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Islamic finance: aims, claims and the realities of the market place²³

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1. INTRODUCTION

Islamic finance has been developed as an alternative to and a radical departure from conventional finance, enabling its practitioners and customers to follow the commandments of God as revealed in the Sharia. We first present a concise overview of the aims and claims of Islamic finance. Next we review the strong and weak points of Islamic finance compared with conventional finance. We continue with the question whether Islamic finance fulfils its promise to provide a viable and credible Sharia-compliant alternative to conventional finance. Before giving a final verdict we discuss the tensions inherent to Islamic finance. All the time, it must be kept in mind that any assessment of Islamic finance can only be of a tentative character, as the Islamic finance industry is still relatively young and in a developmental stage.

2. AIMS AND CLAIMS

2.1 The Aims of Islamic Finance

Islamic Finance aims to follow the precepts of the Sharia. This includes a number of injunctions:

- (i) First and foremost the ban on *riba* must be observed. It is a moot point whether *riba* should be seen as identical with our present-day forms of interest (Visser 2009 p. 32), but most of the leading *fuqaha* or fiqh scholars (specialists in Islamic jurisprudence) are adamant it is.
- (ii) Then, *maysir* and *gharar* are prohibited. *Maysir* is speculation and *gharar* is risk or uncertainty, carrying the connotation of deception and illusion. The prohibition of *gharar* is at the heart of Islamic contract law. It implies that (a) both the subject and prices of the sale exist and parties are able to deliver, (b) the characteristics and the amounts of the countervalues are specified and (c) the quantity, quality and date of future delivery, if any, are defined.
- (iii) Muslims should steer clear of a number of products and services that are forbidden, *haram*, or declared forbidden. The list includes alcoholic drinks, pork-related products, adult

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entertainment and gambling. In general, the Islamic finance industry furthermore tends to follow Maulana Maududi (1903-1979), the father of the idea of an Islamic economy and of Islamic finance, and other strict conservatives, first of all the Wahabite sect, in rejecting music (Maududi 1999 p. 31, Slomp 2007 pp. 47-51). Weaponry is generally, though not universally, excluded as well.

An important corollary of the prohibition of *gharar* and *maysir* is that conventional insurance cannot be permitted. Under conventional insurance, an amount of money, the insurance premium, is paid but it is not known beforehand what will be received in return. Possibly nothing, possibly a large sum of money. Paying money in return for a reduction in risk or uncertainty is not deemed acceptable. Another corollary is that forward and future contracts are generally seen as incompatible with the Sharia.²⁴ One cannot sell what one does not yet possess, as future delivery would not be assured. An exception is made for agricultural products, and often the exception is generalised to include fungible manufactured goods.²⁵ But *bai'salam*, the shariah-compliant forward contract, differs from conventional forwards and futures in that, first, the full price of the product must be paid in advance (*bai'salam* means prepaid purchase) and, second, that at maturity the buyer must actually take delivery of the goods.

Apart from the stipulations on *gharar* and *maysir*, there are other peculiarities of Islamic contract law that must be taken account of. A particularly important one is that (iv) a contract should not cover more than one transaction. A sales transaction and a lease agreement, for instance, cannot be combined in one contract.

Finally, Muslim creditors are under an obligation to show leniency towards debtors who are unable to make repayments. Quran 2:280 says 'If the debtor is in a difficulty, grant him time till it is easy for him to repay; but if you waive the sum by way of charity it will be better for you, if you understand it' (Quran 2004).

²⁴ Forwards are contracts for future delivery concluded directly between buyer and seller, futures are standardized contracts for future delivery traded on an exchange.

²⁵ Goods with interchangeable individual units; buyers do not order a specific individual unit and it is immaterial to the buyer which one is delivered.

