



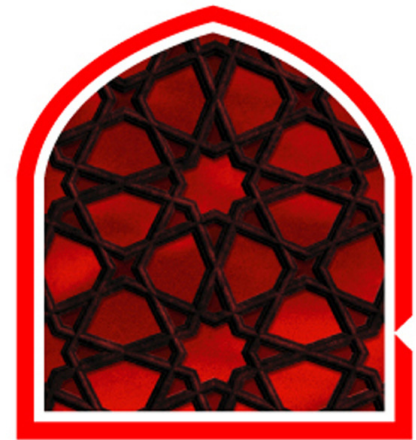
**Islamic Banking:**  
**Need for Innovation**

**Razi Fakh**  
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# Agenda

- 1. Islamic finance – current status**
- 2. Need for innovation**
- 3. Innovations are needed across multiple dimensions of Islamic finance**
- 4. Concluding remarks**



# Islamic finance industry is evolving from niche to mainstream

## • Growth of Islamic banking assets

- Estimated total size of USD 750b.
  - Growing at 15-20% per annum
- GCC Islamic proportion of total banking assets has reached 30%
  - Projected to reach 40% by 2010
- Malaysia Islamic proportion is currently 12%
  - Government target is to reach 20% by 2010
- Within 8-10 years, industry estimated to capture half the savings of the 1.6 billion Muslim world

## • Industry infrastructure

- IFSB
- AAOIFI
- IILM
- Islamic rating agencies

## • Global scale

- More than 250 Islamic banks worldwide operating in over 75 countries
- GCC accounts for two-thirds of global Islamic assets
- Malaysia leading industry maturity and sophistication
- Islamic Development Bank: largest pan-OIC financial institution

