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IBA CEIF
Centre for Excellence in Islamic Finance
Institute of Business Administration

FINANCIAL STABILITY AND ISLAMIC FINANCE

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Abstract

Post global financial crisis, the nature and attributes of Islamic finance have emerged as an alternative mechanism which provide solid pillars for nurturing and maintaining financial stability. This working paper presents the evidence on viability of Islamic finance and questions its relatively weak adoption even in high growth countries, despite acceptance and penetration of Impact Financing globally. The paper evaluates the missing links and gives recommendations for making Islamic finance socially purposeful, economically impactful and environmentally sustainable.

Ishrat Husain

After a decade since the global financial crisis of 2008, we have today much better knowledge about the main factors that precipitated the crisis. We know that financial engineering in which instruments such as complex derivatives, Collateralized Debt Obligations raised to square or cube, Credit Default Swaps, slice and dice securitized portfolio backed only by a trail of papers without any backing of real assets, and individual tranches rated by credit rating agencies led to excessive risk taking by the banking industry. We also know that the theory of decoupling was proved wrong, the contagion effect remained quite strong, widespread and spread instantaneously in both developed and developing countries. This interconnectedness was limited not only to the regulated financial institutions across borders, but also between the regulated and shadow banking systems. The regulations and banking supervisions were not able to keep pace with either the rapidity or complexity of financial engineering perpetuated by the industry. Therefore, the capacity to appraise risk properly fell short. Risk mitigation strategies were ineffective as the source from which risk was emanating could not be properly identified. These shortcomings and weaknesses of the conventional banking system, and the huge damage it caused to the global economy and international financial stability, should have naturally paved way for broader acceptance and spread of an alternative Islamic banking system – a system under which financial stability is in-built offered an ideal choice in this respect.

After all, the main attributes of the Islamic banking system i.e. principle of equity – protecting the weaker contracting party in a financial transaction, principle of participation, i.e. risk sharing in economic transactions – the reward (profit) comes with risk taking and not simply with the passage of time, and the principle of ownership, i.e. asset based financing linking finance with the real economy, provide solid pillars for nurturing and maintaining financial stability. (IMF, 2018)

Under Islamic banking, there is no fixed, predetermined rate of return, i.e. the investors' return is based on the performance of the underlying asset. Exotic artificially contrived instruments do not find any place in the domain of Islamic finance (IF) and therefore the recurrence of the episodes such as that happened in 2008 by and large becomes a remote possibility.

Risk sharing rather than risk transfer, asset based lending rather than paper based engineering and prohibition of investment in non-social activities and gharar, i.e. uncertainty and speculation provide an ideal answer to the problems that we faced in the developments that led to the global financial crisis. By its inherent nature, the incidence of risk is reduced and its amplification and magnification subdued. The transactions are circumscribed and bounded by the limit of the underlying real assets.

An individual, an enterprise, or a group, when it borrows from the conventional banks is obliged to repay a fixed amount as interest at a certain given interval of time, whether the borrower's underlying business is making profit or loss. The risk is concentrated solely on the borrower and any exogenous shocks or endogenous deviations from the original goals of borrowing do not matter. The origin of sub-prime mortgage loans in the U.S. can be traced to this particular characteristic of conventional banking. The banks had enormous liquidity which they wanted to deploy for earning profits. In a booming economy, the prices of houses were on an upward incline. Therefore, on the basis of expected rise in the value of the houses, the banks attracted these borrowers who were not considered credit worthy at that point of time, but would become credit worthy as the house prices kept rising and consequently loan to value ratio kept declining. The banking industry created many instruments for this purpose. When the housing prices started to fall, the borrowers were not in a position to pay the

installments due on time, and they had to lose their property through foreclosures. This was totally inequitable and one-sided transaction, where the banks in their irrational exuberance indulged in excesses, but the borrowers had to pay for these excesses, as the risk was concentrated. The financial system was thus completely destabilized. Under an Islamic financial system, there is in-built risk sharing and both parties suffer equally.

