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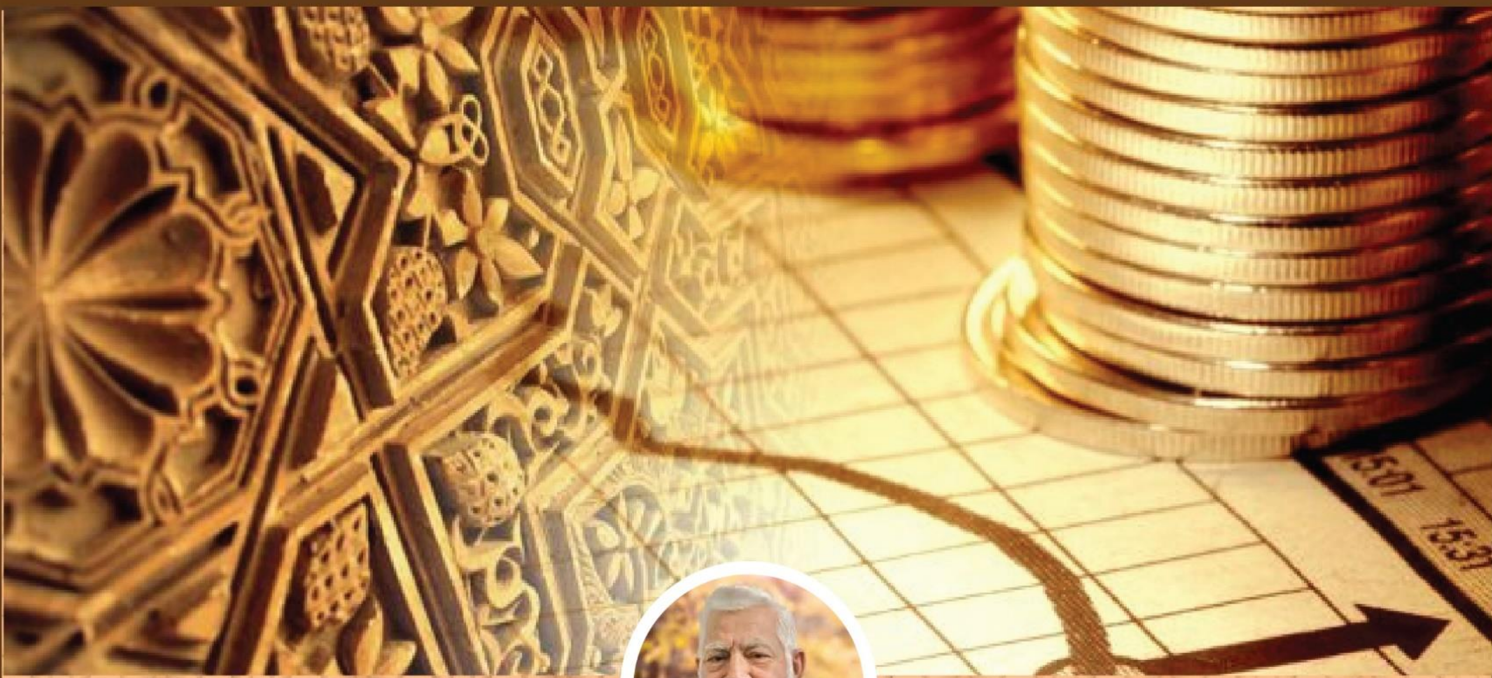
Stability and Sustainability of Islamic Finance



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The causes of financial instability in the world today stem from two primary sources: firstly, the nature of financial relationships, and secondly, the inherent volatility of financial capitalism. The following discussion explores various aspects of these factors in detail.[*]

In finance, uncertainty about the future is a significant factor, given the diverse individuals involved, each managing their uncertainties uniquely. Interpersonal relations, whether among units or individuals, inherently entail heightened uncertainty. Various causes contribute to this uncertainty, notably differing management approaches and governance styles. Mistakes made by management, supervisors, regulatory decisions, and macroeconomic challenges further exacerbate instability within the finance sector and currency dynamics. Despite the various financial systems employed, addressing these issues remains crucial.

