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Islamic Economics and Financial Sector Reform

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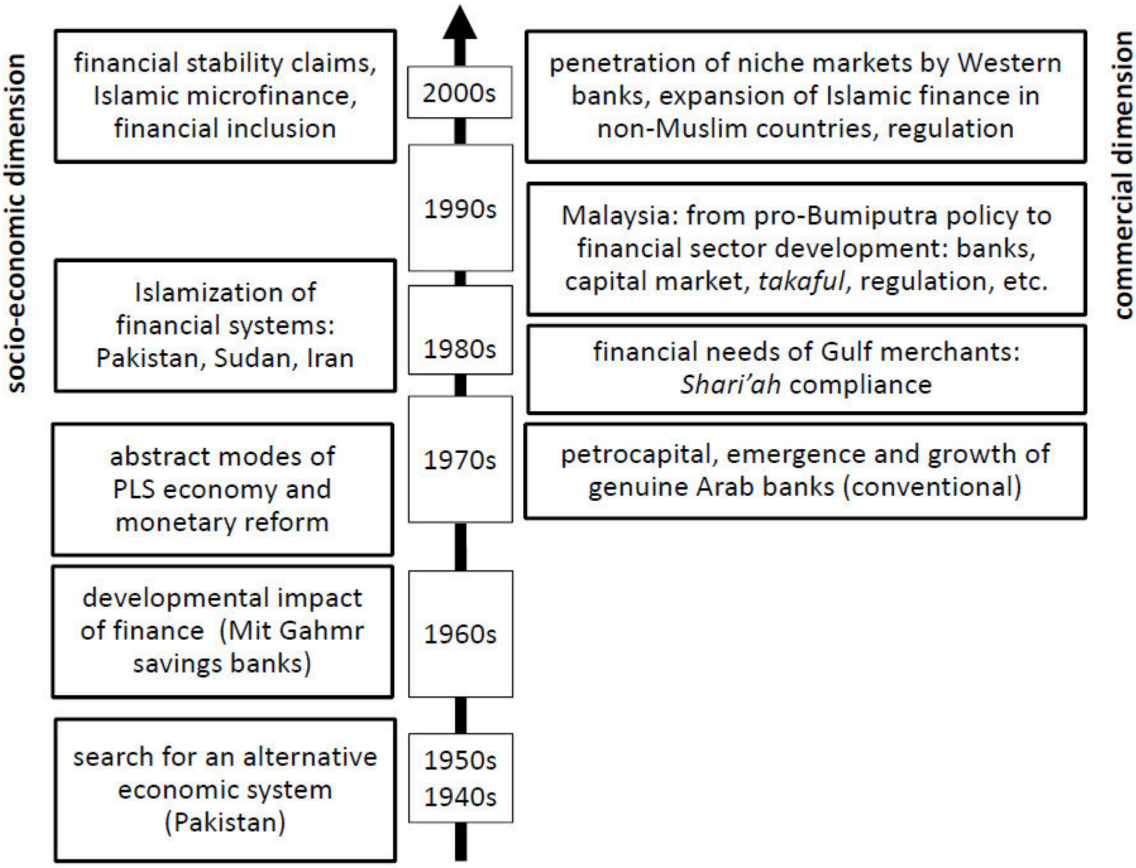
Concepts of a genuine Islamic economic system date back to the 1940s when the idea of a separate Muslim state on the territory of British India after the retreat of the colonial power took shape. The goal was to create a system fundamentally different from the then known economic systems, namely the British type of (colonial) capitalism and the Soviet time of (atheistic) communism. The system should be based on private property and entrepreneurship, but the financial sector should operate *riba*-free. The initial idea, the replacement of interest-based debt finance by partnership-based equity-like finance, was formalized and widely adopted by Islamic economists since the early 1970s. In particular, Muhammad Nejatullah Siddiqi's approach of profit and loss sharing (PLS) as the core principle for the operation of Islamic financial institutions became very popular. It was later called the "two-tier-*mudarabah*" model because PLS contracts were conceptually close to classical *mudarabah* partnerships, and they should be used for the relations of the Islamic financial institutions with the providers of funds ("savers") as well as with the users of funds ("entrepreneurs"). The literature usually called these PLS based financial institutions "Islamic banks". But in retrospect this was a "misnomer" with far-reaching implications.