At the same time, the infrastructure for the Islamic financial services industry (IFSI) has been created. Standard Setting, guideline and development, regulatory institutions to guide the Islamic Finance Service Industry (IFSI) such as Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) and Islamic Financial Services Board (IFSB) have been established. The International Islamic Financial Market (IIFM) in Bahrain is mandated to issue of Islamic financial instruments and to encourage active secondary market trading. International Islamic Liquidity Management Corporation (IILM) has filled in a major gap by issuing short-term Shariah compliant financial instruments to facilitate cross-border liquidity management. Islamic Research and Training Institute (IRTI) – a part of the Islamic Development Bank Group has been engaged in research and training of those engaged in the industry.

Malaysia has recognized the need for human resource development required by the industry and is very successfully operating the International Centre for Education in Islamic Finance (INCEIF). Similarly, International Shariah Research Academy (ISRA) is conducting research in Shariah issues. An Islamic Credit Rating agency has developed the criteria for evaluating credit worthiness of the entities offering Shariah compliant products. Islamic indices have emerged that now serve as more appropriate benchmarks for examining the performance of Islamic funds. Key index providers who offer Islamic indices include Dow Jones, S&P, FTSE and MSCI.

These attributes of Islamic finance and the institutional infrastructure should have led the international financial community to derive the conclusion that IF provides a credible alternative to the current global financial system for financial stability. Therefore, from a theoretical point of view, there is substantive justification for the widespread adoption of Islamic finance not only in Muslim countries, but also in the non-Muslim countries.

The impressive growth of Impact Financing, particularly Environmental, Social and Growth (ESG) funds shows that there is huge demand for ethical and sustainable development financing. These funds tend to outperform those that do not follow ESG standards. 417 companies that score highly on ESG have been outstripping the MSCI EM Index benchmark since 2008-09. These funds reached $10.4 trillion in 2006 and a broader set of funds compiled by the Global Sustainable Investment Alliance (GSIA) shows that $23 trillion were in socially responsible investments that take into account ESG issues. (Global Sustainable Investment Review, 2016). The whole Islamic finance industry is still stuck around $2 trillion out of the global financial assets worth of $250 trillion – less than 1% – when it can be rightfully claimed that ESG is a subset of Islamic finance. We have, therefore, to seriously ponder as to why the Islamic financial services industry has not been preferred and is not being considered an alternative in relation to the current financial system. Not only that, it also lags behind volumes of Impact Investment Funding too.

Some questions are, therefore, raised for the consideration of the regulators, authorities, lawyers, investors, Islamic finance industry professionals and supporting institutions. Why has the industry not been able to reach its potential and expectations? What are the impediments and constraints that have not allowed much progress? Even in pioneering countries such as Malaysia, Bahrain, Saudi Arabia, UAE, Pakistan which have been at the forefront of promoting Islamic finance have not made much headway. The share of Islamic banks in countries having parallel banking regimes has not reached even 50%. In Malaysia, for example it is still in early 20s. In Pakistan, it is 14%. (SBP, 2017)

There is ample evidence that Islamic finance can cater to the huge investment needs of the underserved sectors such as micro, small and medium enterprises, small holder agriculture, low cost housing and infrastructure. This would help in promoting financial inclusion as well as reducing income inequality by creating assets for the not too well endowed segments of the population.

One of these financing modes which can exert a stabilizing influence on the financial system, contribute towards Sustainable Development Goals and also meet the urgent needs of the developing Countries is Infrastructure Financing. The latest Global Report on Islamic Finance of 2018 (IDB; World Bank, 2018) jointly produced by the Islamic Development Bank and the World Bank, highlights the issue and makes recommendations for IFSI to play a proactive role in the financing of Infrastructure Projects.

The United Nations estimates a gap of $2.5 trillion between the annual investment needs of the Sustainable Development Goals (SDGs) of $3.9 trillion and current annual investments of $1.4 trillion (UNCTAD, 2014). The challenge posed by the scale of funding requirements is further aggravated by the need to commit funds for long-term horizons. Moreover, there is broad consensus that to deal with the complex challenges of climate change, growing urbanization, and social imbalances, the world needs to invest more in long-term sustainable projects.

