Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp.139-144

Culture or Accounting

What Are the Real Constraints for Islamic Finance in a Ribā-Based Global Economy?

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Abstract

International financial regulators would like to see Islamic finance adopt accounting practices consistent with global standards. As global standards become more widely accepted—and international regulators more insistent on the importance of global comparability—any financial system that fails to conform stands out in ever-greater relief. Regulators argue, convincingly, that the supervision of Islamic financial institutions and the accounting practices that those institutions use can with little difficulty be adapted to Western (*ribā*-based) norms. However, these arguments miss a fundamental point: for a significant constituency of Islamic financiers, the "otherness" of Islamic finance is more important than any advantages conferred by complicity with the global accounting architecture. The rise of Islamic finance in recent decades has mirrored the growth in Islamic sentiment and the search for an Islamic identity to replace post-colonial models. Non-Muslim regulators and accountants seeking ways to incorporate Islamic finance into the global accounting architecture should start by recognizing the importance of its otherness, rather than by treating that otherness as a technical inconvenience that can be mechanically fixed.

I. Introduction[i]

The inspiration for this paper came from a conference held by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain in February 2000. The conference, in which the author was a discussant to one of the sessions, was centered on the issue of the regulation and supervision of Islamic financial institutions (IFIs). Participants included practitioners of Islamic finance as well as officials from international agencies such as the IMF and the International Accounting Standards Council (IASC), among others.

The strongest impression that the author took away from that conference was that the two sides—Islamic financiers and international regulators—had different agendas. The international regulators extolled the virtues of global accounting comparability. They emphasized the necessity of having a single accounting and regulatory system in order to forestall a reoccurrence of crises such as that seen in Asia, and they tried—unsuccessfully—to convince Islamic financiers that all the instruments and systems of Islamic banking could be expressed within a global regulatory architecture without losing their integrity. The international regulators praised—occasionally in absurdly hyperbolic terms—the importance of the *Core Principles for Effective Banking Supervision*, published by the Basle Committee in 1997. These principles, they argued, were broad enough and flexible enough to encompass all the aspirations of Islamic finance.

But the Islamic financiers felt differently. Time and again, they referred to a need to recognize the different and unique features of Islamic finance, and the conference's final communiqué established a policy group charged with finding ways of adapting international regulatory standards to take account of these different and unique features.

What the international regulators did not fully appreciate—or would not accept—is that Islamic finance is about more than just finance. The move to establish IFIs, which in its most recent manifestation began in the 1960s and continues to gain pace, is part of a search for an Islamic identity. Western colonialism led to the physical occupation of Islamic lands by foreign armies and bureaucracies. Western legal canons were imposed, replacing traditional codes based on Islamic law. Cultural hegemony both preceded and succeeded physical occupation. The secular nationalism of leaders such as Gamal Abdel Nasser and of the Ba'th Party, which followed the withdrawal of colonial powers, ultimately disappointed. The search for an identity that can be both a route to success and a source of pride is now frequently centered on Islam. The development of Islamic finance is part of a movement that includes greater support for Islamically-orientated political parties and more widespread wearing of "Islamic" dress.

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Seen in this context, one can understand why Islamic financiers give such attention to the recovery of defunct Islamic financial vocabulary and forms—the medieval geographers being a particularly rich source. "See," the financiers are saying, "We had these instruments a thousand years ago, when Islamic trade spanned continents."[ii]

Arguments that Islamic finance can be accommodated within global regulatory and accounting principles are, this paper will argue, sound, but they miss the point. For a significant constituency of Islamic financiers, the "otherness" of Islamic finance is more important than any advantage to be gained though consistency with global architecture. As a result, progress will be made toward adapting global norms to the particular circumstances of Islamic banks, and, over time, we are likely to see increasing use of such adapted standards. This is the reverse of the global trend whereby national standards that differ from global ones are diminishingly important. For example, Portuguese banks continue to cite their capital ratios according to Bank of Portugal rules, but they know that analysts are only interested in ratios calculated according to international (Basle) norms. In contrast, we are likely to see an increasing tendency for Islamic banks to cite their AAOIFI ratios rather than, say, Basle ratios. How far this trend goes will depend in part on the response of national regulators in the Islamic regions (who are likely to be sympathetic) and on the acquiescence of international capital markets. And it will also be driven by the ebb and flow of Islamic sentiment.