The business model of a "typical" conventional bank was to collect deposits from the general public ("savers") and to extend loans to the entrepreneurs, to the government and to private consumers. It soon became apparent that PLS based Islamic banks would have serious problems to finance the government and consumers because neither governments (in their general budget) nor households generate a profit which could be shared with a PLS bank. This insight triggered a debate on public finance in Islam, while consumer finance continued to be neglected for quite a while (at least in the academic world).

Besides – and quite independent from – academic discussions – an increasing number of Islamic financial institutions were established as banks and named "banks" in the late 1970s and early 1980s (for example the Dubai Islamic Bank , the Faisal Islamic Bank of Egypt, the Bahrain Islamic Bank, the Islamic Bank of Jordan – a notable exception is the naming of Kuwait *Finance House*). These new institutions followed the banking approach and engaged Shari'ah scholars in order to ensure that their transactions and products did not violate fundamentals of Islamic law.

The banking approach meant that they collected funds from the general public at terms which were, in practice, in line with interest-bearing deposits of conventional banks, and they used these funds for modes of financing which were rarely, if ever, profit and loss sharing but debt creating, risk minimizing and with a predetermined (interest-like) return. Typical classical contracts were *murabahah, salam, istisna'* and *ijarah* which were "modernized" to meet the requirements of banks which are not trades but financial institutions. What came out of this modernization were Shari'ah compliant contracts where the financing component dominated and the traded commodities were secondary at best: for example, *murabahah* to the purchase order, commodity *murabahah* (or *tawarruq*), parallel *salam*, parallel *istisna'*, *ijarah thumma al bay'.*

