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Islamic Finance: Current, Future Trends and Challenges

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Abstract

The purpose of this paper is to clarify, the current Islamic Finance development, principles, norms, instruments, and growth period around the world. The second is the future Islamic finance opportunities. The third is Challenges for Islamic Finance. The paper concluded to that, There are many of the motives that led to the development of Islamic finance and growth, and there are many problems faced this system. Despite the development achieved by the Islamic financial but, there are many challenges that face it. Including the differences between theory and practice as well as variety of views held by practitioners and financial experts pose big challenges.

Keywords: Islamic Finance, Future, Challenges, and Islamic Finance Development

1.0 Introduction

Islam is a system of belief that encompasses not only man's relationship with God, but also provides Muslims with a law that regulates their entire way of life. The Qur'an sets out its notions of equity, justice, fairness, morality and many other values which underpin the entire Islamic system. The Islamic finance, based on Islamic law (sharia), mandates risk- and profit-sharing, prohibits interest payments, and emphasizes ethical investments that contribute to the greater good of society by Kuo (2008). Islamic financing is not tied to any particular jurisdiction, but it can take place anywhere in the world where there are Muslims who wish to engage in financing transactions in a manner consistent with their faith. The Islamic financial system allows for the replacement of interest by a return obtained from investment activities and operations that actually generate extra wealth by Lee & Detta (2007).

This paper is divided into six sections. After introducing the topic, section two highlights Islamic Finance Development. Section three outlines Islamic Financial System. Section four outlines major Norms of Islamic Finance. Section five discusses Islamic Finance Opportunities. Section six discusses Islamic Finance challenges.

2.0 Islamic Finance Development

Islamic financial was emerged in the late seventies and eighties, although the history of Islamic finance due to the birth of Islam by Lee & Detta (2007). In the era of Prophet Muhammad (peace be upon him). The God had forbidden Reba, because the Reba damage country's economy and people. *Allah* says in Holy Qur'an:

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*"Those who eat Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: "Trading is only like Riba (usury)," whereas Allah has permitted trading and forbidden Riba (usury). So whosoever receives an admonition from his Lord and stops eating Riba (usury) shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to Riba (usury)], such are the dwellers of the Fire — they will abide therein".(*surah Al-Baqarah, verse 275*)*

Reba prohibition of Islam is the motivation to activate Islamic finance. From the era of Prophet Muhammad (peace be upon him) to this very day. The emergence of Islamic finance and banking is evident of the revival of Islam and the desire of Muslims in the application instructions their religion. There are two forces behind the development of the Islamic finance. First, desires of Muslims to live all aspects of their lives in accordance with the teachings of Islam. Second, is a growing demand by investors for Shariah compliant financial instruments, and the desire of corporate to raise funds in a cost effective, Shariah compliant, manner which does not dilute shareholder equity by Lee& Detta (2007) & Aziz (2008).

According to Lee & Detta, 2007 the first modern Islamic bank which provided interest-free banking facilities was the Mit Ghamr local Saving Bank provincial rural centre in the Nile Delta of Egypt, this established 25 June 1963. After that date established number of banks in many countries like Saudi Arabia, Sudan, Iran ,Dubai and Jordan. As recent as five years ago, the development of Islamic finance was regarded as an infant industry striving to prove its viability and competitiveness. At that time, the growth of Islamic finance was organic and largely concentrated in countries where the Muslim population was significant. In these five years Islamic finance has recorded dramatic growth and has a presence in more than 75 countries in both Muslim and non-Muslim dominated communities. "Islamic finance is now among the fastest growing financial segments in the international financial system, with an estimated average annual growth of between 15% and 20%.

More recently there has been a growing diversity both in the range of products and services being offered and in the markets that have been developed". The important developments in Islamic finance during this period has been the strengthening of an international Islamic financial. (Aziz, 2008) Islamic finance services are expanding worldwide. More than 200 Islamic financial Institutions (IFIs) are reported to have total combined assets in excess of US$ 200 billion. This development requires the creation of standards of conduct regulating the work of these organizations in 2002 a major structural enhancement was the establishment of the Islamic Financial Services Board (IFSB), which formulates the international regulatory and prudential standards for Islamic finance. IFSB has since issued the standards for capital adequacy, risk management, and corporate governance. By El-Hawary,Grais& Iqbal (2007) & Aziz (2008).

3.0 Islamic Finance System

What is Islamic finance?

