



Global Strategies for Islamic Banking and Finance

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Strategic choices for Islamic finance

1. Integrate into global financial markets **or** develop parallel system?
2. Find immediate solutions **or** make long-term plans?
3. Market-based **or** financial intermediary, institutional-based?
4. Jurisprudence-led **or** benefit-led?

Integration vs. separation

- **Should Islamic finance form a parallel global sub-system? (re-inventing the wheel?)**
 - Separate global clearance and payment mechanism,
 - Separate uniform *Sharī'a* and accounting standards,
 - Separate central banking & monetary instruments,
 - Coordination with global oversight agencies!
- **Or, should Islamic finance coexist and compete with conventional finance at its own game?**
 - Islamic restrictions as financial quality standards, requiring accounting and (adaptive) *Sharī'a* oversight,
 - Use the existing “conventional” finance infrastructure

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What type of wheel would we reinvent?

- The functions of a financial system (Crane et al., 1995):
 - Clearing and settling payments
 - Pooling funds
 - Transferring resources across time and space
 - Managing risk
 - Providing price information
 - Dealing with incentive problems
- ➔ Those functions need not violate Islamic Law
- ➔ Conventional finance is moving away from the deposit/lending banking paradigm (see 3)

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Islamic and Conventional finance

- Share the same efficiency/equity objectives
 - Recent trends in conventional finance raise efficiency and stability by tying credit creation to underlying assets (collateralization)
 - Regulatory agencies focus on minimizing ambiguity and speculation (while allowing proper hedging) in risk transfers
- Are more similar than rhetoric suggests
 - Current “Islamic banking” is a hybrid of universal depository and Investment banking →

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IMF Financial Statistics Manual (2000)

- Appendix 2. Islamic Banking (p.126):
 - “488. The prevailing statistical practice is to classify Islamic financial institutions in the *other depository corporations* subsector. The implication of this practice is that participation certificates and other investment deposits are treated the same way as regular deposits for statistical reporting purposes. The participation of many Islamic financial institutions in bank clearing systems and a concentration of lending activity in traditional, short-term commercial and trade financing are practices that tend to reinforce this classification. Islamic financial institutions that are not primarily involved in deposit-taking activities are classified as other financial corporations. Islamic financial institutions investing mainly as long-term partners in business ventures are akin to mutual funds, and the liabilities of these financial institutions to the public should be classified as stock”.

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Time frame

- Should Islamic finance aim to provide immediate alternatives to conventional financial practice? (see **4**)

OR

- Should Islamic finance take a long-term view, providing future direction based on conventional finance developments? (see **3**)

2

timing



Acknowledging the two sets of baggage in “Islamic Banking”:

3. Static institutional entanglement of financial system functions, banking style:

- Following the forms of conventional finance rather than its functions, and ignoring new trends
- Further aggravation of a conventional banking weakness (depositors as investors)

4. Contract-based Islamic Jurisprudence:

- Emphasizes what to do rather than study what not to do (i.e. Ribā and excessive Gharar), functionally!
- Ignores current “conventional” finance regulations that perform very similar prudential functions



Market based vs. Institution based

(c.f. theoretical treatments in: Allen and Gale (2000), Freixas&Rochet (1997))

- | | |
|---|---|
| <ul style="list-style-type: none">▪ e.g. U.S., U.K.▪ Efficient decentralized information aggregation▪ Agents optimize given their private information▪ Marking to market ensures maximal efficiency▪ Precommitment to market encourages better ex ante investor decision-making▪ Quickly adaptable | <ul style="list-style-type: none">▪ e.g. Germany, France▪ Exploit economies of scale in info. gathering▪ Banks use information to act on the agent's behalf▪ "Investors" are shielded from market risk▪ Allow frequent bilateral renegotiations to recover from bad decisions▪ Stable (barring crises) |
|---|---|

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banks?

