needed in global financial architecture to prevent, or at least lessen, the occurrence of a similar crisis in the future (Elson, 2010). Neither the proponents nor the opponents of government intervention and free-market economy schools of Thought have not given a permanent solution to the crisis nor have they provided a practical prescription for how to deal with its consequences and implications. However, a host of Muslim scholars and professionals maintain that Islamic finance has the potential to become an alternative model for the global financial system (Kayed and Hassan, 2011).

Several factors were responsible for the emergence of the crisis (see Allen and Carletti, 2010; Carmassi et al., 2009; and Mishkin, 2011). The conventional view holds that the crisis was caused by extraordinarily high liquidity, laxity of lending standards, and the rapid pace of financial engineering. The general consensus was that it was the worst since the Great Depression. From an Islamic perspective, the primary cause of the crisis is the laxity of lending standards (reckless lending) usually adopted by conventional financial institutions, which is driven by greed and an appetite for excessive returns, and is facilitated by inadequate and inappropriate regulatory and supervisory frameworks. The crisis is, in reality, a crisis of failed morality. This ethical failure together with a breakdown in the relationship between the originators of subprime loans and their investors ('originate-to-distribute model' or securitization) triggered the crisis (Kayed and Hassan, 2011).

Three reasons for this harmful practice of reckless lending are: (a) inadequate market discipline due to the lack of profit-and-loss sharing (PLS); (b) an enormous increase in the size of exotic and complex financial instruments in line with an overreliance on financial models; and (c) the "too big to fail" concept, which tends to give an assurance to big banks that the central bank will bail them out and come to their rescue in a crisis (Ahmed, 2010). Consequently, loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers increased from about $52 billion in 2001 to more than $400 billion in 2005 and 2006. When house prices began to fall in mid-2006, most probably due to a rise in policy rates, the US housing market experienced a general downturn. This caused the prices of securitized mortgages to decline. Financial institutions suffered large losses and came under strain (e.g. HSBC, Merrill Lynch, Citigroup, Lehman Brothers, and AIG). Facilitated by financial globalization, the collapse of some US financial institutions associated with the subprime mortgage crisis transmitted systemic risk across national borders, causing a crisis in the US financial system which had spillover effects on other economies.

The result is that a number of banks either failed or had to be bailed out or nationalized by their governments not only in the US, but also in the United Kingdom (UK), Europe and elsewhere. This created uncertainty in the market and a credit crunch, which made it difficult even for strong banks to raise funds. The Federal Reserve Board (FED) and other central banks sought to improve the operation of money markets. Market participants feared that more was on the way if the prevailing crisis caused a prolonged recession and led to defaults in other parts of the financial system. Government authorities implemented various policy measures to mitigate the adverse effects of the crisis. It is now understood that the world needs new ways of thinking about finance and the risks it involves (Chapra, 2008). There exists an urgent desire for a new financial architecture to give greater market discipline in the financial system. It is at this point where Islamic finance is expected to make a significant contribution to the global financial system.

3. Islamic Finance

Islamic finance has its roots in the jurisprudential body of knowledge which is referred to as Shariah (Islamic law) and derives its principles from the Holy book Qur'an and Sunnah (the sayings and practices of the Prophet Muhammad - Peace be upon him, PBUH) which governs all economic, social activities and undertakings of Muslims. One of the most important goals of Islam is to realize and maintain greater justice in human society (Chapra, 2008). In the Islamic economic framework, it is not possible to achieve sustainable development without justice. According to the Qur'an (57:25), injustice ultimately leads to destruction.