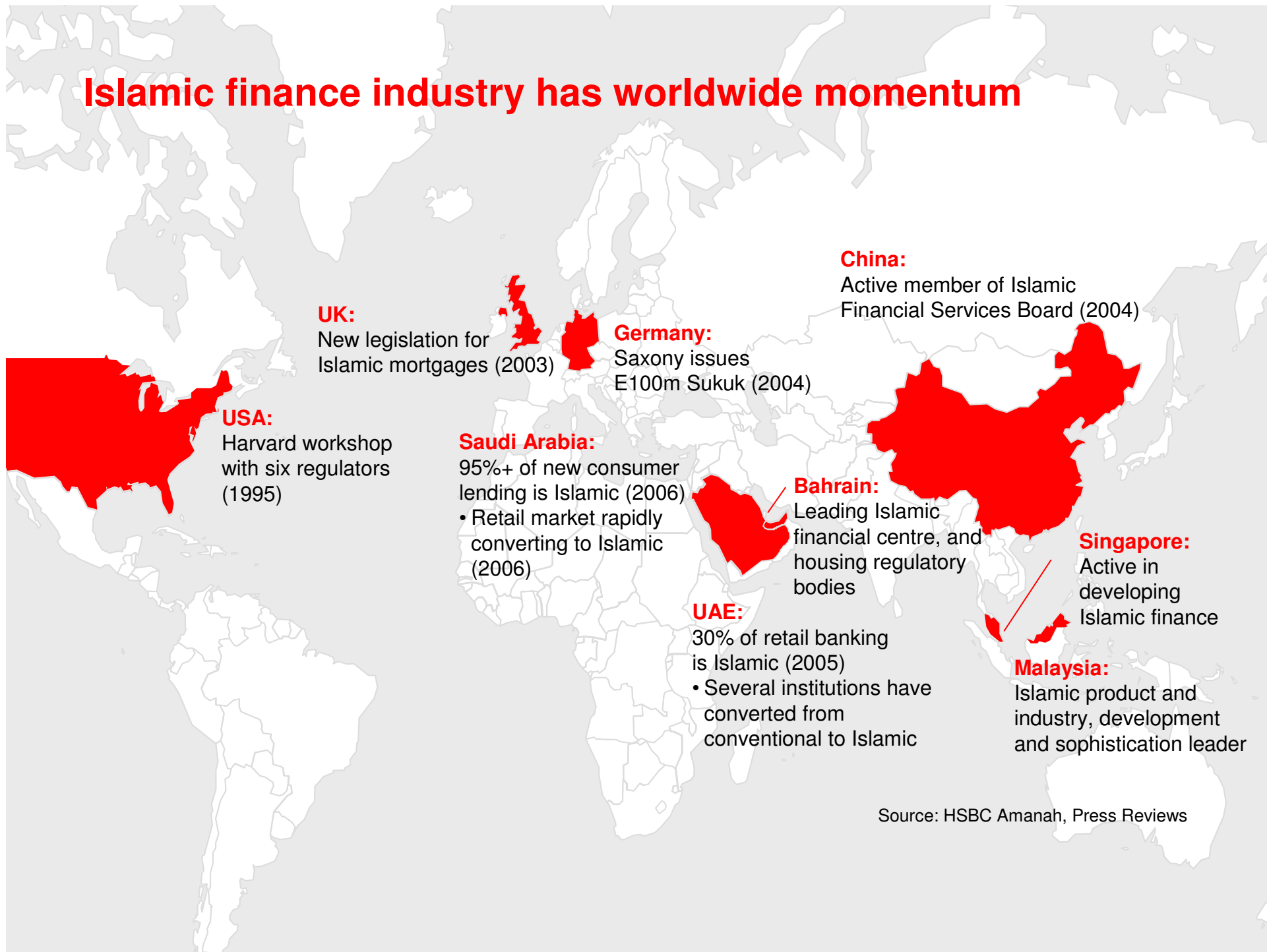
## • Market-driven proposition

- Retail customers historically the backbone of the industry
- Tipping point in retail sector: Saudi Arabia, UAE, Bahrain and Kuwait

Source: Central Bank reports, Bank Negara (Aug 2006), S&P (Aug 2006);

**Industry is reaching mainstream relevance in global financial system**

# Islamic finance industry has worldwide momentum



Source: HSBC Amanah, Press Reviews

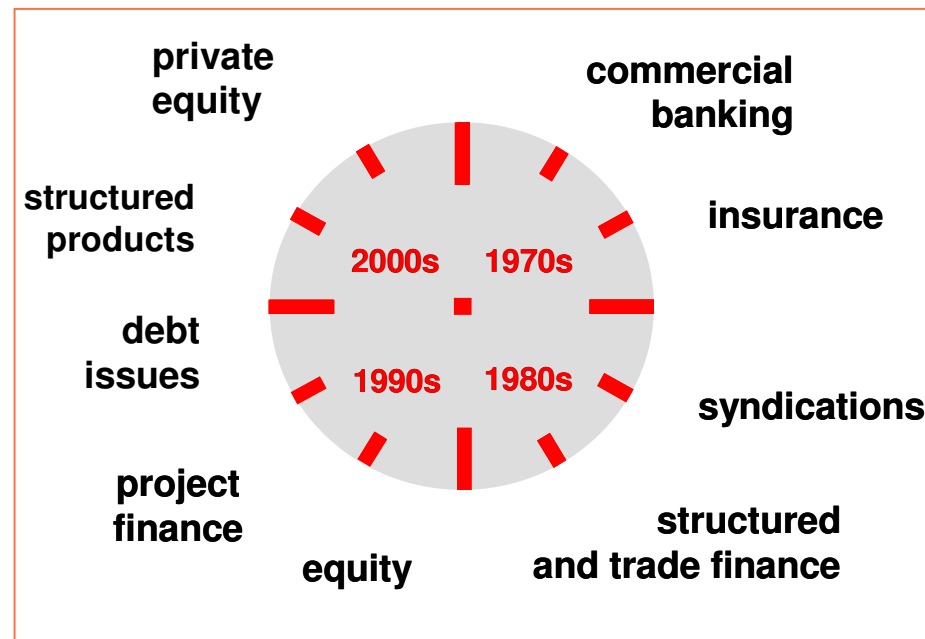
# Industry has developed a comprehensive product offering

## Investment Banking

- Islamic Capital Markets
- Project Finance
- Corporate and Structured Finance
- Financial Advisory
- Underwriting
- Syndication

