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ISLAMIC FINANCE: AN EFFICIENT & EQUITABLE OPTION

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ABSTRACT[1]

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 efficient? (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?

As to the rate of interest, economists found that a zero nominal interest rate is a necessary and sufficient condition for optimal allocation of resources. Deflating the economy at a rate equal to the real rate of interest would automatically set the (nominal) rate of interest to zero, which is an optimal monetary policy that insures that financial resources are allocated efficiently. Unfortunately, this would bring with it several problems both conceptually and practically. Resorting to Islamic modes of finance appears to be a better course towards optimality than deflating the economy.

The article underlines two advantages of Islamic financial instruments. First, in pricing their services, their issuers have *wider latitude*. In addition, Islamic finance brings a consistency of purpose to macroeconomic policy.

The article argues that Islamic finance introduces a measure of efficiency and stability and it would be exposed to lower levels of moral hazard and adverse selection. It can play an important role in economic development and is associated with more systemic integrity, equity, and sustainability of future commitments.

Finally, the paper attempts to look into the reasons why Islamic finance has not spread at a larger scale. First, Islamic finance seems quite different. Second, Islamic finance lacks the proper legal and institutional environment. Third, the present capital markets are not adequately equipped to process the information required by Islamic finance. 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. Fifth, Islamic financial products have to increase in numbers and variety to form a critical mass that would attract a large number of transactors. 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. Seventh, new and unconventional ways, notwithstanding their advantages, would require a sufficient number of pioneers to lead the way and set an example.

[1] The author wishes to express his appreciation for many scholars who made extensive comments on earlier drafts, including Muhamad Umer Chapra, Mohamed Finaish, Nejatullah Siddiqui, Anas Zarqa, Mohamad Elqari, Sami Sweilem, M. Fahim Khan, Munawar Iqbal, and Tariqullah Khan. He is also indebted to two anonimous referees for their substantive comments. Opinions experessed do not necessaritly reflect those of IRTI or the IDB.

ISLAMIC FINANCE: A CONCISE DESCRIPTION

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. The reader may ask:

- Why all the fuss about the rate of interest?
- Is Islamic finance, as an alternative to *interest based* debt finance viable and efficient?
- What does Islamic finance imply for the whole economy?
- Given that Islamic finance is really viable, why is the world not looking forward to adopt it at a much larger scale?

As we describe the main features of Islamic finance, the reader will find answers to the above questions.

I. THE RATE OF INTEREST:

During the last three hundred years the Western World has evolved the current system of finance whose cornerstone is the rate of interest. Huge amounts of debt are being traded in national and international financial markets every working hour, exceeding the gross domestic products of many countries. Since then, lending at a rate of interest has become a household practice allover the world. Developing countries, having played little role in establishing the current financial system, have either adopted this practice or inherited it from their former colonialist masters.

Until the middle of the twentieth century, it seemed to everyone that no wrong could be found with the system. That is when economics has matured as a scientific discipline that commanded both intellectual as well as political influence. Economists, staying within the boundaries of "positive analysis" that purports avoidance of moral judgment, considered the rate of interest as a price: it is the relative price of present money to future money. You could rarely find an economist who would call for a zero price for anything, as prices serve as important tools in resource allocation.

However, in search for optimal monetary policies economists stumbled on the relationship between the level of the rate of interest and the optimality of resource allocation. Monetary economists found that a zero nominal interest rate is a necessary condition for optimal allocation of resources (Friedman, 1969). 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. When this matter was investigated within general equilibrium models, it was found that a zero interest rate is both necessary and sufficient for allocative efficiency (Cole and Kocherlakota, 1998; Wilson, 1979). Though these theoretical results are dependent on some simplifying assumptions, they are robust in a variety of models (Correia and Teles, 1997). They imply that the long forgotten Christian and Jewish teachings as well as those of Islam and Hinduism that prohibit the charge of interest on loans are not an aberration. It is amazing to see such religious teaching stay valid after so many centuries.