The Islamic financial system promotes justice in two ways: (a) the financier should also share in the risk so as not to shift the entire burden of losses to the entrepreneur; and (b) an equitable share of resources should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities, and thus reduce inequalities of income and wealth (Ahmed, 2010). Moreover, there must be sanctity of contracts. Muslims are obliged to conduct their business activities in accordance with this principle: they have to be honest, fair, and just towards others (Walton, 2011). The Qur'an (2:282; 4:33) promotes the idea of a binding commercial contract made in good faith. The objective of Islamic finance is, therefore, to establish a more equitable financial and economic order which at the same time is transaction-friendly (Rethel, 2011). The ultimate aim is to spread socioeconomic justice among all people regardless of their current social positions (Kayed and Hassan, 2011). The Islamic financial system must be fair, just, and unbiased toward the rich minority at the expense of the poor majority.

3.1. Basic Concepts

The most important pillar of Islamic finance is the concept of Shariah compliance, which dictates that Muslims are strictly prohibited from investing in or dealing with economic activities that involve interest (riba), uncertainty (gharar), and speculation (maisir), regardless of their form or shape or the excuses that are often used to justify them. Muslims are also discouraged and forbidden from production and sale of unlawful (haram) activities.

The prohibition of interest is one of the core elements of Islamic economics. Riba, the Arabic word for "usury" means an unjustified increase and is narrowly interpreted as the paying or receiving of interest or any predetermined fixed rate of return on borrowed/lent money. Islam considers interest to be an unjust return because it is money gained without due efforts or productive work. 'Making money from money' is not ethically acceptable and Islam praises the concern of using money for productive purposes (Rethel, 2011). Charging riba tends to drive the poor into more poverty and create more wealth for the wealthy without doing work or engaging in a productive economic activity or sharing the risk involved in a business enterprise. Therefore, Islam accepts all interest-based financial transactions to be unfair, unjust, and immoral and all money generated through such transactions to be unearned money (see Qur'an 2:275; 4:161). However, the prohibition of interest is not unique to Islam. Judaism, Christianity, and other ethical systems jointly accept interest as an unethical and immoral practice.

Islam prohibits speculation, transactions involving extreme uncertainties, gambling, and excessive risk. Because of its similarity to a zero-sum game in which one party's gain will be equal to the loss of another, all forms of gambling are forbidden. Moreover, gambling includes elements of uncertainty since the outcome of a gamble by definition cannot be predetermined. The aim of prohibition of profiting from uncertainty is to prevent excessive risk taking and launching a venture without sufficient knowledge (Rethel, 2011). This applies to situations where the quality of goods cannot be established or to selling something that has not yet been delivered. The rationale is that one party should not unfairly benefit from the other party's ignorance.

While in conventional economic theory, the production of and trade in goods and services are conceptualized as only being subject to the price mechanism, Islamic economics explicitly specify certain products and activities as unlawful due to their harmful and destructive implications. The production and distribution of these goods and services are against the tenets of the Islamic value system and thus are forbidden. Among others, these socially undesirable goods and services include alcohol, pork-related products, pornography, prostitution, drugs, and so on (Walton, 2011).

Islamic finance is much more than the prohibition of interest. Islam preaches moderation in all aspects of people's lives and commands them to live within their own means. Social responsibility, sustainability, and morality in business life are emerging issues that attract the attention of scholars, politicians, social activists, and professionals. While these issues are now topics of interest in the West, they were already present in the ethical and moral codes of Islam. For example, Muslims cannot take part in any transaction that may involve fraud, dishonesty, exploitation, or ambiguity (see Qur'an 83:1). The Prophet Muhammad (PBUH) emphasized the significance of honesty, especially in business dealings. These values are appreciated and shared by many Muslims and non-Muslims alike who want to invest in socially responsible portfolios although such portfolios have lower rates of return than others.

3.2. Basic Principles

One of the basic principles of Islamic finance is that both the financier and the entrepreneur should equally share the profit as well as the loss. It is called the principle of "no risk, no gain" (Chapra, 2008; Ahmed, 2010). Nobody has the right to reward (profit) if he/she does not equally share the risk of incurring loss. Being a partner, rather than merely a lender, forces the financier (lending institution) to assess risks more carefully and to monitor the use of funds by the entrepreneurs (borrowers) more effectively. The double assessment of risks by both the financier and the entrepreneur helps introduce greater discipline into the system, and thus reduces excessive lending and borrowing (Kayed and Hassan, 2011: 558).