1. Inherent Instability of Financial Capitalism

The capitalist finance system has introduced inherent instability and challenges to sustainability, particularly evident in financial capitalism. Excessive credit and indebtedness characterize this system, leading to interconnected institutions heavily burdened by debt, resulting in systemic risks and domino effects. Over the past four decades, from the 1980s onwards, regulatory responses to these issues have been marked by hesitancy and contradiction, posing significant challenges to effectively managing the financial system.

1.1 Excessive Credit or Indebtedness

Numerous studies have established a direct correlation between credit expansion, increased indebtedness, and financial crises. When credit grows beyond a certain threshold, it inflates into a bubble that eventually bursts, triggering crises. Throughout history, spanning approximately a century, many crises have been linked to the excessive growth of credit. Market saturation with credit that surpasses its affordability creates bubbles, leading to systemic issues.

1.2 Interconnectedness of Financial Institutions

The proliferation of inter-bank connections, largely stemming from credit growth, amplifies the interdependence among financial institutions. The 2008 financial crisis serves as a prime example, where institutions like Lehman Brothers, heavily reliant on credit from other banks, collapsed, catalyzing a domino effect. This excessive connectivity creates a web of dependency, wherein one institution's credit woes reverberate through lenders, triggering systemic disruptions.

1.3 Regulatory Dynamics in the Financial Industry

Since the 1980s, especially notable in the American economic landscape, regulatory actions have oscillated between enforcement and deregulation, characterizing the regulatory environment. Regulatory initiatives often lack innovative approaches and are confined within existing paradigms. For instance, the enactment of the Community Reinvestment Act in 1977 and heavy amendments by the Congress in 1989. This act facilitated lending to underserved communities. Subsequent deregulatory moves, such as the repeal of the Glass-Steagall Act in 1999 and the exemption of derivatives from regulations through the Community Futures Modernization Act in 2000, exemplify the shifting regulatory landscape. Even the 2010 reform efforts, while ostensibly addressing issues, continued to permit speculative activities like options trading and virtual asset speculation, perpetuating regulatory inertia.

2. Inherent Sustainability and Stability of Islamic Finance

Islamic finance inherently possesses sustainability and stability factors that render it more resilient and enduring. The foundational principles of Islamic finance, namely realism, justice, and moral screening, contribute significantly to its stability.

2.1 Realism

Realism lies at the core of Islamic finance, anchoring it in principles that prioritize ownership as a prerequisite for financial transactions. Unlike conventional finance, where financing often precedes ownership, Islamic finance mandates ownership or tangible asset backing before providing financing. This realism is exemplified through several key principles.

Firstly, Islamic finance operates on the basis of asset-backed financing, where tangible asset ownership is

[*] This issue brief is based on a talk delivered by Dr. Monzer Kahf, professor of Islamic Finance and Economics, Istanbul Sabahattin Zaim University, Türkiye, at an IPS event.

essential. This approach imposes limits on debt creation relative to asset value, ensuring a more secure financial foundation. Moreover, financial activities in Islamic finance stem from real market signals, emphasizing market-driven finance over speculative ventures driven by financial signals. Additionally, Islamic finance discourages the trading of debts, promoting the retention of debt until settlement. Transactions within Islamic finance must involve tangible value addition, eliminating speculative or non-value-added financial activities. This emphasis on real-value transactions ensures that financial activities contribute meaningfully to economic growth. Furthermore, Islamic finance prohibits the sale, creation, or trading of purely speculative risk, prioritizing tangible assets and real economic activity over speculative ventures. Lastly, Islamic finance inherently includes all economic units, fostering inclusivity and equity within the financial ecosystem. This inclusive approach ensures that all segments of society have access to financial opportunities, contributing to a more comprehensive and equitable financial landscape.

2.1.1 Asset (Property)-Based Finance: Islamic finance revolves around asset or property-based transactions, forming its foundational principle. These transactions are deeply rooted in tangible assets or properties, ensuring a close alignment with real market activities. Whether through sales, leasing arrangements, or project financing, Islamic finance transactions involve genuine exchanges of goods or services, tangible asset utilization, and real economic development. This emphasis on property ownership and asset-backed transactions underscores the essence of Islamic finance, distinguishing it from conventional finance models.