Evolution of Islamic Economics and Finance



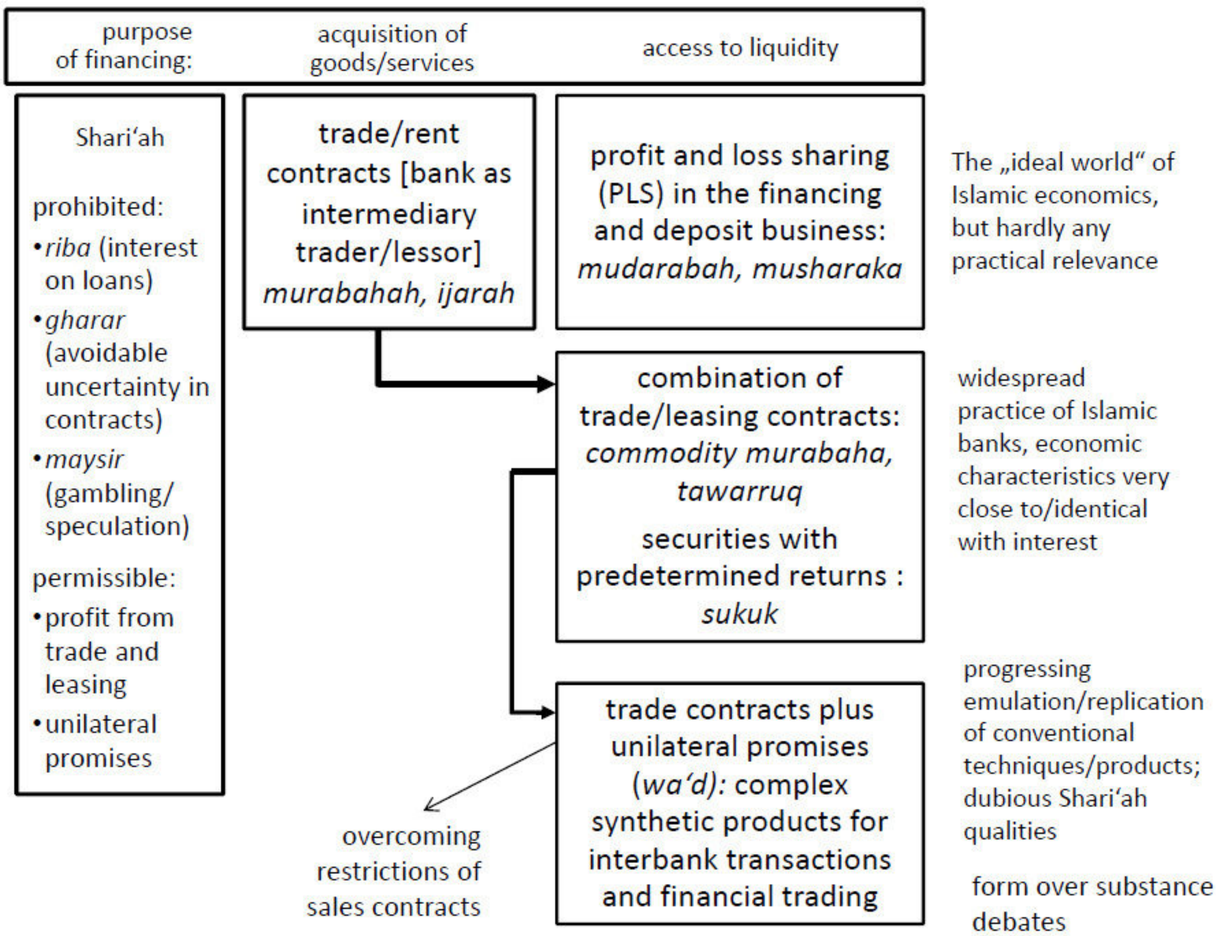
There were many good reasons why Islamic banks as banks shun away from participatory (PLS) modes of finance:

- from the lack of reliable accounting procedures of their customers
- over the threat of adverse selection in PLS offers to unknown customers
- to maturity mismatches between short-term funds and medium to long-term employments.

