Islamic Finance in the context of the worldwide financial crisis: *Where does Islamic Finance fit in the new paradigm for financial services?*

مصرف لبنان
BANQUE DU LIBAN

Raed H. Charafeddine,

First Vice-Governor, Banque du Liban

9th Annual Islamic Finance Conference
Euromoney Seminars
23 February, 2010 | London - UK

Outline

I **Inherent instability of conventional financial system vs. Inherent stability of Islamic financial system**

II **The new paradigm for financial services: Towards “Ethical Finance”?**

III **Where does Islamic finance fit ? Islamic Finance and Social Responsible Investments**

IV **Conclusion**

I. A Financial Instability Hypothesis

Hyman Minsky (1992):

- **“First theorem: The economy has financing regimes under which it is stable, and financing regimes in which it is unstable.**
  - **If *hedge financing* (equity) dominates, then the economy may well be an equilibrium seeking and containing system.**
  - **In contrast, the greater the weight of *speculative and Ponzi finance (interest-debt)*, the greater the likelihood that the economy is a deviation amplifying system.**
- **Second theorem: Over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.”**

I. A - Inherent Instability of the conventional financial system

Mirakhor and Krichène (2009)

- Highly leveraged financial institutions.
- Transactions supported by interest rate.

➢ Financial institutions become “merchants of debt”.

➢ Cycles of boom and bust are endogenously created.

“The recent crisis : Lessons for Islamic Finance”, Mirakhor & Krichene , 2009

I. B - Inherent Stability of the Islamic Financial System

Basic Principles	Impacts
1. Ban of *Riba*	•Prevents uneven distribution of Risks and Profits between lenders and borrowers ; •Avoids an inverted Credit Pyramid where Debt grows faster than wealth.
2. Ban of *Gharar*	•No excessive uncertainty. •Only for-profit (risk sharing) transactions are acceptable. •Zero Sum Games (risk shifting) are not accepted.
3. Ban of *Maysir* "Can't sell what one does not own"	Strengthening linkage between financial and real sector.

I.B - Theoretical Stability of an Islamic Financial System:

- Khan(1986): **"Based on principles of equity participation, Islamic Banking may well prove to be better suited to adjusting to shocks that result in banking crisis."**

- Mirakhor and Zaidi (1988): **"Islamic financial system has the capacity for a better adjustment to macroeconomic disturbances that require the shifting of resources from the traded to the non-traded sector than does the conventional interest – based system."**

"The recent crisis : Lessons for Islamic Finance", Mirakhor & Krichene , 2009

I. B - Theoretical Stability of an Islamic Financial System:

Mirakhor (1988): Open economy model where the real sector is the source of all macroeconomic behavior:

- **No Risk-Free Assets**
- **All financial arrangements are based on risk and Profit and Loss sharing.**

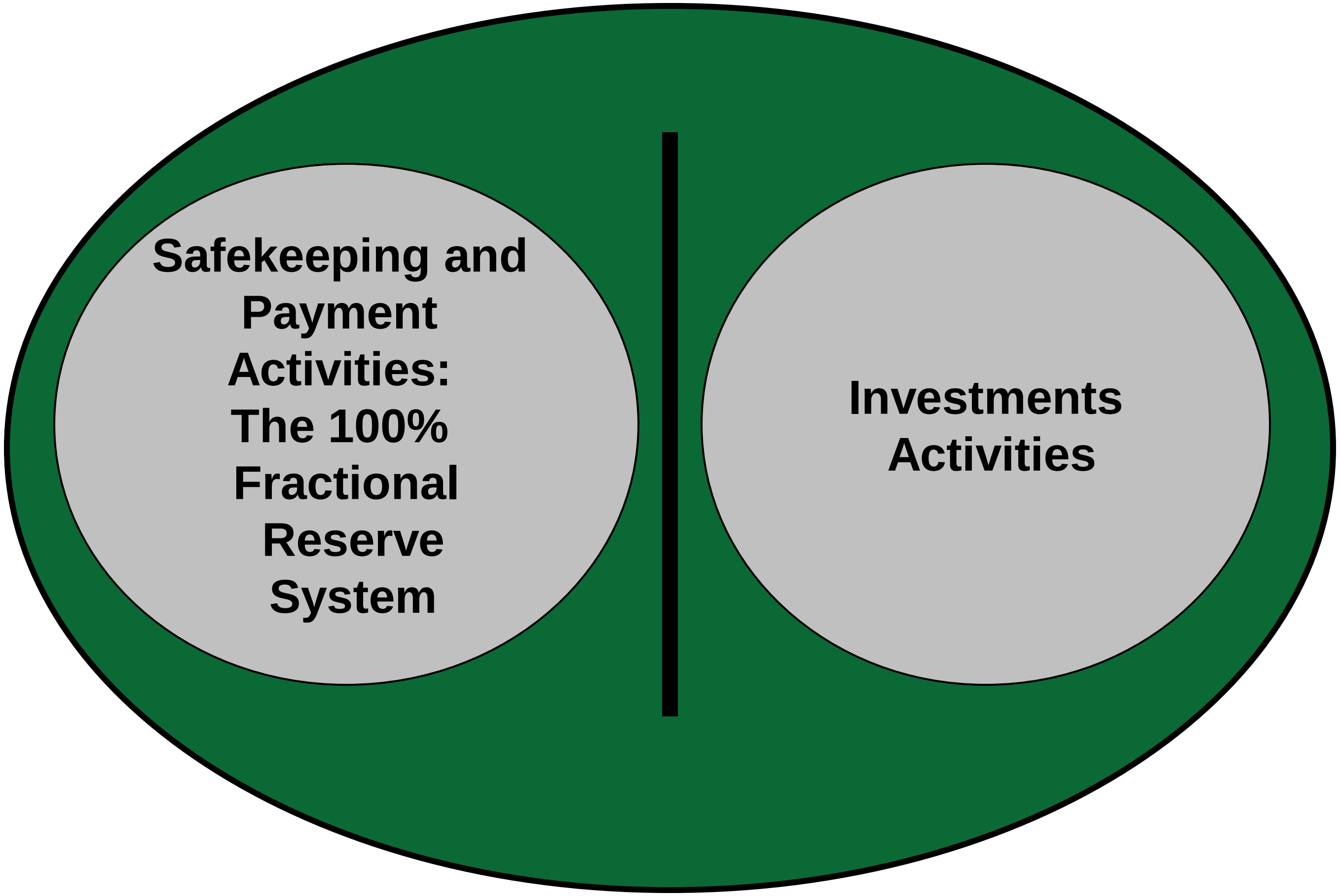
➢ **Rate of Return to financial assets is the rate of return in the real sector – One-to-One mapping between real and financial sector.**