Naturally, economists would be expected to search for the set of monetary policies that would bring the rate of interest to zero, in order to reach an optimal allocation of resources. Considering that the (nominal) rate of interest (*i*) can be written as the sum of the real rate (*r*) of interest and the rate of inflation (π):

$$i \;=\; r + \pi$$

Setting (*i*) equal to zero implies that the real rate of interest *r* is equal to the rate of deflation. Therefore, it appears that deflating the economy at a rate equal to the real rate of interest would automatically set the (nominal) rate of interest to zero. This would be the optimal monetary policy that insures that financial resources are allocated efficiently.

Unfortunately, this appears to be rather difficult, as deflating the economy would bring with it several problems both conceptually and practically. Conceptually, economists would naturally worry about the existence of a liquidity trap when the rate of interest is zero (Uhlig, Harald, 2000). Others may worry that when the rate of interest becomes very low, monetary authorities have less leeway with adjusting it downwards in the face of recession. Another conceptual problem is that deflation has efficiency problems parallel to those of inflation.

Nevertheless, some economists think that the practical and conceptual problems could be surmountable (Ireland, 2000). Usually, when suitable policies are either not found or found to be impractical, an institutional change may be the way out.

It is also obvious that *interest-free* loans cannot be used on a large scale to finance investment. Such loans would appear to be philanthropic rather than enterprising actions. We must therefore design new ways to provide finance independently from philanthropic incentives and at the same time do not involve payment of interest on loans. Here again we find that Islamic finance modes avoid lending at interest[2]. Hence, there would be no rate of interest to try to reduce to zero. This way the problem of efficient allocation of resources is automatically resolved. Avoiding interest would necessarily mean resorting to alternative modes of finance.

II. ISLAMIC OPTION

The option of Islamic finance encompasses an institutional set up that could be applied at the level of individual enterprises, namely banks or financial institutions. Each bank and/or financial institution can apply the Islamic modes of finance either to all its operations or to a window extended to those interested in benefiting from such rules. Its financial product would carry the distinctive quality of being Islamic. It can also be applied at a system-wide scale, where the whole banking and financial system operates according to the rules of Islamic finance.

Some may think that Islamic finance is just “interest-free” finance. That could be construed as enforcing a zero interest rate on the economy. It can be criticized as running contrary to market rules. Nothing can be farther from reality. The logic of keeping a zero rate of interest has been formed for a fiat-money market economy, with an integrated debt market where future money is traded against present money. The Islamic economic system, while based on market rules, has no integrated debt market and future money cannot be traded against present money. That makes the

[2] Needless to say, extending interest-free loans to the needy remains a laudable philanthropic activity in Islam.

"*Islamic modes of finance*" the central institutional setup that replaces *both* the rate of interest and the integrated debt market.

To explain the Islamic option, we start with a short description of how Islamic banks and financial institutions work and then explain the finance modes used by them.

A. ISLAMIC BANKING AND FINANCE

1. Islamic Banks

Islamic banks operate in ways that differ from their conventional counterparts. Nonetheless, they provide fund owners as well as fund users profitable opportunities. On the liability side, they provide *owners of funds* opportunities to place their financial resources profitably, as they become implicit partners of those institutions that share in their net profit, while carrying a proportional share in their risk. On the asset side, they provide finance to enterprises through either sharing directly in the net results of their activities or financing their purchases of assets, goods, and services.

We can therefore expect Islamic banks to hold equity in corporations and sit on their boards of directors. They use the information obtained from their vantage point to reduce risk from information asymmetry and to fine-tune their finance directed to the same corporations. In addition, they can trade in goods and services, provide Islamic insurance, and operate in financial markets. In other words, they operate like universal rather than commercial banks.

2. Islamic Non-Banking Financial Institutions

There can be a variety of non-banking financial institutions that collect funds without taking deposits and use Islamic finance modes to provide finance to entrepreneurs. They mobilize funds through selling stocks, mutual shares, and a variety of instruments (*Sukuk*) with a wide choice of risk sharing and maturities.

