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Islamic Banking and Finance: Philosophical Underpinnings

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Introduction

Islamic banking and finance can be described as a system through which finance is provided in the form of money in return for either equity or rights to share in future business profits, or in the form of goods and services delivered in return for a commitment to repay their value at a future date.

By now, a good deal of intellectual effort has been undertaken by a number of specialists in Islamic economics to explore different aspects of Islamic banking and finance. Even some conventional economists, intentionally or unintentionally, have dealt with the subjects, which may be considered closely akin to it. It is an undeniable fact that Islamic financial institutions have had only a marginal existence during the last 300 years. They did not get the same chance as western financial institutions to gradually evolve their institutional structure, tools and *modus operandi* to their full potential. Therefore, such evolutionary process of Islamic banking and finance must be done through serious intellectual work by economists rather than observing institutions at work. However, Islamic banking and finance has now been in the arena for more than a quarter of a century. It has taken a

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contemporary shape. Whether it has sufficiently approached the Islamic paradigm *par excellence* or not, is a different question.

The *philosophy of Islamic banking and finance* is a set of theories and ideas related to its understanding.[1] In this regard, we must first start with the rules of Islamic Sharīʿah from which the very idea of Islamic banking has been drawn. Second, monetary and macro theory is required to explain why Islam considers dealing through the rate of interest as totally unacceptable, and the economy-wide consequences of such practice. Third, banking theory itself would be necessary to figure out the behavior of Islamic banking and finance as well as to assess its comparative performance.

2. Sharīʿah

Islamic teachings in the fields of *muʿāmalāt*, or transactions, prohibit selling a certain quantity of any present goods or service for a different (presumably larger) quantity of the same good or/and service delivered in the future. This is understood to apply to money as well as to all other goods and services. As a result, any amount of present money cannot be exchanged for a larger amount of money in future. In addition, there are other rules of transactions that must be applied to insure fairness of dealing to both the contracting parties concerned. Mainly *al-ghabn*[2] and *al-gharar*[3] are strictly prohibited.

3. Monetary and Macro Theory

Until the middle of the twentieth century, most economists found no fault with the fact that the present banking and financial system is interest-based. In the mid sixties of the last century, some economists noticed that the current macroeconomic theory is devoid of any satisfactory and acceptable rationale for holding money. As a result of this realization, attempts were made to introduce money explicitly into theory, while building the micro foundations of macroeconomics. During such process, it was natural to look into the issue of optimal monetary policies. Only then, they stumbled on the Friedman's *monetary rule* that a zero nominal interest rate is a necessary and sufficient condition for optimal allocative efficiency.[4] In a fiat-money world, adding one marginal unit of real balances costs no real resources to the community. Imposing a positive price on the use of money would lead traders to economize on its use, by using real resources. 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. These results 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.

In a conventional market economy the rate of interest can be brought down to zero only through deflating the economy at a rate equal to the real rate of interest, which can be attained by steadily contracting the money supply at a rate equal to the representative household time preference.[5] Such policy rule clearly implies that central bankers should implement a long-run policy of deflation, something that they would never accept.[6]

With deflating the economy, some economists would worry about the existence of a liquidity trap when the rate of interest is zero.[7] Other economists advise to exercise deflationary policies only asymptotically in order to apply the Friedman's Rule.[8] Others point out that monetary authorities would have less leeway with adjusting the interest rate downwards in the face of recession[9] if the rate of interest is very low. Certainly, deflation has efficiency problems parallel to those of inflation, even at very low interest rates.[10] While many economists believe that problems involved with zero interest rates are all surmountable, monetary authorities are not yet impressed.[11]

The fact that Islamic banking and finance avoids the use of interest-based lending has significant implications to monetary policy. In managing the money supply, the monetary authority would monitor the real rate of growth and set the rate of monetary expansion to the level consistent with price stability and expected real growth. Some Islamic economists propose a 100 per cent required reserve ratio in order to give the authorities absolute control of the money supply and to appropriate all seigniorage resulting from monetary expansion to the government instead of banks' shareholders.[12] The fact that the economy is as close as possible to price stability implies that the rate of monetary growth is optimal, and there is no need to divert real resources to monetary use. Therefore, Pareto optimality is assured without problematic deflationary policies.

Meanwhile, people can use their cash balances to carry out spot purchases. Those with insufficient cash balances for their current purchases of assets and/or commodities can revert to finance. 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.

