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The Comparative Advantages of Islamic Banking and Finance

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ABSTRACT

Three reasons help explain the continued progress in Islamic banking and finance: deficiencies in the current system that make people search for alternatives, the association of the Islamic financial movement with the recent resurgence in Islamic societies, and the strong moral orientation of Islamic finance. Largely curbing the exchange of current money for future money, Islamic finance promises to reduce speculation and the boundless expansion of credit. It forges closer links between the real and financial sectors of the economy. The current practice of Islamic finance can be improved with some restructuring of Islamic financial markets, financial intermediation based on profit-sharing, and specialization of letting firms in *murabaha* and other trade-based modes of finance. Islamic finance is more suited to a globalizing world than is the conventional finance system, which has failed to elicit the trust of poor countries.

I. INTRODUCTION

The practice of Islamic banking and finance began in earnest more than a quarter of a century ago. The Dubai Islamic Bank, a private company, and the Islamic Development Bank, a symbol of the Muslim peoples' endorsement of the idea launched by the Organization of the Islamic Conference (OIC), were both established in 1975. The idea of Islamic banking is maturing, as numbers are growing and the market share is increasing. It is therefore of profound importance to understand the reasons that Islamic banking has been sustained in an environment overwhelmingly dominated by conventional finance.

Not all Muslims are fully satisfied by the character and performance of existing Islamic financial institutions. Barring the small minority who sees no need for them, most express dissatisfaction either on the ground that they are not Islamic enough or that they are inefficient in comparison to their conventional counterparts. Most do agree, however, that these deficiencies can be remedied over time and there is nothing to justify aborting the experiment. There must be valid reasons for this resilience.

There has been a widespread fear that the dominant interests in the fields of money, banking, and finance will soon gang up to kill the initiative. They would do so, it has been alleged, so that the lucrative markets peopled by Muslims do not slip out of their hands. Nothing of that sort has happened yet, nor does it appear to be on the cards. On the contrary, a great deal of interest in continuation of the Islamic financial movement has appeared among conventional money managers.

Lastly, most of the western professional economists who have found time to pay serious attention to the phenomenon of Islamic banking and finance have been very positive about it. In an intellectual environment in which ideas originating from the Muslim world are often regarded with suspicion, the approval of such intellectuals is particularly meaningful.

An adequate explanation of these observations requires analysis of empirical data and field surveys, many of which have not been conducted until now. Such research can help indicate the future agenda for the nascent scientific discipline of Islamic economics.

II. BACKGROUND

There are three contemporary phenomena that are of relevance. The first is the widespread dissatisfaction with the performance and consequences of the post-World War II global monetary and financial sectors, particularly since the 1970s. The second is that the Islamic financial movement has appeared on the scene as an offshoot of a much broader Islamic resurgence. And the third factor that could partly

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explain the above-mentioned resilience and hope invoked by the Islamic approach to money, banking and finance is the strong moral overtones that have accompanied Islamic finance since its inception.

A widely shared perception holds that there is greater inequality in the distribution of income and wealth today within as well as between nations than has ever existed. Indeed, inequality has been growing with little on the horizon to indicate a reversal in this trend. It is rightfully regarded as a potential threat to peace and a phenomenon unbecoming of human fraternity.

The responsibility for this fact lies at least in part in the monetary and financial system that has evolved over the past half century. While a detailed analysis of that system is not possible in the context of this paper, some reference to its main factors is in order.

At the top of the list is the opportunity the current system provides for money to be exchanged for more money, increasing the income gap. Next in importance is the immense scope for gambling-like speculation that huge volumes of debt-based securities provide in a system that permits sales on margin, short selling and other exotic money games. Last but certainly not least is the philosophy that regards profit maximization as the only legitimate concern of investment managers to the neglect of all other ingredients of human wealth. These perennial features of capitalism, in conjunction with the newfound energy that has accompanied globalization and deregulation, yield consequences that hardly come as a surprise.