## Corporate Treasury & Markets

- Liquidity Management
- Yield Management
- Structured Solutions



## Personal Financial Services

- Home Finance
- Auto Finance
- Current and Saving Accounts
- Debit and Charge Cards
- Investment products:
  - Equity funds
  - Real Estate Funds
  - Capital Protected Funds
  - Takaful

## Commercial Banking

- Import/Export Financing
- Murabaha/Musharaka
- Documentary Credit
- Islamic Guarantees
- Asset Financing
- Shares Financing
- Treasury

Industry has near like-for-like parity with conventional offering

## Why innovate?

- **Islamic finance has seen tremendous growth over the past 25 years**

- Significant number of providers across many regions
- Institutional infrastructure in place - AAOIFI, IFSB, LMC etc
- It now offers solutions to almost all customer needs

- **Drivers of growth thus far:**

- Customer pull
- Replication mentality
- Culture of exceptions

- Replications primarily on the basis of exceptions granted by Scholars and using doctrine of necessity “Dharura”
- The Doctrine of Dharura has enabled the industry’s evolution from concept to mainstream status however continued usage of this doctrine could very well threaten the Shariah credibility and its future

**Innovation is required to shift from Shariah-compliant products to Shariah-based solutions**

# What is innovation?

## Definition

1. (v) make changes in something established, especially by introducing new methods, ideas, or products
2. [with obj.] introduce (something new, especially a product)

