Fondazione Eni Enrico Mattei

POLICY BRIEF

01.2010

Moral values and financial markets: Islamic finance against the financial crisis?

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ABSTRACT

Islamic finance is one of the fastest growing financial industries in the world, and its total assets are estimated to exceed $700 billion (Standard & Poor's 2009). The rise of Islamic finance comes along with opportunities and challenges. Muslim economists believe that the moral economy of Islam can contribute to strengthening the ethical foundations of capitalism against reckless behaviours, while adopting Islamic financial products, e.g. sukuk (Islamic bonds), is seen as a way for non-Muslim governments and institutions to attract foreign capital, much needed in times of liquidity crunch and economic slowdown. On the other hand, Islamic finance attracts suspicion for its alleged links with Islamist political movements and terrorist groups. Moreover, several Muslim economists wonder whether the Islamic financial industry is consistent with the moral teachings of Islam, and it is questionable whether the Islamic financial system has been more resilient to the economic crisis than the conventional one. Indeed, it could be that Islamic finance is affected by the very same flaws of conventional financing methods, such as speculative investment behaviour and accountability and transparency issues. This policy brief aims to provide policy makers and investors with the state-of-the-art of Islamic finance, pinpointing the main policy challenges.

Background

Islamic finance is based on shari'a (Islamic law). According to Islamic tenets, interest (riba) and contractual uncertainty (gharar) are forbidden. In an Islamic framework, financial transactions must be based on tangible assets. Moreover, investments in sectors considered haram (unlawful) by shari'a, such as pornography, gambling and pork-related commodities, are forbidden. On the whole, Islamic economics, which claims to be based on the Koran and Islamic tradition, affirms to support an economy founded on entrepreneurial risk, equity participation and profit-and-loss sharing principles.

Supporters of Islamic finance see it as a bridge between the global economic system and the Muslim world, maintaining that Islamic finance may help integrate Islamic countries in the globalised economy. Financial inclusion is also seen as an effective way of contributing to the integration of Muslim immigrants in the West.

In fact, the growth and expansion of the Islamic financial industry is part of the quest for identity and authenticity of contemporary Muslims. This process should also be viewed from the perspective of the struggle between different and contending definitions of Islam and modernity. It may be argued that the rise of Islamic economics and Islamic banks was born of the refusal of the concept of "modernisation of Islam" in favour of the idea of "Islamisation of modernity". Indeed, Islamist thinker Abul Ala Maududi (1903-1979) laid the basis of a movement of Islamic revivalism with broad political, social and economic implications, which ultimately led to the naissance of Islamic economics and finance.

Thus, the birth of Islamic banks is a thoroughly modern phenomenon, part of a broader process of "awakening of Islam" which intensified during the 1970s. The development of Islamic banks is closely linked to the cash flow of petrodollars made available to Gulf investors after the dramatic increase of oil prices which followed the 1973 oil embargo. Not surprisingly, the developments of Islamic finance always had a profound relationship with the energy commodities market.

Islamic banks developed in the twilight of Arab socialism, in a political and social milieu characterised by the emergence of a new entrepreneurial class which found a powerful source of inspiration in Islamic principles.

The rise of this social class, composed of Islamic entrepreneurs, businessmen, investors, academics and religious scholars (ulema), has been seen both as a cause and as a consequence of the development of Islamic finance. The emergence of this transnational Islamist wealthy class, and of the Islamic private sector that it controls, presents new policy challenges, which have already deeply affected Muslim societies and Muslim communities in the West. Indeed, this new Islamist class strives for an "Islamisation of modernity" with repercussions at political and economic level. This new Islamist middle class sees the consumption of Islamic products and the Islamisation of the public sphere as specific ways of articulating and expressing their identity.

Policy challenges

The foundations of Islamic finance

Early theorists of Islamic economics and finance aspired to promote a moral reform of the economic system. In particular, Islamic contracts such as mudaraba and musharaka, which are based on the concept of profit-and-loss sharing, were seen as the basis for economic reform. Islamic economics was deemed able to promote a new model of development coherent with Islam to sustain growth, social justice and social cohesion. Such an economic model was based on a concept of development aimed to consider both material and spiritual needs. Thus, Islamic economics aimed to substitute the classic concept of homo economicus, mainly driven by greed and self-interest, with the idea of homo islamicus, primarily led by altruistic concerns. According to Islamic economists, Islam can provide the foundations of a new economic system based on the maximisation of social well-being rather than on the maximisation of individual utility.