As it stands, the performance of the current system is generally regarded to be sub-optimal. The monetary and fiscal policies recommended to improve the system's efficiency are often complicated and unconvincing. Furthermore, some of them may be politically impossible to implement. In this situation, any simple and straightforward approach such as that of Islamic economics is bound to attract attention.

The manifold increase in GNPs and the general uplift in standards of living in most, if not all, parts of the world has been tempered by the colossal rise in anxiety levels caused by the increased instability of the system, accompanied by volatile exchange rates, collapsing currency values, and frequent job losses. These undesirable consequences and mixed performance underscore the need for alternative systems.

Islamic resurgence in the twentieth and twenty-first centuries has gone far from unnoticed. Whether one fears a potential clash of civilizations or hopes that interfaith dialogue will help usher in a happy age of coexistence in the global village, Islam has remained a major player in the world scene. The Islamic financial movement in particular happens to be one of the unique features of twentieth- and twenty-first century Islam. The fact that its rise has coincided with the Muslim countries' departure from colonial rule speaks volumes about its place in the Muslim psyche. It is as much an expression of their distinct identity as any other symbol of independence. There is a distinction, however, that no other symbol shares: it is meant for all. As Islam is incorporated in contemporary Muslim societies by accommodating what is new but useful and shedding what has accompanied it for long but is not essential, the significance of an Islamic approach to such a mundane affair as finance dawns on all concerned. After all, it was a moral approach to mundane affairs that was the essence of the Prophet's mission. Anyone who takes Islam seriously can hardly ignore the moral approach to money, banking and finance represented by this new phenomenon. That makes every Muslim a stakeholder in this venture. The same feature makes outsiders give a greater weight to the enterprise than would be otherwise called for by its current size or volume.

A return to ethics and morality is on the cards. Disillusionment with an amoral approach to economics and exasperation at the excesses of secular-materialistic-hegemonic policies of politicians has created a new environment. The "end of history" triumphalist phase is over. People, including the intellectuals, are willing to listen. Is a moral approach to economic activity possible? Is it possible to define distributive justice in terms that take into account not only the immediate and the actual, which is often affected by things transient and insignificant, but also in terms of things essential and durable which relate to the core of the human situation? Is it desirable to manage money, banking and finance in total indifference to such problems as poverty, unemployment and increasing levels of anxiety? The fact that the Islamic financial movement claims to be based on divine guidance and prophetic insights rather than a fine stroke of human ingenuity makes it disarmingly simple. Alone in an age marked by its skepticism and uncertainty, the Islamic financial movement commits itself to a sacred text. To do so in matters economic leaves many gasping for breath. But the fact that the text is supra-human, and not the handiwork of victors in a war or champions of a particular class, introduces an attraction no other school of thought can muster. For whatever the difficulties faced in drawing guidance from a text revealed in the seventh century for life in the twenty-first century, it could not possibly be seen as promoting the interest of one group of people at the expense of the interest of others. The universal nature of the teachings of Islam relevant to finance, be they prohibition of *riba* (interest) and *maysir* (gambling) or the obligatory share of the poor in the wealth of the rich *(zakat*), can hardly be doubted.

But did the movement really demonstrate in practice its ability to fulfill the promise of a moral handling of money, banking and finance that it bears by virtue of its being rooted in religion? That, of course, is a different question, one that needs some research before it can be answered. The most salient point to be made at this stage is that the very promise raises hope no other approach has been able to raise.

III. Islamic Finance in Practice

Raising hope in a desperate situation can take one along part, but not all of the way. What could sustain Islamic banking and finance till now can hardly be expected to guarantee its continued progress in the future. It is one thing to capture a large chunk of the market in one's home base (i.e., the Persian Gulf region), but it is quite a different task to attract customers in the global market place.