2.2 The Claims of Islamic Finance

Islamic finance claims to follow the precepts of the Sharia. These rule all aspects of a Muslim's life. Earning an income by one's own labour is excellent and private ownership is fine, but man should earn his income and manage his possessions as God's steward or vice-regent, *khalifah* (El-Ashker and Wilson 2006 pp. 38-9). Ownership is never absolute, there are no rights without obligations, in particular the obligation of social justice (Lewis 2011). Other people may not be exploited or cheated. It is deemed unfair if a lender receives a fixed return irrespective of the outcome of the borrower's business venture for instance. Interest payments dupe the poor and worsen income inequality. The lender should share in the risks of that business. Profit sharing and profit-and-loss sharing are thus the ideals of Islamic finance (both will be denoted by PLS below). It is claimed that following the Sharia in this respect brings many benefits. The ban on interest payments sees to it that there are few financial transactions independent of goods transactions, which helps to contain speculative activities. The global financial crisis is seen as the consequence of conventional finance not following the ethical principles of Islam (Leins 2010).

3. STRONG AND WEAK POINTS

3.1 Strong Points

Compared with conventional finance, Islamic finance has (potential) strong points and weak points. We start out with the potential strong points.

(i). *Lower danger of insolvency because of the absence of interest rate risk.* Under PLS, if strictly applied, fluctuations in a firm's income are passed on to financiers or creditors, including a bank's depositors, in the form of profit sharing. This should reduce the danger of insolvency. PLS financing, however, is generally only a minor part of an Islamic bank's asset portfolio (for reasons that will be made clear in the next section). Iqbal estimated that in the mid-1990s PLS financing made up no more than 15% of Islamic bank financing (Iqbal 1997 p. 40). Recent

figures suggest that things have not changed much in the meantime. At the end of 2009, the share of PLS financing in outstanding financing and advances of one of the leading Islamic banks, HSBC Amanah Malaysia Berhad, was no more than a paltry 1.4% (HSBC 2010). The corresponding, and perhaps more typical, figure for Albaraka Bank (Pakistan) was 16.4% at the end of 2011 (Albaraka 2012).²⁶

Moreover, banks do not always pass losses on to holders of PLS accounts. Quite often there is an implicit promise of some minimal return on deposits, or a de facto guarantee of nonnegative returns. The bank may in that case suffer losses after all and face the danger of insolvency. Indeed, there are indications that returns on PLS accounts in Islamic banks often follow interest rates on conventional bank deposits (Cevik and Charap 2011). This probably reflects the fear that customers might defect to conventional banks if returns are disappointing.

The upshot is that the practice of Islamic banking is far removed from the ideal of PLS on both the assets side and the liabilities side of the balance sheet, and thus from the claimed benefits of PLS.

(ii). *Protection against financial crises.* Even if PLS is not dominant in Islamic banking, it can be argued that the industry is less prone to the excesses that have led to the 2007-2008 financial crisis than the conventional banking sector. As credit transactions must be both interest-free and, in principle, be associated with goods transactions, Islamic banks are less free to engage in large-scale borrowing on money and capital markets than their conventional colleagues. Furthermore, they cannot freely invest in risky derivatives, in contrast to conventional financial institutions, because these generally are tainted with interest and in conflict with the other Islamic requirements for forward contracts.

Empirical research is scarce, but the available evidence suggests that Islamic banks do not differ substantially from conventional banks in their business model as measured by the share of fee-based to total income or share of non-deposits in total funding. Their capital-asset ratios,

²⁶ Unfortunately, it is not always possible to determine which percentage of financing is of the PLS mode, as banks do not always provide a relevant breakdown in their financial statements.

however, are higher, as are their liquidity ratios. This, argue Beck, Demirguc-Kunt and Merrouche (2010), explains their better performance during the crisis. High capital-asset ratios are helped by the obstacles to large-scale borrowing, especially short-term, facing Islamic banks and high liquidity ratios may result from the underdeveloped Islamic interbank money market, as the opportunities to invest liquid assets on an interest-free basis are restricted. A negative factor was relatively poor risk management. This may be due to the relatively small size of Islamic banks, but also to the underdeveloped Islamic financial markets. Furthermore, even if Islamic banks do not indulge in risky interest-related activities, they still are exposed to credit risk. Islamic financial institutions, and other Islamic investors for that matter, had their share of trouble following the collapse of real-estate prices in large parts of the globe, including the Middle East. Nevertheless, Islamic banks performed on average better than conventional banks in the wake of the crisis, but against that Beck, Demirguc-Kunt and Merrouche found that returns on shares of Islamic banks over longer periods were lower than those on conventional bank shares. A similar picture is painted by the literature on the yields on Islamic investment funds (Hakim and Rashidian 2004; Girard and Hassan 2006; Hoepner, Rammal and Razek 2009.