The thesis of this paper is rooted in two interlocking questions: First, are IFIs and the instruments they employ so inherently different from *ribā*-based banks and instruments that they cannot be measured and monitored through the norms applied to *ribā*-based banks and instruments? If the answer to that question is "no," then it must be that resistance to such incorporation is based on something more than financial considerations. That then leads to the second question: if not financial, what is the basis of that resistance?

These two questions are addressed from two vantage points. The first is that of a bank analyst who analyzes financial institutions and instruments in a professional capacity. The second is solely that of an interested observer. The Islamic world has suffered much at the hands of Western analysts who sought to impose their own discourse on Islamic themes, and who believed that they were better able than Muslims themselves to articulate their aspirations and concerns.

II. Is Islamic Finance Different? The Regulatory and Accounting Perspective

A. Treatment of Deposits

The greatest potential difference between the accounting practices of Islamic finance and that of *ribā*-based institutions lies in the approach to on-balance-sheet and off-balance-sheet instruments. One of the principles underlying Islamic finance is that providers of funds should share in the risks and rewards of the ventures that they fund. Bank depositors are providers of funds, so the question arises as to whether they should be required to take a write-down in the value of their deposits if the value of the assets they have funded has been written down. This is a major difference from Western practice—depositors in a Western bank have a claim on the bank for the full value of their deposit plus any accrued interest. If the bank writes down the value of the assets, the bank's obligation to depositors is unchanged. Since Western regulators, and the accounting systems that they promote, have the safeguarding of individual deposits as one of their primary objectives, a profit-and-loss sharing (PLS) approach to deposits clearly presents huge problems for them.

And yet, within the Islamic context, the treatment of PLS deposits is far from straightforward. *Qar∞ ®asan* is a well-established Islamic financial instrument akin to a Western bank's demand deposit. The bank is obliged to return the deposit on demand and in full. (The bank is compensated for this obligation by the fact that *qar∞ ®asan* deposits are interest-free.) On the other hand, Islamic banks offer investment funds, which are kept off-balance-sheet, and where the return to investors is directly linked to the performance of the fund. The difficulty—in respect of integrating the Islamic and Western systems—lies in the ground between these two points. Some Islamic banks collect deposits that are not wholly *qar∞ ®asan*, but are on the balance sheet.

The way into analyzing the status of Islamic banks' deposits is to ask first, "What is the explicit presentation of these deposits in the published accounts?" Then we must ask, "Whatever the presentation may be, what would be the likely treatment of those deposits, in practice?"

A survey of published accounts indicates that most Islamic banks do not see their on-balance-sheet deposits as being profit-and-loss sharing.[iii]

- Of the balance sheets reviewed, only Kuwait Finance House made clear that a portion of some of its deposits bore the risk of investment loss.

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- Most banks refer in their annual reports to investment funds that they offer as part of their range of financial products. The fact that these funds are presented as a separate product—sometimes explicitly included in the accounts as an off-balance-sheet item—would imply that a distinction is being made between one type of account, which contains investment risk, and another that does not.
- Of the balance sheets reviewed, none raised any "fair value" accounting issues in respect of deposits. (If the deposits were to be written down to cover write-downs on the assets side, the fair value of deposits would be less than the book value.)

It is hard not to conclude that, except where specific exclusions are made (as in the case of Kuwait Finance House), the banks surveyed recognize that they have an obligation to repay to customers the book value of their deposits. Furthermore, these deposits have not, in practice, been treated as PLS. Islamic banks that have written down the value of assets have not in practice written down the value of deposits. The present author has on several occasions asked distinguished gatherings of Islamic bankers to name a single occasion on which depositors in an Islamic bank have been forced to accept a write-down in the value of their deposits—no one has ever been able to cite a case.[iv]

In practice, Islamic banks are drawing a distinction between deposits that are on-balance-sheet and that they, their customers, and their regulators assume will be paid in full; and investment funds that are off-balance-sheet and whose value fluctuates with the performance of the fund.[v] Yet Islamic banks face a dilemma: if the funds are to be repaid in full, then they must be *qar∞ ®asan*, repayable on demand, and unremunerated. This raises questions of liquidity (the maturity structure of liabilities will be overwhelmingly short-term) and competition (none but the pious will place money for free when *ribā*-based banks will pay a return). On the other hand, if the funds are profit-and-loss sharing, with a longer maturity and (hopefully) paying a return, should they really be on the balance sheet?

From a regulatory and accounting perspective, the dilemma hardly seems insurmountable. If PLS accounts were taken off the balance sheet, the main reservation that Western regulators have about Islamic banks would be eliminated. The question of maturity structure could then be addressed, in the short term, by giving Islamic banks extended access to a central bank discount window, and, over the longer term, through the development of medium-term liability instruments that suit the risk appetites of Islamic depositors.

