

Diversification Away From The Dollar

Warren Edwardes - Delphi Risk Management Limited - 8 August 2002 - Originally published in Banker Middle East

Banker Middle East: What do you see in the future of Islamic banking?

Edwardes: Aside from the internal dynamic of the Islamic Finance sector, I see evidence of a political weighting influencing the current development of Islamic finance. I envisage a rapid development of euro denominated Islamic funds, a trend away from the heavy concentration of Islamic money in US dollar assets and a growing demand for gold and euro denominated equity funds, on grounds related to the events in Palestine and the intention to genetically profile 100,000 US residents of Middle East origin.

Banker Middle East: What are the current issues in Islamic banking?

Edwardes: There is a noticeable change in sentiment amongst Islamic portfolio managers away from the US Dollar to the euro on political grounds related to events in Palestine as well as security from seizure and diversification. In terms of currency trading, this is not permitted in Islamic portfolios as it is regarded as Gharrar (speculation). However, currencies have to be bought and sold spot to effect investments or purchase real assets. Derivatives are not looked upon favourably on two grounds - speculation and the connection with interest. But firms such as Delphi are devising Islamically acceptable forms of derivatives. 20 years ago packages of investments in a currency at 0% coupled with a forward sale at an off-market forward rate were commonplace. But just as fiscal and regulatory authorities no longer regard zero coupon bonds as generating capital gains, so also have such devices been criticised and they are no longer Islamically acceptable. Just as Takaful (the act of a group of people reciprocally guaranteeing each other) is an acceptable Islamic form of insurance, options for delivery of commodities by a producer of such a commodity should be acceptable. So also should options or forward derivative contracts on any of the Islamic financial instruments be permissible. Let's talk about Financial Takaful instead of Islamic derivatives.

Banker Middle East: What about trading of debt?

Edwardes: The trading of debt is controversial and whilst it is acceptable in pragmatic Malaysia a number of Middle East based Shari'ah scholars believe it to be Haram. Perhaps a solution would be to follow the practice in the currency swaps market and adopt a process of novation.

Banker Middle East: What needs to be done to improve the knowledge and understanding of Islamic banking?

Edwardes: Islamic banking needs to be demystified. Just as in any other line of business there is a great deal of jargon. Derivatives talk about Butterflies and Betas. Islamic bankers have Istisnas and Ijaras. Arabic is appropriate when discussing finance in Arabic. But when Islamic banking is discussed in English the use of Arabic can be just as befuddling as the use of Greek in derivatives. Replacing Arabic terminology, such as "Ijara" with "leasing" or "Musharakah" with "equity participation", will lead to a greater understanding of the Islamic banking system.

Banker Middle East: What are the major limitations of Islamic banking, and how can they be solved?

Edwardes: The problem for Islamic banking practice is that it is by and large less based on principles but on precedent in the middle ages. This makes product development difficult. There needs to be a rapid development of dual qualified professionals schooled in both Shari'ah and finance, not necessarily expert in both but sufficiently versed in both disciplines to be able converse with bankers and Shari'ah. There are far too many Islamic bankers who preface their comments with "I am not a Shari'ah expert .." It may sound contradictory, but there is a need for both standardisation and innovation. Standardisation of plain vanilla products such as Murabaha (cost plus financing or sale on a profit basis) along with their English spelling, would aid negotiability and much needed liquidity. And standard documentation along the lines of ISDA should be agreed upon. Innovation is required to meet the unfilled needs of borrowers, such as for overdraft finance and for Islamically acceptable derivative products so that real world risks such as exchange rate and commodity risks can be negated.

Banker Middle East: Do you think there is a future for conventional banks who do Islamic banking? Do you think it is wise for conventional banks to take up Islamic banking?

Edwardes: Given a choice between a pure Islamic bank and a highly rated reputable international bank providing the same service, a client would rather go to the one that has a brand name than the one that provides Islamic-only services, without the brand name. There is always a flight to quality in times of uncertainty. But even before September 11, globally branded and rated financial institutions were increasingly providing Islamic finance directly or in partnership with regional distributors. Just as Internet-only banks soon faced competition from conventional banks, so also will Islamic banks.

Banker Middle East: What is the difference between risk in conventional banking and Islamic banking? How can Islamic banks best manage risk?

Edwardes: There are numerous common risks between Islamic banking and conventional banking. Given that everything is acceptable in conventional banking, Islamic banking is a special case of conventional banking. But the major special features are property, operational, commodity, equity, liquidity risks and strangely enough, interest rate risk.

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