CHAPTER 4

Islamic Banking and Finance: A Tool for Economic Development

Introduction

Islamic banking and finance (IBF) has emerged over the past couple of decades as a force to be reckoned with – an increasingly important element of the global financial system. Even if its share of overall global financial assets is still fairly modest, it has become a systematically significant component of the financial sectors of a growing number of countries. The most established Shari'a compliant financial markets today are the GCC countries and Malaysia but the sector is continuing to expand geographically and is experiencing rapid growth in a number of economies ranging from Turkey to North Africa and Indonesia. The potential for further growth is obvious. Muslims account for roughly a quarter of the world's population, although only slightly over a tenth of them worldwide use Islamic finance. However, there is also a far more broad-based– and growing – interest in Islamic financial products as an ethical, principles-based alternative or for diversification purposes. In a number of cases, the sale or issuance of Islamic financial products by non-Islamic entities and issuers has served as a way of attracting clients or capital from predominantly Muslim countries.

The geographic expansion of IBF has gone hand in hand with intensive development of the sector through the introduction of new products and practices. Perhaps the greatest success story of recent years has been the growing global footprint of the Islamic capital markets. In many cases, these products have gone through significant evolution that has involved both scholarly debates and a market-driven process of selection where some solutions have been found to be more resilient and have consequently gained popularity. The rise of capital markets has in turn facilitated the further growth and development of Islamic financial institutions which can now operate in accordance with the religious principles underpinning them. The availability of a growing range of quality Shari'a compliant assets has in turn enabled these entities to invest in the economic successes of some of the most dynamic emerging markets in the world. These developments have provided new important linkages for pooling capital and investing in productive purposes.

The rapid growth of IBF over the past two decades has clearly coincided with a great deal of economic development in the economies that remain the main hubs of Shari'a compliant finance in the world. What is less clear is the extent to which we can infer a causal connection between IBF and economic development, let along the direction of such causality. After all, the growth of IBF is likely to have been the result of the economic success and resilience of countries with large Muslim populations that have decided to permit or, in a number of instances, more or less actively encourage it. The period of the rapid rise of IBF has coincided with years of brisk economic growth in the Middle East and South East Asia. This rise was more or less contemporaneous with, and analogous to, the take-off of emerging markets globally, which of course had little to no link to Islamic finance. Having Islamic channels to facilitate and capitalize on this broader progress would have made Shari'a compliant products and institutions beneficiaries of the performance of key Muslim-dominated emerging markets, rather than the other way around. A cynic might even argue that the long-period of slow development in IBF also coincided with a much more challenging economic environment for the Middle East and other emerging markets at a time of low oil prices and before the real take-off of globalization.

While it is likely impossible to produce an unequivocal and widely accepted assessment of Shari'a compliant finance as a driver of the economic success of the countries pioneering it, there are a number of indicators to suggest that the contribution has nonetheless been significantly positive. Whether these achievements would have materialized in the absence of IBF is one of those what-ifs of counterfactual history that will forever defy a conclusive answer but the role of IBF in the virtuous cycle of development experienced by a growing number of countries bears careful consideration.

Inclusion

A priori, one of most compelling cases for IBF comes from its ability to cater to customers who do not accept conventional financial products. Providing them with the option of structures that are consistent with their beliefs and preferences is more likely to bring them within the realm of formal financial intermediation. This in turn will boost savings through official channels and provide more funds for investment, which is positive for economic development. In some instances, customers relying on conventional products are more likely to use financial services when Shari'a compliant products are available to them. A possible case in point is the development of the corporate fixed income markets in the GCC, and most notably in Saudi Arabia. Anecdotal evidence suggests that the lack of Islamic alternatives was one of the factors delaying corporate issuances in the region. It is unquestionably the case that the emergence of fairly standardized sukuk structures has helped fuel the corporate fixed income market in the region. The vast majority of corporate issuances, especially in Saudi Arabia, have been Shari'a compliant in recent years. Of course, the broader development of the economy and the growing sophistication of the financial sector is another explanatory factor.