Source: Oxford English Dictionary



## Innovation includes

Replication

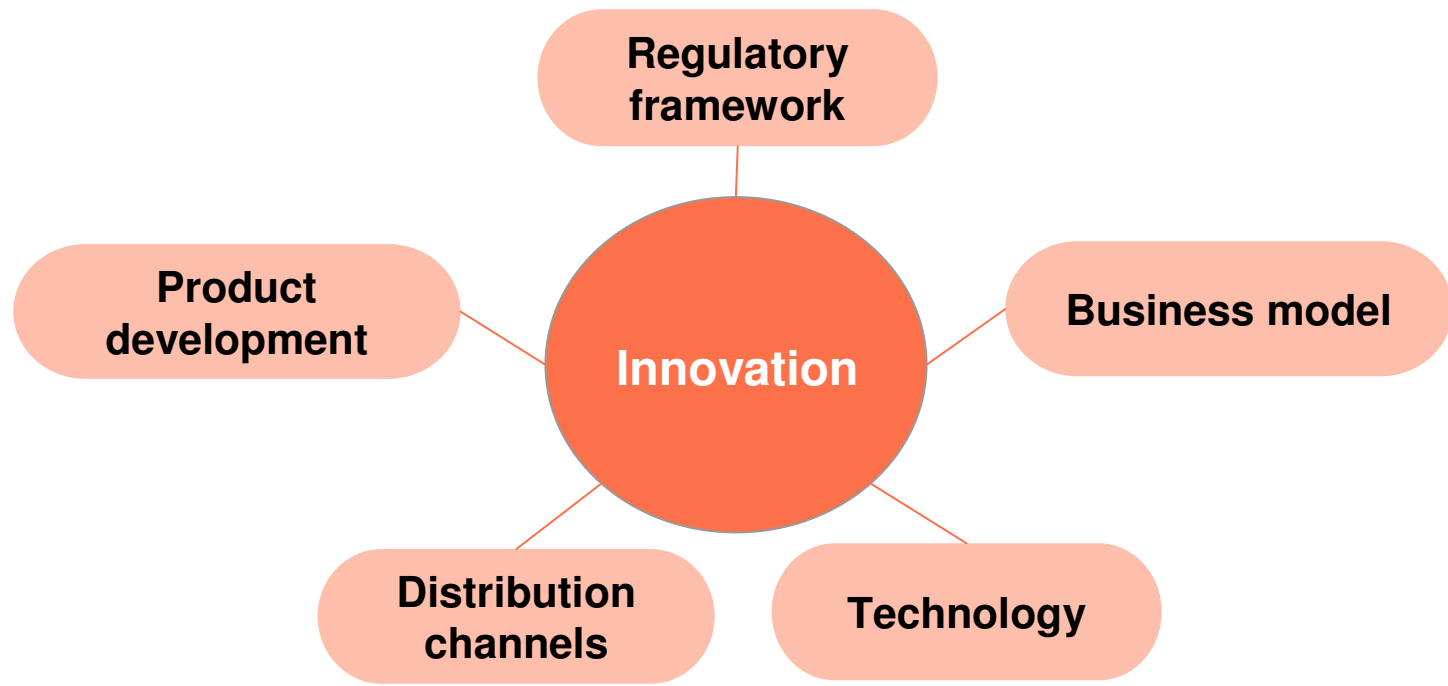
Enhancement

New ideas or solutions



Need to plug gaps in customer needs

# Holistic innovation is needed along multiple dimensions



Industry infrastructure is a “work-in-progress”

# A proactive regulatory framework is needed to develop the industry

- **Review of all statutes to ensure Islamic finance is not penalized**
  - Tax, legal and accounting level playing field
- **Need for proactive dialogue between regulators and practitioners**
  - Move away from catching-up mode to proactive mode
- **Need for codification of Shariah principles applicable to Islamic transactions**
  - Standardization is key

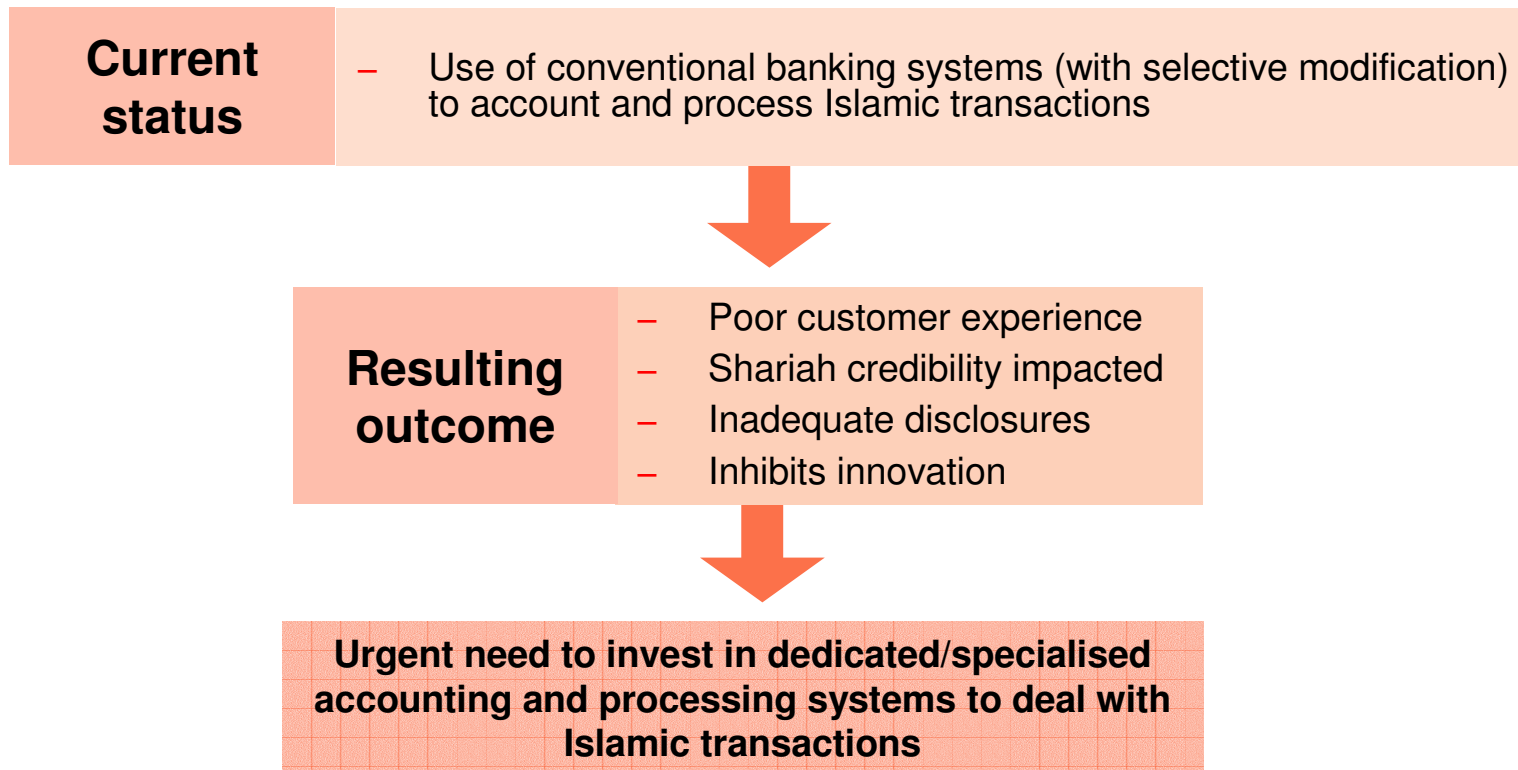
**Required shift from reactive to proactive regulatory stance**