Most the earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either "interest free" or "Islamic" banking. Prohibiting the receipt and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation (Usmani, 2005; Pervez, 2008).

The conventional financial system focuses primarily on the economic and financial aspects of transactions, But the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. Islamic financial system based on Islamic teachings on work ethic, distribution of wealth, social and economic justice, and role of the state.(Iqbal&Mirakor,2007). The Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contracts.

3.1 Principles of an Islamic financial system

The basic principles of an Islamic financial system can be summarized as follows:

Prohibition of interest, Prohibition of Reba, as enshrined in the Verse 2:275 of holy Quran. Reba in its Qur'an meaning paying money for the use of money. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal is considered Reba and is prohibited. (Ayub, 2005; Sachedina, 2005). This prohibition is based on arguments of social justice, equality, and property rights.

Risk sharing, The provider of financial capital and the entrepreneur share business risks in return for shares of the profits.

Money as "potential" capital. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.

Prohibition of speculative behavior. An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks. (Ayub, 2005)

Shariah-approved activities, the business activities that do not violate the rules of sharia are eligible for investment

3.2 Islamic financial instruments

Trade with markup or cost-plus sale (murabaha)

The murabaha means that The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin.(Usmani 2005)

Leasing (ijara)

Leasing is designed for financing vehicles, machinery, equipment, and aircraft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee).(Pervez, 2008)

Profit-sharing agreement (mudaraba)

Modaraba is a contract between an Islamic bank and a Client whereby the Islamic bank provides a specific amount of funds to the Client for an enterprise for defined purposes in exchange for a reasonable and highly predictable profit. The Client receives a share in the profit as compensation or a fee for his know-how and management. (Usmani 2005; Pervez, 2008)

Joint Venture (Musharaka Financing)

Musharaka financing is the same financing contract as Modaraba except that the Client also provides a part of the capital, in addition to providing management and know how. On the other hand, the Investor may provide a part of the management and know-how, in addition to capital.

Sales contracts . Deferred-payment sale (bay' mu'ajjal) and deferred-delivery sale (bay'salam) contracts. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay.

A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market. (Usmani, 2005; Pervez, 2008).

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4.0 Major Norms of Islamic Finance

All transactions in an Islamic system must be governed by norms of Islamic ethics as enunciated by the Shariah. There are basically four sources of Islamic Law: Quran, Sunah, Ijma', and Qias.

4.1 Norms Relating to *Riba*

Prohibition of riba is central to Islamic financial ethics and law. All transactions and contracts must be free from elements of riba. The word riba literally means, "Increase". In the following section we will discuss the types of riba that stated in quran and hadith.

Riba in Debt

The word "interest' is now understood as riba. Islamic scholars have defined riba as that "increase" which an owner of valuable property (mal) receives from his debtor for giving him time to repay his debt. Conventionally, interest or the excess (increase) in loan is the consideration or compensation for the period of re-payment of loan. The form of riba falling under Quranic prohibition, according to some scholars, is riba al-jahiliyya or pre-Islamic riba.(Delorenzo, 2005)

Riba in Exchang

There are now two conditions for exchanging money for money: hand-to-hand, and in equal quantity. However, any violation of this rule will result in one of two forms of forbidden riba: (a) ***riba al-fadl:*** where money is exchanged for money hand-to-hand, but in different quantities, or (b) ***riba al-nasiah:*** where money is exchanged for money with deferment.

Exchange/ Transfer of Debt

Debt originates with a loan. Debt also originates with a sale and other transactions wherever the payment of money is deferred to a future date. when a debt is exchanged for money, it must be at par; and when a debt is exchanged for debt, it must also be at par. When debt is sold or transferred to a third party for money, it must be sold at par.

Time Value of Money

Time value of money indeed has a place in Islamic finance. The return available to the individual saver on best "permissible" investment (from trade or otherwise) constitutes time value of money in Islamic finance. An implication of "zero time value of money" is that the spot price in a trade must be same as the deferred price. A seller in a trade, whether on spot or deferred payment basis, is free to charge any price and the profit that accrues to him is legitimate.(Yaquby,2005; Delorenzo, 2005)

Risk and Return

An important Shariah maxim that is related to prohibition of riba is "Al-Kharaj bid Daman" or revenue goes with liability. This is an important maxim governing financial contracting in Islam. In conventional parlance, it implies that no positive returns are to accompany conditions of zero risk. Thus, a party in a financial contract is entitled to returns, only if it bears risk.