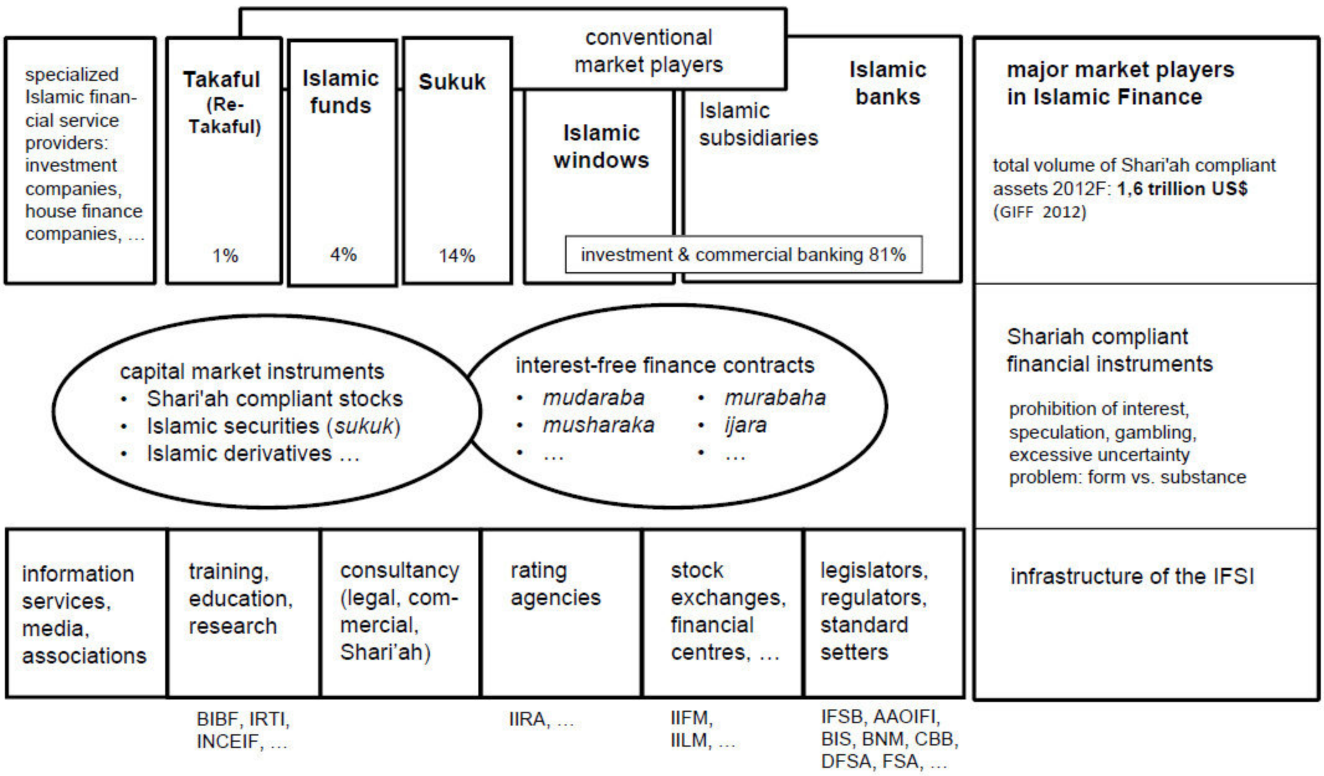
In addition, the "savers" (providers of funds) considered their PLS accounts as equivalents to conventional deposits and expected not only a factual (albeit not contractual) guarantee of their funds and a predetermined rate of return (close to the conventional rate of interest for savings and term deposits).

To cut a long story short: Islamic banks followed the banking approach and created a large variety of functional equivalents of conventional banking techniques and products, including all types of non-PLS debt-creating modes of financing (including modes to finance government deficits and private consumption). In addition, prominent Shari'ah scholars have certified the Shari'ah compliance of toolboxes that can be used to structure products for the leveraged (and speculative) trading of financial assets within the financial sector with no apparent or at best very weak links to the real economy. The (binding) unilateral promise (*wa'd*) has become a kind of "magic bullet" in Islamic financial engineering. The *wa'd* is not subject to the restrictions of exchange contracts and it facilitates the structuring of Shari'ah compliant replication not only of futures and options but also complex (synthetic) derivatives. This is not to say that the Islamic financial system has already become as detached from the real economy as large parts of the conventional banking system have been, but it could happen. The differences between Islamic banks and conventional banks are reduced mainly to the form and hardly to the substance of their activities. They provide financing to the same groups of customers and for the same kind of projects at roughly the same commercial terms.

Prohibition of *riba* and Financing Techniques



Structure of the Islamic Financial Services Industry



This is in a clear contrast to what the early (academic) proponents of Islamic *finance* – who unfortunately used the term Islamic *banking* – had in mind. From today's perspective, their models were much closer to financial intermediation through non-bank investment houses and risk-bearing capital market products (such as investment funds on the "deposit" side and securities on the financing side of the intermediation business) than to banks and risk-free deposits and loans.

There could have been an alternative model. Islamic economists had indicated a systemic alternative in the mid-1970s (i.e. when modern Islamic banking had just started). Unfortunately, these ideas were ignored by financial practitioners as well as the Shari'ah scholars who did not communicate much with Islamic economists (and still rarely do so). The lack of communications between economists and Islamic jurists may be due to the very different methodological approaches and subject areas of their disciplines – economics and jurisprudence – and to the fact that only a minority of approx. 20% of the leading Shari'ah scholars have passed through some formal education in economics or business administration.

