Islamic Finance: its Ethical Inspiration and its Economic Dimensions

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Excellences, Distinguished Guests, Ladies and Gentlemen:

It is a distinct pleasure for me to be in Torino and an honour to be invited by IPALMO and the Chamber of Commerce of Torino, to discuss Islamic Finance (IF) in its ethical and economic dimensions. Our topic encompasses the main principles of Islamic finance but also touches on the related principles of corporate governance, social responsibility and ethics.

The Great Financial Crisis of 2008-2009, soon to be followed by the Great Sovereign Debt Crisis of 2011-2012, has heightened interest in Islamic Finance and its principles. At a time when the Western banking and financial system appears under siege and disconnected from real activity, we can and should learn lessons from Islamic finance. I will also discuss the opportunities and role for Islamic finance in the context of the Arab Spring and the potential areas of cooperation with Italy.

Introduction

The statement that the Islamic Finance Industry is a fast growing, but still a nascent industry has become a cliché: the industry has grown by 15-20% annually in the past decade but its assets of about $1.3 trillion only represent some 1% of global financial assets. The Sukuk market remains small. Malaysia, the largest market, is US$17.2 bn while the DIFC is second with US$15 bn.However, IF is benefiting from a number of favourable structural and cyclical drivers: strong growth in the Emerging Market Economies (EMEs) of Asia and the GCC, positive demographics of young and rapidly growing populations, and a shift of preferences of savers/investors towards Islamic finance in Muslim countries reflecting, in part, a self-reaffirmation or awakening of cultural and religious identity.

A report from the Pew Forum on Religion and Public Life last year estimated that 1.57 billion[2] Muslims populate the world, some 23% of the total and expected to increase to 2.2 billion by 2030 or 26.4% of global population. Census data from 232 countries and territories showed that 20% of Muslims lived in the Middle East and North Africa but the

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[2] By 2030, the global Muslim population is expected to increase by 35%, rising to 2.2 billion, or 26.4% of the world's total projected population of 8.3 billion. Also by 2030, 79 countries are expected to have a million or more Muslim inhabitants, as opposed to the current number of 72. A majority of the world's Muslims (over 60%) will continue to live in the Asia-Pacific region, while about 20% will live in the MENA region. Muslims will remain relatively small minorities in Europe and the Americas, but will constitute a growing share of the total population in these regions.

majority, 60%, is in Asia. The key features of the Muslim populations are that they are young and fast growing. Given that Asia and MENA have low banking and financial penetration rates, highlights the potential for growing IF into those regional markets.

In non-Muslim communities and countries, the ongoing Global Financial Crisis and Great Recession has attracted investors and issuers (including sovereigns) to the perennial principles of ethics, solidarity, risk sharing, financing of real activity and real assets which lie at the core of Sharia compliant finance. Increasingly the call for financial sector reform is for banking & finance to return to basics and be directly linked to the real economy. As an op-ed in the Vatican's official newspaper Osservatore Romano put it: "*The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service*.[3]"

What are the main drivers of the diffusion of IF? Apart from the shift in financial preferences of Muslim populations, these include growing incomes per capita, the share of Muslims in the population, status as an oil producer, economic integration with Middle Eastern countries and proximity to Islamic financial centers[4]. While higher interest rates have a negative impact on Islamic banking, reflecting the implicit benchmark and opportunity cost for Islamic banks, the quality of institutions is found not to matter, probably because the often higher hurdle set by Sharia law trumps the quality of local institutions in most countries. Interestingly, Islamic banking appears to be complementary to rather than a substitute for conventional banking, suggesting that IF widens the choice set of consumers and investors, leading to higher potential welfare.

Core Principles of Islamic Finance

Islamic finance is based on Shari'a principles which express an intention to meet the financial needs of participants with integrity and in a manner that is just, fair, trustworthy and honest, while ensuring a more equitable wealth distribution.

In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called "*riba*" in Islamic discourse. Instead, profit-and-loss sharing arrangements (PLS) or purchase and resale of goods and services form the basis of contracts. Islamic law generally prohibits trading in financial risk, such as financial derivatives (which is seen as a form of gambling). In addition, Islamic law prohibits investing in businesses and activities that are considered *haram* or sinful including gambling, drugs, prostitution, arms, alcohol or pork, or businesses that produce media that are not consistent with Shari'a principles.