Islamic finance, in its purest form, strongly supports the share of equity in businesses and PLS in projects and ventures (Chapra, 2008). In the absence of interest-based financial transactions, financial relationships between financiers and borrowers are best understood within the framework of PLS contracts (Kayed and Hassan, 2011). Two of the most frequently used modes of financing in equity finance routes are mudarabah (profit-sharing) and musharakah (profit-and-loss-sharing partnership) contracts (Rethel, 2011; Walton, 2011). Heavy reliance on equity financing has supporters even in mainstream economics (e.g. Kenneth Rogoff of Harvard University and the International Monetary Fund –IMF). One important advantage of the equity finance route through PLS contracts is that it requires a high level of disclosure and transparency in the financial system (Ahmed, 2010).

The prohibition of interest makes the debt financing route a controversial issue in Islamic finance. The greater reliance on equity financing does not necessarily rule out debt financing as all the financial needs of economic agents cannot be satisfied only through issuance of equity and PLS contracts. Therefore, debt financing is not excluded but should not be promoted for inessential and wasteful consumption and unproductive speculation. The crucial point is that the Islamic financial system does not allow the creation of debt through direct lending and borrowing rather it requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing such as murabaha, ijara, salam, istisna, and sukuk.

The Islamic financial system sets down a number of conditions that help prevent excessive expansion of debt. Chapra (2008) and Ahmed (2010) stated them as follows: (a) the asset which is being sold or leased must be real, and not imaginary or notional; (b) the seller or lessor must own and possess the goods being sold or leased; (c) the transaction must be a genuine trade transaction with full intention of giving and taking delivery; and (d) the debt cannot be sold and thus the risk associated with it cannot be transferred to a third party (i.e. it must be borne by the lender himself).

The first condition eliminates most of the speculative transactions that involve excessive uncertainty and gambling (i.e. derivatives). The second condition ensures that the seller (or lessor) shares a part of the risk to be able to get a share in the return. It also puts a constraint on short sales. There are exceptions to this rule (e.g. salam and istisna) in cases where the goods are not available in the market and need to be produced before delivery.
This condition shows that Islamic financing modes can only expand in line with the rise of the real economy. The third and fourth conditions eliminate speculative transactions and prevent debt from rising far above the size of the real economy. They not only motivate the lender to be more careful in evaluating the credit risk but also curb an unnecessary explosion in the volume of transactions. Finally, they help release a large amount of financial resources to the real sector, thereby expanding employment and self-employment opportunities and the production of needs-satisfying goods and services.

Regarding the debt financing route, the issuance of sukuk or Islamic bonds is a good example of loan capital raising methods in Islamic finance. They are similar to products of the structured finance and securitization process in contemporary finance (Yanpar, 2014). A sukuk is structured when the contracting party that needs financing, the originator, establishes a special purpose vehicle (SPV) as a part of their financial contract, to facilitate investment and generate cash from assets (Walton, 2011: 16).

3.3. Money, Credit, and Banking

Islamic finance is based on the idea that money has no intrinsic value. It is a medium of exchange. There is no permission to allow money to be traded for money except at par because one cannot make money out of money. Money has the potential to be capital and is considered capital only if it is invested in a business (Walton, 2011). However, banks lend more money than they actually have in their deposits under a fractional reserve system.