The contribution of the moral economy of Islam is seen by several Muslim economists as a decisive factor in giving stronger ethical foundations to capitalism. In particular, the critique of Islamic economics against reckless financing and banking methods may positively contribute to the architecture of a revitalised financial system. In this respect, Islamic economics can also benefit from the dialogue with the Christian and Judaic traditions. In particular, the social doctrine of the Catholic

Church (developed in over a century, from Pope Leo XIII's encyclical letter Rerum Novarum, 1891, to Pope Benedict XVI's Caritas in Veritate, 2009) already provides an organic moral framework for economic development, which shares interesting features with Islamic economics. However, leading Muslim economists have argued that the expansion of the Islamic financial industry has not been consistent with the aspiration of Islamic economics to give birth to an ethical financial system.

Indeed, the recent developments of Islamic finance have been accused of neglecting this spiritual and moral dimension. Financial engineering developed Islamic contracts formally respectful of the Islamic shari'a (especially for what concerns the avoidance of interest) but, according to several Muslim scholars, the Islamic contracts are not dissimilar from the conventional ones from a moral point of view. To put it differently, the debate among Islamic economists is shifting from the mere issue of shari'a-compliancy to the broad problem of consistency with the moral and social objectives of shari'a (maqasid al-shari'a). Indeed, Islamic finance has not actually promoted a fairer distribution of wealth and it has not alleviated poverty, as its early theorists hoped. On the contrary, in the Islamic world the gap between the rich and the poor is far greater than in the Western world. In other words, several Muslim scholars argue that Islamic economics and finance did not succeed in promoting the auspicated shift from homo economicus to homo islamicus. Such a phenomenon has been explicitly seen as the failure of Islamic economics.

However, this process coincided with a great expansion of Islamic finance and the multiplication of Islamic banks. The evolution of Islamic finance has greatly increased the application of shari'a scholarship to contemporary finance. In particular, attempts to introduce new equity-based financial products have been seen as remarkable innovations in the industry. However, these innovations pose new challenges in terms of sharia'a supervision. Moreover, several scholars argue that sharia'a compliance should fully take into account elements such as corporate governance, corporate social responsibility, labour practices and transparency, which have been until now largely neglected.

Also, conventional Western banks opened Islamic windows, identifying the growing potentiality of this market segment. Currently, finance compliant with shari'a (Islamic law) has its main centres in the Gulf Cooperation Council countries and in Malaysia, but it is rapidly expanding worldwide, including the Islamic communities in the West.

Islamic finance and the financial crisis

A crucial endeavour is to assess the resilience of Islamic finance to the international financial crisis initiated by the subprime mortgage crisis. Several Muslim economists have seen the global financial crisis as a vindication of their belief that the capitalist system is fundamentally flawed because of its reliance on interest (riba in the Kuran), on speculative and greedy behaviours, on unwarranted long-term credit expansion and on the lack of transparency and effective regulation. The financial crisis has also explicitly been seen as an opportunity for Islamic banking to seize a large market share, taking advantage of the alleged shortcomings of conventional finance.

The crisis has therefore been considered as a chance for Islamic economy to show its potential in reforming and revitalising global economy. Advocates of Islamic finance have argued that a new shari'a based financial architecture may provide valuable instruments to manage risk and prevent further crises of the system. Muslim economists identified in the culture of leverage of the conventional system the main roots of the financial turmoil: reckless investments are indeed seen by Islamic economics as a form of gambling. Muslim scholars maintain that an economic system based on Islamic principles will not be vulnerable to debt crises. Following this line of reasoning, several Muslim economists criticise counter-cyclical policies aimed at macro-stabilisation, encouraging instead a whole paradigm-shift aimed to eradicate the culture of interest and debt.

In this context, it has been claimed that Islamic finance has been more resilient because it has been less reliant on derivatives, the financial products considered to be one of the main causes of the crisis of the banking system because of their tendency to encourage speculative behaviours. Actually, financial derivatives are employed to trade risk, distributing it among different market actors with the aim of enhancing productivity. Since their original goal is to manage and reduce risk, several Islamic scholars consider them to be acceptable in an Islamic framework. Thus, Islamic finance has not been immune to the adverse consequences of hedging and speculation. At present, the Islamic financial industry is studying new methods of risk analysis and management, in order to create hedging instruments and securitisation tools which are at the same time sharia'a-compliant and effective.

The Islamic financial system seems to have suffered less than the conventional one, due to the fact that Islamic financial transactions are supposed to be tied on tangible assets. Thus, the avoidance of interest-based financial products by Islamic financial institutions is seen as the main explanation of their partial resilience to the credit crunch (Standard & Poor's 2009). However, the dependence of Islamic banks on the real estate market, especially in the Gulf Cooperation Countries (GCC), highlights the vulnerabilities of the Islamic financial sector.