Potentially, such a move could reduce significantly the size of the balance sheets of Islamic banks. Balance-sheet size is frequently (and misguidedly) a source of pride to managers and shareholders, and the prospect of having to move a large proportion of assets and liabilities off the balance sheet would be a disincentive to many.

B. Calculation of Capital Adequacy

From the regulatory perspective, the main purpose of bank capital is to insulate depositors against loss. The calculation of capital adequacy is a function of the availability of capital in relation to the size of potential losses.

Calculating available capital presents no problems. Islamic banks' capital funds comprise elements such as paid-up shares, reserves, and retained earnings, just as Western banks' funds do. The difficulties arise in judging the size of potential losses. The potential loss that capital will have to absorb is less when part of the balance sheet comprises PLS accounts, since such losses will be absorbed by the depositor. It is on this basis that Islamic financiers have frequently argued that they require less capital than *ribā*-based banks.

In March 1999, AAOIFI published a *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks*, which identified three types of risk arising from the management of PLS accounts:

1. Nominal commercial risk: the risk that the assets funded by the deposit will have to be written down, so causing the deposit to be written down.
2. Fiduciary or management delinquency risk: the risk that a bank could be sued or suffer reputational damage, whether or not it has acted improperly.
3. Displaced commercial risk: the risk that customers may refuse to accept the possibility of sharing losses, and so take their business elsewhere, thereby diluting the bank's franchise.

According to AAOIFI, the first risk is borne entirely by the depositor and presents no threat to capital. However, the other two risks are borne entirely by the capital. This situation leads AAOIFI to assign a risk weighting to assets funded by PLS deposits based on fiduciary and displaced commercial risk. Since that risk weighting is less that the risk weighting that would routinely be assigned to assets funded by PLS deposits, this

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accounting methodology has the effect of raising Islamic banks' capital ratios above the level that would be seen if Basle-based methodology were used.

The point at issue between the Islamic treatment and the Basle treatment comes back to the treatment of deposits already discussed. If the liabilities that are available to absorb losses are moved off the balance sheet, or at least clearly identified on it, the potential losses that capital may have to bear should be explicit. Any problems comparing capital ratios of Islamic and Western banks would then arise only over which risk-weightings to assign to respective on-balance-sheet asset classes. Western regulators have themselves had disputes on this issue (for example, on the weighting assigned to mortgages), but by and large have been able to resolve them.

It would therefore appear that if the issues surrounding the differential treatment of deposits can be resolved, there is no reason Islamic capital adequacy standards can not become directly comparable with those based on the international Basle methodology.[vi]

III. THE NATURE OF ISLAMIC FINANCIAL INSTRUMENTS

It is sometimes argued that IFIs cannot be integrated into the international regulatory and accounting architecture because the nature of Islamic financial instruments is unique and consequently incomparable with that of instruments used elsewhere. *Prime facie* this appears improbable. Every banking system has its particular features, some of which may even be unique. The *Core Principles for Effective Banking Supervision* were devised specifically with the aim of being appropriate for banking systems throughout the world, and there has been no significant backlash against them on the basis of non-comparability (though some may have other reasons for not wishing to adhere). It seems hard to argue that if financial institutions that have grown up in a Buddhist, Confucian, or any other cultural context find no problems with comparability, those from an Islamic context should.[vii] The same would apply when the analysis is based on geographical and historical antecedents rather than cultural ones. Furthermore, if the international regulatory and accounting architecture can accommodate the derivative instruments now being concocted by Western banks, they can surely accommodate the complexities of Islamic financial instruments

In practice, Islamic financial instruments do not seem to present particularly difficult accounting issues (other than those already mentioned). As an analyst of IFIs, the author has had to seek guidance on the timing of income recognition on *murāba®a*, but income recognition is an issue that arises with *ribā*-based financial instruments as well. Many Islamic banks used to declare the remuneration of depositors as a dividend below the net profit line (to make the point that they engaged in profit-and-loss sharing), but that practice has now stopped. Islamic financial instruments are less familiar to Western regulators and accounts, but that does not mean that they are *inherently* incomparable.

A. If There Were a Will, There Would Be a Way

An English expression says, "Where there's a will, there's a way." If Islamic financiers wanted to integrate their regulatory and accounting practices with the global architecture, they could find ways of doing so. The fact that they do not implies that they do not wish to. The final section of this paper explores why that might be so.

