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Islamic Finance: An Effective & Reasonable Option

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Abstract: *In Islamic finance - financial institutions, products and services designed to comply with the central tenets of Sharia (Islamic law) – is one of the most rapidly growing segments in global financial services. Islamic finance starts from one basic concept that is to avoid trading directly present for future money. Finance is provided in the form of money in return for either equity or rights to share proportionately in future business profits. It is also provided in the form of goods and services delivered in return for commitment to repay their value at a future date. This is an obvious option in addition to the conventional practices of interest-based finance through which people borrow money and pay it back in the future in addition to interest. This paper addresses itself to four questions: (1) Why all the fuss about the rate of interest? (2) Is Islamic finance, as an alternative to interest based debt finance viable and effective? (3) What Islamic finance implies for the whole economy? (4) Given that Islamic finance is really viable, why it has not been adopted at a larger scale?*
Keywords: *Islamic finance, financial institutions, Sharia.*

I. Introduction

In Islamic finance – financial institutions, products and services designed to comply with the central tenets of Sharia (or Islamic law) – is one of the most rapidly growing segments of the global finance industry. Starting with the Dubai Islamic Bank in 1975 (and operations in the United Arab Emirates, Egypt, the Cayman Islands, Sudan, Lebanon, the Bahamas, Bosnia, Bahrain and Pakistan), the number of Islamic financial institutions worldwide now exceeds over three hundred, with operations in seventy-five countries and assets in excess of US$400 billion.

Though initially concentrated in the Middle East (especially Bahrain) and South East Asia (particularly Malaysia), Islamic finance principles are now increasingly found elsewhere. This includes developing economies where the financial sector is almost entirely Islamic (Iran and Sudan) or where Islamic and ‘conventional’ financial systems coexist (Indonesia, Malaysia, Pakistan and the United Arab Emirates). It also includes developed economies where a small number of Islamic financial institutions have been established and where large conventional banks have opened Islamic financing windows (such as in Europe and the United States).

While Islamic finance has been practiced for many centuries, it is important to recall that only in the last thirty years have the Islamic financial institutions offering Sharia-compliant products and services become more widespread and substantial. Indeed, even in Muslim countries it is only very recently that analogous Islamic finance products and services have been offered in direct competition to the financial products and services offered by conventional banks [6]. Clearly, as Islamic products and services enter these markets, an important consideration is the attitudes, perceptions and knowledge of market participants towards these new methods of finance. For individual consumers and business firms, these factors determine the extent to which they choose to patronize these alternative products and services [7]. Key concerns include the influence of religious persuasion and the relative pricing, costs and benefits, convenience and access of Islamic products and services vis-à-vis conventional bank products and services. For conventional financial institutions, the presence of financial institutions offering Islamic financial products and services may affect their competitive position and how they construct new marketing strategies. It may also influence to their decision to introduce Sharia-compliant products and services themselves.

II. A brief review of Islamic finance

Islamic finance is defined as a financial service or product principally implemented to comply with the main tenets of Sharia (or Islamic law). In turn, the main sources of Sharia are the Holy Quran, Hadith, Sunna, Ijma, Qiyas and Ijtihad. The Holy Quran is the book of revelation given to the Prophet Muhammad; Hadith is the narrative relating the deeds and utterances of Muhammad; Sunna refers to the habitual practice and behaviour of Muhammad during his lifetime; Ijma is the consensus among religion scholars about specific issues not envisaged in either the Holy Quran or the Sunna; Qiyas is the use of deduction by analogy to provide an opinion on a case not referred to in the Quran or the Sunna in comparison with another case referred to in the

Quran and the Sunna; and Ijtihad represents a jurists' independent reasoning relating to the applicability of certain Sharia rules on cases not mentioned in either the Quran or the Sunna.

In brief, the principles of Islamic finance are as follows: (i) the prohibition of Riba (usually interpreted as usury or interest) and the removal of debt-based financing; (ii) the prohibition of Gharar, encompassing the full disclosure of information, removal of asymmetric information in contracts and the avoidance of risk-taking; (iii) the exclusion of financing and dealing in activities and commodities regarded as sinful or socially irresponsible (such as gambling, alcohol and pork); (iv) an emphasis on risk-sharing, the provider of financial funds and the entrepreneur share business risk in return for a pre-determined share of profits and losses; (v) the desirability of materiality, a financial transaction needs to have 'material finality', that is a direct or indirect link to a real economic transaction; and (vi) consideration of justice, a financial transaction should not lead to the exploitation of any party to the transaction [8].

