PHILOSOPHY OF ISLAMIC BANKING AND FINANCE

DR. MABID ALI AL-JARHI

Keynote address, Conference on Islamic Banking and Finance, January 5 – 7, 2004, Darussalam, Brunei, Jointly organized by University of Brunei, Darussalam and Islamic Research and Training Institute, IDB

Dear brothers and sisters,

السلام عليكم و رحمة الله و بركاته

I would like to start with expressing my deepest appreciation to the University of Brunei, Darussalam and the Islamic Research and Training Institute, a member of the IDB Group in Jeddah, for cosponsoring this conference. Indeed, the presence of IRTI in this gathering is a manifestation of its continued interest to contribute to the advancement of research in Islamic economics. I also would like also to express my highest regards and deepest appreciation for the government and the people of Brunei for their gracious hospitality and valuable services in making the arrangements of this conference, so efficiently and successfully, Darussalam.

Islamic finance has been brought back to modern life after years of absence. It has been around in its contemporary form for about a quarter of a century. It is perhaps time to ask why Islamic finance. After all, the world economy has been working with conventional finance with for decades and no one seemed to crave for something different.

For practitioners, the *raison d'être* for any practice is market success, which has been achieved by Islamic finance. However, economists would think that Islamic finance must have justifications for its existence; justifications that would rely on economic logic.

I will attempt here, within the time allowed to dwell on the economic justifications of Islamic finance. Some of you who had a chance to look into my writings would find that this is one of my favorite subjects. Let me first state my claim that Islamic finance has rightful claims to being efficient, stable, reduces moral hazard and adverse selection, and provides a more effective means to finance development. Its system demonstrates integrity and enhances equity. Meanwhile, we must not forget that its practice by Muslims is religiously gratifying, but it is made for and can serve all.

EFFICIENCY

Let us first try to describe Islamic finance in few words. Islamic finance is provided in the form of **money** in return for either equity or rights to share in future business profits, or in the form of **goods and services** delivered in return for commitment to repay their value at a future date. It 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.

Islamic banks and financial institutions are supposed to hold equity in corporations and sit on their boards of directors. The information they obtain helps them fine-tune their finance directed to the same corporations. In addition, they trade in goods and services, provide insurance, and operate in financial markets. In other words, they operate like *universal* rather than *commercial* banks.

Islamic banking and finance started as an innovative non-conventional way of doing business and quickly gained popularity and acceptance. That may indicate that it is useful both to individuals and societies.

Until the middle of the twentieth century, it seemed to everyone that no wrong could be found with the present interest-based financial system. In search for optimal monetary policies, monetary economists finally found that a zero nominal interest rate is a necessary and sufficient condition for allocative efficiency (Friedman, 1969, Cole and Kocherlakota, 1998; Wilson, 1979). This result is robust in a variety of models (Correia and Teles, 1997).

The reason is simple. After switching from metallic to fiat money, adding one marginal unit of real balances costs no real resources to the community. Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transactions costs. They would therefore use some real resources instead of money. However, when the rate of interest is zero, traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment. The long forgotten

Christian and Jewish teachings of prohibiting the charging of interest on loans are not an aberration after all. It is amazing to see such religious teaching stay valid after so many centuries.

STABILITY

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 (Khan, 1986).

In conventional finance, present money is traded in integrated debt markets against future money. Hundreds of billions of dollars of debt are traded daily in bond markets, which 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."

In contrast, debt is created in Islamic finance through selling goods and services on credit. Resulting debt instruments are not readily tradable. We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines a mark-up rate. Such credit markets would be fully segmented, while the debt instruments themselves are traded only for nominal values at maturity. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion through the debt market would therefore be remote and the justifications to choke capital movements with restrictions become unnecessary.

Examination of daily records of trading in financial markets vividly shows that institutional participants carry out huge speculative transactions. More often than not, such transactions are sources of instabilities. In contrast, Islamic banking and financial institutions are automatically prevented from carrying out such gambling activities; destabilizing speculations would be significantly curtailed in financial markets.