It is timely to start (or re-start) a debate on a more fundamental financial system reform. In the aftermath of the global crisis, the interest in 'unorthodox' models of financial intermediation has grown in academia and media as well as in politics and the business community. The economic core of the early profit and loss sharing models of Islamic economics (financing only for the real economy and sharing risks between financiers and entrepreneurs) indicates the direction for a systemic reform of the Islamic finance industry: a shift from the banking model of financial intermediation to a more capital market and funds based model. The development of a viable alternative to the banking model would raise the bar for Shari'ah scholars to approve replicates of complex conventional instruments.

Suppose investment account holders of Islamic banks understand fully that they are no depositors but investors (at least as long as investment accounts are based on *mudarabah* contracts) and that the value of their funds is exposed to an investment risk.

- Once the "deposit illusion" is gone, investment account holders will become more risk sensitive and concerned about the use of their funds.
- For the modest returns they have received in the past (in line with interest paid for secure conventional deposits), they will hardly accept high risks. Leverage had boosted the returns for shareholders, but not for the investment account holders. This went widely unnoticed so far due to the deposit illusion of investment account holders and the opaqueness of Islamic banking.
- Most probably "enlightened" investment account holders will ask for the disclosure of the risk profile of their investments.
- An Islamic universal bank that commingles its own funds plus funds raised on the Islamic capital market plus investment account holders' funds in one large pool will have difficulties to provide the required information.

A more transparent system would be a system where investment banking and retail banking are separated as it was the case in the US until the end of the 1990s and as it was recommended recently in the final report of the High-level Expert Group on reforming the structure of the EU banking sector.

But one could go even further and envisage a system where the public does not place its savings in investment accounts of Islamic retail banks and leaves it to the discretion of the bank management where and with what risk/return profile this money is invested. An alternative would be a system where savers place their money in mutual funds with different and *ex ante* disclosed investment strategies and risk profiles. A large variety of investment funds with different profiles will emerge: from very secure investments in sovereign *sukuk* with relatively low returns over diversified portfolios of corporate and project financing and a mixture of debt and equity instruments to venture capital funds with high risks and chances for high returns.

- Instead of 'depositing' money with a bank, savers will purchase certificates of investment funds that could be traded on an exchange (provided some Shari'ah requirements are observed).
- The trading ensures the liquidity of the certificates, but it does not guarantee a nominal value (which depends on the performance of the underlying portfolio). However, Shari'ah compliant capital protection strategies could be designed for participants in medium to long-term investment schemes.
- In contrast to opaque Islamic banking practices, the saver should know in advance whether his money is invested in bubble prone markets, speculative commodity transactions, the short selling

of stocks, sovereign sukuk, manufacturing enterprises, etc., and he has knowingly accepted the associated risk.

For conventional finance the replacement of bank deposits by mutual funds may look utopian, but for Islamic finance such an approach would be more consistent with the concept of *mudarabah*-based savings and investments, and it would bring finance closer to the much cherished basic principles of Islamic finance in substance.

What is envisaged here is an Islamic version of a concept known as "narrow banking" (or "limited purpose banking") which is rather old but surfaced again in the aftermath of the global financial crises. For a short while, the concept even gained the attention of policy makers, but this is seemingly is over now.

Banks would be reduced to so-called "narrow banks" which accept and guarantee deposits only for transactional purposes and keep the funds received from the public in cash or highly liquid central bank papers (= 100% reserve). There is a long tradition of "100% money" reform proposals in conventional economics (starting with Irving Fisher in the 1930s), and Islamic economists had also taken up such ideas in the past – albeit primarily under the perspective of monetary policy and less as an model for a banking system reform.

To approach the ideal, a decomposition of Islamic banks should be considered: The transaction and the investment function should be separated and performed by different legal entities.