Long-term finance plays a major role in sustainable economic development because it helps advance structural transformation of economies, stimulates development of infrastructure, and provides funds for fixed investments to enhance production capacity. The need for funding long-term investments is so huge that resources by governments, multilateral development banks, and other traditional development partners remain insufficient. The role of the private sector is critical in meeting the challenges of long-term financing needs. However, the existing financing patterns clearly indicate the preference of investors for assets with short-term maturity despite their meagre returns. Thus, extending the maturity structure of finance is a key policy challenge for the development community. Market factors under existing conditions, together with systemic biases toward short-term debt and risk transfer mechanisms, substantially reduce the availability of funding for long-term financing. In turn, this creates deficiencies in resource allocation and a gap in long-term funding, despite the ample supply of global savings. While the gap exists globally, it is particularly critical in developing economies because it hampers the implementation of much-needed investment projects to enhance welfare. To deal with the ongoing underfunding problem in long-term investments, the report proposes the use of Islamic finance, which is based on risk sharing rather than risk transfer, and thus offers many advantages.

The main policy recommendations of the report can be summarized as follows:

1. Strengthen the financial system by developing a supportive legal, administrative and regulatory environment that establishes and protects investors' rights, provides effective mechanism for dispute resolution, institutes a sound insolvency framework and strengthens financial supervision for the efficient mobilization of resources on the basis of risk sharing.

2. Enhance the institutional framework and diversity of instruments for long term financing by promoting the development of capital markets for Shariah compliant instruments. The resources

thus mobilized by engaging pension funds, sovereign wealth funds, asset management firms, venture capitalists and private equity funds can be invested in long term projects.

3. Provide incentives for Islamic financial innovation based on Fintech solutions, especially for mobilizing the dormant Islamic social sector to support investments with environment and social as well as economic impacts. Crowd-funding, for example, can pool resources (Zakat, Sadaqat, Waqf) from small surplus units and channel them towards investment in large scale projects.

4. Capitalize on blended finance and public-private partnerships (PPPs) by developing new products and expanding existing ones to increase the use of Islamic finance for projects of mutual benefit to the public and private sectors.

Challenges for Islamic Finance:

Islamic finance industry has done remarkably well in the last decade, although from a low base and still constitutes a small fraction of global finance. The risk-sharing nature of Islamic finance has attracted attention in all financial sectors, including banking, capital markets, and insurance. Despite the huge potential, Islamic financial sector is a small player in the global financial markets and requires a concerted push for the regulatory and legal changes to take root.

To reduce uncertainty and provide protection of property and investors rights, macroeconomic and political stability, institutional development, and an enabling legal and regulatory regime are necessary. At the micro level, the organizational framework of financial institutions and the diversity of financial instruments offered determine the extent to which financing needs are met. Currently, Islamic financial institutions are subject to the similar regulatory regime as conventional institutions, thus forcing them to develop financial instruments similar to conventional instruments, even if those instruments are Shariah-compliant. However, this structure limits the full benefits that could be obtained through the risk-sharing feature of Islamic finance.

Countries are at different levels of development with respect to the key recommendations related to the developments in national plans and strategies, the legal and regulatory frameworks, the Shariah governance regime, liquidity infrastructure, and deposit insurance schemes. Some countries, such as Indonesia, Malaysia, Oman, and Pakistan, have adopted national action plans for the development of the Islamic financial sector, including separate Islamic financial laws. In other member countries, adoption is still at very early stages.

This multi-track path would continue to be followed but the key players engaged in Islamic finance must consider and examine these recommendations on long term infrastructure financing, and if found appropriate and workable, embark on an action plan to implement them. This may provide opening to the IFSI to demonstrate that it can be socially purposeful, economically impactful and environmentally sustainable.

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