(iii). *Increase of participation in the official financial system.* There are many Muslims who could not bring themselves to enter a conventional bank's office and make use of the bank's services. If an Islamic bank sets up shop in their neighbourhood, the fact that it is Islamic might be just the incentive they need to enter the world of formal finance (Demir et al. 2004). In this way Islamic banks contribute to a higher degree of financial intermediation, which both economic theory and empirical research say generally fosters economic development (Ang 2008). Islamic investment funds may fulfil a similar role. These also offer an alternative for some non-Muslims seeking ethical investment opportunities, even though the wholesale rejection of the amusement industry, to name one characteristic, might strike some as overly strict.

3.2 Weak points

The basic idea underlying economics is that there is no such thing as a free lunch. This applies also to Islamic finance. What can be seen as its weak points?

(i). *A shift of risks from shareholders to depositors.* If PLS principles, strictly applied, reduce the danger of insolvency for banks, the flip side of the coin is that depositors run a higher risk. A strict application of PLS principles would shift the risk of losses from shareholders to depositors but depositors do not have the rights of shareholders. In particular, they are not in a position to replace managers. As returns to depositors in actual practice do not fluctuate in step with an Islamic bank's earnings, this objection to Islamic finance loses much of its force. Moreover, alternatives to deposits are becoming available. *Sukuk*, Islamic certificates, for instance, offer investors a return linked to LIBOR. Though *sukuk* are mainly aimed at institutional investors, the Securities Commission Malaysia is taking measures to make them more attractive to retail investors, first of all by facilitating the issuance of *sukuk* of a relatively low denomination.

(ii). *Higher transaction costs.* Islamic contract law stipulates that each transaction requires a separate contract, which makes for higher costs (El-Gamal 2006 pp. 1, 6, 12; van Duyn 2010). This is very clear if we look at the most widely used Islamic bank financing contract, the *murabaha* or mark-up sale. Under a *murabaha* sale a bank buys a good for his own account, but at the behest of a customer, and sells it to the customer with a mark-up, usually against deferred payment. The bank, or any other intermediary, is obliged to assume formal ownership for some period of time, however short, and carry the risk of loss or damage. This brings increased costs with it, on top of the added complications of having to deal with two separate contracts and possibly complications in the tax sphere or a negative attitude of supervisory authorities with regard to banks acting as traders.

Furthermore, the requirement that financial transactions are linked to goods transactions may result in circuitous ways to provide a loan. The *tawarruq* contract popular in de Gulf Cooperation Council (GCC) countries, for instance, involves the purchase of a good by a bank on behalf of its customer that may be paid in instalments, followed by a sale to a third party against immediate payment.²⁷

(iii). *Principal-agent problems.* Under PLS finance, Islamic banks are less well equipped than conventional banks to deal with principal-agent problems. Under PLS finance, there is a higher moral-hazard risk than under conventional interest-based finance. Moral hazard is the risk that

²⁷ The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).

debtors act in a way detrimental to the interests of the creditor. First, the financier and the firm seeking funding must agree on an accounting rule to determine profits if profits or profits and losses are to be shared. Second, the firm has an incentive to cook the books as it has an interest in showing low profits. Third, whereas under conventional loans the borrowing firm first must pay interest to the financier before anything is left for the owners (the entrepreneur or the shareholders), under PLS even a low return on invested funds leaves something for the firm's owners or managers and this may lead them to take it easy or spend more on such things as luxurious business trips or expensive office furnishings. PLS therefore requires close monitoring of the customer by the financier, which is costly. These are serious problems and consequently PLS finance takes only a small slice of the Islamic finance market. The principal-agent problems are therefore not so much solved as circumvented.