- Those Islamic financial institutions which accept demand deposits would be obliged to match their liquid liabilities with liquid risk-free assets – in the extreme with a 100 per cent cash reserve or Shari'ah compliant risk free liquidity papers issued by governments and central banks. Such Islamic banks would be barred from lending to enterprises or consumers, and would thus become narrow banks, earning income from fees and from the liquidity papers they hold. Capital requirements would be minimal, and because of matching maturities on the asset and liability side and the safety of the assets, liquidity and credit risks would be virtually non-existent.
- The financing of corporate clients and consumers would be undertaken by separate legal entities which are comparable to mutual funds. These "Islamic finance houses" could mobilise resources by selling standardised certificates based on *mudarabah* contracts (such as *mudarabah sukuk*). The finance houses and the subscribers would share profits, while losses had to be borne by the subscribers as the providers of capital.
- Subscribers of *mudarabah* certificates will understand that their money is not guaranteed, and that it is invested in projects or assets with risk/return characteristics which were explicitly explained to them as is done, for example, in the prospectus of a conventional mutual fund. It could be stipulated the any investment of funds in asset classes with higher risks than those explained in the prospectus would be considered a breach of the contract and implies - in case of losses - claims against the finance house.
- Finance houses could engage in any kind of financial activity and would offer the public broad or targeted investment packages with a wide variety of maturities as well as different asset baskets and risk profiles.
- As a result the financial markets would become more transparent by giving investors clear choices of different risk/return packages. Market discipline would become more effective, with investors being able or even forced to make informed choices.
- The actual market value of the assets would determine the price of the *mudarabah* certificates, which would be traded on the stock exchange – provided they are predominantly based on the ownership of real asset (including shares of Shari'ah compliant companies). If an active secondary market emerges, the certificates would be liquid, but not at a fixed face value.
- Islamic finance houses would also need to explain in much more detail the Shari'ah qualities of their products, and the subscribers would then be able to decide whether a particular product meets their own Shari'ah criteria or not. At present, *fatawa* on the Shari'ah compliance of financial instruments and products are usually very brief (if accessible at all), and the Shari'ah qualities of more complex banking products are hard to assess for customers (or agencies operating on behalf of the consumers).
- This new system would allow financial holding companies to be established, operating an Islamic narrow bank and one or several specialized finance houses under the same brand name. This would not be a problem so as long as the financial services of different types were housed in separate legal entities. Separate production and joint distribution of different financial products

would make it possible to restructure the activities of existing Islamic banks and maintain economies of scope.

One consequence of a restructuring of the Islamic finance industry along the lines of a narrow banking approach would be that Islamic narrow banks will lose the power to employ demand deposits in lending or trading activities. Since demand deposits do not receive direct financial benefits, all profits from their investment are presently acquired by the Islamic banks. This boosts the return on equity, especially if the volume of demand deposits is disproportionately large.

This would no longer be possible for a narrow bank, but the loss for shareholders could be much less than it seems at first sight: narrow banks need only minimal capital (to finance their own long-term assets), and regulatory capital requirements could be reduced drastically (even close to zero). It should be possible for narrow banks – Islamic or conventional – to earn a competitive return on the substantially reduced equity from a wide range of fee-based financial services.

Separating Islamic banks as narrow banks from non-bank Islamic finance houses will drastically reduce risk from maturity mismatches, credit defaults and insufficient backup capital. While the narrow banking proposals look like a revolution in conventional finance, they appear more as the next step of the evolution in Islamic finance – towards a financial system which is Shari'ah-compliant in form and substance.

A narrow banking approach would not only facilitate the observance of the prohibitions of *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling) as understood by Islamic jurists, but also the application of more general principles of Islamic economics as propagated by academicians, politicians, regulators and practitioners in writings, addresses and keynote speeches, namely

- finance in support of the real economy,
- transparency and fairness in business relations,
- risk sharing between fund owners and fund users.

Further, during the recent financial crisis it was claimed that the observance of Islamic principles would lead to a finance industry which is more resilient and stable than conventional finance. An Islamic banking system which increasingly replicates derivatives and structured products of a type which contributed to the recent global financial meltdown will hardly meet these claims.

Recommended Reading

Related to Narrow Banking:

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