By creating money out of nothing and putting it into circulation, central banks and commercial banks have together succeeded in the existence of speculative bubbles (Hassan, 2009). Islamic scholars derive two policy conclusions from this analysis. One is that the supply of money should be proportional to real economic growth to achieve a sustainable development and a more equitable distribution of wealth (Kayed and Hassan, 2011). The other is that there must be independent central banks along with legal limits on governments' ability to borrow so that they do not run into budget deficits within the frameworks of price and financial stability (Chapra, 2008). The discipline that the Islamic financial system wishes to introduce in the economy cannot take place unless governments reduce their borrowings from the central banks. Monetization of budget deficits will provide more reserves to the banks and promote excess liquidity. This, in turn, along with high leverage enables banks to resort to lax lending. Moreover, in a capitalist economy a central bank's regulations and policies are designed for conventional banks and the central bank acts as a lender of last resort. However, most Islamic banks do not enjoy such privileges. Because they are working under different operational procedures than those of the conventional banks, central banks cannot directly control or give support to Islamic banks in case of liquidity problems. In addition, Islamic banks suffer from the same systemic problems that conventional banks are facing due to, for example, lack of proper regulation since many of them are working under secular systems (Hassan, 2009). Thus, there must be no discrimination between the two types of banks with respect to coverage of the central bank's regulations and policies.

In Islamic finance, only one type of loan is permissible, qard'al hasan (good loan), which is an interest free loan where the lender is not allowed to benefit, neither directly nor indirectly, from the lending relationship (see Qur'an 2:245). This applies to 'any advantage or benefit that the lender might secure out of the loan such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall' (Walton, 2011: 10). There is also permission for the suspension of repayments in case the borrower faces financial difficulties (see Qur'an 2:280). In all other cases, lenders (i.e. depositors, banks or portfolio investors) must share in the profits or losses of the business, unlike conventional loans where the borrower has to pay back the principal and interest independently of the success of his/her project and can avoid these obligations only in a bankruptcy.

In conventional banking, the main source of bank profits is the interest rate differential between deposits and loans as the interest rates on deposits are usually lower than the interest rates on loans. In contrast, Islamic finance uses different models of deposit taking. Deposits are taken either as demand deposits for safekeeping or as investment deposits. In investment deposits, funds are placed in profit-and-loss-sharing investment accounts and these deposits are not guaranteed. They are used to finance investment projects and depositors share both the profits and the losses of the enterprise. Thus, depositors turn into shareholders, equity financiers. Bank lending to consumers and small firms generally takes the form of murabaha, a sale with an agreed-upon profit.

Islamic banks assume a leading developmental role in promoting productivity and entrepreneurship (Kayed and Hassan, 2011). Islamic banks must focus on productivity that results in profits on investment projects only when they are successful and all financial transactions must be fully asset-backed (Walton, 2011). In other words, Islamic finance is directly connected to the real economy as its main function is to provide finance to real economic activity (Rethel, 2011). The essence of the market is entrepreneurship, and trade (not banking) is the primary function of markets. Therefore, a close link exists between financial flow and productivity. This feature of Islamic finance protects the financial system from the potential risks of excess leverage and speculative activities (Ahmed, 2010).

3.4. A Short History

The modern history of Islamic finance can be divided into three periods: its emergence in the 1970s and 1980s, its consolidation and increasing internationalization in the 1990s, and finally its take off in the early twenty-first century. During this time, Islamic finance has evolved from an alternative economy at the margins to an increasingly normal field of financial activity (Rethel, 2011). By the mid-1980s, Islamic assets under management amounted to approximately $5 billion. By the mid-1990s, this figure roughly increased to $150 billion. Islamic finance has experienced major transformations and growth, especially since 2000. As a result, the global financial community witnessed efforts to structure Shariah-compliant financial instruments, to develop and institutionalize Islamic capital markets, and in particular, to make Islamic finance acceptable and thus investable to the mainstream. Currently, institutions offering Islamic financial services are estimated to exceed 300 worldwide and to operate in about 50 of the World Bank's member countries.

Islamic finance is now among the fastest growing segments of the international financial system with an annual growth rate of 20% and total assets of almost $1.5 trillion, which is expected to surpass $2 trillion in 2015 and at first glance, appears to be an attractive alternative to the existing financial hegemony (Ahmed, 2010).