2.1.2 A Cap on Debt Creation and Debt Size: Islamic finance imposes a cap on debt creation, tethering it to actual market transactions. This limit ensures that debt remains within bounds dictated by real economic activities. Providers of Islamic finance facilitate genuine economic transactions, aligning financial flows with real production and consumption needs. Complexity in debt structures is discouraged, maintaining transparency in the financial system. Additionally, Islamic finance emphasizes smaller-scale financing to avoid excessive indebtedness and promote financial prudence. By anchoring debt creation to tangible economic activities and imposing limits on its size, Islamic finance fosters financial stability and sustainability, contributing to a more resilient financial ecosystem.

2.1.3 Signal Transmission from Market to Finance: In Islamic finance, transactions begin with real market activities like sales, purchases, leasing, and investment partnerships. These transactions originate from genuine market exchanges, ensuring a direct link to tangible economic activities. They are integrated into the financial system, shaping the terms and conditions of financial arrangements. Importantly, financing terms are determined by the dynamics of the real market, aligning financial activities with market realities and needs. This anchoring in real market dynamics maintains a robust and sustainable framework for Islamic finance.

2.1.4 Elimination of Debt Trading and Holding onto Debts: In Islamic finance, when an institution creates a debt, it is obligated to retain it until maturity. Unlike conventional finance, Islamic finance prohibits the trading or transfer of debts to other entities. This principle ensures that the institution bearing the debt is responsible for its management and resolution. Debt cannot be offloaded onto other units within the economy, eliminating the practice of passing on financial liabilities. Consequently, debt remains with the originating institution throughout its lifecycle, reducing the interconnection between banks that is often based on debt trading. This approach fosters accountability and encourages prudent risk management within the Islamic financial system.

2.1.5 Removal of Non-Real-Added-Value Financial Transactions: Islamic finance strictly prohibits non-real-added-value transactions, including zero-sum activities, gambling, speculative contracts, and pure cash exchanges without tangible goods. These transactions lack economic substance and are deemed impermissible. By focusing on real commodities and preventing collusion, Islamic finance ensures that financial activities contribute to tangible economic development. This fosters stability and sustainability within the financial system.

2.1.6 No Sale of Risk and No Creation of Risk Trading Instruments: In Islamic finance, selling or creating risk trading instruments is prohibited. Ownership entails inherent risk, integral to earning potential, with market and liquidity risks managed but not tradable. Risk itself does not create value and cannot be traded; it is a facet of ownership. While risk is related to returns, it is not the core cause; returns are generated by asset ownership. Islamic finance emphasizes genuine ownership and value creation, prohibiting the sale of risk as tradable commodities.

2.1.7 Inclusiveness: In Islamic finance, inclusiveness is key, ensuring equal access to financial services for everyone, regardless of status. This approach reduces costs and risks by involving diverse participants in the financial system. Additionally, Islamic finance promotes wealth circulation within society, fostering economic stability and equitable resource distribution. Overall, it contributes to a more equitable and sustainable financial ecosystem where wealth is shared among all members of society.

2.1.8 Development Approach: Islamic finance adopts a developmental approach, prioritizing the financing of both consumers and businesses for economic growth. There are no preferences between these sectors, reflecting Islamic finance's inclusive nature. By financing consumption, SMEs, infrastructure, technology, healthcare, and clean energy, Islamic finance stimulates employment and fosters technological progress, contributing to overall development. Furthermore, Islamic finance avoids funding harmful activities, directing resources towards beneficial endeavors, thus promoting societal well-being and reducing associated costs. Overall, this approach supports sustainable economic development and societal advancement.

2.2 Justice (Economic Justice)

The second fundamental principle in Islamic finance is economic justice, which revolves around the concept of earning through ownership. In Islamic finance, ownership of assets and goods that have the potential to grow or increase in value is essential. For instance, owning grains stored in an airtight container with no potential for growth does not align with the principle of economic justice. Similarly, debt, being an interpersonal relation, does not inherently increase or generate value. As Paul Samuelson famously stated, economics should be understandable to everyone, and debt does not exhibit the characteristics of value creation or growth.