In practical terms, these prohibitions and recommendations manifest themselves as the following commercial products and services offered by Islamic financial institutions: (i) Mudarabah, the provision of capital to a partial-equity partnership in return for a share of profits, but where the losses on funds lent are borne by the lender; (ii) Musharakah, full equity partnerships where the provider of funds and the entrepreneur directly and wholly share in the business, (iii) Murabaha, an instrument used for financing the purchase of goods and services where the financial institution purchases these on behalf of the customer; (iv) Bai muajjall, deferred payments on products encompassed under Murabaha; (v) Bai Salam, advance or pre-paid sale contracts of goods and services; (vi) Istisna, or manufacturing contracts to cover work in progress and paid by the financial institution on behalf of the customer; (vii) Ijarah, lease financing in the form of operating leases only; (viii) Takaful or Islamic insurance in the form of cooperative self-help schemes, and (ix) Quard Hassan, benevolent loans offered interest free.

In turn, these commercial products and services underlie the various depositor and investor accounts offered to retail customers. In terms of Islamic banks, these are again very similar to the products and services offered by conventional banks with the exception that Islamic financing principles apply to the underlying bank assets and liabilities. For example, unlike a conventional savings account, interest is forbidden on balances in Islamic accounts. Depositors can, however, obtain benefits in the form of 'voluntary prizes', whose value depends, in part, on the deposit's balance and the bank's profitability. These services are often offered fee-free to depositors.

Islamic products and services also increasingly manifest themselves as mutual funds underpinned by investments in Sharia-compliant equity or property, Sukuk (Islamic bonds), Takaful (Islamic insurance) or Ijarah (Islamic leasing) constructed with Islamic principles in mind. For example, a Sharia-compliant equity mutual fund would, through a process of sector screening and dividend 'purification', normally exclude: banking, insurance or any other interest-related activity; alcohol, tobacco, gambling, armaments; any activity related to pork; other activities deemed offensive to Islam; and any sectors or companies significantly affected by any of the above.

III. Literature Review

Alsadek Gait and Andrew Worthington have provided a synoptic survey of the comparatively few empirical analyses of attitudes, perceptions and knowledge of Islamic finance. Individual consumer, business firm and financial institution attitudes to Islamic finance are examined and briefly compared with the larger body of extant work on attitudes, perceptions and knowledge of conventional financial services and products.

Nadeem Ul Haque and Abbas Mirakhor have attempted to present a viable approach for the design of an instrument of government finance (and monetary management) in an Islamic economy where conventional transactions based on an ex-ante promise of a risk-free rate of return are forbidden. Resources to finance government infrastructural and development projects can be mobilized through the issuance of a national participation paper (NPP) and this instrument can also serve as an instrument of monetary management. Various conceptional issues underpinning the introduction of such an instrument and methods of calculating a corresponding rate of return are discussed in principle, this approach has been accepted in Iran.

Mohammad Nejatullah Siddiqi has surveyed the practices of Islamic finance significantly. The survey addresses the causes of the dichotomy and offers alternative research approaches and themes that may in the future facilitate convergence of the practice with the theoretical aspirations - a transformation from merely meeting the criteria of legality to that of achieving the objectives of Islamic law.

M. Kabir Hassan and Rasem N. Kayed have discussed about the most salient values of the Islamic financial system are fairness and socio-economic justice. The exuberance of Islam's uncompromising commitment to the well-being of humankind goes beyond its caring for existing generations to ensuring a sustainable future for generations to come. This is evident by giving utmost priority to the environment and preserving earth's valuable–yet limited–endowments and resources, and by limiting public borrowings to available resources hence freeing future generations from the burden of debt. The Islamic system of production and finance based on profit-and-loss sharing (PLS) is more efficient and equitable in distribution of wealth and income. Allocation of funds under risk sharing will be based on the viability and expected profitability of the proposed entrepreneurial undertakings rather than on the creditworthiness of competing entrepreneurs. Furthermore, risk sharing offers both entrepreneurs and investors incentives to be truly engaged in productive economic activities, wherein entrepreneurs will be encouraged by the prospect of seeing their ideas transformed into business entities, and financers will be obliged to assess the risk involved more cautiously, and effectively monitor the use of funds by the entrepreneurs. The appropriate implementation of such partnership contracts increases the likelihood of business success, injects more discipline into the financial market by reducing excessive lending, and ultimately will have positive implications for the socio-economic well-being of society at large.