4. Islamic Finance and the Global Financial Crisis

Islamic finance has remained relatively positive and untouched given the obscurity and volatility of the recent financial turmoil (see Kayed and Hassan, 2011: 558; Walton, 2011: 17-22). If global banking operations had been conducted in accordance with the principles of Islamic finance, then the global financial crisis would have been prevented or at least its impact significantly reduced because most, if not all, the factors that caused or contributed to the development and spread of the crisis are not allowed under the rules and practice of Islamic finance.

First, a simple but basic rule in Islamic trade is that one cannot sell or lease unless he/she possesses real assets. Islamic finance prevents selling something that you do not own. Practical implications of this rule include limitations on the use of derivatives and prohibition of short selling (Ahmed, 2010).

Second, Islamic finance is based on equity capital rather than debt (loan capital) and lending is conducted on the basis of asset backing. As a result, mortgage loans under such a system are backed by a real asset structure that would protect the banking sector against potential loan defaults. However, in the recent crisis, trillions of dollars were traded without the proper backing of assets. That is, the link between financial flow and real economic activity broke down (Rethel, 2011). In addition, because Islam preaches moderation in all aspects of Muslims' lives and commands them to live within their own resources, the majority of Muslims would not have run to take out loans that they had no possibility of repaying just because an opportunity had existed.

Third, Islamic finance encourages close relationships and trust between financiers and investors. Nevertheless, the collapse of the relationship between the originators of subprime loans and their investors was one of the prompting factors of the recent crisis.

Fourth, Islamic finance requires that potential investors and all stakeholders are fully aware of the opportunities and risks of the business ventures. In addition, financial institutions are obliged to obey the rules of full disclosure and meet transparency standards. Yet the absence of an adequate and effective regulatory framework to monitor and thus to ensure the interests of investors was another major factor that contributed to the current crisis (see Allen and Carletti, 2010: 10-11).

Fifth, given the merits of equity based financing, an honest application of PLS contracts necessitate full disclosure and transparency. These contracts allow the market to assign correct risk premiums to companies, thereby enhancing the potential for market discipline to take place. They also provide built-in mechanisms and balances, which serve to ensure the stability of the financial system.

Sixth, default risk cannot be transferred or sold off. Both lenders and borrowers have mutual interest in the transaction and subprime deals are unlikely to occur in an Islamic financial system. Because Islamic finance views the relationship between the lender (financial institution) and the borrower (investor) as a partnership, the lender has a continued stake in the transaction. Risk shifting is gambling and each and every loan made by a conventional bank is subject to the risk of default. Banks sought to protect themselves against the risk of default by selling these risks to third parties in subprime lending. This would not occur in a true PLS contract where both parties were exposed to the same gain and loss.

Seventh, Islamic finance provides an option for those who are eager to invest in socially responsible portfolios because investor trust was eroded during the recent crisis due to unethical accounting and business practices, and the resulting corporate failures. In Islamic finance, virtual (non-asset backed) money has no place in accounting books. Both Muslims and non-Muslims understand the importance of socially responsible investment projects now (Ahmed, 2010). At the same time, both Muslims and non-Muslims can engage in unethical practices like fraud, corruption and greed as Muslims' actions are not always in harmony with the ideals they advocate. The difference between the ethical dimensions of the two systems is that Islamic finance is governed by divine commands, limiting the unregulated profit motives of conventional finance (Walton, 2011). Western business ethics are, on the other hand, man-made guiding principles, based on trial and error, and a lack of authority and power of generalization (Kayed and Hassan, 2011).

Given these features of Islamic finance and assuming that Muslims always act upon the teachings of Islam in their financial transactions and daily lives, theoretically it would be impossible for a crisis of the type that the world economies experienced recently to occur in an Islamic financial system.

