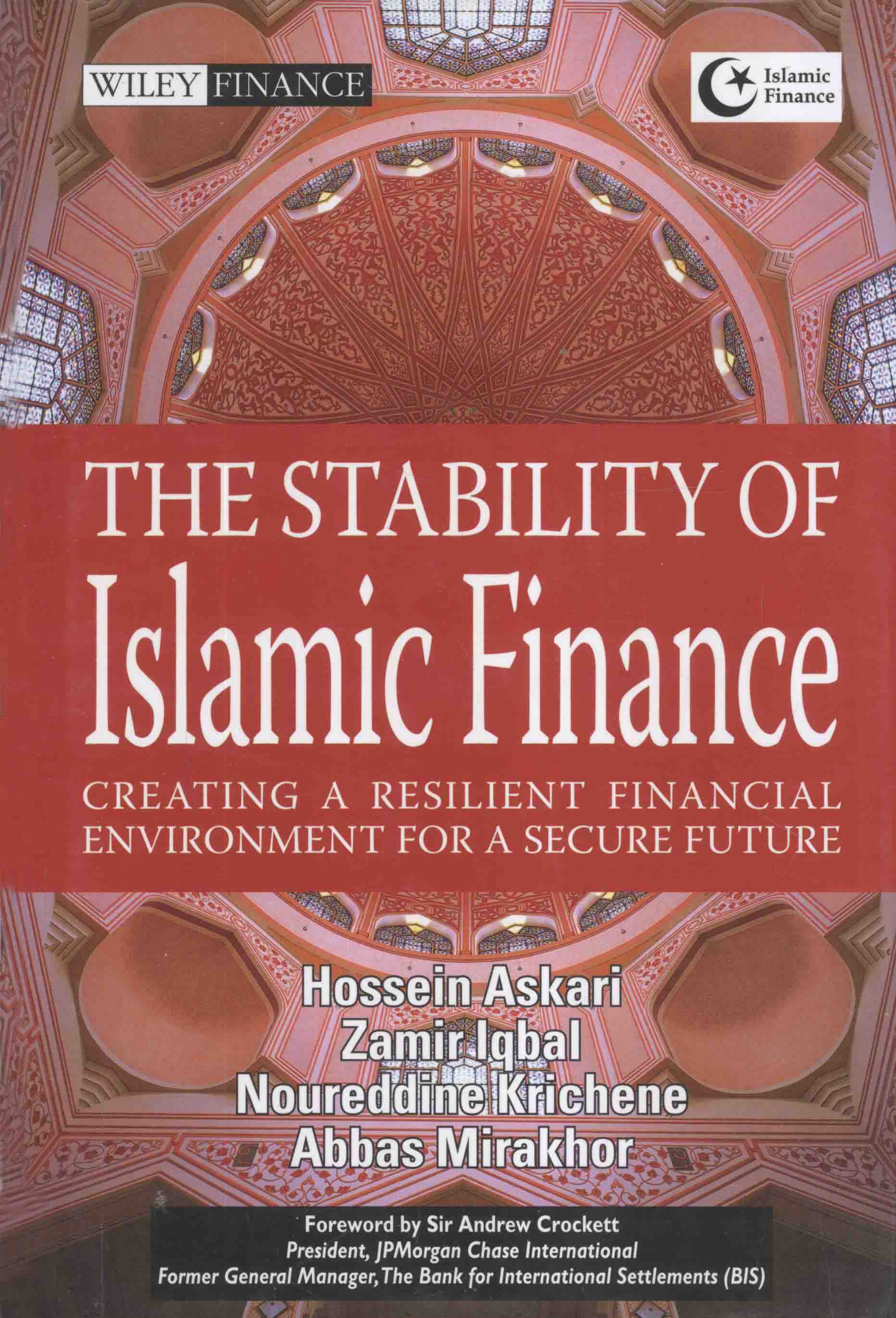

WILEY FINANCE

Islamic Finance

THE STABILITY OF Islamic Finance

CREATING A RESILIENT FINANCIAL ENVIRONMENT FOR A SECURE FUTURE

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Foreword

Over the past 25 years or so, Islamic (*Shari'ah*-compliant) finance has made impressive strides. As of 2007, some $600 billion of assets were managed in *Shari'ah*-compliant accounts around the world. An additional substantial sum is represented by *sukuk*, or Islamic bonds. Notably too, the development of Islamic finance is not limited to Islamic countries. Global institutions such as HSBC, JPMorgan, and others, have begun to offer *Shari'ah*-compliant financial services through their worldwide networks.