Non-banking financial institutions have even greater flexibility to deal with equity and partnership than universal banks, as they are not encumbered with guaranteed demand deposits. The advantages of financing working capital requirements to enterprises in which they hold equity can therefore be more pronounced than in universal banking.

More light can be shed on how Islamic banking and financial institutions operate when we explain the Islamic modes of finance.

B. ISLAMIC MODES OF FINANCE

Islamic modes of finance can be grouped into three categories:(i) equity and profit sharing, (ii) credit purchase, and (iii) leasing.

Equity finance as popularly known implies that savers would provide funds to enterprises in return for a share in its prospective net returns as well as a share in its management. Meanwhile, **profit sharing** finance implies that finance providers would provide finance, not for the whole life of the financed enterprise, as in case of equity, but for shorter period, as in the case of providing working capital finance. Profit sharing finance may be provided with and without sharing in management.

Credit purchase implies that the financing institution provides goods and services for spot delivery in return for a debt instrument that promises payment of their value at a specified future date. That value differs from spot prices by a certain margin called *mark-up*.

The debt instrument is not negotiable. In case of temporary insolvency the debtor is granted an extension with no increase in maturity value. Only delinquent debtors with no valid excuses can be subjected to penalty. Alternatively, the financing institution can pay the value of the goods and services spot and get them delivered at some specified time in the future. In this case, the debt instrument would be written in terms of goods and services.

Some may think that this type of *sales finance* is no different from interest. They may say that trading present against future money involves explicit interest, while trading goods against future money may involve *implicit interest*. While both interest and markup reflect time preference, the latter is far from similar to the former. Several differences can be cited in this regard[3]. First, the nominal value of the debt involved in sales finance cannot grow by itself. The value of debt is set at the time of sale and cannot be increased. In contrast, interest is set as a compound rate per unit of time, allowing the nominal value of debt to grow until it has been repaid. Second, finance is provided in conjunction with acquiring and subsequently using a commodity. This has serious implications with regard to the relationship between the real and the financial sectors, which will be taken up further below.

Leasing (operational lease[4]) finance implies that the financing institution purchases a durable asset and leases it to a customer in return for regular payments reflecting the cost of holding, maintaining the asset in addition to transferring the property of the asset from the financing institution to finance recipients.

C. BANK DEPOSITS IN ISLAMIC BANKING

In addition to demand deposits, which are guaranteed but earn no return, Islamic banks also take investment deposits for specific maturities. Investment deposits are either general or restricted. The former are grouped with equity in one pool and invested in several ways. Each earns a proportional share of the net profit of the pool. The latter are placed in specific investments chosen by respective depositors and earn a proportional share of the profit on their investment.

In all cases, Islamic banks use the deposits they obtain to provide finance in the modes outlined above and get a proportion of the profit or a commission as a fee.

When the bank gets a proportion of the profit in compensation for its efforts, the profit sharing ratio between the bank and depositors is set at the outset. However, the actual rate of return eventually paid out to Investment deposits is not predetermined. It is closely linked to the performance of the real economy, as finance modes are generally directed to finance trade in goods and services as well as the actual production processes. It also depends upon the performance of individual banks in relation to choice and management of investment.

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3 I am indebted for this explanation to one of the two anonymous referees who have contributed to improving this paper.

4 This is called operational lease in contrast to financial lease. In the former, the leaser bears all risk attached to the asset until its title is transferred to the lessee, while in the latter, the lessee assumes all risks from the very beginning.

D. ISLAMIC FINANCIAL INSTRUMENTS[5]

Financial instruments play an important role in reducing transactions costs for both savers and investors. As they can be tailored to the tastes and requirements of both parties, they can drastically reduce the cost of negotiating terms related to size, maturity, profit-sharing formula and other relevant conditions.

Financial instruments increase the reach of financial institutions to fund suppliers and users, enabling institutions to deal with large numbers of customers and thus realize significant economies of scale. This *reach factor* manifests itself through the ability of trading instruments in primary and secondary markets. In this regard, we can find two advantages of Islamic financial instruments over their traditional counterparts.

