

Islamic banking lessons for the financial sector

The authors analyze how faith-based values have shaped some of the unconventional products and services that Islamic banks offer. Might there be useful lessons for conventional banks.

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As national governments, central banks and international financial institutions continue to struggle to contain the fallout from the recent financial crisis, a consensus is forming that radical change is needed within the global financial sector to ensure there is no repeat of the events of 2008.

The U.K. government, for example, is contemplating undertaking a complete overhaul of its financial regulations in September 2011, which would require banks to hold more capital and partly separate consumer operations from investment banking.

Even the United States – the birthplace of many of the toxic real-estate assets, credit default swaps and other derivative instruments that helped to trigger the crisis – appears to be coming round to the need for tougher regulation.

Clearly, serious mistakes have been made and lessons need to be learned. But to whom should governments, regulators and financial bosses turn for inspiration?

Perhaps a good place to start would be to study those banks that have performed best since the crisis – many of which, ironically, were shown to be “underperforming” in 2006, during the heady days of the housing boom, as research by finance professors Andrea Beltratti and René Stulz has revealed.

One area of the banking sector that has consistently outperformed most other banks since the onset of the crisis is Islamic banking. Though still a very small part of the global financial system, Islamic banking has consistently enjoyed double-digit annual growth, even during the worst years of the global downturn.

As many international financial institutions try to strengthen their capital and reduce their risk operations, perhaps they could learn a thing or two from their more prudent Islamic counterparts.

After all, unlike most conventional banks, including many of the traditionally cautious credit unions in the United States and saving banks in Europe, Islamic banks did not participate in the dubious practices that triggered the unravelling of the global financial system.

Due to constraints placed on them by their faith-based values, they did not engage in irresponsible lending, nor did they speculate on the extremely opaque derivatives markets.

While many Western banks are fighting tooth and nail to raise enough capital to meet the Basel III reserve ratio requirements, most Islamic banks are better equipped for the new capital requirements due to their higher equity base.

Admittedly, some of our readers might be taken aback by the suggestion that a banking model that derives much of its influence from a religious faith could possibly have anything to teach secular Western banking, which has dominated global finance for decades.

By no means are we saying that Islamic finance is a cure-all to the world's financial ills. Far from it! Islamic banks face some important challenges of their own - more on these later.

What we are saying, though, is that, as in any business sector, it is worth studying and learning from examples of best practice in order to improve one's own performance.

Take the example of Barclays Bank, one of the world's oldest financial institutions, which has survived over three centuries' worth of financial crises. Founded by the Quakers in 1690, Barclays grew to become the hub of a wider Quaker banking network based on values of "honesty, integrity and plain dealing." The founding premise was, "Wealth was accumulated slowly and could easily be lost," as the historian Richard Saville explained it.

Islamic banking - like the Quakers' banking network long before it - has been able to shrug off the worst effects of the financial crisis by drawing inspiration from its faith-based values.

In this article, we will explore how such values have shaped some of the unconventional

products and services Islamic banks now offer, drawing on extensive, hands-on experience we have gained as consultants on Islamic banking issues. This includes devising market-entry strategies and restructuring Islamic banks, everywhere from Southeast Asia to the Persian Gulf, from Turkey to the United Kingdom, as well as developing Shariah-compliant offerings and Islamic private-banking strategies for European firms.

We will also look at some of the challenges to be overcome if the sector is truly to come of age. After all, compared with its Western counterpart, Islamic banking is still very much in its infancy.

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