These Islamic principles uphold the principles of integrity, transparency, fairness and good corporate governance. Islamic finance, through its set of principles for good governance

[3] http://www.vatican.va/news_services/or/or_quo/text.html, 3 March, 2009.
[4] See the recent Working Paper by study by Patrick Imam and Kangni Kpodar, "Islamic Banking: How Has it Diffused?" WP/10/195, August 2010.

and responsibility, can help curtail excessive risk taking[5] and promote higher level of honesty, fairness and integrity.

Sharia Governance

Islamic finance embeds the basic tenets of good corporate governance, stressing the three main areas of accountability, transparency and trustworthiness; hence the principles of good corporate governance are integral to Islamic finance.

Islamic banking however, offers a different paradigm from conventional banking. Instead of being a 'depositor', you are an 'investment account holder' in an IFI. Takaful, the Islamic insurance industry is based on the principle of collective, cooperative sharing of risk. From the viewpoint of corporate governance, IFIs embody a number of interesting features since equity participation, risk and profit-and-loss sharing arrangements form the basis of Islamic financing. An IFI is subject to an additional layer of governance that of ensuring Shari'a compliance, since the suitability of its investments and financing, both assets and liabilities, must be in strict conformity with Shari'a and the expectations of the Muslim community. Thus a typical bank will have a conventional board and a Shari'a board.

Inequality, Ethics and Finance

In an age of increasing inequality within countries and between countries, of growing uncertainty as to the future, where greed & cupidity and accumulation of personal wealth are promoted to our young people as being the major motivation of their lives, the strength of IF is that it re-introduces moral values and ethics as an integral part of finance.

Currently, of total world income, 42% goes to those who make up the richest 10% of the world's population, while just 1% goes to those who make up the poorest 10%! In 2010, Standard & Poor's 500 Index company CEOs received, on average, $11.4 million in total compensation— a 23 percent increase in one year. Based on 299 companies' most recent pay data for 2010, their combined total CEO pay of $3.4 billion could support 102,325 median workers' jobs. In 1980, BusinessWeek magazine estimated that the top executives of the largest U.S. companies made 42 times the pay of factory workers. In 2010, the gap between CEO pay at S&P 500 companies and the median U.S. worker had soared to 343 times[6]. It is difficult –if not impossible- to justify on economic grounds the vast differences between executive compensation of top management and the average compensation of employees.

Last year's World Economic Forum survey on Ethics produced some striking results: Over two-thirds of the 130,000 respondents believe the current economic crisis is also a crisis of ethics and values. Some two-thirds of respondents believe that people do not apply the same values in their professional lives as they do in their private lives. In the same vein, only

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[5] The Great Financial Crisis and excessive have taken their toll: according to www.failedbankreporter.com there were 25 US bank failures in 2008, 140 in 2009, 157 in 2010 and 97 so far this year.

[6] AFL-CIO Executive PayWatch website.

a quarter of people believe that large multi-national companies currently have a "values-driven" approach to their sectors. The proportion rose to 40% for small and medium-sized businesses. Honesty, integrity and transparency were the values that were considered most important to both private and professional life according to 51% of all respondents.

Islamic Finance is based on a system of ethics and values derived from the principles of the Quran and the Hadith. Therefore, Islamic businesses must operate on a basis of fairness and integrity, while also treating everyone equally. The need for honesty, transparency, truthfulness, and fair dealing is also inherent in Islamic business requirements which have wide-ranging implications across the full spectrum of business activities, from advertising to after-sales customer service.

IF intersects with Responsible Investment and ESG

According to the 2011 Annual Report of the UN Principles of Responsible Investing, companies accounting for about 20% of the world's capital (over USD 30 trillion of assets) have been signed up to the Principles[7]. This rapid growth shows no sign of abating as responsible investment continues to increase in importance in mainstream and emerging markets. Given that the core principles of responsible investing are strongly related to Shari'a principles, there is large potential for expansion of IF and convergence with responsible investment, acting as a bridge between conventional and Islamic finance.