First, in pricing their services, the issuers of Islamic financial instruments have *wider latitude*. When dealing with savers and investors, they negotiate a profit share between zero and 100. Conventional security issuers, meanwhile, are bound to negotiate a small cut within the much narrower differential between the borrowing and lending rates. Wider latitude enables financial intermediaries to be more effective in mobilizing resources on the one hand and attracting investors on the other.

In a conventional economy, when intermediaries raise the rate of interest to mobilize more savings, they have to charge investors correspondingly higher rates of interest. In Islamic finance, intermediaries can mobilize more savings by offering higher rates of profit sharing to savers; the profit here would be obtained from investment net of all costs including finance costs. Meanwhile, they can entice more investment by offering investors higher profit share, that would implicitly mean lower finance costs. In other words, attracting more saving does not conflict with enticing more investment in Islamic finance. Islamic finance can therefore be said to have a consistency of purpose that is missing in conventional finance.

It is rather interesting to conclude that financial intermediation in the non-banking sector would imply lower transactions costs and mobilize both savings and investment more effectively than conventional finance.

5 Al-Jarhi, 1998.

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.

I. 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 markups 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.

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 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 (Khan, 1986).

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.

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[6]. 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 financial institutions are automatically prevented from carrying out such gambling activities; destabilizing speculations would be significantly curtailed in financial markets.

We have noted above that 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.

III. MORAL HAZARD AND ADVERSE SELECTION

We have mentioned above that 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," (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.

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[6] At maturity both countervalues, *viz*., debt and its nominal value would be spot and equal in amount, thereby fullfilling the necessary conditions for trading money in Islam. Meanwhile, debt can be swapped against tangible goods or services (according to Imam Malik and Ibn Taymiah, but not for cash.

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.

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).

IV. 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 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*. Some of those Muslims may have to keep their savings outside the financial system thereby contributing to idle financial resources in their countries.

V. 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 every one 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.

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.

Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it would be. Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with *proper corporate governance* allows depositors some influence on banks investment decisions and allows banks and financial institutions a share in the decision-making process, by sitting on the boards of directors of firms receiving funds.

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.

VI. 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.

Income maintenance would involve regular (monthly) payments to the needy. Wealth maintenance, meanwhile, involves transferring to the poor a combination of productive resources, which would be capable of generating sufficient income to maintain at least one household.

Zakah collection would be expected to be carried out mostly by nongovernmental and sometimes by governmental organizations. Islamic banks can help by acting as custodians and in the disbursement of the proceeds. In addition, non-banking financial institutions can also take part in collecting Zakah, using Islamic banks as depositories, and invest the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they would also add a proportion of Zakah due on their shareholders equity[7]. They can even accept direct payments of Zakah and other donations on behalf of philanthropic institutions.

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.

VII. 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.

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 unsustainablility several times.

Unconventional 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

[7] Understandably, there may be other expenditures items which would be financed from zakah proceeds. That is why only a proportion of them would be handed to collectors. Such proportion can be determined by society and could change from year to year.

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.

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 purposes[8]. 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.

8 In cases where a loan is earmarked for the purchase of commodities, a conventional bank would find it cheaper to inforce earmarking through a sale-finance contract.

ACCEPTANCE OF ISLAMIC FINANCE

Islamic finance has achieved a great deal of progress especially in the areas of financial innovation, central banking operations, establishing money markets, accounting, disclosure, regulation, and rating standards. The relationships between Islamic and conventional banking and financial institutions have been cooperative and mutually beneficial. Nonetheless Islamic finance has not expanded to its full potential. We will take these issues in this section.

Islamic finance has been practiced for more than a quarter of a century. It has gained acceptance and succeeded in making inroads into the financial industry, providing services to Muslims and non-Muslims alike. The size of the Islamic finance industry is estimated to go beyond $150 billion, and is still growing strong. A large number of Islamic banks and financial institutions have been established in both Muslim and non-Muslim countries. Some Muslim countries, notably Iran, Pakistan and Sudan have established full-fledged Islamic monetary and financial systems. Others, e.g., Bahrain and Malaysia have sought to develop a significant Islamic financial sector with modern capabilities. Many conventional banks, both national and international have entered the field of Islamic finance through opening windows and branches.