5. Opportunities and Challenges Ahead of Islamic Finance

The current crisis has opened the door to a new international financial order and created an occasion to restructure global economic institutions. This should motivate Islamic finance to exploit existing opportunities and reveal its potential by offering important alternatives to the international financial system. However, there are many opportunities and challenges for Islamic finance. Each of these opportunities and challenges has deep implications for the development and future direction of the Islamic financial system.

5.1. Opportunities

The scope of Islamic finance business has been expanded with the emergence of more diverse Islamic financial institutions and the development of Islamic financial markets (Ahmed, 2010). Examples include International Islamic Financial Market (IIFM), Liquidity Management Centre (LMC), and the issuance of sukuk (Rethel, 2011). The IIFM is a multilateral institution founded by Bahrain, Brunei, Indonesia, Malaysia, Sudan, and the Islamic Development Bank to establish, develop, and promote Islamic money and capital markets. Indeed, it is a state driven initiative that approves and promotes the issuance of sukuk. The LMC, set up in 2002, is also based in Bahrain and is equally owned by Bahrain Islamic Bank, Dubai Islamic Bank, Kuwait Finance House, and the Islamic Development Bank. It offers services such as arranger, manager, and placement agent and gives advice on the structuring and documentation of sukuk. Moreover, it actively promotes a secondary market for sukuk. The volume of the global sukuk market increased from $340 million in 2000 to more than $46 billion in 2007. In recent years, more than $110 billion were raised through the issuance of sukuk by Muslim and non-Muslim sovereign and sub-sovereign borrowers, companies from non-Muslim countries and multilateral developmental agencies. This figure is expected to increase to $200 billion in 2015.

There has been a significant evolution in the regulatory and legal framework of Islamic finance, which is shaped by the distinctive features of Islamic financial transactions (Ahmed, 2010). Examples include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) (Rethel, 2011). The AAOIFI was founded in Algeria in 1990 and registered in Bahrain in 1991. It is a standard-setting organization which has so far issued up to 70 standards on accounting, auditing, governance, ethics, and Shariah. It also offers training programs and confers qualifications. Its standards are endorsed by the regulatory authorities of the major centers for Islamic finance. The IFSB was founded in 2002 and became operational in 2003. Its full members are the central banks and regulatory authorities of 18 African, Middle Eastern and Asian countries, and the Islamic Development Bank. Its major function is the setting of prudential standards to enhance the soundness and stability of the Islamic financial services industry.

The international dimension of Islamic finance has rapidly extended as it becomes an important part of the international financial system and as it holds a steady position contributing to global financial integration. First, the rise of Islamic finance has been acknowledged by major institutions of the conventional financial order such as the World Bank, IMF and IOSCO (International Organization of Securities Commissions) in their publications and reports. Second, the creation of Islamic indices was an important milestone in the development of Islamic financial markets since they were crucial for the establishment of Islamic mutual funds. The major international Islamic market indices are the Dow Jones Islamic Market (DJIM) Indexes and the FTSE Global Islamic Index Series (GIIS). Third, the two big international rating agencies, Standard & Poor’s and Moody’s have, only recently, started to rate Islamic financial instruments and entities for their financial creditworthiness. Also, a Bahrain-based Islamic International Rating Agency (IIRA) was set up in October 2002 and began its operations in July 2005 to assess both conventional creditworthiness and the Shariah quality of Islamic corporations and institutions. Fourth, big conventional market players such as Citibank, HSBC, UBS, and Deutsche Bank are becoming increasingly important providers of Islamic financial products through opening Islamic windows not only in Muslim countries but also in Western, non-Muslim countries.

The current shift of perspective in the West regarding the merits of Islamic finance has also to be viewed as an opportunity for Islamic financial institutions to make joint investments with governments and other financial institutions, including multilaterals (Kayed and Hassan, 2011).

Among others, Germany, France, and Japan have recognized the potential contribution of Islamic banking toward restoring credibility and stability to the international financial market after the recent crisis. France is particularly interested in Islamic finance and declares its intention to make Paris a great center for Islamic finance, along with London. The Vatican has also approved Islamic finance and wants conventional banks to consider the ethical rules of Islamic finance in order to establish an honest and transparent relationship with their customers. The G20, a major international economic policymaker, including the three developing Muslim countries of Turkey, Indonesia, and Saudi Arabia can play a significant role in creating the new international financial order.