➢ **Absence of an inverted debt pyramid.**

➢ **Interest rate is absent. No discrepancy between interest and profit rates. Economy at full employment equilibrium.**

“The recent crisis : Lessons for Islamic Finance”, Mirakhor & Krichene , 2009

I. C Conceptual Islamic Banking System



"The recent crisis : Lessons for Islamic Finance", Mirakhor & Krichene , 2009

I. D - Challenges to the Islamic Financial System

- **Regulators have to agree on a definition of Islamic finance: Establishment of a universal regulatory framework allowing the measurement of cross-country differences.**

- **Only banks (licensed by central banks) should be allowed to practice Islamic banking.**

- **Financial innovations that lead to speculation or to fictitious assets, such as securitization, should be forbidden.**

"The recent crisis : Lessons for Islamic Finance", Mirakhor & Krichene, 2009

I. D - Challenges to the Islamic Financial System

- **Many types of financial transactions and instruments should be excluded from Islamic finance, particularly securities often disguised as collateralized instruments that make them more expensive than those issued under the conventional system.**

- **Whereas in the conventional system, the failure of a few institutions cannot threaten the entire system, damage to the reputation of Islamic finance is a pronounced systemic risk.**

"The recent crisis : Lessons for Islamic Finance", Mirakhor & Krichene, 2009

II. A - The Prevailing Paradigm for Financial Markets

- **Market fundamentalism: The “invisible hand” and the “Laissez-faire”.**
- **Markets tend towards equilibrium. Deviations occurs in a random manner (Bell-shaped curve).**
- **The common interest is best served by allowing participants to pursue their self-interest.**
- **Rational Expectations of market participants.**

II. B The New paradigm for financial markets

- **Markets are imperfect. Regulatory Authorities intervention prevented markets from breaking down.**
- **Outlier events occur more frequently than in a random distribution (Thick tails).**
- **Recognition of additional uncertainty factor that characterizes the behavior of financial markets.**

Soros(2008): Reflexivity theory on the Interaction between investors, conceptions and markets. Human behavior is driven by :