B. Islamic Banking as a Cultural Expression

It is not disputed that Islamic sentiment has increased in the Muslim world over the last thirty years, even after discounting any aspects of that sentiment that may more properly be considered articulations through Islam of issues that are essentially secular, traditional, or tribal. The reasons for that increase have been widely discussed and fall outside the scope of this paper.[viii]

The revival of Islamic banking has been part of this wider increase in Islamic sentiment. In some cases, the beginnings of the revival can be placed at the start of the "post-post-colonial" era, a time of disappointment and unfulfilled hopes (so, in Egypt, the years that followed the death of Nasser). In others, it has to be related more to economic factors, such as the 1973 oil price hike. In all cases, the growth of IFIs has additionally to be linked to the growth of capital markets as a whole, including, in their most basic form, greater demand for bank-deposit taking functions and the need to fund state-driven economic growth. This growth in capital markets has been powered largely by increased resources. In the Gulf, the creation of new banks, both Islamic and *ribā*-based, occurred in two main phases: after the 1973 price hike and after the increase in oil prices that followed the Iranian revolution in 1979.

It should also be recognized that in some cases the establishment of IFIs might itself promote an increase in Islamic sentiment. The creation of Islamic banks in Sudan, which were more willing than *ribā*-banks to lend money

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to small businesses, is believed to have been a factor enhancing support for the Muslim Brotherhood in the late 1970s.[ix]

C. Islamic Finance as a Religious and Cultural Business Model

Yet the observation that the creation of IFIs has tended to run parallel to an increase in Islamic sentiment does not in itself explain why Islamic financiers should resist integrating aspects such as regulation and accounting practices with the global architecture. But an explanation does start to appear when we consider how practitioners articulate the merits of Islamic finance as a business model.

Islamic financiers do not generally argue the merits of Islamic finance in terms of its economic or financial efficiency relative to *ribā*-based systems, even though in some areas they would have a convincing case when doing so. So for example, Islamic financiers do not argue that IFIs have inherently greater operating efficiency than Islamic banks (although their low cost of funds means that in some respects they do). Nor do they argue that Islamic banks have inherently stronger asset quality or solvency (although if loan losses can be set off against deposits, that would likely be the case). Nor do they argue that IFIs are inherently more profitable than *ribā*-based banks.

Rather, the merits of IFIs are articulated in terms of their proximity to wider Islamic issues of equity and inclusion. Examples include:

1. The provision of financial services to people who might otherwise be excluded from the financial system. A few years ago, a *ribā*-based bank in Kuwait concluded that the deposit balances and transaction volumes of some of its clients were so minor that the bank was unable to make a profit from their custom. Those clients were encouraged to take their accounts elsewhere, and many went to Kuwait Finance House, the only Islamic deposit-taking bank in Kuwait, which accepted them because it believed that as an Islamic bank it has a duty to provide them with banking services, whether or not they generate profits for the bank. On the credit side, the *muzāra*ᶜ*a* financing technique is often cited as a method of extending credit to small farmers in a way that would not be attractive to *ribā*-based banks. *Muzāra*ᶜ*a* might involve a bank's providing seed, fertilizer, and machinery to a farmer and linking the timing and size of the repayment to the success of the crop.[x]
2. The promotion of greater equity in global financial relationships and the avoidance of unmanageable debt burdens. It is argued that if international banks and lending agencies extended credit on a profit-and-loss sharing basis, they would take greater care in credit appraisal, avoiding, for example, loans to huge prestige projects that they suspected would never make an economic return. The third-world debt burden, it is argued, would not have been created, and could not continue to exist, under an Islamic financial system.
3. IFIs conduct financial transactions in line with Islamic religious principles. Many Islamic banks cite Qur'anic injunctions against interest in their annual reports. A prominent position is usually given to the photographs of the members of their *sharī*ᶜ*a* boards, who are responsible for ensuring that nothing the bank does contravenes the tenets of Islam. Practitioners of Islamic finance frequently cite precedents for current Islamic practice from the actions of the early Muslim community, which is believed to provide a model for Islamic conduct. It is clear that the religious aspect of IFIs is central to their identity in a way that, for example, Hinduism is not to Indian banks, nor Catholicism to Italian banks.[xi]

Some consideration must be given to occasions when *ribā*-based banking systems have been converted to an Islamic model by government fiat. Iran, Pakistan, and Sudan provide examples. In these cases, the conversion was driven either by the interaction of political and religious factors (i.e., the need for politicians to secure the support of the religious authorities) or, with Iran, by a belief that only an Islamic system of finance could fulfill the government's social agenda. The Iranian government did not introduce legislation converting existing banks to an Islamic system because it believed that Islamic banks would be more efficient, profitable, or strong. It believed that Islamic banks would promote greater economic equity, as well as discharge the obligation of the Muslim community to conduct itself in a manner consistent with the *sharī*ᶜ*a* and the best practices of its forebears.