Habib Ahmed has investigated the failure of risk mitigation at different levels as the main cause of the crisis. While following the principles of Islamic finance would have prevented the occurrence of the crisis, the practice of Islamic finance of mimicking its conventional counterpart can make the industry vulnerable to similar crises. Lessons for the Islamic financial sector are drawn by suggesting ways in which risks can be mitigated at the levels of institutions, organisations and products. In doing so, some key risks arising in Islamic finance are identified and various ways in which the Islamic finance sector can be made stable and resilient are proposed.

IV. Advantages of Islamic Finance

This section examines Islamic finance from several sides, including efficiency, stability, moral hazard and adverse selection, role in economic development, integrity, equity and sustainability.

Efficiency

At the macroeconomic level, Islamic finance avoids the use of interest-based lending. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by mark-ups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources.

Conventional finance allocates financial resources with paramount regard for borrower's ability to repay loan principal and interest. In modes of Islamic finance that are based on equity and profit sharing, focus would be on the profitability and rate of return of the concerned investment. This type of finance has the potential of directing financial resources to the most productive investments. This would increase the efficiency of the financing process and reinforce efficiency in the real sectors.

Stability

A conventional bank has on the one hand liabilities that include demand, time and saving deposits, which the bank guarantees. On the other hand, it has assets that are mostly composed of debt instruments each of which has a quality that depends on the ability of the corresponding debtor to repay. Default on the asset side, if it happens in significant proportion, would imply inability to meet the bank's obligations on the liability side. Such default can be expected at times of crises, be it of macroeconomic nature or caused by circumstances specific to the bank. A bank operating according to Islamic rules of finance has liabilities of different nature. Only demand deposits are guaranteed. Meanwhile, investment deposits are placed on profit-and-loss sharing basis. When such bank faces macroeconomic or specific crises, investment depositors automatically share the risk. The bank is less likely to fall and a bank run is less probable. It can therefore be said that an Islamic banking system is relatively more stable when compared to conventional banking.

In conventional finance, present money is traded in an integrated debt market against future money, which takes the shape of commitments to pay specified amounts at specified future dates, or bonds. Bonds are supposed to be easily traded financial instruments, many of which are listed in international financial markets. Hundreds of billions of dollars of debt are traded daily in those markets. Bonds markets provide an easy and automatic mechanism through which short-term funds flow at will from one country to another. Much of those flows follow factors that are only nebulously related to economic fundamentals. They bring an important element of instability into national economies. They threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists have come to call "contagion."

The integrated debt market has grown immense in size as well as in scale of integration that now encompasses the whole world economy. Many experiences, as lately manifested in the Southeast Asian economies, have shown that integrated debt markets are sources of both domestic financial instability and contagion. Some economists have come forward with proposals to place restrictions on capital movements in contrary with what has been considered in economics as received doctrine.

Islamic finance never provides present money in return for future money. All Islamic modes of finance involve money on the one end and goods and services on the other. Monetary flows through Islamic financial modes would have to be tied directly with commodity flows. In other words, Islamic finance removes the dichotomy between financial and real activities. Obviously, this leaves little room for excessive credit expansion, as the finance extended is automatically earmarked for specific uses.

Speculative activities related to interest rate expectations would become out of place. Changes in spending would automatically be reflected on changes in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces. In other words, markets are more likely to operate efficiently and smoothly. It is therefore interesting to note that Islamic finance, though non-conventional, supports market forces and mechanisms more than does conventional finance.

V. Moral Hazard and Adverse Selection

Islamic banks hold equity and trade in goods and services as they operate as universal rather than commercial banks. Universal banks are defined as "large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters," .

A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform.

In summary, banking theory indicates that universal banking would be exposed to lower levels of moral hazard and adverse selection. In addition, by sitting on the firms' board of directors, banks could influence corporate governance in the whole productive sector, leading to improvements in economic performance.

Empirically, it has been found that using a combination of debt and equity finance by banks seems to carry several advantages to both banks and firms, confirming theoretical findings. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and to moral hazard during downturns. Applied research has found that universal banks face lower risk than commercial banks during both upturns and downturns. In addition, the risk differential between universal and commercial banks gets wider and more significant during downturns.

VI. Finance and Development

Given the characteristics of Islamic finance mentioned above, particularly the fact that Islamic banks operate according to the rules of universal rather than commercial banking, we can ask which system gives better support to economic development. In this regard, we can intuitively conclude that the practice of universal banking by Islamic banks put their financing activities right in the centre of the development process. Bankers in this case become both partners and financiers of entrepreneurial efforts to develop the economy. Empirical findings seem to confirm such intuition.