4.2 Norms Relating to *Gharar*

The Arabic word gharar means risk, uncertainty, and hazard. Unlike riba, gharar is not precisely defined. The concept of gharar has been broadly defined by the Islamic scholars in two ways. First, gharar implies uncertainty. Second, it implies deceit. The

Quran has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. (Pervez, 2008)

Settlement Risk

Traditional explanations of gharar are often in terms of settlement risk (also called counterparty risk in conventional parlance). Such risk is seen to be present when the seller has no control over the subject matter. The reason for the prohibition of gharar is the risk or uncertainty, which casts a shadow on the delivery of subject-matter and settlement of the contract, rather than the non-existence of the subject-matter. Jurists have enumerated the following cases to highlight the existence of gharar, Sale of fish in the water, Sale of a bird in the air, Sale of catch by a game catcher.

Inadequacy and Inaccuracy of Information

The gharar in a contract is essentially related to availability of information pertaining to its possible outcomes for both parties. All parties to the contract must be informed enough to make reasonable estimates of the outcomes. Thus information is central to the Islamic system of contracting. Absence of adequate and accurate information (jahl) is a source of gharar. (Yaquby, 2005)

Pure Games of Chance (*Al-Qimar* & *Al-Maisir*)

The term gharar is also used in the context of pure games of chance. the Quran prohibits contracting under conditions of uncertainty and gambling (qimar).

"ye who believe! Intoxicants and gambling, sacrificing to stones, and (divination by arrows, are an abomination, - of Satan's handiwork: eschew such (abomination), that ye may prosper" ***5:90***

4.3 Norms Relating to Mutual Cooperation (*Ta'awun*)

The mutual co-operation, solidarity and brotherhood are central to Islamic ethics.

The second verse of Surah Maida in the holy Quran says:

"Assist one another in the doing of good and righteousness. Assist not one another in sin and transgression, but keep your duty to Allah" ***5:2.*** The Prophet (pbuh) reinforce this principle of cooperation and mutual assistance in the following hadith.

"Believers are to other believers like parts of a structure that tighten and reinforce each other.''(Al-Bukhari and Muslim).

5.0 Islamic finance opportunities

Islamic finance is still a niche market in the overall global financial industry. Prospects for the industry are quite bright owing to strong demand for financial services from a large segment of the world's 1.4 billion Muslims and the need to effectively channel rising international savings, including those of high-net-worth individuals. Islamic financial institutions have been able to enter international markets successfully, currently managing $700 billion in assets. The size of Islamic financial dealings affects local markets in some countries, like Malaysia, Bahrain, and

Indonesia. However, its impact on international financial markets can still only be regarded as 'developing' given its current small size (Aziz, 2008). In addition to meeting Islamic Code requirements and satisfying the needs of Moslem customers, the expansion of Islamic financial services to customers around the world has been helped by the growth in information technology and by the 'new legislation' passed in many countries, both of which have made the movement of funds more flexible and created a 'window of opportunity' for Islamic banks and financial institutions (Al-Salem, 2008).

Although few in number and slow to develop, there is strong demand for Islamic investment products. However, at the present time even in Moslem countries, there is a 'wide gap' between the number of conventional or traditional institutions and the number of Islamic institutions, especially banks, operating in the various countries. Some of these latter traditional or conventional institutions are more than 200 years old, compared with the oldest Islamic institution in Kuwait which has started only 30 years ago. It is held by the present author that, given current trends and attitudes which signs of increasing not decreasing in strength, this gap_will be closed in time, with a relatively larger increase in the number of new Islamic banks and financial institutions than traditional or conventional ones in various countries, not just Moslem countries. In this respect, the number of Islamic banks established has been of the order of 3-4 % annually across the world, most of it in Islamic countries.

