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THE SEVEN ADVANTAGES OF ISLAMIC FINANCE

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I. efficiency

In a system with positive rates of interest, people can increase their earnings by depositing cash in the bank rather than use it for transactions. In order to carry the same volume of transactions they must use real resources in place of money, which could have been used to produce goods and services. This means that the community output is less than the maximum. Such situation is considered by economists as suboptimal and inefficient.

Islamic finance provides opportunities to save and earn profit on savings. However, in this case savers present their financial resources according to the Mudaraba or Wakala contracts. In both cases, there is a degree of risk sharing. Therefore, the rate of profit on "investment or Wakala deposits" will not automatically encourage the inefficient substitution of real resources for cash. Therefore, the Islamic financial system is more efficient at the macro level than the conventional financial system.

Conventional finance allocates financial resources with paramount regard to 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 has the potential of directing financial resources to the most productive investments, thereby increasing efficiency.

Modes of Islamic finance that are based on mark-up finance the acquisition of goods and services, including productive assets. When conducted in an open market with sufficient competition, the cost of finance, or mark-up, will depend on the relative value in use of each commodity, whether in consumption or production. Resource allocation would again be optimal.

II. 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

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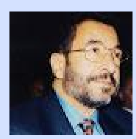

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that are mostly composed of debt instruments that are subject to the risk of default. Default on the asset side in significant proportion would imply inability to meet the bank's obligations to depositors. Such default can be expected at times of crises, 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 bank-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.

Conventional finance has an integrated debt market. Hundreds of billions of dollars of debt are traded daily. Bonds markets 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 created in Islamic finance through selling goods and services on credit is not readily tradable, implying a fully segmented debt market. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion through the debt market would therefore be remote.

Individual and institutional participants in financial markets carry out huge speculative transactions, based on gambling contracts. More often than not, such transactions are sources of instabilities. In contrast, Islamic financial institutions are automatically prevented from carrying out such gambling activities; destabilizing speculations would be significantly curtailed in financial markets.

All Islamic modes of finance involve money on the one end and goods and services on the other. Monetary flows through Islamic financial modes are tied directly to commodity flows. In other words, Islamic finance removes the dichotomy between financial and real activities. Obviously, this leaves little room for instability due to excessive credit expansion, as the finance extended is automatically earmarked for specific uses.

III. lower risks of moral hazard and adverse selection

Islamic finance does not provide funds directly to customers. Instead, it finances the commodity and asset requirements of customers. This means that both the finance provider and the finance user are fully and equally informed, and there is no information asymmetry. Therefore, there are no risks of moral hazard and adverse selection.

Conventional finance provides borrowers with cash. Borrowers know more about the use of the loans they obtain than banks do. There is a great deal of information asymmetry, implying substantial risks of moral hazard and adverse selection.

IV. finance and development

Islamic banks, by financing both demand and supply simultaneously, 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.

It is widely accepted that economic development requires mobilization of vast financial resources. Many Muslims, Christians, Jews, Hindus and Buddhists abhor interest. They hold their funds outside the banking and financial sector to avoid Reba. Fewer funds would be directed to the development process. Islamic finance would automatically attract such funds that would be otherwise kept idle. In addition, it provides them with a way through which they can participate in the development process without exceeding their religious beliefs, instead of suffering from *cultural exclusion*.

V. system integrity

Conventional finance can be likened to a *spectator's game* where few skilled players stay in the playground and a big crowd is watching from outside. Islamic finance, meanwhile, is similar to *participatory sports*, where everyone is playing and no one is concerned with mere watching. In addition, there is a moral side to Islamic finance that seems to be in the back of mind of everyone.

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 economic system itself becomes more compact with wider involvement. The real and financial sector, banks and savers, investors and fund owners are all strongly glued to each other. This finally leads to an economic system with a high degree of integrity that can better withstand shocks.

VI. equity

Islam prescribes a tax-subsidy approach to reducing poverty. A levy called *Zakah* is paid out by the wealthy to give to the poor. Zakah can be collected by nongovernmental and governmental organizations. Islamic banks can help by acting as custodians and in the disbursement of the proceeds. Islamic banks can use Zakah proceeds to finance micro projects whose title could be eventually transferred to the poor.

Under conventional lending, banks give their utmost attention to the ability to repay loans, depending overwhelmingly on the provisions of collaterals and guarantees. Thus, those already rich would have most access to finance. In contrast, Islamic finance could provide the poor through sale finance (Murabaha, Bai' Bethaman Ajel, Ijarah and Ijarah Muntahia Bittamleek) with consumers durables as well as productive assets for installment payments that fall within their income. Goods financed will serve as collateral to the bank until payments are all effected. The poor will need only to verify his income through proper documentation or depositing his receivables or salary with the bank.

In addition, providing funds on equity or profit-sharing basis would be more concerned with profitability and rates of return and less concerned about collateral as the primary consideration. In both cases, those who are not wealthy, but have worthy investment projects, would have relatively more access to finance.

VII. sustainability

Conventional debt places debtors in difficulties if circumstances do not allow them to repay in time. Interest is usually calculated on the outstanding balance, usually compounded annually and sometimes at shorter intervals. Delinquent debtors are 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.

We can therefore conclude that interest based financing lacks a great deal of sustainability. Creditors have to stop every few years to give debtors relief in terms of rescheduling and forgiveness. Sometimes this also includes floating low quality debt at lower market value and swapping it with equity. The system has demonstrated unsustainability several times.

Debt created through Islamic finance has characteristics with which debt crises are less likely to rise. Particularly, the total value of debt, which includes the spot value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning. The total value of debt can be repaid in installments, without increase in its total value, as there is no compounded interest to pay on outstanding balance.

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.

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.

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