Pursuing a comparative advantage seems to be one possible solution. Comparative advantages of Islamic finance include the following:

- Islamic finance forges a closer link between real economic activity that creates value and financial activity that facilitates it.
- Islamic finance does not allow creating new risks by which to profit.
- Islamic finance is global and cosmopolitan. Having committed itself to a text accessible to all and Prophetic precedents available easily, Islamic finance is open to any innovations that are in congruence with its fundamentals. It is not a closed system and it possesses no regional, ethnic, or class affiliations.

It may be argued that some of these advantages need state sponsorship to be pursued effectively. While that may be the case, before the issue of state sponsorship is addressed, it must be noted that the real source of strength for Islamic finance has always been private initiative. Once a framework for proper exercise of property rights and management of economic enterprise was in place, individuals were left free to organize business the way they liked. When one felt the need for clarification of a given text, or found oneself in a situation in which no available text offered guidance, the Prophet was approached for a ruling. After the death of the Prophet, people turned to those who had been close to him. And as time passed, scholars collected these rulings and developed a whole body of jurisprudence on their basis. Rules relating to finance are also a part of the corpus so developed. But the remarkable thing is that there is nothing "official" about this corpus. It was and remains to date the work of certain individuals endorsed by other individuals, however large their numbers. Those actually involved in financial dealings followed the ruling of their choice as dictated by their conscience and their circumstances. As long as they operated within the framework defined by the texts they enjoyed a great amount of flexibility in their operations. The state did not legislate Islamic commercial law; hence the state could not enforce any particular rulings. The state came into picture when a dispute between trading parties brought them to a court of law, and the court took into consideration the particular rulings shared by the parties which were, therefore, supposed to be the basis of their interaction.

IV. The Islamic State and Financial Markets

This does not mean to suggest that the early Islamic state left the financial markets alone, unsupervised and unregulated. On the contrary, like the market as a whole, whose supervision and regulation dates back to the Prophet's time, financial markets also were monitored and regulated to ensure that they operated within the framework of the divine guidance mentioned above. The rich literature on *hisba* (market regulation) bears witness to that. Just as the Islamic state never took over the markets in general, it never took over the financial markets. Though the society's money, the payment mechanism, soon came to be managed by the state in the same manner that it ensured proper weights and measures, financial practices relating to investment, intermediation, exchange of currencies, transfer of funds, securitization, and others, were all developed in the open market by those engaged in the art.

These facts demonstrate the vast scope that Islamic finance, by its very nature, provides for individual initiatives, innovations and experimentation. It is not viewed as a given list of prohibitions and permissions handed down to all concerned. It rather is a great quest for justice, balance and felicity in economic and financial life in which God provides broad, eternal and universal guidance. His Prophet then proceeded to further apply that guidance to the concrete situation of seventh-century Arabia. It is always a challenge for the faithful to act in accordance with divine guidance. Those who came after the first generation of Muslims enriched Islamic heritage by deriving more elaborate rules from the divine texts and the Prophetic traditions applicable to a variety of lands and peoples. Of course, they lacked the Prophetic immunity from error. Today in circumstances entirely different, but armed with centuries of history, a similar challenge arises. The challenge lies not in conforming to a given set of rules but in realizing the objectives of the *shari*ᶜ*a*, for which the current generation of Muslims have to do for themselves what the earlier generation had done in their particular time and place.

It is in the nature of the arts that the artist alone knows the details of the job. The art of business enterprise or financial management is no exception. The scholar, however, can help. But he should not aspire to take over the art doing itself. That may kill the art or stifle it. He should rather be at hand to advise and look for any possible guidance the past may have to offer.

Happily, the story of modern Islamic finance in the private sector is not very different. The best of all worlds will be for the practitioners of Islamic banking and finance to internalize the Islamic values and proceed to do their job. They should turn to *shari^c^a* scholars for advice when needed. But it is too much to ask them for blueprints for doing things with which they are not the least familiar. It is not, however, only the scholar's job, but also the job of the business and financial community among Muslims to forge ahead with the distinct Islamic vision of finance in practice and bear witness to it through their activity in the open market.