Moreover, the phenomenon of Islamic finance seems likely to continue to increase in importance. Over recent years, Islamic financial accounts and instruments have been growing twice as fast as conventional finance. Given the size of the untapped market, and the growing wealth of Islamic countries, especially those that are major oil exporters, this trend seems set to continue.

Amid this ferment of practical activity, rigorous studies by well-trained economists have been relatively rare. In this sense, this new book by a group of four Western-trained Islamic economists is greatly to be welcomed. It builds on and extends their earlier work on the topic and will become essential reading for all those with an interest in the economic implications of Islamic finance.

The book develops themes that link Islamic finance to existing traditions in economics; that assess the stability properties of Islamic financial instruments, and that explain some of the key Islamic concepts in economists' terms. It will be an invaluable source for those who want to know more about the nature of the financial instruments that go to make up an Islamic financial system, and to understand how an Islamic financial system might work in a twenty-first century context.

Everyone knows that a key concept of Islamic teaching is the avoidance of interest payments that are fixed in advance. (Interestingly, this prohibition is not different from that of other faiths at certain stages of their development.) But much less well-known to non-Muslims are the social teachings that lie behind the prohibition, and the variety of concepts that are permissible in economic transactions among Muslims.

Islamic finance has its roots in the teachings of the Prophet Muhammad (himself a merchant) and is grounded in the social, moral and cultural precepts of the *Qur'an*. Much has been written about the relationship of Islamic finance to Qur'anic teachings; but much less, until very recently, about how Islamic finance is related to traditional economic doctrines, and how Islamic finance might perform in a turbulent and unstable time like the present. This volume therefore fills an important gap.

The book begins with an overview of classical capital theory, pointing out its consistency with many of the concepts and limitations of Islamic finance, once interest (the return to capital) and profit (the return to entrepreneurship) are seen as a *combined* return to the provision of capital resources. Pursuing this theme, the authors analyze capital theory from Adam Smith and David Ricardo through William Stanley Jevons, Karl Marx, Eugen von Böhm-Bawerk, Knut Wicksell and others.

This sets the scene for developing the central thesis of the book, namely that Islamic finance is potentially a more stable means of financing capital accumulation than one that attempts to separate the functions of providing capital and bearing risk. Since Islamic finance requires a much greater relative role for equity capital, it is, the authors contend, better protected against the instability that can come from excess leverage.

The authors seek to demonstrate how conventional finance can generate cyclical instability in credit creation which in turn leads to economic booms and busts. They describe the process we would now call "procyclicality" in the financial system and relate it to the Minsky hypothesis of endogenous financial instability. During a bubble, many assets become effectively monetized and add to demand, while in a bust, liquidity evaporates and credit shrivels. Central banks, while trying to offset these tendencies, have often added to them.

Focusing on the management of interest rates to manage the real economy, the authors argue, has in practice fuelled speculative booms, and the ensuing busts have proved impossible to prevent. Central to all this is the process of credit creation generated by ability of banks to create money substitutes through issuing interest-bearing liabilities.

An interesting chapter deals with the current financial crisis. The book blames the internationalization of the crisis on excess money creation in reserve centers, and self regarding policies by individual countries. Although not directly related to the theme of Islamic finance, the authors implicitly support the idea of a common reserve currency as the basis of a more stable international financial system.