5.2. Challenges

Islamic finance is challenged simultaneously on theoretical, operational, and instrumental grounds (Kayed and Hassan, 2011). Theoretical challenges emerge from the embedded elements of morality and ethics from which Islamic finance derives its legitimacy and thus, are about the distinctive features of Islamic finance (e.g. the Islamic financial system, PLS contracts, modes of financing, etc.). Operational challenges focus on the means and procedures necessary for the honest application of Islamic finance and include innovation, financial engineering, intermediation, risk management, and supportive infrastructure. Instrumental challenges are the most important ones that involve the transformation of the Islamic financial model into working policies and enabling institutions.

Given these challenges, it is very difficult to remove the interest-based conventional financial system completely because interest charges and speculation remain deeply rooted in every aspect of the conventional financial system.

Second, although Islamic finance strongly supports an equity finance route over a debt finance route, little effort has been undertaken to create Islamic stock markets. The use of equity and PLS is still very small while that of debt-creating modes is dominant. In addition, PLS contracts are not appropriate in all cases, particularly when there is an actual need for a personal loan not designed for commercial purposes. Therefore, growth has been driven by Islamic loan markets, especially through the widespread issuance of sukuk.

Third, the realization of an interest-free global financial system is still far away, and involves a huge amount of groundwork in the legal, institutional, accounting, and regulatory structures.

Fourth, Islamic finance tends to be more internationally oriented than conventional finance because it is based on divinely inspired principles rather than national laws. However, the notable differences in the use of some products between jurisdictions in South-East Asia, the Middle East, and North African countries make it inherently difficult to develop common standards and best practices of Islamic finance.

Fifth, recent innovation in Islamic finance focuses on making modern financial instruments compatible with Islamic principles. Islamic financial professionals provide close analogues to almost all financial products. This brings us to the following question: Will Islamic finance follow a similar crisis in the future unless it commits itself to being Shariah-based (the substance) rather than the Shariah-compliant (the norm)?

Sixth, in order for the Islamic financial system to perform its proposed developmental function in society, it must be a part of a homogenous and comprehensive Islamic system where political, cultural, social, religious, educational, and economic institutions complement each other and work harmoniously to achieve the same goals.

Seventh, all participants in the Islamic financial industry (i.e. policymakers, managers, employees, clients, and shareholders) must be educated and informed about the virtues and principles of Islamic finance. This should then spread to society through the government or ministry of education via Islamic finance courses at all levels of education.

6. Conclusion

Islamic finance with its focus on profit-and-loss sharing and prohibition of interest-based financial transactions has entered a new bright stage of development, emerging after the global financial crisis. It appears to be a more equitable and efficient alternative to the existing system in the international financial market. To supporters of this view, the Islamic financial system is capable of minimizing the severity and frequency of financial crises by getting rid of the major drawbacks of the conventional system. Islamic finance introduces greater discipline into the financial system by requiring the financier to share in the risk. It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses and of which the buyer wishes to take delivery.

It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully. To sum up, Islamic finance is well endowed to make remarkable contributions toward a more healthy and stable international financial system. Of course, this does not mean that Islamic finance can suddenly present itself as a comprehensive alternative to the conventional system. Since the architecture of the conventional financial system has existed for a long time, it may be too much to expect the global community to adopt a radical structural reform of the kind that the Islamic financial system proposes. The recent financial crisis has provided an important test case for Islamic finance. The opportunities as well as the challenges ahead for Islamic finance are enormous. However, Islamic finance is still in its infancy and has a very small proportion of international finance. It is expected that the system will gradually gain impetus over time and complement the international efforts now being made for promoting the health and stability of the global financial system.

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