V. NEED FOR RESTRUCTURING ISLAMIC FINANCIAL MARKETS

An example utilizing *murabaha* (cost plus) financing and *mudaraba* (financing by sharing the outcome) might further clarify this. *Murabaha* is considered to be superior to debt financing in a number of respects. Its inclusion in the toolbox of Islamic financial instruments makes that box particularly capable of handling all financial situations for it serves to keep the financial market in sync with the market for real goods and services, thus making it less vulnerable to gambling-like speculation. Demonstrating these and other possible virtues require *murabaha* to be practiced in earnest as a means of financing the acquisition of means of production and needed goods by people who are expected to be able to pay for them after some time. It would be a caricature of Islamic finance if, instead, *murabaha* was used as a trick to do what conventional finance is doing, i.e., lending on the basis of interest. It is only the practitioner who can ensure that *murabaha* does not degenerate to that level.

Since financial intermediation does not involve selling goods and services directly, it would be more appropriate to get financial intermediaries involved in *murabaha* business indirectly, as will be explained later. The same applies to other forms of business like *salam* (payment now for delivery of agricultural goods in future), *istisna^c^* (prepaid orders for manufactures), leasing, and others. A financial institution is not fully equipped to handle these businesses directly. It is often reluctant to fully expose its capital to the risks involved in direct businesses. As a result it tries to make the transactions as risk-free as possible. It does not care if this means, on the average and in the long run, settling down for a lower rate of return.

Now imagine a whole range of businesses doing *murabaha*, *salam*, *istisna^c^* and leasing. These businesses would know the risks they would be taking. They would also be able to diversify their activities as a means of reducing risk. Perhaps they are already specializing in handling different market segments in terms of the commodities involved. These businesses would need financing. This financing could come from Islamic financial institutions. This would create a buffer between the changing circumstances of real businesses and those handling only finance. It will thus relieve the Islamic financial institutions from the need to reduce risk by making their contracts look like payment of less money now in exchange for more money to be received in the future. The fact that their stake will not be in individual deals based on one of the contracts mentioned above but in a large basket of deals will make a crucial difference. In its own interest, the business being financed will have reduced the risk of loss by diversification and other methods. The financial institution will have the added opportunity of diversification by offering its funds to a variety of businesses.

Mudaraba, or profit sharing, seems to be the soundest basis of the Islamic financial institutions' financing of *murabaha* companies and leasing companies. Islamic banks accepting people's savings in their investment accounts on the basis of *mudaraba* would be giving that money out on the basis of *mudaraba*. This conforms to the earliest form of financial intermediation discussed in Islamic jurisprudence, *al-mudarib yudarib* (one person's taking another's money on the basis of *mudaraba* and giving that money to yet another person on the basis of *mudaraba*). The risks involved will be financial risks which financial intermediaries have learned, and continue learning, how to handle. Business risks will become the concerns of business houses closer to those who buy and sell; even produce and import/export; build and lease; as well as those who hire and sublet. There will be no need to twist and turn a trade deal to make it serve the purposes of a financial intermediary.

One might need to encourage the establishment of a whole range of companies: *murabaha* companies, *salam/istisna^c^* companies, and leasing companies, so that finance is channeled from Islamic banks to those actually engaged in the production of wealth. Whether it is the construction sector, agriculture, manufacturing industries, the transport and communication sectors, foreign trade, domestic commerce, or the government's infrastructure building activities, ways can be found to meet their financial needs through these companies without recourse to interest-based lending and borrowing.

This vision, which involves separating purely financial transactions from business transactions, has two advantages over what is currently observed in the Islamic financial markets. First, it would comprise a mixture of sharing-based modes with trade-based modes of financing, unlike the current situation that is dominated by trade-based modes. This would result in the creation of fixed payment obligations or debts. Secondly, it would enable Islamic financial institutions to do needed long-term financing, a field from which they are presently shying away. With the exception of *istisna*[c], which can be a basis of long-term financing, all other trade-based modes of financing, e.g., *murabaha*, leasing and *salam*, are suitable only for short-term financing. Given this change they could rightfully demonstrate how their activities avoid contributing to the instability of the system, something often accused of interest-based institutions. By doing this, the system will enjoy the unique feature of sharing-based intermediation: synchronization between revenues and payment obligations, and still retain the flexibility which the presence of very low risk modes of financing impart to a system. A strong presence of sharing-based modes of financing will give credibility to the claim that the Islamic financial system is juster than the conventional system.