The record of Islamic banking and financial institutions indicates that Islamic finance started as an innovative non-conventional way of doing business and quickly gained success, popularity, and acceptance. That may indicate that it is useful both to individuals and societies. We elaborate below some of its accomplishments.

VIII. ACCOMPLISHMENTS OF ISLAMIC FINANCE

Some of the most recent accomplishments of Islamic finance are noted below.

3. Development Finance

Islamic finance is not only practiced at the domestic level in the form of retail and wholesale banking, but also extends to the area of development finance at the international level.

The Islamic Development Bank (IsDB) is a regional financial institution with a membership of 53 countries. Its subscribed capital has recently been raised to SDR 8.1 billion. It represents one of the most significant manifestations of south-south cooperation. While its members are all developing countries, each member benefits from the IsDB resources in proportion of its developmental need rather than its capital subscription. The IsDB works in close cooperation with the World Bank, the IMF and regional financial institutions.

During its first 25 years of operations that ended in March 2001, the IsDB provided project financing and technical assistance exceeding SDR 5.5 billion and trade financing of around SDR 12.2 billion. Out of project financing, 28.2 percent went to public utilities, 21 percent to public sector, 16.7 percent to transport and communication, 13.8 percent to agriculture, 13 percent to industry and mining and 6.7 percent to financial services and other sectors. In total, SDR 3.1 billion went to project financing in IsDB least developed member countries, which amounts to 56.4 percent of total project finance (Islamic Development Bank, 1421H).

4. Asset Securitization:

Much of the efforts in Bahrain, Brunei, Indonesia, Malaysia, the United Arab Emirates, Egypt, Iran, and Sudan have been concluded with the successful issue of new and innovative Islamic financial instruments for financing both private and public sectors operations. More fruits are expected to come forth as those efforts continue. Simultaneously, efforts are intensifying to resolve some serious and possibly troublesome jurisprudential issues.

One of the examples of success has been in the area of identifying a collection of government-owned income-earning assets of high quality and issuing financial instruments backed by them. Such instruments are readily tradable in the market and can be used to carry out open market operations. Similar examples of leasing- and *Salam*- based instruments are found. Such instruments would reduce the government need for deficit finance and help in developing an Islamic financial market.

In addition, the Islamic development bank itself has developed the *Islamic Banks Portfolio* and the *Unit Investment Fund*. Both represent asset-backed securities held by Islamic financial institutions and backed by assets, which they manage. The IsDB has also established the *Infrastructure Fund* and the *Islamic Corporation for the Development of the Private Sector*, ICD. Both institutions are qualified to issue asset-backed securities to finance their operations.

5. Central Banking Operations:

Sudan has succeeded in developing fully-fledged central banking operations that are in line with Islamic principles to serve its banking system and to regain control of monetary and credit aggregates. Pakistan is evolving similar central banking operations that would suit transforming its banking and financial system to an Islamic system. Malaysia has developed its central banking operations to deal with a mixed system that combines both conventional and Islamic finance.

Such operations include designing regulatory and supervisory rules specially tailored for Islamic banking, centralized *Shari'ah committee* in the central bank to insure compliance, product quality as well as homogeneity of products. They also involve setting up rules for an inter-bank market that avoids the use of the rate of interest.

6. International Islamic Financial Market:

The Islamic Development Bank has joined efforts with some of its member countries as well as international financial institutions to provide the necessary infrastructure for establishing an International Islamic Financial Market (IIFM). Such efforts included the following:

- ♦ Establishing the *Islamic Financial Services Board* that would develop and assist in applying internationally recognized regulatory and supervisory standards for Islamic finance. The Board includes in its membership several monetary authorities in countries having Islamic banks and financial institutions in addition to the IMF and the Basle Committee for banking supervision. The Board will soon launch its operations from its headquarters in Malaysia.
- ♦ The IDB and some of its membership have launched the *Council of the International Islamic Financial Market* that would operate as a guiding authority in cooperation with concerned central banks to regulate and supervise Islamic financial activities. In particular, it would set up guidelines for the design and trading of Islamic financial instruments. It has recently been founded in Bahrain.
- ♦ The Bahrain Monetary Agency is currently working hard to establish the first *Liquidity Management Center*, which will provide the services to public and private institutions that wish to issue asset-backed securities. It is expected that the pioneering efforts in Bahrain would be followed by establishing similar liquidity management centers in other countries, eventually leading to the proliferation of Islamic financial instruments.