For example, also the Indonesian experience shows no significant differences between the performances of the conventional system and the Islamic financial system. In particular, the profitability of Islamic rural banks in Indonesia exhibited a negative trend, raising new questions about the resilience and efficiency of Islamic banks as a whole. At present, Muslim economists are trying to assess the possible impact on Islamic banking of new monetary policies aimed to stabilise the global financial system. Furthermore, the performances of countries such as Pakistan, Iran and Sudan, which wholly "Islamised" their financial system decades ago through the ban of interest, have certainly never been encouraging. It is highly questionable that the Islamic risk management and the asset-based financial system that these countries claimed to have applied have been more efficient than the conventional ones.

On the whole, the main strength of the Islamic financial industry during the economic slowdown has been its aversion towards interest-based products. Its main weakness is represented by its investments in risky sectors, in the GCC area but also in Europe and in the United States. In particular, the credit management methods adopted by the Islamic financial industry have been seen as largely unsatisfactory. The financial crisis has therefore prompted a debate among Islamic economists and bankers in order to elaborate new financial tools able to guarantee better risk management procedures. Islamic finance has been claiming to be more efficient and more resilient to the financial crisis than the conventional one, but it seems to be affected by the same problems of conventional finance, in particular regarding investment behaviour and accountability and transparency issues.

Islam in the global economy

Advocates of Islamic finance have often asserted the compatibility between the Anglo-Saxon model of capitalism and Islamic finance. Indeed, Islamic economics supports private property and free trade, and it is generally adverse to economic dirigisme. In this respect, Islamic finance may play a role in integrating Islamic countries into the global economy, whilst respecting Islamic cultural and religious heritage. Indeed, the Islamic economic system may possibly encourage an economic development of Muslim countries which is coherent with their history and culture, like in the Malaysian case. Moreover, Islamic finance is seen as contributing to the financial inclusion of Muslims living in the West.

On the other hand, some critics of Islamic economics argue that Islamic finance, instead of furthering the integration of the Muslim countries, is actually promoting separation and segregation. In this respect, critics of Islamic finance also underline the links between some Islamic financial institutions and Islamist political movements animated by a radically anti-Western agenda. How can Islamic finance – they argue – play a role in the integration of Muslim countries in the global economy, when some Islamic banks have been linked with the Muslim Brotherhood, a political movement hostile to Western values and interests? It is important to stress that this position is shared also by secular Arab governments, suspicious of the ties between Islamic banks and Islamist movements.

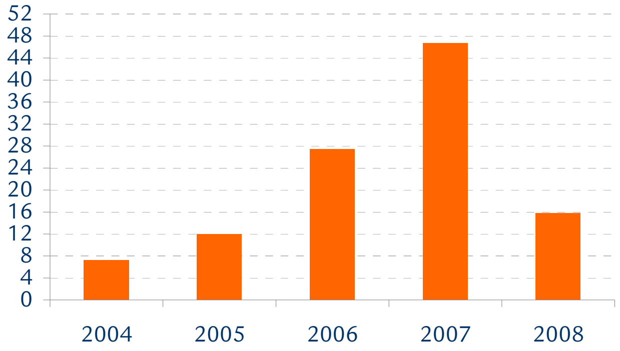
Further considerations

The weaknesses of the Islamic financial industry became particularly evident during the 2009 Dubai debt crisis. In the previous years, Dubai was developing into the global hub of Islamic finance. Dubai already hosted the world's oldest fully-fledged Islamic bank, the Dubai Islamic Bank, established in 1975. Moreover, Dubai was attempting to surpass Malaysia as the first global issuer of Islamic bonds (sukuk).[1]

[1] Sukuk are officially defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as the following: "Investment sukuk are certificates of equal value

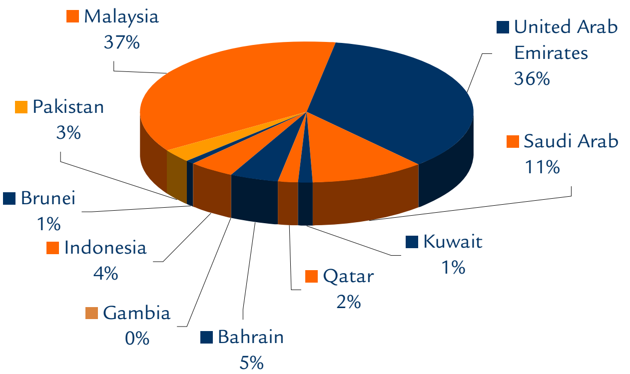
Indeed, a crucial market segment of the Islamic financial industry is constituted by Islamic bonds (sukuk), which have long been considered one of the most promising sectors of the Islamic financial industry. The sukuk issuance is now a remarkable macroeconomic feature especially in Malaysia, the United Arab Emirates and Saudi Arabia. The sukuk market has been deeply affected by the economic downturn, since the issuance of Islamic bonds in 2008 shrank to $14.9 billion, with a 56% decrease compared to 2007.