Since Islamic finance avoids interest and interest-based assets, it is, the authors argue, inherently more stable than conventional finance, and need not inhibit the mobilization of savings and the efficient allocation of investment. Islamic financial instruments are more directly linked to the productivity of the real investments they finance, and therefore not only promote the social objective of "sharing" risks and rewards, but cushion financial intermediation against the inherent risks of excess, both in booms and slumps.

Doubtless, defenders of conventional financial systems will say that better regulation and risk management can also protect financial stability, and that a wider range of permitted financial contracts can better achieve the completeness of markets. It is not my purpose here to defend the specific claims made by the authors of the book. Overall, however, it is a provocative and insightful assessment of the economic properties of Islamic finance that deserves to be read and reflected on by Islamic and non-Islamic economists alike.

Andrew Crockett
President, JPMorgan Chase International
Former General Manager, The Bank for International Settlements (BIS)

Acknowledgments

We are grateful to Sir Andrew Crockett for taking the time from his busy schedule to write the Foreword to this book. Sir Andrew is, without a doubt, among a handful of the most respected and experienced international bankers of the last quarter of a century—senior official of the International Monetary Fund, executive director of the Bank of England, head of the Bank for International Settlements (BIS), member of the Group of Thirty, and the president of JPMorgan Chase International. We are thrilled and honored by his contribution.

We are indebted to our editor, John Owen, for improving the manuscript. We also acknowledge the hard work of our production editor, Joel Balbin. The support of John Wiley & Sons (Asia) for Islamic economics and finance is greatly appreciated.

Finally, none of this would have been possible without the love and support of our families; to them we will always remain grateful.

Glossary of Arabic Terms

ajar: Reward for doing good
al-adl: Justice
al-ihsan: Perfection
al-khiyar/khiyar: Option
al-mal: Wealth or property
al-maysir: Gambling or any game of chance
al-Mu'minun/Mo'meneen: Those who believe with the heart
amanah: Trust
bay' al-salam: Sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller
bay' al-urbun/urbun: A sale in which the buyer deposits earnest money with the seller as a partial payment of predetermined price in advance but agrees that if he fails to ratify the contract he will forfeit the earnest money, which the seller can keep
bay' bithaman ajil (**BBA**)*:* Sales contract where payment is made in installments after delivery of goods. Sale could be for long term and there is no obligation to disclose profit margins
bay' mu'ajjal: Sale on credit; that is, a sale in which goods are delivered immediately but payment is deferred
faqih (pl. *fuqaha'*)*:* Jurist who gives rulings on various juristic issues in the light of the *Qur'an* and the *sunnah*
fatwa: Religious verdict by the *fuqaha'*
fiqh: The whole corpus of Islamic jurisprudence. In contrast to conventional law, *fiqh* covers all aspects of life—religious, political, social, commercial, and economic. *Fiqh* is based primarily on interpretations of the *Qur'an* and the *sunnah* and secondarily on *ijma'* (consensus) and *ijtihad* (individual judgment) by the *fuqaha'*. While the *Qur'an* and the *sunnah* are immutable, *fiqhi* verdicts may change in line with changing circumstances
fiqhi: Relating to *fiqh*
fuqaha' maqasid: The goals of a *Shari'ah* expert
gharar: Literally, deception, danger, risk, and uncertainty. Technically, it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the countervalue, the date of delivery, the ability of either the buyer or the seller to fulfill their commitment, or ambiguity in the terms of the deal—thereby, exposing either of the two parties to unnecessary risks

hadith **(pl.** ***ahadith*****):** Saying, deed, or endorsement of the Prophet Muhammad (peace be upon him) as narrated by his companions

hajj/umra: The pilgrimage to Mecca

hifz al-mal: Protection of wealth or property

hila **(pl.** ***hiyal*****):** Artifice

ijarah: Leasing. The sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership

istisnah' **(short form for** ***bay' al-istisnah'*****):** A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver well-described products (or premises) at a given price on a given date in the future. The price need not be paid in advance and may be paid in installments in step with the preferences of the parties, or partly at the front end and the balance later on, as agreed