- ♦ The Islamic Development Bank has been working on establishing an *Islamic Rating Agency*, which is expected to come to life soon.

7. Accounting and Auditing Standards:

Through the efforts of the Islamic Development Bank and the active collaboration of many Islamic banks and monetary authorities, the *Accounting and Auditing Organization for Islamic financial Institutions* (AAOIFI) was established in Bahrain. It has issued a set of accounting standards, which have become quickly acceptable by many regulatory authorities. AAOIFI also prepared standards on Capital Adequacy, Governance and Shari'ah Standards, which are readily applicable to Islamic financial institutions.

IX. RELATIONS BETWEEN ISLAMIC AND CONVENTIONAL FINANCIAL INSTITUTIONS

The relationships between Islamic and conventional banking and financial institutions have proven fruitful in many aspects. The market mechanism has enabled both kinds of institutions to interact and develop working relationships and alliances.

A. LESSONS ISLAMIC AND CONVENTIONAL BANKS CAN LEARN FROM EACH OTHER.

Islamic financial institutions share with their conventional counterparts similar specializations and business interests. Differences that exist between their modes of operations afford them excellent opportunities to cooperate and collaborate. Areas like joint financing and financial market operations can be the stage of daily collaboration. As conventional financial institutions have been first in the field, they can be a valuable source for professional techniques and standards. In other words, Islamic financial institutions have a lot to learn from conventional financial institutions in this regard.

Islamic financial institutions, being aware of their innovative methods, have toiled to develop the new modes of finance. That included a lot of work to formulate new contractual arrangements on both their asset and liability sides. In addition, they have been able to acquire a niche that conventional financial institutions do not have. The latter can participate and make use of such new and innovative techniques that would help them better serve their customers.

As would be expected, Islamic financial institutions depend on their conventional counterparts in working with financial markets. They often collaborate to design new products, which they can jointly market and manage. This includes funds, securities, and the like.

Many of the funds created and marketed by Islamic financial institutions involve financial instruments traded in international financial centers as well as financial centers in emerging markets. Trading in those instruments would have to be done through conventional financial institutions, which are geographically proximate to those markets. The management of such funds may also require the assistance of financial services institutions, which are closely located and may even have trading privileges in those markets.

B. CAN CONVENTIONAL BANKS LEGITIMATELY OFFER ISLAMIC FACILITIES?

One of the ultimate indicators of the success of Islamic finance is that their modes of operations appear sufficiently attractive to conventional financial institutions so that they ultimately enter the market of Islamic finance as partners or even as competitors to Islamic financial institutions. This is an important area where collaboration can introduce a wider variety of financial products into the market. Competition would also improve efficiency and benefit both savers and investors.

Through cooperation with Islamic financial institutions, conventional institutions can ascertain the quality of their Islamic financial products. If they wish to compete, they must make sure that their products have the proper qualities that the market of Islamic finance requires. Otherwise, the market could end up being cluttered with products that meet little interest on the customers' side. In particular, compliance of Islamic rules of finance must not be compromised, if financial products are to be marketed as *Islamic*.

Given that conventional producers of Islamic financial services are strictly observing the quality requirements of such products, we can safely say that Islamic finance will increasingly gain universal acceptance. This will demonstrate that Islamic finance is not just for Muslims alone. It is rather for everybody.

X. EQUAL OPPORTUNITY FOR ISLAMIC FINANCE

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 favor 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 fulfillment 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* (Falk and Fischbacher 2000) in general and the *prisoner's dilemma* (Janssen 2000) 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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