Speculative activities related to interest rate expectations would become out of place. Change 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, reinforces conventional market forces and mechanisms.

MORAL HAZARD AND ADVERSE SELECTION

We have mentioned above that Islamic banks 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 " (Calomiris, 2000).

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.

Obviously, adverse selection can be avoided by careful screening of finance applicants. When a bank provides equity and debt finance simultaneously, it will have more access to information than when only debt finance is provided. We can therefore conclude that screening would be more effective and adverse selection less probable with universal banking.

Reducing possibilities of moral hazard requires monitoring the firm that obtains finance. All three kinds of ex ante, interim and ex post monitoring must be exercised to be effective (Aoki, Masahiko, 1994). Equity finance provides the bank with access to information necessary to practice monitoring at all intervals. It also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt finance would reduce the firm incentives to hide its profits. Furthermore, when the firm faces problems, the bank, as an equity holder, will assist in order to protect its investment.

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.

FINANCE AND DEVELOPMENT

Given the fact that Islamic banks operate according to the rules of universal banking, we can ask whether it 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 center 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.

Calomiris (2000), through his study of pre-World-War I Germany, has found that universal banking served to reduce the cost of financing industrialization in Germany relative to its corresponding level in other countries where commercial banking is prevalent. He also found that the financial sector reached a higher level of allocative efficiency in the former than in the latter country. We can therefore rest assured that banks operating as universal banks give better support to development efforts.

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*, while the economies in their countries would have idle financial resources.

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 (Dewenter and Hess, 1998).

In Islamic finance those who finance investment share a good part of the risk involved with those who carry out actual investment activities. In addition, Islamic finance allows savers to share with banks the risks associated with choosing the right investment and how successful it will be. Banks and financial institutions share in the decision-making process, by sitting on the boards of directors of firms receiving funds as well as entering into partnership of limited term with business enterprises. 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.

Unconventional debt created through Islamic finance has characteristics with which debt crises are less likely to rise. Particularly, the total value of debt is set from the very beginning. It can be repaid in installments, and there is no compounded interest to pay on outstanding balance. When debtors face unavoidable circumstances that would make them temporarily insolvent, debt rescheduling would be granted at no extra cost to borrowers. This implies that creditors share a combination of "unforeseen risks" with debtors.

Debt in Islamic finance 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 unlikely.

It is generally acceptable that Islamic Financial institutions must contribute to economic development. They can also be given a role in eradicating poverty. Some *Zakah* proceeds (the redistributive tax paid by the rich) can be entrusted with Islamic financial institutions to be used for establishing micro enterprises that would be owned and operated by the poor.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provision of collaterals and guarantees. Thus the rich would have most access to finance. In contrast, to the extent that Islamic finance provides funds on equity or profit sharing basis, it would be more concerned with profitability and return and less concerned with collateral.

Those who have worthy investment projects would have more access to finance.

Many specialists in economics and finance find Islamic finance more efficient, significantly effective, and viable. Large multinationals provide Islamic financial services to their customers in significant amounts. Still, some note that it has not been adopted worldwide at a large scale. We can identify some reasons.

First, Islamic banking and finance seems quite different from conventional practices. Second, Islamic financial institutions can operate more effectively with proper legal and institutional environment, which is yet to become a reality at a large scale in many countries. The famous fiscal prejudice against profit and in favor of interest is just an example. Third, present capital markets are not adequately equipped to process the information required by Islamic finance. This requires a careful blend of laws and ethics. It may take some time before Islamic ethics are introduced appropriately in the capital market.

There is sometimes the feeling that Islamic finance works outside the authority of governments. Quite the contrary, Islamic financial institutions are usually subjected to rigorous regulations and supervisions by authorities wherever it is practiced.

Islamic finance should give equal chance to compete as well as work hand in hand with conventional finance. The market itself would finally decide the proper mix of both conventional and Islamic finance that suits the world economy. This would ultimately benefit economic development.