# Business model innovation is needed to ensure sustainability

- **Window model has enabled growth of Islamic finance, however:**
  - Longer term need for dedicated Islamic entities
    - Regulatory framework and licensing flexibility
  - Need to consolidate with the aim of creating stronger and more competitive Islamic finance providers
    - Create opportunities for specialist firms:
    - E.g.: brokerages, Islamic investment banks, consultancy practices, venture capital firms
- **Current business models essentially serve the educated and affluent (bankable) population, however :**
  - Do not serve the underprivileged customers
    - Ensure inclusive proposition
  - IFIs could potentially work towards rolling out microfinance-type institutions
    - Service micro-entrepreneurs and job creation

**Evolution of business model key to industry development**

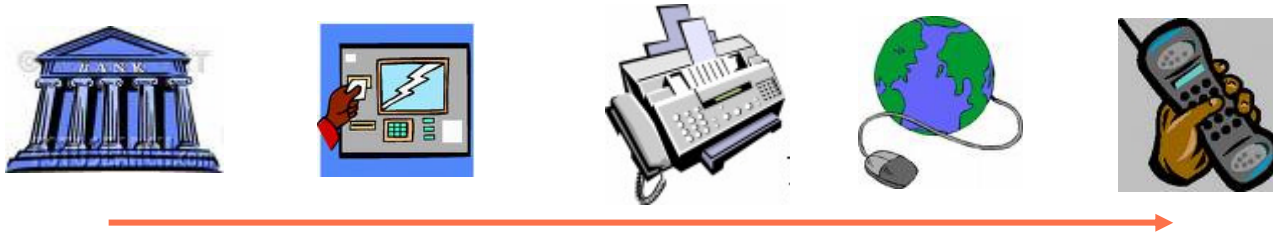
# Investment in technology critical for innovation



**Need for technology platform which would facilitate Shariah based solutions**

## Distribution channel replication needed

- **Current Islamic channels are replications of conventional channels**
- Meet needs of Islamic customer



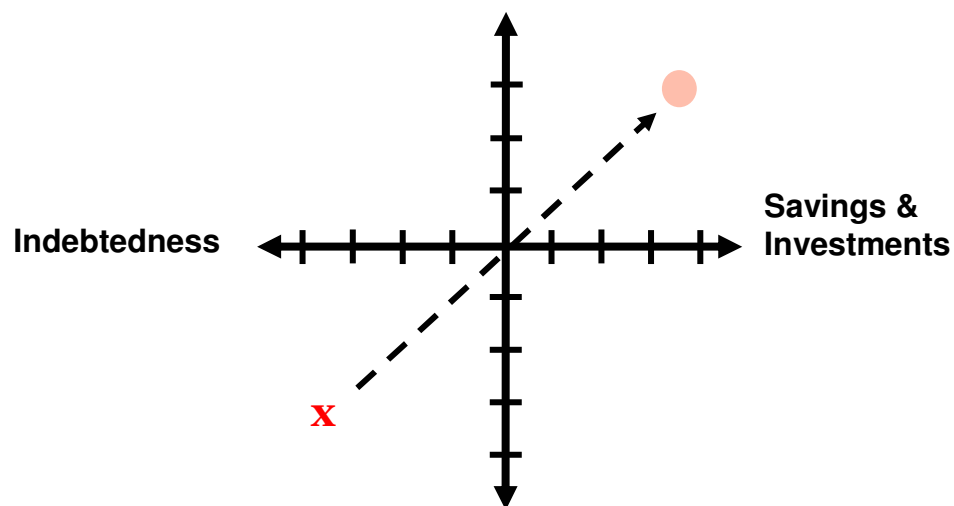
- **Conventional channels will continue to evolve**
- Islamic providers should continue to replicate and leverage off conventional