IF: Performance Post-Great Financial Crisis

The Islamic Financial Industry (IFI) is busy re-discovering itself, adapting services and products to the banking & financial needs of modern 21st century economies, societies and governments. Islamic finance is challenged to participate in defining and contributing to a new international financial architecture and its foundations. Islamic finance has to be part of the mainstream and not simply an interesting niche market. Implementation of Shari'a principles can help restore trust and confidence in the banking & financial sector: the critical ingredient that cannot be restored through central bank monetary injections, quantitative easing or government bailouts!

Islamic finance, one of the world's fastest growing asset classes before the Great Financial Crisis hit in August 2007 continues to expand, albeit at a slower pace. Islamic banks and institutions had grown without taking on to their books toxic assets, such as mortgage-related debt or complicated derivative products. Unlike many Western banks, they are not highly leveraged, making Islamic compliant products relatively safe investments. However, there have been some casualties: the Global Financial Crisis had real effects, resulting in the Great Recession and contagion effects in the MENA region and emerging market economies. Some Islamic banks faced large losses because of their exposure to ailing property markets. However, Islamic banks have out-performed conventional banks during the 2008-2010[8].

[7] http://www.unpri.org/publications/annual_report2011.pdf

[8] To compare the effects of the crisis on Islamic and Conventional Banks, a comparative study done by Maher Hasan and Jemma Dridi (IMF working Paper, Sep 2010) looks at the impact of the crisis on profitability, credit and asset growth and external ratings in a group of countries where the two types of banks have significant market share. Islamic Banks (IBs) were affected differently than conventional banks (CBs). Factors related to

Some institutions faced crises due to mismatches between short-term debt and long-term investments, sector concentration, poor risk management, and a reliance on bulky but volatile mark-to-market investment revenue, rather than diversified, fee-based income streams[9]. As a result major IFIs are setting up separate investment banking subsidiaries[10]. This suggests that we should move back to a separation between commercial & investment banking, a new Glass-Steagall Act.

Standardisation in Islamic Finance

Though centuries old, IF remains in its infancy as an industry. Its growth is being stunted by problems relating to the standardisation of products and the absence of instruments for liquidity management. Regulators and bankers are attempting to address these issues. In the Middle East, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are promoting increased standardisation and harmonisation of sharia products to improve the industry's credibility and make it more appealing for investors. The International Islamic Financial Market (IIFM) has also developed a standard ISDA/IIFM Tahawwut Master Agreement.

The Hawkamah Institute for Corporate Governance set-up a task force[11] to develop standardized documentation for Sukuk, starting with the most widely used; the Ijarah Sukuk. The aim is to facilitate the listing process for Sukuk, lower the set-up and transactions costs, and encourage more issuers to list Islamic securities. We are building on the landmark Hilal Sukuk issued by the IFC on the DIFC, which today is the second biggest market for Sukuk. In parallel, Hawkamah is also working on establishing a Sharia Board at the DIFC which can be used as a reference point by the issuers who wish to issue Sukuk out of the DIFC. The idea is to ultimately develop an Islamic Securities Market at the DIFC by increasing liquidity in the Islamic capital markets and through encouraging standardization in the Islamic finance industry.

Building Blocks of an International IF Market

The time has come to push Islamic finance into the mainstream. The market needs to open up for governments and the corporate sector. The opportunity for Italy is substantial in this regard – its big corporates, like Fiat or ENI can consider issuing a Sukuk on the DIFC. If Italy

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IBs' business model helped limit the adverse impact on profitability in 2008, though weaknesses in risk management practices in some IBs led to a larger decline in profitability in 2009 compared to CBs. IBs' credit and asset growth performed better than did that of CBs in 2008–09, contributing to financial and economic stability. External rating agencies' re-assessment of IBs' risk was generally more favourable. A caveat needs to be underscored at this juncture: this is the first "banking crisis" encountered by the IFIs whilst conventional banks have been through many; given this distinction, the performance of IFIs is quite impressive!

[9] Moody's Islamic finance report (2010).

[10] Qatar Islamic Bank and Boubyan Bank in Kuwait have recently followed Saudi banks in setting up separate investment banking subsidiaries. Al Rajhi Capital, for example, is the investment banking subsidiary of Al Rajhi Bank, one of the world's largest Islamic retail banks, and offers brokerage, asset management, advisory, research, capital markets and underwriting services.