Figure 1: Global issuance of *sukuk* (Islamic bonds - billions of US dollars)



SOURCE:
Islamic Finance Information Service in Shayerah Ilyas, "Islamic Finance: Overview and Policy Concerns", CRS Report for Congress (2009)

Figure 2: Global *sukuk* issuance by country (2008)



SOURCE: Standard & Poor's (2009)

representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after the receipt of the value of the sukuk, the closing of the subscription and employment of funds received for the purpose for which the sukuk were issued."

In particular, Dubai World, the investment company that manages the portfolio of the Dubai government, was establishing itself as a leading global issuer of sukuk. Several other companies based in the Gulf were investing in the Islamic financial industry the petrodollars gained during the oil bonanza. The Dubai debt crisis may therefore have a negative impact not just on Dubai, but on the Islamic financial industry as a whole.

Moreover, Islamic finance suffers from lack of effective international regulation, which has been highlighted during the Dubai crisis. Each Islamic bank has a shari'a board, whose aim is to assess whether the bank transactions respect Islamic law. The problem is that these matters are highly open to interpretations and there are wide disagreements among Islamic scholars about the compatibility of several financial products with Islamic law. In order to address this issue, some institutions have been created, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board. However, it is not yet clear whether the establishment of those institutions has been effective in guaranteeing international consistency to the Islamic financial sector. Indeed, the lack of standardisation of Islamic financial products prevents the Islamic financial industry to fully develop towards its potential. Hence, a tighter regulatory structure and greater coordination are needed in order to increase the efficiency of the industry and enhance its credibility.

Last but not least, the alleged ties between some Islamic financial institutions and Islamic terrorist groups are one of the main reasons for the suspicion of the international community. Thus, regulative authorities have to carefully monitor the sector, in order to prevent money laundering and the funding of radical groups. Further research is needed in this area, due to the important consequences that these findings may have in terms of policy making. An answer to this question is imperative, since the debate has been, until now, strongly ideologically polarised between supporters and critics of Islamic finance. Since links between some Islamic financial institutions and political, and terrorist, movements have emerged in the past, security concerns are legitimate. Enhancing the transparency of the Islamic financial industry will also contribute to increasing its credibility. Moreover, links between Islamic financial institutions and Islamist movements should be put under careful scrutiny, in order to avoid foreign investors, whose agenda may be politically motivated, to control crucial sectors of Western economies.

Conclusions

Islamic finance has showed a partial resilience against the economic slowdown. Most likely, the development of the industry will continue in the foreseeable future. Hence, opening Western markets to Islamic finance presents evident opportunities, such as attracting capital in times of economic slowdown and strengthening economic relationships with several Muslim countries. However, the risks should not be underestimated.

Firstly, the shortcomings of conventional as well as Islamic finance demonstrate the need for strengthening regulation and transparency, as well as improving risk management practices at a global level. Indeed, the moral economy of Islam seems to have been unable to promote the development of institutions and practices which can actually contribute to strengthening the moral fabric of the economic system.

Secondly, Western governments and Western businesses with interests in Muslim countries should also consider the possible long-term policy implications of the expansion of Islamic finance. The impact of the growth of Islamic finance in secular Muslim countries, such as in the Maghreb, may present political challenges that should not be underestimated. The history of other Islamic countries offers interesting analogies. In Sudan, an alliance between the Muslim Brotherhood and an Islamic bank paved the way for the 1989 Islamist coup. In Egypt, the alleged links between some Islamic financial institutions and radical Islamists led, in the 1980s, to a crackdown of the government against them, as they were accused of subverting the state. To sum up, the development of Islamic finance may empower social strata (the new Islamic middle class) and political movements whose agenda does not necessarily coincide with the governments and the ruling elites, leading to possible destabilisation of those countries and subsequent risks for foreign investors.

Moreover, allowing Islamic financial institutions to invest in strategic Western economic sectors, such as defence, transports, telecommunications, would come along with new challenges in terms of security and sovereignty. Thus, an effective policy making action should address these concerns, relying on new research in this critical area.

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This Policy Brief draws on the results of the research project on the Islamic model of capitalism, carried out by FEEM as part of its research on the new models of capitalism. In particular, the brief summarises the main issues discussed at the international Conference on "Moral Values and Financial Markets: Islamic Finance against the Financial Crisis", held at FEEM in Milan on 18-19 November 2009 and jointly organised by FEEM and Durham University (UK).