The comparative advantage of Islamic banking and finance lies in three main areas: it keeps the financial sector in sync with the real sector, it is less vulnerable to gambling like speculation, and it is cosmopolitan and universal. The first two features contribute toward greater stability, among other things. The third makes Islamic banking and finance far more suited to the global village than is the current system, which has been suspected of being partial to the developed countries of the West. The claim to impartiality and cosmopolitanism will be credible insofar as the system is perceived to be rooted in divine guidance. A restructuring of the Islamic financial markets along the lines suggested above will go a long way in enabling that market to demonstrate these distinctive features and thereby attract more adherents.

Much of this restructuring can be accomplished in the private corporate sector. Although some of it is already under way in the form of new subsidiaries and syndicates, it can take the Islamic financial movement a long way if the state in Muslim countries shows awareness of the Islamic approach to economic life in general and to money, banking and finance in particular. The moral approach to worldly wealth, to what Alfred Marshall called the ordinary business of life, is not unique to Islam. All religions share it. Even in the so-called materialist western society, the common man cannot possibly be amoral or immoral. The problem lies with a view of economics as a scientific discipline that refuses to admit ethics and morality. The major failure of capitalism noted above—namely, that it promotes inequality between nations and within nations—cannot be remedied merely by the introduction of Islamic finance. Rather, it requires behavioral changes on the part of all economic agents—the individual consumer and producer, as well as the state.

The suitability of the Islamic finance for the global village and its superiority over conventional finance does not lie in the opportunities it might offer for the wealthy to make more money through investment. Rather it lies in its promise to ensure that good returns to investments shall be accompanied by promotion of the good of the society as a whole. A combination of efficiency with morally superior end results requires that institutional changes be accompanied by moral regeneration.

VI. Conclusion

The role of the state in pursuing the comparative advantages of Islamic finance does not lie only in removing legal hurdles in the way of Islamic financial practices and enacting laws enabling the adoption of such practices. It does not end with the establishment of proper regulatory mechanisms and reform of the central bank. Rather, the Islamic state should aspire to project the moral approach to economics and finance both in world forums as well as in its domestic policies. This is not a call for implementation of a given set of do's and don'ts. Such a set defined in today's terms does not exist and no individual or state has the wherewithal of defining such a set in isolation from the rest of humanity. The formulation of a just and equitable set of economic and financial arrangements for the global village of the twenty-first century should be a joint human enterprise in which Muslims—individuals as well as states—should vigorously participate. Although the twin projects of Islamic economics and Islamic finance have set an important precedent, it is necessary that more resources are directed to these projects so that they can attract more people.

Although some faculty members of Western universities have given a positive response to the projects, their success in Western academia has been very limited. Scholarships, research grants, and endowed chairs for Islamic economics and Islamic finance in leading universities are needed to change this, and Islamic financial institutions must take a lead in this respect.

In line with the three bases of the comparative advantage of Islamic finance—namely, through its relation to real-financial linkage, its reduction of speculation, and its focus on the interests of mankind in general, researchers should give priority to the relevant contemporary practices and formulate alternative methods to confer such advantages. Also, practitioners should eschew methods fostering money games with no links to goods and services, speculation based on risks engineered by the speculator, and those serving one section of people at the cost of others. It is in the nature of financial systems that no community can have one in isolation with the rest of the world. It is necessary therefore to bring others on board—through action, persuasion, and thought—in order to establish and maintain a just and equitable financial system for the Muslim peoples of the world.