(iv). *Insurance*. Islamic financial products include insurance. Conventional insurance is not deemed acceptable, not only because it is closely connected with investment in interest-earning assets but also because conventional insurance involves *gharar* and *maysir*, as we have seen above. The Islamic solution, *takaful*, is in contrast claimed to be based on brotherhood. *Takaful* is a mutual fund where participants contribute to a kitty from which participants who meet with adversity receive a compensation. The kitty usually is managed by a commercial firm. Any profits may be distributed after the end of the book year, which may prevent the building up of reserves. In case of high claims during any book year this may leave claimants with less than full compensation of damages. If reserves are insufficient the managing firm may provide credit facilities, but policy holders or participants cannot take this for granted and may be in for unpleasant surprises.

(v). *Fewer opportunity for hedging risks*. A ban on forward contracts and other derivatives may reduce speculation and add to the stability of the financial system, but it also reduces the opportunities to hedge risks or optimize the risk–return profile of a wealth portfolio. With less scope for hedging, the supply of funds for high-risk, high-return projects may be affected, and with it possibly economic growth.

(vi). *Legal uncertainties*. Border-crossing Islamic finance deals are often governed by English law, but if the underlying assets are located in Middle Eastern countries, enforceability of the contracts may become a problem. This problem, however, is not peculiar to Islamic finance but inherent to any contract with these countries. With Islamic contracts may come another risk, so-called *sharia risk*. There are no uniform standards determining which financial instruments are sharia-compliant and which are not, though a couple of standard-setting bodies, first of all the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), with its seat in Bahrain, attempt to bring harmonization. The AAOIFI's standards, however, have not been universally adopted and are only mandatory in a few countries: Bahrain, Malaysia, UAE, Saudi Arabia, Lebanon, Syria, Sudan and Jordan. Parties to a contract that are unable or unwilling to fulfil their obligations may consequently see room to claim that the contract was void because it was not sharia-compliant after all. A couple of such cases have been brought before English courts (Moody's 2010). In retail banking or in general the usual bank – customer relationships, where standard contracts dominate, such problems are less likely to arise than in wholesale transactions.

4. DOES ISLAMIC FINANCE FULFIL ITS PROMISE?

Islamic finance aims to provide a sharia-compliant alternative to conventional finance that does not suffer from the defects of conventional finance. Does it succeed?

The ethics of Islamic finance mainly imply following the sharia-based bans enumerated in Section 2.1 above. The ideals of brotherhood touted by proponents of Islamic finance appear hard to put into practice; it occurs probably mainly in the form of *zakat* (Islamic charity) contributions and, on a small scale, *qard hasan* (beneficence) loans, loans against at most a very small administrative fee for the benefit of the less well-off. Qard hasan loans, however, play an insignificant role in the average Islamic bank's activities. Albaraka Bank (Pakistan), for instance, only has a very small amount of *qarz-e-hasna* loans, as they are called in Pakistan, on its balance sheet: 0.06% of total domestic advances. And these, moreover, are not for the benefit of the poor, the entry instead 'represents mark-up free financings to staff advanced under the Bank's human resource policies' (Albaraka 2012). In HSBC Amanah Malaysia's qard hasan loans are even

punier at 0.01% of the total (HSBC 2010). Furthermore, Islamic banks do not hesitate to finance huge building projects in Bahrain, Qatar and Dubai, where conditions for the workers are reported to be appalling (Leins 2010). More generally, Islamic financial institutions are not in the forefront of sustainability or corporate social responsibility movements. It is not impossible, however, that this may change some day. After all, the view that man is God's vice-regent is not different from the Christian notion of stewardship. Indeed, there are some initiatives in this direction, however tentative. The CFA Institute, an association of investment professionals that promotes high ethical standards, has a division 'Islamic Finance and Environmental, Social, and Governance (ESG) Investing', for instance (cfainstitute.com; Hayat 2010).