It is widely accepted that economic development requires mobilization of vast financial resources both internally and externally. Any financial resources left hoarded would imply unrealized potential for economic development. As Islamic teachings emphatically prohibit trading present for future money at a rate of interest, many Muslims hold their funds outside the banking and financial sector, thereby missing an opportunity to apply those funds to the development process. Islamic finance opens the door to the effective use of much needed financial resources within many Islamic countries that would be otherwise kept idle. In addition, it provides Muslims with a way through which they can participate in the development process without exceeding their religious beliefs. Muslim minorities in other countries, whose banking systems do not provide Islamic financial products, suffer from cultural exclusion. Some of those Muslims may have to keep their savings outside the financial system thereby contributing to idle financial resources in their countries.

Risk is known to be one of the most important ingredients of making investment. Those who finance investment share a good part of the risk involved with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves apart from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only.

We can therefore notice that risk as well as decision-making is spread over a much larger number and wider variety of concerned people. Risk sharing is balanced by sharing in decision-making. This allows for wider involvement in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the mere feeling of involvement. It adds to the stability of banks. Holders of investment deposits with banks share in both the profits and losses. When a bank faced the unlikely event of an overall loss over the placement of its investment pool, its depositors shoulder their proportional share of the loss. Individual banks as well as the banking system as a whole would therefore be less likely to break down.

Equity

Islamic financial institutions must be viewed as basically private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they can contribute to the efforts taken by the whole society in that regard.

Islam prescribes a tax-subsidy approach to reducing poverty. A levy called Zakah is paid out by the wealthy (those whose wealth exceeds a certain minimum level) in proportion to their property.

Zakah proceeds are to be earmarked for several uses including income and wealth maintenance for the poor. Income maintenance is provided within narrow limits to those incapable of work and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor productive assets, which they can use to produce goods and services and sell them for profit. This method of poverty reduction can be closely intertwined with that of economic development, as redistribution is mostly directed towards making the poor more productive, which in turn contributes to economic development.

As to income maintenance, Islamic banks and financial institutions can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, the titles to such enterprises are transferred to the poor, certain measures must be taken to insure that the new businesses would not be immaturely liquidated to finance consumption outlays for their owners. The experience of Islamic banking and financial institutions in project financing should come in handy in eradicating poverty and increasing equity through proper use of Zakah proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collaterals and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profit-sharing basis would be more concerned about profitability and rate of return and less concerned about collateral as the primary consideration. Those who are not wealthy, but have worthy investment projects, would have more access to finance.

Sustainability

Conventional debt has certain characteristics that could place debtors in difficulties if circumstances do not allow them to repay in time. Interest is usually calculated on the outstanding balance of debt, usually compounded annually and sometimes at shorter intervals. Delinquent debtors are often subjected to penalty rates of interest, which are higher than regular rates. It is not uncommon to find borrowers who end up paying debt service that is many folds the original principal they borrowed. This is particularly symptomatic of developing countries debt, as they continue to face debt problems that sometimes reach crisis levels. Creditor countries and institutions have often sought to find ways and mechanisms to provide debt relief to debtor countries. Despite continuous efforts, the debt problems faced by developing countries seem to be ever-present.

When debtors face unavoidable circumstances that would make them temporarily insolvent, they are often granted grace periods to help them bring their finances back to order. No penalty fees can be levied in this case. In other words, debt rescheduling, when justifiable, would be granted at no extra cost to borrowers. Therefore, we can conclude that Islamic finance is sustainable and less liable in itself to cause undue hardship to debtors.

Quite often, conventional debt cannot be repaid because it was not used for its prescribed purpose. Under the rules of conventional finance, creditors assume that the use of the loans they extend would strengthen the ability of debtors to meet their future obligations. However, conventional loans are usually offered without ways or mechanisms to assure their use for certain purposes8. In contrast, Islamic debt is created through the finance of acquiring goods and services on credit. In other words, the loan is used from the very beginning for its prescribed purpose. Default resulting from improper use of borrowed funds would therefore be most unlikely.

As Islamic finance provided to finance investment is asset-based, i.e., it is used to acquire real assets; it is much less likely to lead to debt crises. Such type of asset-based finance, directly contributes to the ability of the economy to meet its internal and external financial obligations. This is certainly a welcome effect.

VII. Conclusion

Now we come to the final question we raised with regard to Islamic finance. Theoretically and empirically, it is not difficult for specialists in economics and finance to find Islamic finance not only viable and acceptable, but also efficient and significantly effective. It is not therefore surprising to see large multinational financial institutions providing Islamic financial services to their customers in significant amounts. As an innovation, Islamic finance has been practiced for more than a quarter of a century. Some people might think that it should have received wider acceptance worldwide. There are several reasons why this has not happened.