Another area where the lack of Islamic alternatives seems to have historically deterred industry development was insurance. Insurance penetration levels in the GCC countries remain very low by international standards but the emergence of Shari'a compliant structures along with the establishment of a comprehensive regulatory framework for the sector has fueled rapid growth in recent years. For instance, the Cooperative Insurance Companies Control Law in Saudi Arabia in 2003 sought to provide a formal basis for the sustained development of the sector in a way that was consistent with the principles of the Shari'a. The Kingdom has since then seen brisk expansion of the sector and a total of 35 insurance companies were listed on Tadawul, the Saudi Stock Exchange, as of early January 2013, several of them takaful operators. The economic development contribution of such institutions, of course, is in little doubt as they help pool capital and manage risks.

In practice, of course, some of the growth of IBF has happened at the expense of conventional finance as many customers have preferred Shari'a compliant products, even if they do not object to conventional products either. For yet other customers, Islam is only one consideration among many in guiding their choices. This reality seems to account for the modest market share of IBF in countries such as Turkey which have overwhelming Muslim populations, but also fairly mature and competitive financial sectors where explicitly Islamic alternatives were authorized relatively recently. Ultimately, the ability of Islamic institutions and products to maximize their developmental impact will have to rely on factors other than Shari'a-compliance alone. Products will have to be reasonably priced, well structured, and transparent, among other things.

But even more generally, IBF is underpinned by an inherently inclusive philosophy and hence likely to produce development that is broad-based and sustainable. The Quranic concept of development explicitly recognizes inclusion through its three dimensions, which include individual self-development, the physical development of the earth, and the development of humanity as a collective whole. IBF is based on principles designed to foster economic and social development in parallel. It is characterized by a social ethos which views injustice perpetrated by a person against others as an injustice to the self. The ban on practices such as riba, gharar, and maisar is designed to limit practices where certain individuals can gain at the expense of others or harm others. At the same time, the practice of risk-sharing is inherently inclusive by placing all participants in a deal or a transaction in an analogous position.

Even beyond this, a true believer is expected to share their wealth with those less advantaged and hence the scarcity experienced by individuals is seen as a failure by individuals in a community to behave in a way that ensures this. A just society should not have extreme differences of wealth. In practice, of course, the social ethos of IBF is likely to be enhanced by the fact it is most established in developing countries with significant poor populations which have historically remained outside formal financial intermediation. This has encouraged initiatives such as community banking in ways that are not necessarily that different from non-Muslim societies.

A particular instance of the inclusive nature of IBF has been its involvement in driving social business. Microfinance is based on the idea of funding entrepreneurs who are too poor to qualify for conventional bank credit. No collateral is required for such loans. Microfinance is seen as a more effective way of helping people out of poverty than conventional charity. In many cases, it is provided to people previously outside the system of formal financial intermediation. These included groups such as women as well unemployed and illiterate people. The principle of solidarity lending is further used to foster shared responsibility.

The Islamic Development Bank operates a Microfinance Development Program in an effort to reduce poverty through access to microcredit. A number of Islamic countries have established microfinance institutions that replicate elements of the operating model of Grameen Bank, established by Muhammad Yunus in 1976. While Grameen itself is not strictly Shari'a compliant as it both charges and pays interest, its objective of helping the poor resonates with the Islamic approach to economic inclusion. A number of banks have since been created to provide microfinance on an explicitly Shari'a basis.

Real Assets

Shari'a compliant finance is effectively a form of principles-based, or moral, investment. It rests on values that are tried and tested for centuries. IBF does not recognize money as an asset in its own right, hence for instance the ban on riba. Money is viewed exclusively as an accounting unit whereas transactions have to be backed by real assets. Due to this philosophy, IBF inherently deals with real, concrete assets and encourages their mobilization for productive purposes. By contrast, the notion of using money – or purely financial constructs – to generate wealth is frowned upon. Hence, for instance, the development of Islamic derivatives has been fraught with controversy and technical challenges. A typical Islamic financial product, as a result, is 'plain vanilla' and scholarly developments in recent years have tended, if anything, to strengthen this link. A case in point is the debate on whether sukuk must be asset-based and to what extent their price can be allowed to vary.