ju'alah: Performing a given task for a prescribed fee in a given period

khalifah: Vice-regent

kifala: Guarantee

manafaah al-ikhtiyarat: Variant of *al-khiyar*

manfaa maal/manfa' ah: Usufruct. Benefit flowing from a durable commodity or asset

maqasid al-Shari'ah: Basic objectives of the *Shari'ah*: the protection of faith, life, progeny, property, and reason

masalahah: Public good as determined in the light of the rules of the *Shari'ah*

maslahah: Literally, benefit. Technically, it refers to any action taken to protect any one of the five basic objectives of the *Shari'ah*

mudarabah: Contract between two parties—a capital owner or financier (*rabb al-mal*) and an investment manager (*mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier. The investment manager's loss lies in not getting any reward for his services

mudarib: Investment manager

murabahah: Sale at a specified profit margin. This term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or as a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. Also referred to as *bay' mu'ajjal*

musharakah: Partnership. Similar to a *mudarabah* contract, the difference being that here both partners participate in the management and the provision of capital and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital

niyyah: Intention

qard-ul-hassan **(short form:** ***qard*****):** Loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God

qimar: Gambling

kanz **(pl.** ***konooz*****):** Treasure(s). Refers to wealth held in the form of gold, silver, and other precious metals

***Qur'an* (also written as *al-qur'an*):** The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (peace be upon him). Lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life

rabbul-mal/rabb al-mal: Capital owner or financier

riba: Literally, increase, addition or growth. Technically, it refers to the "premium" that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest, as commonly understood today, is regarded by a predominant majority of *fuqaha'* to be equivalent to *riba*

Shari'ah: The corpus of Islamic law based on Divine guidance, as given by the *Qur'an* and the *sunnah*, and embodies all aspects of the Islamic faith, including beliefs and practices

shirakah bai'/shirakah: Partnership. Technically, is equivalent to *musharakah*

***sukuk* (short form of *sukuk al-ijarah*):** Negotiable financial instrument issued on the basis of an asset to be leased. The investors provide funds to a lessor (say, an Islamic bank). The lessor acquires an asset (either existing or to be created in future) and leases it out if it is not already leased out. *Sukuk al-ijarah* are issued by the lessor in favor of the investors, who become owners of the leased asset in proportion to their investment. These entitle the holders to collect rental payments from the lessee directly. Can also be made tradable in the stock exchange

sunnah: The second-most important source of the Islamic faith and law after the *Qur'an* and refers to the Prophet's (peace be upon him) example as indicated by his practice of the faith. The only way to know the *sunnah* is through the collection of *ahadith*

surah: A chapter of the *Qur'an*

takaful: An alternative to the contemporary insurance contract. A group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each. Any loss is met from the collected funds

tawarruq: Reverse *murabahah*. Buying an item on credit on a deferred-payment basis and then immediately reselling it for cash at discounted/prize to a third party

wa'd: A time-bound promise to deliver on terms contracted

wakalah: Contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually for a fixed fee

zakah: Amount payable by a Muslim on his net worth, as a part of his religious obligations, mainly for the benefit of the poor and the needy. Obligatory duty on every adult Muslim who owns more than a threshold wealth

Contents

Introduction

The financial crisis that broke out in August 2007 is considered by many to be the worst since the end of the Second World War. Representing the collapse of trillions of dollars of fictitious credit derivatives and the meltdown of uncontrolled credit growth, the scope and intensity of this crisis have kept increasing well into 2009 and could potentially continue on a downward path for some time to come.

The crisis has crippled the financial system of many advanced countries, and has claimed as victims long-established banking institutions that had been deemed "too big to fail." Large bailouts by governments and massive liquidity injections by central banks may have only fanned the flames. Capital markets have frozen, leading stock markets worldwide to crash, wiping out trillions of dollars in share values and retirement investment accounts. The level of economic uncertainty prevailing in 2009 is unprecedented over the last 80 years. Has the crisis been correctly tackled or has it only been inflamed? Given the incredibly high liquidity injections by major central banks, is money supply out of control? How long will the crisis last? How many sectors and countries will it affect? What will be its impact on growth and employment? What will be its fiscal and inflationary cost? Will inflation run out of control in the future? What are the lessons for the future? What steps need to be taken to prevent a similar episode?