An increase is projected in the number of alliances developed to establish new Islamic Banks, in the provision of licenses for Moslem-related insurance companies, and in the number of new geographic markets for Islamic banks and financial institutions, such as Malaysia (Aziz, 2008). The emergence of Islamic banking in recent decades is considered as one of the 'most important trends' in the financial world, with an increase in the scope of Islamic financial activities being anticipated. As the average of world-wide growth rate in the size of the assets of Islamic banks and institutions has been 24% over last five years, suggesting a 'high demand' for establishing more Islamic banks and institutions in Islamic and other countries (Al-Salem, 2008). Distinct from developments in Islamic countries is the interest of a few global financial centers, such as London, that now provide policy and tax incentives to promote Islamic finance and thus attract funds from high-net-worth clients. The same motivation seems to have been driving global banks such as HSBC, Standard Chartered, Deutsche Bank, and Citibank to set up special hubs to structure Islamic finance products. In reality, though current industry hype may be partially driven by the availability of surpluses generated by oil revenues, Islamic banking is emerging as an alternate financing option that coexists alongside the conventional financial industry. In addition to traditional Islamic products, the industry is now offering consumer financing for residential purposes and structured financing vehicles for supporting infrastructure and housing, among other mechanisms (Aziz, 2008).

Product innovation is emerging, with several different types of hybrid sukuks and combinations of structures that integrate different forms of musharaka (partnerships) with other products. Despite these developments, an increasing share of equity-based credit products, such as murabaha (sales) and ijara (leasing), remain the dominant form of financing across Islamic financial institutions. These trends are expected to persist and the industry is set to grow. Standard & Poor's Services Rating Agency estimates that the industry has the potential to grow to $4 trillion over the medium term. As highlighted above, exceptional growth in Islamic finance—particularly since 2000, which coincides with growth in oil revenues—has raised questions as to whether interest in Islamic finance is a one-time phenomenon or a sustainable one with long-term prospects. Although industry motivations and driving factors vary across the world, interest in Islamic finance is here to stay. Confidence-building factors include the large financial industry investments across main hubs in the GCC, Middle East, Southeast Asia, and South Asia—occurring within countries and in growing foreign ownership and joint ventures across borders—in the industry's infrastructure development. This development includes:

(1) The issuance of holistic banking licenses and the opening of special windows or hubs dedicated to Islamic asset management, private equity, and hedge funds, accompanied by the Dow Jones Islamic Index to which all such transactions subscribe.
(2) The development of shariah knowledge and understanding, and the engagement of shariah advisors and scholars who are providing the consensus, guidance, and the legitimacy necessary to uphold Islamic financial products and structures.

(3) The development of Islamic standard-setters—such as the Islamic Financial Supervisory Board, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the International Islamic Financial Market (IIFM)—both by central banks and by a range of multilateral development agencies (including the Islamic Development Bank).Combined, these efforts have helped develop and initiate the implementation of Islamic prudential regulatory, accounting, and auditing frameworks as well as the inspection and supervision of financial institutions. All these regional and global efforts are serious long-term initiatives that are irreversible, though maintaining and building momentum on these fronts constitutes a necessary step toward addressing the industry's possible challenges (Akhtar, 2008).

6.0 Challenges for Islamic Finance

There are many serious problems, the Islamic finance movement is facing. Differences between theory and practice as well as variety of views held by practitioners and financial experts pose big challenges. The level of credibility of the Islamic financial system entails the conceptual divide between the Shariah scholars and modern financial experts, which is creating confusion. Further growth and development of Islamic finance is also encountered several of other challenges, including limitations of system and development of issues. In this paper we will focus in the basic challenges that are faced Islamic financial system.

The first challenge is corporate governance. All financial institutions need high standards of corporate governance as they are entrusted with other people's money. However, this need is particularly great in Islamic financial institutions due to several issues that are specific to their business model. Decisions on profit distribution, for example, require the careful balancing of the interests of multiple stakeholder groups – not just shareholder, as in conventional banks, but the interests of holders of investment accounts as well. Investment account holders are exposed to many of the same risks as shareholders, but lack the same control rights – such as the ability to vote for board members – that are attached to equity ownership. Balancing these different stakeholder interests requires the adoption of strong corporate governance practices (Memon, 2005; Akhtar, 2008).

The second challenge is to ensure that the industry's undoubted success does not turn into complacency. The sensational growth of the industry in recent years combined with high levels of liquidity has means that Islamic banks have not needed to fight for funding or ideas. Newer entrants to the industry have merely tended to copy the strategies they see being successfully pursued by their more established rivals. There is a high degree of "cloning" of business models. As a result, a very high percentage of Islamic banks have a strategy that is heavily weighted towards real estate and asset finance. They tend to be project-driven and do not have a steady source of "bread and butter" revenue to tide them over any downturns in economic activity.