IV. CONCLUSION

The distinguishing feature of Islamic finance lies in its expression of Islamic values, and that expression has been given greater value by the *aporia* that has pervaded much of the Muslim world in recent times. (The fact that many of those Islamic values are shared by other systems of belief is irrelevant.) In this context, it is hardly surprising that the cries of international regulators that Islamic finance *can* be integrated into the global regulatory and accounting architecture, and that advantages would accrue to all if they *were,* find scant resonance in the

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Muslim community. Islamic financiers are engaged in what they see as a far grander enterprise: playing their part in a holistic reconstruction of Islamic institutions and social structures.

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[i] *Ribā* is the Arabic word for "interest" or "usury." (Its precise meaning is itself a subject of dispute among scholars.) In this paper, the terms "*ribā*-based economy" and "*ribā* bank" are used in contradistinction to an economy or bank that eschews the payment or receipt of interest, in accordance with the tenets of the *sharīʿa* (Islamic law). The term "Western banks" is also used in the paper in contradistinction to those that are based in an Islamic or developing market environment.

[ii] In case any Western financiers should think of deriding such reference to historical precedent, a recent edition of Risk, a financial industry journal whose articles are sometimes so abstruse that they appear to contain more Greek than English letters, included an article by two investment bankers about an eleventh-century finance deal led by a Genovese alum merchant that, the authors said, illustrated many contemporary issues surrounding the boundaries between hedging and insurance.

[iii] The 1999 balance sheets of the following banks were reviewed: Al Rajhi Banking and Investment Corporation, Bahrain Islamic Bank, Dubai Islamic Bank, Kuwait Finance House, Muslim Commercial Bank, Qatar International Islamic Bank, Qatar Islamic Bank, and United Bank Ltd. The GCC banks were selected because they are retail deposit takers, with reasonably sophisticated businesses including exposure to Western financial markets. The Pakistani banks were included because in addition to these factors, they operate in a financial system that is explicitly managed according to the tenets of Islamic finance.

[iv] When Kuwait Finance House, like other Kuwaiti banks, declared a net loss in the early 1990s, it did not write-down the value of deposits. When Qatar Islamic Bank had to write down loans that it had made to the Bank of Credit and Commerce International, it did not write-down the value of deposits. Nor did Dubai Islamic Bank, when in 1998 its asset write-downs were so severe that the bank needed to be recapitalized (or to put it another way, the shareholders had to accept the loss in order to protect the depositors). Nor does the collapse of so-called Islamic investment companies in Egypt in the late 1980s provide an example. *De facto*, the companies were investment funds, not banks. *De jure*, they were not regulated as banks, or apparently as anything else.

[v] Among the banks surveyed, a qualification must be made for Kuwait Finance House, which, as already mentioned, has some on-balance-sheet funds that bear investment risk.

[vi] An assumption is being made that the concept of fiduciary responsibility is clearly defined and accepted within Islamic law. That is, a difference is recognized between losing money due to poor investment decisions and due to fraudulent investment management. If that difference is not defined and accepted, then an Islamic bank acting as a *mu∞ārib* (fund manager) could be liable to compensate investors for routine losses.

[vii] To avoid any confusion, it should be emphasized that the fact that a banking system *does* not adhere to international regulatory architecture is not same as saying that it *can not*.

[viii] See for example, Piscatori, James. Islam in a World of Nation States. New York: Cambridge University Press, 1986. Chapter 2, "The Nature of the Islamic Revival."

[ix] Woodward, Peter. "Sudan, Islamic Radicals in Power" in Esposito, John (ed.). Political Islam. Boulder: Lynne Rienner, 1997.

[x] One should recognize that many "microfinance" initiatives in developing countries would also offer this type of facility, but without any explicit Islamic overtone.

[xi] Some European banks have their origins in religious sentiment: for example, Italy's Monte dei Paschi de Sienna and Portugal's Caixa Economic Montepio Geral. The name of both banks refers to the Catholic religious concept of a "Holy Mountain." Yet, this religious dimension is expressed through a mutualist business model rather than a religious identity.

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