While precise answers are not possible, the crisis has slowed down economic growth in many industrial countries, increased unemployment to levels not seen in 25 years, triggered food riots and energy protests in many vulnerable countries, imposed extraordinary fiscal costs with unprecedented government bailouts and fiscal stimuli, and perhaps threatened the lives of more than a hundred million people around the world. Notwithstanding its far-reaching and devastating consequences, the crisis has made the quest for financial stability a pressing and fundamental issue.

Financial instability has been a recurrent phenomenon in contemporary economic history, affecting countries with varying intensity and resulting in massive unemployment and lost economic output. The most enduring crisis was the Great Depression of 1929–33. Eminent economists who lived through that period fought to establish a banking system capable of preserving long-term financial stability. Their proposals became known as the Chicago Reform Plan, as it was economics professors at the University of Chicago who elaborated them.[1] Unwittingly, their proposals were a natural restatement of some basic pillars of Islamic principles and finance. The Chicago Plan basically divides the banking system into two components: (i) a warehousing component with a 100 percent reserve requirement, and (ii) an investment component with no money contracts and interest payments, where deposits are considered as equity shares and are remunerated with dividends, and maturities are fully observed. In the aftermath of the Chicago Plan and in the subsequent literature it has become clear that a financial system along Islamic principles is immune to instability.

Financial stability is a basic concept in finance. It applies to households, firms, banks, governments, and countries. It is an accounting concept conveying notions of solvency, or equilibrium. For an entity, financial stability can be defined as a regular liquid treasury position, in which the sources of funds exceed the uses of funds. The sources of funds are diverse and include income streams (salaries, transfers, taxes, interest income, dividends, profits, and so on), borrowing or loan recovery, and sales of real and financial assets. The uses of funds include current expenditures (including interest and dividend payments, rents, salaries, taxes, and so on), capital expenditures, purchase of assets, lending or debt amortization. Accounts are separated into income or current accounts, and balance sheet or capital accounts. Financial stability means that consolidated accounts are regularly in surplus.[2]

Financial instability can be defined as the opposite of financial stability. It can be associated with payment defaults, payment arrears, or insolvency. It manifests itself through a regularly deficient treasury position, in which the sources of funds fall short of uses of funds or payments obligations. When financial instability persists, access to borrowing becomes highly restricted. The entity facing financial instability may have to recapitalize, liquidate assets, restructure liabilities, seek a bailout, or, in extreme circumstances, may be subject to merger or even liquidation.

In banking, there is stability if the maturities of assets and liabilities are matched, if assets preserve their values and do not depreciate, and if the amount of IOUs is fully backed by gold or warehouse deposits that served for issuing these IOUs. The excessive issuing of gold or warehouse certificates, or bank notes, may cause instability, as manifested in a run on a bank by domestic or international depositors.[3] The amount of claims may exceed the stock of gold or merchandise; under these conditions, conversion may be suspended, bankruptcies may occur, or IOUs may be devalued. Under a fiat-money system, the central bank may act as the lender of last resort to preserve stability by printing new money, which in turn may lead to currency depreciation.