The "cloning" of business models leads to financial institutions becoming exposed to the same economic and industrial sectors. The Islamic banking sector as a whole is highly exposed to the property sector –real estate, commercial property and construction. The assets-based business models favored by many Islamic banks have not been tested in a downturn. A business model which look robust in conditions of rising asset values and abundant liquidity may not be so when the economic environment changes. (Bacha,2008;Aziz, 2008)

The third challenge is the Islamic money market yields that move in sync with conventional rates simply means that, users of an inter-bank money market (IIMM) would face the same extent of interest rate risk that conventional players do. It is indeed ironical that despite creating new markets and institutions that are supposed to enable interest free operations, players end up with as much interest rate exposure if not more. This unfortunately is the reality of IIMMs operating within a dual banking system. An Islamic financial system operating within a larger conventional macro environment cannot completely sterilize itself from interest rate risks. If a common customer pool that can freely move funds between banking systems is the explanation for interest rate risk transmission to Islamic banks. The existence of an IIMM may actually enhance this transmission through the pricing in interbank rates, through the pricing of Islamic money market instruments and through the central bank's money market operations. Changes in interest rates in the conventional money market would simply be transmitted to Islamic banks when they use the IIMM for their liquidity management. Similarly, since IIMM instruments are priced using discounting, interest rate changes cause re-pricing risk because discount rates change. (Bacha, 2008)

The fourth, Price and yields of IIMM instruments will invariably converge with those of conventional money markets because of the possibility for pure arbitrage. As such, Islamic institutions issuing IIMM instruments will face higher cost if conventional interest rates rise, while investors of IIMM instruments would get lower returns if the opposite happens. The third transmission channel arises from central bank intervention. Regardless of whether the intervention is a routine open market operation to influence liquidity or execution of new monetary policy, the central bank's actions in the IIMM must reflect its actions in the conventional money market.

Failing which, profitable arbitrage against the central bank or a carry trade between the markets would both be feasible. Given this, no matter how supportive a central bank is of the Islamic financial sector, it cannot possibly maintain dual rates nor cause changes in one market and not in the other. Thus, Central Bank actions would constitute another channel/ means of interest rate risk transmission (Bacha, 2008).

7.0 Discussion and Conclusion:

In conclusion, there are many of the motives that led to the development of Islamic finance and growth. And there are many problems faced this system. The factors that behind the development of the Islamic finance, desire of Muslims to live all aspects of their lives in accordance with the teachings of Islam and growing demand by investors for Shariah compliant financial instruments, and the desire of corporations to raise funds in a cost effective, Shariah compliant, manner which does not dilute shareholder equity. The development of Islamic finance was regarded as an infant industry striving to prove its viability and competitiveness. At that time, the growth of Islamic finance was organic and largely concentrated in countries where the Muslim population was significant. In these five years Islamic finance has recorded dramatic growth and has a presence in more than 75 countries in both Muslim and non-Muslim dominated communities.

Islamic financial institutions have been able to enter international markets successfully, currently managing $700 billion in assets and the size of dealings affects local markets in some countries. The average of world-wide growth rate in the size of the assets of Islamic banks and institutions has been 24% over last five years. There is larger increase in the number of new Islamic banks and financial institutions than traditional ones in various countries, not just Moslem countries. Distinct from developments in Islamic countries is the interest of a few global financial centers, such as London, that now provide policy and tax incentives to promote Islamic finance and thus attract funds from high-net-worth clients. The same motivation seems to have been driving global banks such as HSBC, Standard Chartered, Deutsche Bank, and Citibank to set up special hubs to structure Islamic finance products. Also, the industry is now offering consumer financing for residential purposes and structured financing vehicles for supporting infrastructure and housing, among other mechanisms.

Despite the development achieved by the Islamic financial but, there are many challenges that face it. Including the differences between theory and practice as well as variety of views held by practitioners and financial experts pose big challenges. The level of credibility of the Islamic financial system entails the conceptual divide between the Shariah scholars and modern financial experts, which is creating confusion. Further growth and development of Islamic finance is also encountered several of other challenges, including limitations of system and development of issues.

From our opinion, The Islamic financial system, that cannot be working correctly no only due to differences theory and practice as result the divide between the Shariah scholars and modern financial experts, which is creating this differences, But Islamic Finance now under the capitalist economic systems, that imposing some restrictions on all financial institutions. So must provide an Islamic economic system to work together with Islamic finance system under Islamic law (shariah). Islamic financial system which represents as part from the Islamic Economy, so without this system the Islamic Finance will be weak, Because capitalist systems and its laws surround the Islamic Finance System.

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