In case of profit sharing modes of Islamic finance, focus would be on the profitability and rate of return of the concerned investment. Financial resources would be directed to the most productive investments. This would increase the efficiency of the financing process and also reinforce efficiency in the real sectors. In credit-purchase and leasing modes of Islamic finance, money is not given outright, but rather commodities are given in return for debt obligations. Credit expansion in the face of increasing credit-purchase of assets and commodities would be tied directly to higher demand for assets and commodities, which would have a direct bearing on aggregate supply. Consequently, credit finance under Islamic finance would be less inflationary in comparison to conventional banking and finance.

3.1 Behaviour of Credit Markets

An important part of macro theory relates to the behaviour of credit markets. In conventional finance, present money is traded against future money either in integrated debt or in bond markets, where huge sums of debt are traded daily. Debt markets act as an easy conduit to move short-term funds at will from one country to another, more often than not, in reaction to factors that are only nebulously related to economic fundamentals. Such flows threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists have come to call "contagion."

In contrast, debt is created in Islamic finance through selling goods and services on credit, which by itself is 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 an equilibrium mark-up rate. Such credit markets would be fully segmented. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion would therefore be remote and there would be no pressing need to choke capital movements with restrictions.

Institutional participants in conventional credit markets carry out huge speculative transactions which most often turn out to a major source of instability. In contrast, Islamic banking and financial institutions are strictly prevented from carrying out such gambling activities. Thus, it seems reasonable to deduce that destabilizing speculative activity would significantly be curtailed in Islamic financial markets. Speculative activities related to interest rate expectations would become out of place. Change in spending would be reflected directly on change in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces.

3.2 Risk-sharing

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

Risk is known to be one of the most important ingredients of making investment. In Islamic finance, those who finance investment share a good part of the risk with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists and traded among them. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves shielded 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 will 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. The banks and financial institutions can also share the decision-making process as their representatives sit on the boards of directors of firms receiving funds.

It, therefore, may be noticed that risk as well as the responsibility for 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 involvement of a wider section of entrepreneur and investors in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the feeling of involvement. It adds to the stability of banks. Investment depositors share risk indirectly with firms, while relying on banks for monitoring. Having the proxy vote of depositors and other investors, Islamic banks, would be capable of influencing the corporate governance of firms in a way that reduces the risks of failure and promotes profits. In other words, the stability of the banking system will reinforce and be reinforced by the stability of the real sector. The main results of this would be a higher integrity of the whole economic system.[13]

3.3 Equity Considerations

An important aspect of macro theory is equity. Islamic financial system is basically viewed as 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 might contribute to the efforts taken by the whole society in that direction.

Zakāh proceeds are known 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 working and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor enough productive assets, to make them more productive, which in turn contributes to economic development.

Islamic banks can help by acting as custodians of and participants in the disbursement of the *zakāh* proceeds. Government and nongovernmental organizations (NGOs) collecting *zakāh* can deposit part of the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they may also add a proportion of *zakāh* due on their shareholders' equity[14]. They might even accept direct payments of *zakāh* and other donations on behalf of *zakāh* payer individuals and philanthropic institutions.

As to income maintenance, Islamic banks 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, 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 reducing poverty and increasing equity through proper use of *zakāh* proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collateral 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 with profitability and rate of return than with collateral and guarantees. In an Islamic financial system those who are not wealthy, but have worthy investment projects, may also have appropriate access to finance.

4. Banking Theory

Let us first look at the liabilities of Islamic banks of which only demand deposits, placed on the basis of profit and loss sharing, are guaranteed. When such banks face macroeconomic or bank-specific crises, investment depositors automatically share the risk. The bank is less likely to fall bankrupt as bank run is least probable. It can, therefore, be said that an Islamic banking system is relatively more stable than conventional banking.[15]

Banking theory studies finance as a process that runs among three parties: a *principal*, an *agent* and an *intermediary*, where both the principal and the agent jointly finance a project which is managed by the agent and partly financed by the principal.[16] The success of the project depends on the agent putting a minimum effort. Information asymmetry exists between the agent and the principal, and the latter cannot perfectly monitor the former. An intermediary performing monitoring on behalf of the principal would ameliorate the *principal-agent problem*.[17]

Islamic banking and finance relates to banking theory in two aspects. First, Islamic banks perform the function of intermediation between fund owners and firms. Banking theory can justify this role in fashion similar to the role of commercial banking, which intermediates between borrowers and lenders. As monitoring is costly, models containing a costly state-verification problem, CSV, conclude that an efficient solution to the monitoring problem can be obtained when an agent pools deposits to finance investment projects.[18] Second, Islamic banks are supposed to practice equity finance simultaneously with credit purchase and leasing finance. This implies that they are some kind of kin of universal rather than of commercial banks. Banking theory comes again to show that such a role brings extra advantages to Islamic banking.