In Islamic finance, assets that do not possess the potential for growth or value addition are not suitable for financial transactions. Therefore, Islamic finance does not begin with debt or loans but rather with real goods in the market, and any debt created is limited and tied to tangible assets or activities that have the potential for growth or value generation. Another crucial condition in Islamic finance is the moral acceptability of assets. Assets that are deemed immoral, such as cigarettes, are not considered acceptable for financing within Islamic finance principles. The concept of earning through ownership entails that assets themselves are morally sound and capable of generating value. In contrast, conventional finance often begins with debt, which inherently does not possess the ability to grow. While conventional finance relies heavily on debts and interest, Islamic finance prioritizes morally acceptable assets that have the potential for growth and value creation.

In Islamic finance, the relationship between banks and depositors is rooted in ownership. Depositors are considered partners of the Islamic bank, forming a mutually beneficial partnership. Deposits in Islamic banks are structured as profit-sharing arrangements, where depositors share in the bank's profits. They assume a virtual partnership with the bank, sharing the risks associated with the assets owned by the bank. In the event of lower earnings or losses, depositors bear an equal share of the risk.

In contrast, conventional finance often transfers the risk from depositors to banks or financial institutions by guaranteeing a fixed return. This arrangement can lead to inherent injustices. Islamic banking emphasizes ownership and participation. Islamic banks engage in activities such as owning or leasing assets, creating new projects, or expanding existing ones. They do not engage in functions such as providing debts, rescheduling debts, or trading risks using deposited funds, as is common in conventional banking.

The final aspect is social justice, distinct from economic justice, and it encompasses various means and institutions. Islamic social institutions, such as zakat (obligatory almsgiving), awqaf (endowments), charities, non-governmental organizations (NGOs), and microfinance organizations, play vital roles in safeguarding the interests of the poor and needy. These institutions are dedicated to ensuring the equitable distribution of resources and opportunities within society, reflecting the values of compassion, solidarity, and communal responsibility upheld by Islamic principles.

2.3 Moral Screen

The third pillar of Islamic finance is the moral screen, which dictates that only morally acceptable properties can be owned by Muslims. This principle extends to the methods of exchanging these properties, where both the contract itself and its conditions must adhere to moral standards. For instance, in a partnership contract, the moral imperative of justice takes precedence over mere consent. This means that regardless of the agreed-upon conditions, losses should be distributed in proportion to each party's capital contribution, reflecting the application of the moral principle of justice.

Similarly, not all consensual conditions are truly consensual, as they may be agreed upon under duress, emergency circumstances, or emotional influence. However, the principle of justice remains paramount. Regarding goods such as cigarettes, Islamic finance prohibits their involvement from planting tobacco to selling cigarettes due to their harmful nature. In Islamic finance, the acceptability of a commodity is determined by weighing its good aspects against its bad aspects. This assessment is informed by scientific knowledge of the time. For example, there was a time when Muslims considered coffee to be haram due to perceived harm. However, when scientific evidence demonstrated its non-harmful nature, the ruling was revised, and coffee became permissible. Similarly, cigarettes were once not considered haram, and even some Shariah scholars used tobacco. However, with scientific evidence proving the harm of cigarettes, they were deemed haram and removed from the realm of Islam.

In the context of moral screening, it's important to note that there was a time when science had not yet proven the harmful effects of liquor, despite its known harmful nature. Now, with scientific evidence supporting its harmfulness, the moral screening process in Islamic finance advocates for environmental friendliness and developmental sustainability.

In the realm of financial markets, the discussion extends to the necessity of institutions like 'muhtasib' and 'hisbah' to oversee transactions before they reach formal regulations and law enforcement. These institutions play a crucial role in screening transactions based on moral principles. Additionally, financial embezzlement serves as a safeguard to ensure that potentially harmful practices do not enter the market unnoticed by regulations. Financial embezzlement focuses on moral values rather than quick societal benefit, providing a level of scrutiny that formal regulations may struggle to keep pace with.