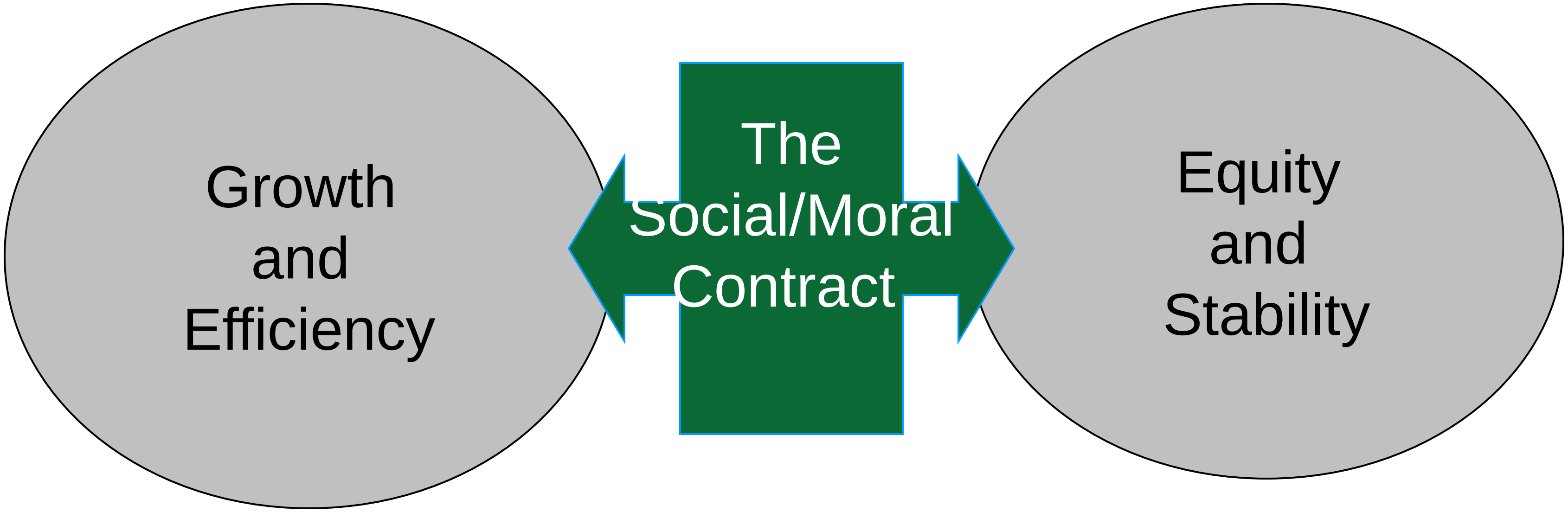
- **A Cognitive function**
- **A Manipulative function (Influence/Impact)**

⇨ Both functions interact in opposite directions

II. C - Towards “Ethical Finance”?

Amidst the global financial crisis, increased attention has been given to the *role that ethics and values may play* **in charting the future of the global financial system.**

II. C - The Fundamental Tradeoff



II. C - The tie between Religion and Business Ethics

- **An interfaith study was conducted leading to the declaration of a Code of Ethics on International Business (1994).**

- **The study concluded that there were four key concepts that recurs among the three religions:**
  - **Justice (fairness)**
  - **Mutual Respect (love and consideration)**
  - **The notion of stewardship entrusted by God (trusteeship)**
  - **Honesty (truthfulness).**

III. Islamic Finance and Social Responsible Investments

Investment Criteria	Islamic Finance	SRI
Basic Principles	• Improve living conditions and well-being through Wealth creation and preservation • Prevent injustice in trade relations • Establish Social Equity • Man acts as steward on earth with the role of protecting human and natural resources	• Improvement in the quality of life • Creation of wealth for the society • Focus on sustainable development
Sector-based Screening	Additional Specific exclusions and Purification requirements: Financial / Selected Entertainment / Pork products	Common exclusions: Alcohol / Tobacco / Pornography / Gambling / Weapons / Harmful businesses

Islamic finance and SRI : any crossover ? , Novethic 2009

III. - Islamic Finance & Social Responsible Investments

Investment Criteria	Islamic Finance	SRI
Financial based Screening	**Specific to Islamic Finance**	**Not applied**
Environmental, Social and Governance **Best-in-class screening**	**Although shared as a principle, Not applied as analysis or restrictive selection criteria.**	**Specific to SRI**
Norm-based screening **(Business Compatibility with UN Global Compact)**	**Tenets of Islam comply with the 10 principles despite being based on different sources and motivation and often stricter standards. However applicability in Islamic finance is not examined.**	**Specific to SRI**

Islamic finance and SRI : any crossover ? , Novethic 2009

Islamic finance and SRI could be compatible and complementary as they both focus on more ethically-responsible and transparent practices.

“Islamic finance and SRI : any crossover ?” , Novethic 2009

“Faith and Investment”, Mohammad Siddiqui, November 2006

III. Islamic Finance and SRI Compatibility & Complementarity

- **Both Islamic Finance and SRI investment universe are not strictly defined and would vary according to the applied screening method.**
- **Both guidelines are consistent with Ethical Finance, although they do not preclude full compatibility in the approaches:**
  - **–They do not employ the same expertise**
  - **–They do not target the same clientele**
- **Islamic Finance and SRI do not have any conflicting purposes.**

Islamic finance and SRI : any crossover ? , Novethic 2009

Conclusion

Ethics and Social Responsibility principles are not exclusive to Islamic Finance.

Morality cannot be legislated and therefore we can't rely on it to act as a safeguard to ensure the adoption of low-growth low-risk model among all the parties.

El Gamal , 2008

Last Note

"How to convince multiple populations at very different stages of economic development to shun fast growth in favor of greater equity and stability?"

El Gamal , 2008

Thank You