As for the leniency to be shown towards defaulting debtors, the risks, including moral-hazard risk, are plainly too high for financiers not to cover against. On the webpage describing its Islamic home purchase plans, Ahli United Bank in England displays a warning in capitals that 'YOUR HOME IS AT RISK IF YOU DO NOT KEEP UP MONTHLY PAYMENTS ON YOUR HOME PURCHASE PLAN' (http://www.iibu.com/buy_home/buyhome.aspx). That means that they will not hesitate to repossess a home in case of payment arrears. Islamic Relief, a major charity, requires borrowers in its microfinance projects to provide guarantors who will be held responsible for repayment if debtors default (Khan 2008 p. 46). These are not exceptions.

Even on some of the major claims of Islamic finance the record is mixed. Interest may be banned, but there is such a demand for income streams that do not fluctuate too much that products have been developed that come very close. One of the great success stories of Islamic finance is the development of the market for sukuk. These come in various guises; one popular form is the sale – lease-back construction. The financier sets up a separate entity, a Special Purpose Vehicle, which sells sukuk to investors. The proceeds are used to buy real estate from the borrower who then leases the same real estate back. The lease payments are funneled by the SPV to the investors. As the lease rate is usually fixed at LIBOR plus a margin, investors receive a steady income stream which is very much akin to interest, but formally interest (LIBOR) is only a benchmark. Furthermore, the link between financial transactions and goods transactions can be reduced to a mere formality. We have already mentioned *tawarruq*. This can be seen as a prevalence of form over substance. An even more glaring case is *bai inah*, or *bai-al-einah*,

repurchase by the seller. Under a bai inah contract the financier sells a good to the customer against deferred payment and buys it immediately back against constant payment. The customer need not even see the good in question. It is a circuitous way to obtain a money loan and the link with a goods transaction is no more than formal. Bai inah, though not admissible in the Middle East, is very popular in Malaysia; it made up 32% of HSBC Amanah Malaysia's outstanding financing and advances at the end of 2009 (HSBC 2010).

5. INTRINSIC TENSIONS

Islamic finance wrestles with tensions between on the one hand principles rooted in revelations received by the prophet Muhammad fourteen centuries ago and in *ahadith*, traditions, from the same period or soon after, and on the other hand the needs of present-day financial market participants. The principles are held immutable by the great majority of Muslims, first of all the Islamic reform movement of which the Islamic finance industry is an offshoot (Visser 2009 Chapter 1). The fuqaha (fiqh scholars) are fully aware of this tension. Sheikh Muhammad Taqi Usmani, a retired judge of the Federal Sharia Court of Pakistan and one of the most sought-after members of the sharia boards that have to determine whether the products developed by Islamic financial institutions pass muster, acknowledges, for instance, that murabaha is far removed from the ideal of PLS, but states that it should 'be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where mudarabah or musharakah [that is, PLS instruments] are not practicable' (Usmani n.d.). As chairman of the sharia board of the AAOIFI he has taken steps to reduce the similarity between sukuk and conventional bonds. In 2008 the AAOIFI sharia board advised sharia boards of financial institutions to make sure that ownership of underlying assets was transferred to sukuk investors and that it is not permissible for the investment manager (SPV) to undertake to repurchase these assets for their nominal value at the end of the maturity of the sukuk (AAOIFI 2008). Sukuk holders should be subject to some form of market risk and the principal should therefore not be guaranteed.

Despite the attempts to bring the practices of the Islamic finance industry more into line with Islamic principles as interpreted by the leading fiqh scholars, some prominent Muslim observers

are disappointed. Mahmoud A. El-Gamal, a prolific, and profound, writer on Islamic finance, for instance sees ‘an Islamic finance movement that is at best an economically inefficient replication of the conventional finance for which it purports to be a substitute’ (El-Gamal 2003, p. 17). In his eyes Islamic financial instruments are sharia-compliant in form but not in substance. Moreover, the Islamic norms observed by the Islamic finance industry are, according to him, those of a hopelessly outdated, medieval jurisprudence that also contributes to an unfortunate separatist Islamic identity that fans feelings of superiority (El-Gamal 2007). M. Umer Chapra, another leading writer on Islamic finance and associated with the Islamic Research and Training Institute of the Islamic Development Bank, is also disappointed in the disparity between the ideals of Islamic finance and everyday reality. He deplores, in particular, the minor role played by equity and PLS modes of finance (Chapra 2007, 2009). Similar concerns have been voiced by Mehmet Asutay, the director of the Durham Centre for Islamic Economics and Finance (IIBI Lectures 2012).