3. Islamic Finance Stability During Financial Crises

Theoretical analysis suggests that Islamic finance is inherently more stable due to its direct alignment with real market transactions. Numerous studies have investigated this theoretical stability and have found Islamic financial institutions to be less affected by crises compared to conventional finance. While some Islamic financial institutions may be indirectly impacted by crises due to their involvement in both Islamic and conventional finance, overall, Islamic finance has demonstrated resilience. Scholars such as Mabid Ali Al-Jarhi (2017), Suria Rismawati Sanwari, Roza Hazli Zakaria (2013), Mohamed Arouri (2013), Kun-ho Lee and Shakir Ullah (2016) have concluded that Islamic finance offers a viable alternative to the challenges posed by conventional financial systems. Lee and Shakir Ullah specifically highlighted Islamic finance's conservative investment mechanisms as a key factor contributing to its resilience during the 2008 global financial crisis.

Despite the challenges posed by the Covid-19 pandemic, Islamic banking showed remarkable resilience and expansion globally. Throughout the pandemic, the profitability and market share of the Islamic banking sector increased. Moreover, the global sukuk market, a key component of Islamic finance, exhibited notable resilience in 2020. Islamic firms have continued to expand in size despite the global economic downturn caused by the pandemic. While some studies may not show strong resilience or deterrence, comparing Islamic and conventional banks during the 2008 financial crisis reveals a different picture. Islamic banks experienced a higher rate of growth compared to conventional banks during this period, with their profitability also increasing at a faster rate.

4. The Way Forward

Any reform in finance should be rooted in the fundamental principles of Islam. Central to this is the concept of earning by owning. In Islamic finance, generating income is not as simple as clicking buttons on a computer in the New York market; it involves financing real commodities available in the market. Islamic finance plays a crucial role in financing the growth and exchange of real commodities, signaling to both consumers and producers to stimulate economic activity. In contrast, conventional finance often obscures this function by engaging in a myriad of activities that may not directly contribute to this fundamental role. Therefore, any reform in the financial sector should prioritize the implementation of the property theory of finance, aligning with the principles of Islamic finance.

The path forward entails embracing property-based financing while rejecting quick returns without ownership, which can breed corruption and stifle entrepreneurial spirit within society. Encouraging individuals to accumulate wealth without actively engaging in productive endeavors undermines the ethos of hard work and innovation. Islamic finance must prioritize transactions rooted in real assets and transactions, avoiding any practices that promote harmful risk trading. The fundamental principle of realism underscores the necessity for Islamic finance transactions to be anchored in tangible assets and genuine market activity. Legitimacy within Islamic finance instruments hinges on their representation of real assets, reflecting a commitment to ethical and sustainable financial practices.

Realism in Islamic finance allows financing to be tailored to the size of the market, ensuring that financial transactions align closely with real-market activities. This approach acknowledges that not every transaction in the real market is fully debt financed, thereby shaping the finance sector in accordance with the scale of real transactions. Islamic finance derives its moral framework from Islam, incorporating moral, ethical, and legal screening rules into its practices. In Islamic law, moral commitment permeates all aspects of life, and these principles are intricately woven into Islamic finance contracts. Moral commitment manifests in Islamic finance contracts in two primary ways: firstly, through the selection of properties or assets subject to contracting, and secondly, through the underlying structure, terms, and clauses of the contracts themselves.

Islamic finance, rooted in principles of realism, justice, and moral screening, offers a stable and sustainable alternative to conventional systems. Its emphasis on asset-backed transactions, limiting debt, and avoiding speculative activities fosters resilience, as seen during the 2008 financial crisis and the Covid-19 pandemic. By aligning financial activities with real economic transactions, it promotes inclusivity and fairness while reducing systemic risks. Furthermore, its commitment to wealth circulation ensures equitable access to financial services for all. Looking forward, reforms in the financial sector should adopt Islamic finance's property-based model, ensuring ethical, sustainable practices that contribute to long-term economic stability and social justice.

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