←←← Global Trend ←←←

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Forbidden transactions in Islam

- **Ribā=Trading in credit** (no traditional "banks")
 - Charging interest on loans or credit extensions
 - Economic objective: increase efficiency and equity by marking to market (see proof based on the analysis of Ibn Rushd in <http://www.ruf.rice.edu/~elgamal/riba.pdf>)
- **Gharar=Trading in risk** (no "insurance" sales)
 - Unnecessary sales in which risk is a major component (c.f. Al-Sarakhsī, Al-Bājī, ibn-Taymiya, etc.).
 - Economic objective: increase efficiency through risk sharing (see proof based on the criteria summarized in Al-Darīr in <http://www.ruf.rice.edu/~elgamal/gharar.pdf>)

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“Banking” Functions

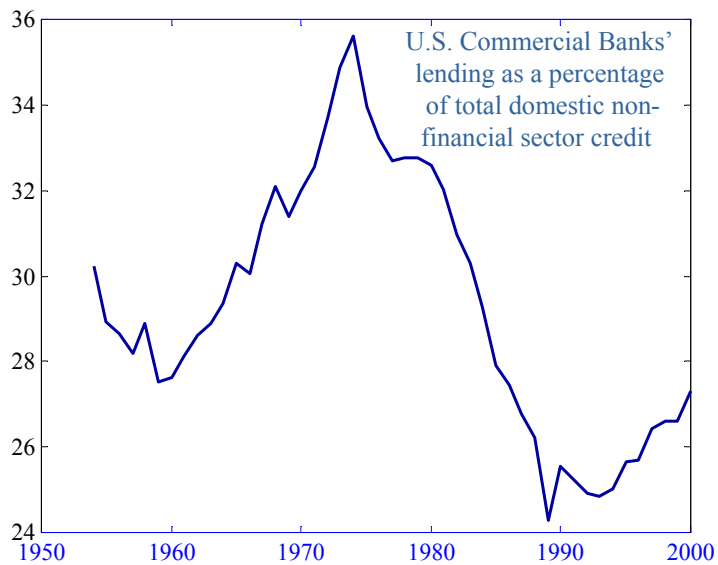
- Riskless credit = risky credit + insurance
 - Banks with deposit insurance schemes (through temporal smoothing of risk) include forbidden lending with interest, as well as forbidden insurance sale → (i.e. *Ribā* + *Gharar*)
- “Islamic banking”
 - Fee-for-service components (identical with conventional banks)
 - Without the insurance function (PLS), banking does not perform its temporal smoothing task
 - → Adopt a market-oriented approach

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U.S. Commercial Banking: Trends I

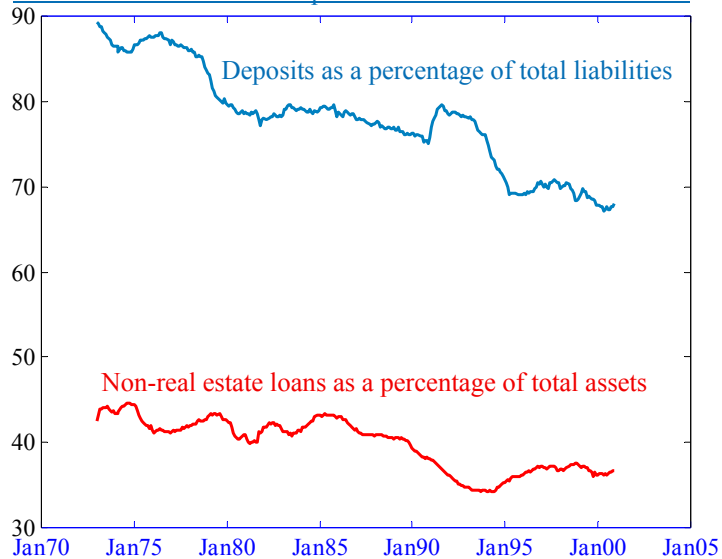


Source: Federal Reserve Statistical Release Z.1, December 8, 2000

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U.S. Commercial Banking: Trends II