The global financial crisis has clearly highlighted the risks inherent in a financial system where the links between the fundamentals and their financial expression become attenuated. The widespread use of complex financial products, elaborate derivatives, and speculative practices, along with inadequate supervision, have been widely recognized as being among the key contributing factors to the most devastating financial crisis in human history. The costs of these practices run into the trillions and amplified by economic and social disruptions. A financial system based on clear, simple principles, real assets, and an aversion to speculation is therefore ultimately good for development.

In fairness, it is of course important to recognize that another benefit of IBF in recent years has been its relative youth. The fact that many products are at the early stages of their development often means that markets tend to operate at the low end of the risk spectrum. For instance, issuers in Islamic capital markets have been large companies, often ones that are at least partially government-owned or backed. Corporate sukuk issuers have tended to be the bluest of the blue chips with long track records and developed governance mechanisms. Sovereign or quasi-sovereign issuance is another important category, but one of considerable importance in directly or indirectly driving economic development.

Islamic capital markets have not yet meaningfully trickled down to smaller companies with less favorable credit ratings. This is still partly the result of issuing Islamic securities that tend to be more costly than issuing conventional ones. The standardization of products and the growth of a ratings culture are likely to change this but the process will require many more years. Whether this will reduce the 'safety' of IBF remains to be seen but this is clearly one of the risks to guard against. On the other hand, the culture of risk-sharing should, in principle, provide precisely the right sort of protection as investors in riskier products will have an incentive to understand the risks they are entering into. This would have to be further encouraged by regulators, however, as many, especially less sophisticated, investors still tend to operate with a philosophy of seeking return, disregarding risk, and hoping for the best.

Another reason for the seemingly greater resilience of Islamic financial products in some cases comes from a demand-supply imbalance in what is still an evolving market. The amount of quality paper issued does not match the demand for it. Many quality sukuk issues, for instance, have been heavily oversubscribed and a number of Islamic investors are struggling to find sufficient quality assets to place their funds in. The increasing maturity of the market with a larger scale of issuance and more liquid secondary platforms may hence, with time, reduce the 'Shari'a-compliance premium.'

Sustainability

Sustainable development is better than growth involving a great deal of volatility. Not only do two years of 5% growth take an economy (slightly) further than one year of 10% expansion followed by another year of stagnation, but steady sustained growth is also less disruptive. Economic volatility in the form of sharp business cycles is characterized by excesses during boom years and sharp disruptions during the downturns. The economic and social costs of such disruptions can often be enduring in nature.

The fact that IBF is grounded in real assets and investment in productive ventures means that it is less likely to deliver volatility than a model that permits – or even encourages – speculation and leverage. Islamic investments are thus generally likely to benefit from a clear, strong link to economic fundamentals and genuine growth drivers, rather than temporary, speculative gains. The main limitation in this regard, based on the recent experience in the Gulf, has been the central role of real estate among the activities funded by Islamic institutions. While this is an important theme in view of the demographic and economic diversification trends observed in the region, the setbacks of recent years highlight the need for tighter regulation, a closer link to demand fundamentals (and lesser reliance on potentially speculative prestige projects), as well as a need to broaden the pool of Shari'a compliant assets and investment opportunities facing local institutions.

Overall, however, the principles-based nature of IBF does appear to account for at least some of its resilience during the global downturn. Moreover, the disruptions that were experienced by the sector, notably in the areas of real estate and certain types of sukuk, typically constituted important learning experiences that helped drive standardization and product development, as well as develop the human capital base for emerging sectors such as sukuk.

Knowledge

The development of IBF has contributed to an increase in economic and financial knowledge. The growth and expansion of Islamic financial institutions has engendered a rapidly growing demand for training institutions as well as research centers. Some of these, such as the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), along with a several others, operate with an international remit. The Islamic Development Bank set up its Islamic Training and Research Institute in 1981. Several institutions exist also at the national level, for instance the Waqf Fund of the Central Bank of Bahrain, which was set up in 2006 and organizes activities ranging from round table workshops to corporate governance and training.