There is, thus, a tension which manifests itself in continuous attempts by Islamic financial institutions to develop new products, including various forms of derivatives, that meet the needs of customers and on the other hand attempts by sharia boards and standard-setting bodies to make the industry act in accordance with what they believe should be the norms for an Islamic society. It remains to be seen to what extent Islamic finance will be able to find ways to meet the needs of their customers without coming even more under the suspicion that they do not much more than mimic conventional finance in a complicated way.

6. A FINAL VERDICT

It should not be forgotten that Islamic finance was born from attempts to Islamize society. That means that a full-scale substitution of conventional finance by Islamic finance would cut off the main sources of external funding for a number of industries whose products most people, including many Muslims, would prefer not to do without. It would also hurt the rest of the economy, as the range of products offered by Islamic financial institutions is limited and costs tend to be higher. Opportunities to hedge risks, for instance, would be severely restricted.

The final verdict should be that Islamic finance is a useful addition to the range of financial products, catering for the needs of a specific market segment, but falls short of its own ideals and offers little that is attractive to non-Muslims. Some non-Muslims may feel attracted by the ethical principles underlying Islamic finance, in particular the ban on interest, but for others it offers not much more than an opportunity to diversify their portfolios or to profit occasionally from the availability of funds at attractive rates (in particular when oil prices are high and a large supply of funds from the Middle East is available). To end on a positive note, a flourishing Islamic finance sector may help to combat the interconnectedness between financial institutions and the uniformity of their business models that were, through the huge scale of the activities of these institutions on derivatives markets and their dependence on short-term borrowings, important factors in the 2007-2008 financial crisis (though the cooperative banking sector can, and to some extent does, have the same beneficial effect, as it is not subject to constant pressure from shareholders to maximize shareholder value in the short term and thus should be better able to follow prudent policies). In line with this, the conventional banking industry could have learnt from the Islamic financial sector that one should preferably be not too dependent on short-term borrowing. It chose instead to learn this lesson the hard way. Experience is the best teacher, but often also the most expensive one.

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This study considers how Islamic, Christian and other ethical investors can positively co-invest for a beneficial impact. It is produced within the framework of the OECD-MENA financial programme (Organisation of Economic Corporation Development- Middle East and North Africa).

Ethical Investment Study

Social Responsibility for the
Gulf Investment

Editors: Aryona Rexha & Sonul Badiani

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Supporting Arab Financial Markets

Objective

AFF provides a framework for strategic discussions on key issues facing the development of Arab financial markets. It does so by linking decision-makers and opinion-formers from the public and private sectors - both in the Arab world and their international counterparts.

Rationale

Arab economies are at cross-roads where vital decisions need to be taken on future directions. The challenges of economic diversification, job creation and globalisation will be met by countries in a variety of ways. AFF seeks to provide a clearing house of ideas and experience as part of this evolutionary process by bringing together leading groups and individuals involved with these challenges to exchange views, disseminate and initiate research papers and identify best practice.

Focus

The three main challenges addressed by the AFF are:

- Development of Arab capital markets
- Economic liberalisation
- Integration of Islamic finance

AFF achieves its objective by coordinating national and international conferences, commissioning and distributing discussion papers, regular briefings with financial commentators, government advisors and think tanks and through monthly newsletters via its website.

Structure

AFF is guided by a Governors' Board to determine its policies and future programme, where all corporate members are represented. Alderman Sir Gavyn Arthur, a Barrister of the Middle Temple and former Lord Mayor of the City of London, is Co-Chairman. An Advisory Board appointed by the Governors' Board reviews research papers and liaises with other groups active in the Focus areas (capital markets, liberalisation and Islamic finance). Sir Roger Tomkys KCMG DL, the former Chairman of the Arab British Chamber of Commerce is co-chairman together with HE Dr. Abdulla Bishara, vice-chairman of KIPCO and former Secretary General of the Gulf Cooperation Council.