[11] Visit the www.hawkamah.org website for information on the IF Task Force and a Policy Brief on IF Corporate Governance.

develops the enabling legal, tax & regulatory framework, it can extend its IF services not only to the Muslim migrant populations in Italy & Europe, but also to newly emergent countries of North Africa where IF has been repressed. Under appropriate conditions, Italy could issue a sovereign Sukuk, filling a big gap in the market.

What are the building blocks of an international IF Market and the mainstreaming of IF?

First, the MENA oil exporters have accumulated substantial international assets, mostly liquid and held in low yielding G7 sovereign assets, in excess of US$3.2 trillion, nearly on a par with China's foreign assets. The GCC countries should develop their local financial markets –preferably in local currencies- to allow the listing of foreign sovereign and corporate debt and Sukuk as well as equity.

This would be a major step in recycling 'petrodollars' without intermediation risk through the 'too big to fail and 'too inter-connected to fail' markets and institutions of London and New York. Eventually, the GCC will develop a common currency and deep, liquid local currency equity, bond & Sukuk markets allowing them to export their capital without the risk of exposure to TBTF and TICTF banks[12].

Two, governments and central banks –building on successful experience in GCC countries, Malaysia & Indonesia and others- need to introduce Sukuk as an integral part of their public finance and public debt management framework. The use of Sukuk by natural resource exporters would provide governments with an alternative source of funding to smooth out volatile revenues from natural resource price fluctuations & diminish macroeconomic and financial vulnerability. Central banks should build money markets through the introduction of Shari'a compliant monetary instruments; facilitating Liquidity Management through the creation of an Islamic Interbank Money market and the development of a secondary market for enhancing liquidity. This is critical if central banks are to play their traditional role of lender of last resort.

Three, investment in infrastructure, public works, development projects & housing can be a major driver of demand for Islamic Securities. Infrastructure and development projects with a predictable revenue stream are particularly suitable for Shari'a compliant financing, resulting in a real asset-backed instrument providing continuous security to investors. The Gulf countries are now in the midst of a major wave of infrastructure investment of some US$2.2 trillion. There is wide potential for this to be financed through Sukuk issuance. This is a political decision as much as it is a financial one. Shari'a compliant finance discourages over-exposure of the financing facility beyond the value of the underlying asset, given that the issuer cannot leverage in excess of the asset value[13]. Ultimately, the flexibility of Sukuk

[12] A DIFC Economic note 7 published last year, addressing the case for the creation of the debt market, is currently being discussed by the MoF/ DoF.

[13] Recent examples include: Syarikat Prasarana Negara Berhad, the Malaysian public infrastructure company wholly-owned by the Ministry of Finance, which successfully priced MYR 2bn 7-Year, 10-year and 15-year Islamic Medium Term Notes issued end-July 2011. The Sukuk program, whose proceeds will be used mainly to part finance the Kelana Jaya and Ampang LRT Line Extension Project (LEP) and other infrastructure improvement initiatives by Prasarana, is guaranteed by the Malaysian government . The offering was structured as a Sukuk Al-Ijarah (leasing Sukuk). Indonesia's first sale of local-currency Sukuk was backed by

instruments may hold the key to increasing its share in financial markets. Although most Sukuk issues so far have been debt-like, their ability to be structured as a near-equity instrument through convertibility means they could access a much wider investor base than traditional loan financing.

Four, is the scope of IF for development finance and poverty alleviation. The MENA region and many developing countries in Africa & Asia have young and fast growing populations: they need to be provided with core infrastructure – e.g. public utilities, education, health, transport etc.

Given the new requirements of financing reconstruction and economies in transition as a result of the Arab Spring, it is time to set-up of a MENA Bank for Reconstruction and Development. The mission of a MENA BRD is to foster regional infrastructure investment, job creation, and lower income disparities and promote growth & development through institutional rebuilding. The MENA BRD can be formed by equity participation from the GCC countries (including their SWFs & various economic & social development funds), Europe through the EIB/EBRD, the WB/IFC and other countries and stakeholders, including the US, China, and Turkey.

With the facilitation and creation of market instruments, the MENA BRD may undertake both conventional and Sharia-compliant products and services in support of its activities. With the rapid growth of Islamic Finance and its ability to reach parts of society that traditional banking misses, the MEBRD can play a pivotal role in adding to the development of an Islamic Financial Market in the region.