Models that provide rationale for relationship banking postulate a positive relationship between the severity of asymmetric information between banks and fund users on the one hand and informational distance on the other. When conclusions of such models are applied to Islamic banks, if unencumbered with constricting regulations, they would tend to build relationships in their core markets. Such retrenchment permits them to fend off the competitive threat to their captive market. Outside their core segment, they offer credit-purchase and leasing finance, which bear some similarity to transactional loans. In equilibrium, both forms of relationship and transactional finance compete with each other but Islamic banks would be expected to specialize in a core market with relationship or universal banking.[19]

Islamic banks should, therefore, function as universal banks, which are "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."[20]

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 seekers. When a bank provides equity and debt finance simultaneously, it will have more access to information than in a situation when only debt finance is provided. It could, therefore, be concluded that screening would be more effective and adverse selection less probable with universal banking.

Reducing possibilities of moral hazard requires monitoring of the firm obtaining finance.[21] Equity finance provides the bank with access to information necessary to practice continuous monitoring. 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 Islamic banks should operate as universal banks, and when they do, they would be exposed to lower levels of moral hazard and adverse selection.

Universal banking has recently attracted much writings from both proponents and antagonists.[22] Meanwhile, the arguments levelled against it created much discussion in the beginning but proved unfounded at the end. It has been credited with encouraging industrialization in pre-war Belgium, Germany, Italy and Japan. This confirms Gerschenkron's and Schumpeter's opinions that such form of banking spurs economic growth and helps backward countries to catch up with the developed ones.[23] This has also been confirmed by careful review of historical experience.[24]

More recently, Da Rin and Hellmann (2001) have introduced financial intermediation into the *big push* model which has two Pareto-rankable equilibria. They showed that universal banks can induce an economy to move from low to high equilibrium if they are sufficiently large to invest in a critical

mass of firms. The costs of mobilizing the critical mass are reduced, if banks are allowed to own equity that allows them a share in the value they help create by mobilizing the critical mass. This means that universal banks will find it easier to promote investments in new industries. While providing a sophisticated analytical framework for the behaviour of universal banking, Da Rin and Hellmann's model is a good step towards building a macro theory of banking.

Universal banks have been accused of altering the corporate capital structure in favour of debt and against equity, inefficiently combining banking with trade, of concentration to a degree that produces anti-competitive behaviour (what came to be known as the organ bank hypothesis). They have also been accused of benefiting from the inside information about the firms they lend while exercising monopolistic power over access to external finance, leading to conflict of interest between banks and other shareholders, particularly those who have delegated their voting proxy rights. None of such accusations was found credible.[25]

5. Conclusion

In conclusion, it may be said that Islamic banking and finance as a discipline has evolved both theoretically and empirically. It has emerged as a lively, provocative and dynamic branch of economics.

It is not an overstatement to say that it may be interpreted as the dawn of the only alternative to the current orthodoxy in banking and finance.

Notes

[1] See the definition of philosophy in Cambridge International Dictionary.
[2] *Al-ghabn* in transactions implies deception and misrepresentation or cheating.
[3] *Al-gharar* in transactions implies uncertainty.
[4] Friedman (1969); Cole and Kocherlakota (1998); and Wilson (1979). This result is robust in a variety of models, see Correia and Teles, 1997.
[5] Friedman (1969), p. 34 quoted by Ireland (2000).
[6] Wolman (1997).
[7] Uhlig, Harald (2000).
[8] Cole and Kocherlakota (1998); and Ireland (2000).
[9] For alternative ways to overcome the zero-bound interest rate policy, see Goodfriend (2000).
[10] Lucas (1994). For an assessment of the welfare cost of implementing a zero rate of interest, see Wolman (1997).

[11] Economists also recommended the application of 100 per cent required reserve ratio. However, policymakers have not been impressed, despite the obvious benefits.
[12] Al-Jarhi (1983).
[13] An important area for further research is how to measure the return of overall risk-sharing in the economy. The approach of Lucas, 1987 and Auffret 2001 would be worthwhile in this regard.
[14] Understandably, there may be other expenditure items which would be financed from *zakāh* proceeds. That is why only a proportion of them would be handed to banks. Such proportion can be determined by society and could change from year to year.
[15] Khan (1986).
[16] Ennis (2000).
[17] Holstrom and Tirol (1997).
[18] Diamond (1984).
[19] Hauswald and Marquez (2000).
[20] Calomiris (2000).
[21] Aoki, Masahiko (1994).
[22] For a dialogue between proponents and antagonists, see Fohlin (1998) and Temin (1998).
[23] Al-Jarhi (2003).
[24] Da Rin, Marco and Thomas Hellmann (2001).
[25] Fohlin (2000); Barth, Caprio and Levine's (2000); and Gorton and Schmidt (1996).

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