Assets and liabilities decomposition for U.S. commercial banks



Source: Federal Reserve Statistical Release – H.8, Feb. 2, 2001

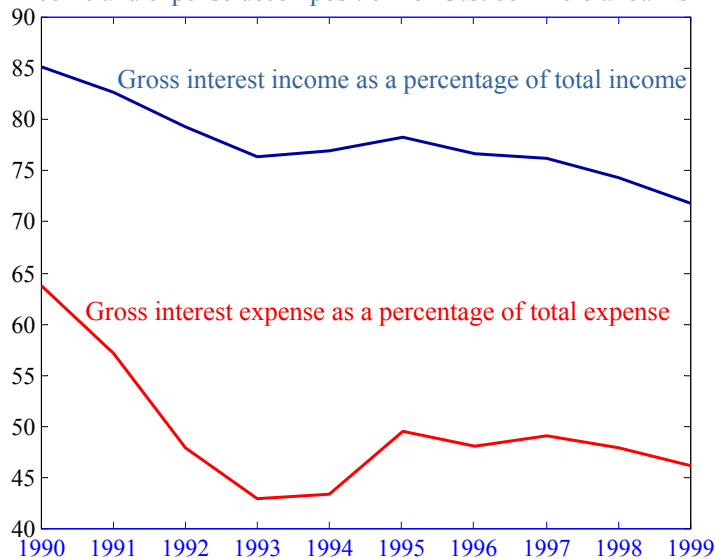
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U.S. Commercial Banking: Trends III

Income and expense decomposition for U.S. commercial banks



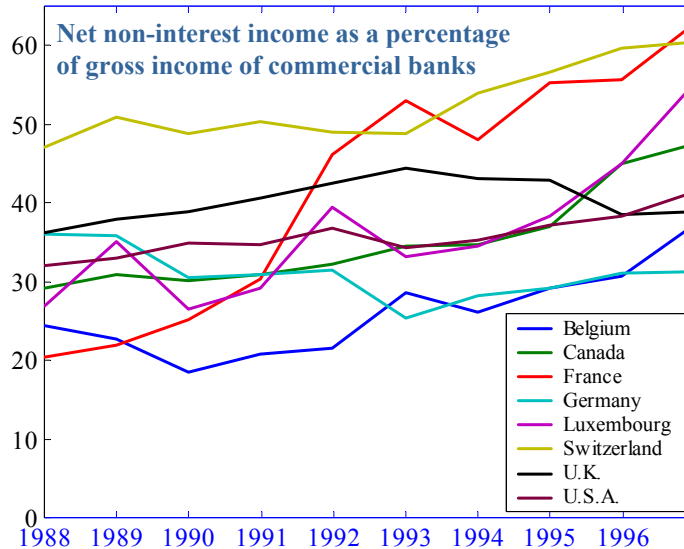
Source: Federal Reserve Bulletin, June 2000

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Global Commercial Banking Trends



Source: Bank Profitability: Financial Statements of Banks, OECD, 1999.

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Why has “conventional” (*Ribā+Gharar*) finance been increasingly in decline?

- **Diminished advantage in collecting liabilities:**
 - Removal of artificial legal restrictions favoring banks
 - Improvement in investment diversification and resource pooling through mutual funds, REITs, &c.
 - Freedom of resource transfer within and across national borders
 - → Small savers now have access to same markets as big savers
- **Diminished advantage in generating assets:**
 - Advances in securitization allowed more direct access to resources without recourse to bank intermediation
 - Advances in IT improved statistical assessments of credit risk, bypassing one of conventional banks’ competitive advantages
 - More domestic and foreign competitors
 - → Separation of the credit-origination and transfer functions

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“Function or form?” A Necessary prelude to “Islamic Finance”

- Let contract A be forbidden based on juristic analogy ($\uparrow \curvearrowright \epsilon \tau \boxtimes \quad \wp \# \diamond \triangleleft$), and let contract B be another contract that is permissible by the same criteria.
- If contracts A and B are shown to be economically identical (in the Arrow-Debreu sense), do we:
 - Forbid B , through the apparent analogy ($\diamond \wp \wp \quad \wp \# \diamond \triangleleft$)?
 - Permit (the often less efficient) B , while maintaining the prohibition of A (avoids iterative analogy= $\wp \# \diamond \triangleleft \quad \square \boxtimes \boxtimes \wp \# \diamond \triangleleft$)?
 - Or, revoke the earlier false juristic analogy based on the economic analysis of its proof ($\square \boxtimes \boxtimes \wp \# \diamond \triangleleft$) and reasoning

4

jurists

Strategic suggestions

1. Integration vs. isolation: \rightarrow recommend integration with supervision/monitoring
2. Short vs. long-term horizon for Islamic finance: \rightarrow recommend long-term planning
3. Market-oriented vs. institution-oriented (banking): \rightarrow recommend market-oriented
4. Jurisprudence leading or trailing: \rightarrow suggest that Jurisprudence is at its best reacting slowly to benefit-led realities