In this context, it might be useful to know that the DIFC has also signed a MoU with World Bank's Multilateral Investment Guarantee Agency (MIGA)[14] for promoting portfolio and foreign direct investment. From this initiative, public and private sector enterprises could benefit from improved access to cross-border financing as a result of MIGA's provision of political risk insurance, which helps international investors mitigate non-commercial risks (relevant in the current scenario). Such investment can be extended for development finance & would be in line with the tenets of Islamic Finance.

Five, IF can be influential in contributing towards poverty alleviation. The practice of charitable giving, or Zakat, is one of the Five Pillars of Islam, whereby practitioners are expected to contribute between 2.5% to 20% of their annual income. Appropriately managed Zakat funds can become a major source Islamic micro-finance and micro-credit. Microfinance shares the same goals as Islamic finance. The use of interest found in

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revenues from roads and railways in May 2011. The Islamic Development Bank issued a MYR 400mn Sukuk in local currency in Malaysia during 2008. Proceeds were used for funding of a toll road in Malaysia.

[14] MIGA can insure eligible investments made by investors in a MIGA member country into a developing member country. The types of investments the agency can cover include equity, shareholder loans, certain shareholder loan guarantees, management contracts, asset securitisations, capital market bond issues, and leasing, services, franchising and licensing agreements. The political risks that MIGA can cover include currency inconvertibility and transfer restrictions; expropriation; war, terrorism, and civil disturbance; breach of contract; and non-honouring of sovereign financial obligations.

conventional microfinance products and services can easily be avoided by creating microfinance hybrids delivered on the basis of the Islamic contracts of *mudaraba*[15], *musharaka*[16], *and murabaha*[17]. Perhaps most alluring to IFIs is the large potential market for Islamic microfinance products and services. Three of the region's countries-Algeria, Iran, and Syria-lack any sort of microfinance program at all.

Islamic Banking began as an effort for Muslims to engage in financial services consistent with the principles of the Sharia, which promotes social and economic fairness. Likewise, the modern microfinance revolution began as an effort to combat poverty and social injustice in developing countries. Both the principles of Islamic finance and microfinance seek to prevent economic exploitation by prohibiting usury.

Final comments

The DIFC and the Italian authorities with the banking & non-banking corporate sector have an opportunity to develop institutional and working relationships between each other. The DIFC can support the development of an Islamic finance Sector in Italy by: advising on development of legal, tax and regulatory framework governing Islamic financial institutions in Italy; assisting Italy in joining the ranks of countries –including UK, France, HK, Singapore and Japan- by removing tax, legal and regulatory barriers to Islamic finance; facilitating dialogue among Sharia Boards; through exchange of information and best practice; by promoting training, professional and educational programs; facilitating the issuance of Government of Italy Sukuk and facilitating the issuance of Sharia compliant securities by Italian banks & companies, including mutual funds.

The year 2008- will mark a 'defining moment' in post WW II history, marking a watershed for financial markets, marking the end of the American financial empire that had evolved post WWII. We are challenged to re-design the existing financial architecture which has been in place for nearly a century and the Bretton Woods system. This is a time for bold vision and action. A new economic geography with a renewed dominance of emerging markets requires a new global financial geography. We are moving away from a unipolar to a multipolar world order. As this happens, the West will no longer be the standard or the arbiter of what it means to be modern. Political, social, cultural and ethical values, economic and financial orthodoxy, policy recipes, and as a consequence, the moral high ground, will have to be redefined in a new reality. It is in this context that Islamic finance is challenged to participate in defining and contributing to a new international financial architecture and its foundations. Islamic finance has to be part of the mainstream and not simply an interesting niche market.

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[15] In a *mudaraba*-based transaction, the IFI and the customer may enter into a partnership in which the IFI invests capital in the customer's microenterprise while the customer invests labour. The profits are shared according to a mutually agreed ratio while losses are borne by the IFI.

[16] In a *musharaka*-based transaction, both the customer and the IFI invest capital and share profits according to a mutually agreed ratio; losses are borne in proportion to capital contribution.

[17] In a *murabaha*-based transaction, the IFI purchases a specific good which the customer will purchase from the IFI at a deferred mark-up that may be paid in instalments.