First, Islamic finance seems quite different from conventional practices, as it is not based on borrowing and lending.

Second, Islamic financial institutions, like their conventional counterparts, can operate more effectively when the proper legal and institutional environment is provided, something that is yet to happen at a large scale in a significant number of countries. The well-known fiscal prejudice against profit and in favour of interest is just an example, where interest payments are partially or fully tax exempt, and profit gets no such advantage.

Third, the present capital markets are not adequately equipped to process the information required by Islamic finance. This requires a careful blend of laws and ethics, the latter playing more important role than the former. Islamic finance would thus require a certain set of ethics in the market. Scholars elaborate on the details of the required ethics based on Islamic principles. It may take some time before Islamic ethics are introduced appropriately in the capital market. Needless to say, the required ethics make sense irrespective of religious beliefs. Religion, however, provides commitment to abide by those ethics in letter and spirit.

Fourth, Islamic banks and financial institutions working in mixed systems that allow for both conventional and Islamic practices have been able to approach but have not yet reached their ideal model. Islamic financial institutions are expected to provide equity/profit sharing and debt finance while giving higher weight to the former. Yet, when they operate in mixed environment, their asset structure tilts towards debt finance. The reason for this is two-fold. On the one hand, dealing with equity and profit-sharing finance requires supporting environment and institutions. On the environment side, entities obtaining this type of finance need to have orderly bookkeeping, audited financial statements, and suitable corporate governance. In most countries where Islamic banking is practiced, those elements are hard to come by. It would also make things a lot easier if banking laws, rules enforcing obligation fulfilment and credit (or investment) rating is available.

They are also expected to provide debt and equity finance simultaneously to the same customers, as universal banks should do. However, such pattern of operations is not common. This could be related to the commercial banking culture that dominates the banking systems where Islamic financial institutions operate. The universal banking model has to be brought closer to the minds of practitioners of Islamic finance. Monetary and financial authorities also need to become more tolerant of universal banking especially that the movement towards banking deregulation has become more prevalent.

Fifth, Islamic financial products have to increase in numbers and variety to form a critical mass that would attract a large number of transactors. Once the Islamic market for financial instruments acquires depth and breadth, the public will find it more convenient to join in.

Sixth, there is sometimes the feeling that Islamic finance works outside the authority of governments. Quite the contrary, Islamic financial institutions are consistently subjected to rigorous regulations and supervision by authorities wherever it is practiced. More often than not, their regulation and supervision are made even more rigorous than that imposed on their conventional counterparts. Those working in the field of Islamic finance are equally concerned about the integrity and the stability of both national and international markets.

With no exception, all institutions practicing Islamic finance work under government regulatory and supervisory authorities in their respective countries. Such authorities are sufficiently empowered to collect information and point to violations. All parties concerned with the health of world finance are invited to cooperate with regulatory and supervisory authorities to make sure that the practices of conventional as well as Islamic institutions cause no concern.

Seventh, in order to switch to a new financial system, cooperation is needed from several parties, including bankers, savers, investors, businessmen, and governmental institutions. As economists know too well, when cooperation is scarce, people make irrational decisions that keep them away from an optimal solution. As economists have argued within a theory of reciprocity in general and the prisoner’s dilemma in particular, a subgroup of cooperating agents can, under certain conditions bring the whole population to an optimal solution. This implies that new and unconventional ways, notwithstanding their advantages, would require a sufficient number of pioneers to lead the way and set an example.

Finally, we are inclined to propose that countries should give equal chance to Islamic finance to work side by side with conventional finance. The market itself would finally decide the proper mix of both conventional and Islamic finance that suits the world economy. By removing restrictions, obstacles and hindrances facing the application of Islamic finance, the world would benefit and economic development can be better served.

In order to help the Islamic financial industry further develop itself and overcome the obstacles it faces, countries must be invited to develop and continue to improve the important infrastructure needed to support the industry and insure its proper functioning. Now the institutional foundations of the regulation and supervision of Islamic finance has been established, efforts must continue to develop further the proper regulatory and supervisory mechanisms that suit Islamic finance and, at the same time, ensure adequate transparency, proper risk management, internal controls, and effective corporate governance.

Like the conventional financial industry, the Islamic financial industry has its success but faces certain challenges. Developing and improving the proper enabling environment will go a long way in helping the Islamic finance industry to deal with the challenges it faces. Once such environment becomes sufficiently workable, the Islamic financial industry can become more capable of handling sophisticated financing techniques and instruments. It can then accomplish more successes, especially in the areas of designing market based instruments for monetary control and government financing that satisfy the Islamic principles and promote greater reliance on equity finance.

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