**Need to enhance customer experience through education of sales force**

# Shariah-based mindset is critical for product innovation

## Shariah-based solutions

- Income-sharing products
- Shift from debt-based product offering



## Shariah-compliant products

- Letter of the law
- Replicating conventional credit service offering

## Examples

- Securitization to create instruments with predictable yields and full spectrum of maturity
- Venture capital and private equity vehicles and instruments to enable “real economy” play
- Hedging instruments for risk management – e.g. using risk pooling concepts of Takaful
- Savings scheme using infrastructure projects as sources of investment return
- Substitute commodity-based financing products with specific asset-backed/linked products

**Significant scope to improve the quality of product proposition**

# Key enablers to facilitate innovation

## Key enablers

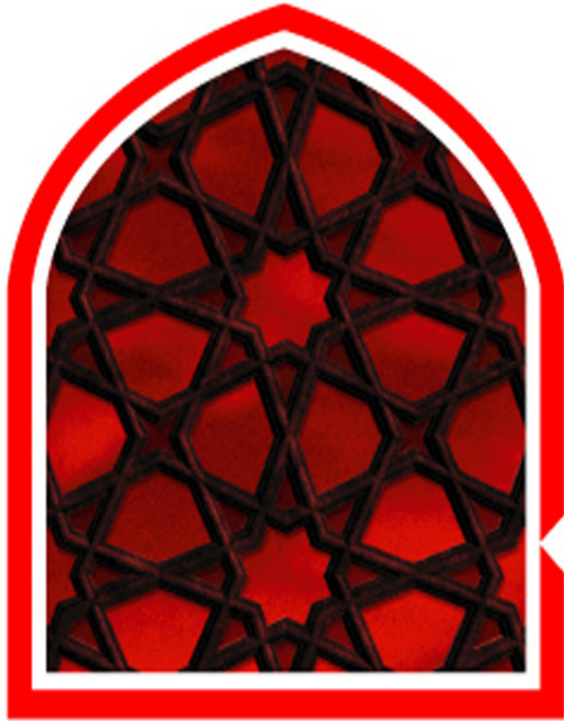
- **Dedicated people**
  - Greatest intangible to enable Islamic finance and build its future
- **Committed sponsorship**
  - Academic input to formulate visionary framework and development
  - Capital sponsorship to bring plans to life
- **Change in mindset**
  - From Shariah-compliant to Shariah-driven products and services
- **Education of all key stakeholders**
  - To build understanding
- **Proactive engagement**
  - Regulators, practitioners and Shariah scholars to set a common agenda

Need for an initiator to enable innovation

## Closing thoughts

- **History of development**
  - Industry development from Savings Association (1963) to USD 750b industry
  - Global momentum behind industry: consumer, corporate and government
- **Islamic finance is at a cross road**
  - Industry has progressed but with a cost
    - Culture of exceptions (Tawarruq and Murabaha)
    - Shariah credibility
    - Competitive disadvantages
- **Doctrine of necessity has gotten the Islamic finance industry this far**
  - Innovation, however, is critical to migrate the current system to a Shariah - based alternative
  - Innovate while preserving what is distinct about Islamic finance

**Innovation is fundamental for the next stage of evolution**



**Thank you**

**Razi Fakh**

Acting CEO, HSBC Amanah