The inclusive nature of IBF is likely to have been a positive force for broader financial literacy, although such an impact is impossible to meaningfully quantify. The fact that Shari'a compliant products have fostered financial sector development in a transformative way in a number of countries has brought many more people into the sphere of formal financial intermediation and created at least an opportunity to foster greater financial literacy and planning. Several market participants have directly driven the process by creating tailor-made long-term savings and investment schemes as well as promotional and informational literature to support them. Ultimately, success in this regard will be an important positive force for development. In many advanced economies, collective savings schemes represent a crucial element of the financial sector and have been instrumental in driving corporate governance in many of the companies they invest in.

Islamic Multilateral Institutions

Multilateral development banks have been a key instrument in fostering economic development globally since World War II. The establishment of the Islamic Development Bank (IDB) marked an opportunity to pursue these objectives in line with Shari'a principles. The bank was set up in Jeddah in 1975 (formally founded in 1973) with the backing of 23 member states of the Organization of the Islamic Conference (OIC). The stated purpose of the bank is to foster economic development and social progress of member countries and Muslim communities individually as well jointly in accordance with the principles of Shari'a. The bank currently has 56 members and an authorized capital of US$150 billion.

The explicit objective of the IDB is to "foster economic development and social progress of member countries and Muslim communities in non-member countries in accordance with the principles of the Shari'a." Many of the projects undertaken by the bank have been in developing infrastructure, especially in its poorer member states. The bank has supported them through equity investments and loans for productive projects and companies. Among its other activities, the IDB seeks to foster foreign trade and it has been instrumental in stimulating the growth of south-south trade. By mid-2012 total financing approved by the IDB Group amounted to US$87.3 billion with average annual net growth of 12.1%.

The IDB has, since its inception, actively supported the development of Islamic financial institutions and financing channels in its member states as well as the standardization of IBF through some of the international advisory organizations it has helped establish. It has thus indirectly stimulated the expansion of Shari'a compliant finance and financial inclusion in a number of economies.

A key objective of the IDB-sponsored multilateral institutions operating in the area of IBF has been to foster regulatory standardization and harmonization. This has helped reduce market fragmentation and costs, thereby improving access to financial products and stimulating development.

Conclusion

Islamic finance, in spite of its rapid growth in recent years, remains an industry in a fairly early stage of its development. This reality doubtless constitutes one of the explanations for its impressive success in recent years. Given the limited levels of market saturation in many areas and the considerable pent-up demand for Shari'a compliant products, Islamic investors and institutions have been able to grow and reap profits without necessarily having to resort to a great deal of product development. While this has typically meant a relatively limited product range as compared to conventional products, it has also entailed a relative simplicity and transparency of the product structures. Clearly, one of the vulnerabilities of conventional finance – as well as some of the more creative, supposedly Islamic products – in the pre-crisis days was its complexity, often to a point where neither financial engineers nor regulators fully understood the risks inherent in them. The consequences of this culture during the financial crisis speak their own very clear language about the dangers of a lack of transparency.

The commitment to clear ethical principles and real assets has allowed IBF to deliver sustained and inclusive development in a number of countries. Its ability to do so has grown dramatically in recent years as the industry matures and grows in sophistication. Even allowing for the aforementioned limitations, it now offers a significantly broader range of products than was the case just 10 years ago and these offerings have been tried and tested by client preferences and the vagaries of the global economy, which in many cases has further increased their robustness.

The fact that IBF operated on a sound footing is also reflected in the fact that recent regulatory developments have brought a growing degree of de facto convergence between Islamic and conventional finance. Recent years have seen a greater clamoring for principles-based finance and regulation and a growing aversion to speculation, leverage, and complexity. Ultimately, most of the risk factors that brought the global financial system to the edge of the abyss during the recent crisis are explicitly condemned by Islamic banking and finance.