BASIC ECONOMIC PRINCIPLES OF ISLAM

- The basic framework for an Islamic economic system is a set of rules and laws, collectively referred to as *Shari'ah*, governing economic, social, political, and cultural aspects of Islamic societies. *Shari'ah* originates from the rules dictated by the *Qur'an* and its practices and explanations (more commonly known as *sunnah*) rendered by the Prophet Muhammad (pbuh). Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the *Qur'an* and *sunnah*.
- The foremost priority of Islam and its teaching on economics is *justice and equity*. The notion of justice and equity, from production to distribution, is deeply embedded in the system. As an aspect of justice, social justice in Islam consists of the creation and provision of equal opportunities and the removal of obstacles equally for every member of society. Legal justice, too, can be interpreted as meaning that all members of society have equal status before the law, equal protection of the law, and equal opportunity under the law. The notion of economic justice, and its attendant concept of distributive justice, is characteristic of the Islamic economic system. Rules governing permissible and forbidden economic behavior on the part of consumers, producers, and government, as well as questions of property rights and the production and distribution of wealth, are all based on the Islamic concept of justice.
- The Islamic paradigm incorporates a spiritual and moral framework that values human relations above material possessions. In this way, it is concerned not only about material needs but also establishes a balance between the material and spiritual fulfillment of human beings.
- Whereas conventional thinking focuses on the individual, society, or community and appears as a mere aggregate having no independent significance, the Islamic system creates a balanced relationship between the individual and society. Self-interest and private gains of the individual are not denied, but they are regulated for the betterment of the community. Maximizing an individual's pursuit of profit in enterprise or satisfaction in consumption is not the sole objective of society, and any wasteful consumption is discouraged.
- The recognition and protection of the property rights of all members of society are the foundations of a stakeholder-oriented society, preserving the rights of all and reminding them of their responsibilities.

BASIC PRINCIPLES OF ISLAMIC FINANCE

- *Prohibition of interest.* Prohibition of *riba*—a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales"—is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (that is, guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of "interest" as widely practiced. This prohibition is based on arguments of social justice, equality, and property rights. Islamic law encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and the creation of additional wealth, whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of accumulating and distributing wealth in the economy be fair and representative of true productivity.
- *Money as "potential" capital.* Money is treated as "potential" capital—that is, it becomes actual capital only when it is joined with other resources in undertaking a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.
- *Risk-sharing.* Because interest is prohibited, suppliers of funds become investors, rather than creditors. The provider of financial capital and the entrepreneur share business risks in return for a share of the profits. The terms of financial transactions need to reflect a symmetrical risk-return distribution that each party to the transaction may face. The relationship between the investors and the financial intermediary is based on profit/loss sharing principles, and the financial intermediary shares the risks with the investors.
- *Prohibition of speculative behavior.* An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.
- *Sanctity of contracts.* Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is

intended to reduce the risk of asymmetric information and moral hazard.

- **Shari'ah-*approved activities*.** Only those business activities that do not violate the rules of *Shari'ah* qualify for investment. For example, any investment in a business dealing with alcohol, gambling, or casinos is prohibited.
- ***Social justice*.** In principle, any transaction leading to injustice and exploitation is prohibited. A financial transaction should not lead to the exploitation of any party to the transaction. Exploitation entails the absence of information symmetry between parties to a contract.

OUTLINE OF THIS BOOK

In our quest to elaborate on the causes of financial instability in the conventional financial system and to assess the stability of Islamic finance, we begin our analysis by reviewing the nature of capital (through the seminal writings of Adam Smith, David Ricardo, William Stanley Jevons, Karl Marx, Eugen von Böhm-Bawerk, Knut Wicksell, and other giants of the field), explaining the concept of the rate of return, marginal productivity of capital, and the rate of interest.

In Chapter 2, we assess how financial instability leads to economic recession or depression. Credit expansion and abundant liquidity, supported by cheap money policy and low interest rates, lead to speculative booms and asset price bubbles. Financial innovations, Ponzi finance, swindles, and fraud have invariably developed during speculative booms. During a bubble many illiquid credit instruments become monetized—through securitization, for instance—and further fuel liquidity expansion. Over-indebtedness erodes creditworthiness and causes defaults. The sharp credit contraction, deflation of asset prices, and bankruptcies that follow thereafter lead to economic recession or depression. We examine Minsky's hypothesis that the conventional financial system is unstable and that instability is endogenous in such a financial system, which is apparently destined to experience periods of financial instability. However, Minsky's endogeneity analysis, while integrating Keynes' views regarding instability of expectations and Schumpeter's view on creative destruction adapted to financial innovations, is not fully supported by the facts.

We deduce the common factors that led to financial turmoil in these episodes and examine the ordeal that followed instability. The general pattern was