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Agenda

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Faith in finance: the economics of Islamic finance

In recent years, Islamic finance has been a growing market worldwide, both in terms of retail products and corporate finance. Its key principles can be linked to the economics literature, relating to measures that might mitigate 'market failures'. This article examines these principles and the various contractual forms of Islamic finance

The term 'Islamic finance' encompasses a wide range of retail and corporate financial products, which comply with Islamic—or *Shariah*—law. Nonetheless, the principles of Islamic finance are not limited, as regards their application, to Islamic products per se, and broadly embrace fairness in reward structures and social justice. A key principle is that *riba*, or 'interest', is prohibited (see the glossary at the end of this article). While financing without *riba* has existed for many centuries—and thus Islamic finance is not strictly 'new'—it has undergone something of a revival in recent years.

As the situation stands today, the degree to which financial institutions (and their products) may be regarded as 'Islamic' as opposed to 'Western' or 'conventional', varies markedly, from 'purely Islamic' in countries such as Iran and Sudan, to the 'coexistence' of Western and Islamic banks in Indonesia, the United Arab Emirates and Malaysia, and 'Western' systems that allow Islamic banks to operate within the established system (as in the UK).[1] Precise figures are difficult to find: in terms of assets controlled, estimates of all (retail and corporate) global Islamic banking range from $200 billion to $500 billion;[2] however, estimates of the size of Islamic finance are as high as $1,020 billion for 2007.[3] The global market has been estimated to be growing at a rate of 15–20% per annum.[4]

Of the Western systems, the UK has experienced a particularly rapid expansion in Islamic products offered to the retail and corporate sectors. *Shariah*-compliant retail products, such as mortgages and bank accounts, have become widely available, from both Islamic and 'Western' banks. The UK Islamic mortgage market is currently valued at £164m, and has been growing at 68% annually, albeit from a low base.[5] As regards corporate transactions, there has also been much discussion about London competing to be a key financial centre for Islamic finance, with *sukuks* being listed on the London Stock Exchange for the first time in February 2007 by Aldar Properties, followed by Dubai Islamic Bank in March 2007.

Key features of Islamic finance

Shariah law leads to a set of principles to be applied to financial transactions. These principles outline financial contracts that are permissible (*halal*) and those that are not (*haram*). However, an examination of the rationale behind *halal* and *haram* contracts highlights forms of *halal* contract that would appear to be 'encouraged'. As discussed below, it is here that there may be a divergence between theory and practice in Islamic finance or, put another way, 'the spirit' of Islamic finance versus 'the rules'.

Four key principles of Islamic finance are set out in Table 1, below, with each being linked to economic concepts and, in particular, the idea that the principles might have the effect of addressing certain 'market failures'.

In economics, a type of market failure may occur when unconstrained human behaviour and, in particular, excessive rivalry or competition between individuals in a market, generate an outcome that falls short of the optimum from a societal perspective. Given that the principles of Islamic finance appear to be aimed at constraining particular excesses of human behaviour (eg, opportunism and gambling), while encouraging forms of behaviour that may have beneficial effects for the economy as a whole (eg, entrepreneurial effort having knock-on innovation spillover benefits), these linkages with market failures indeed appear possible.

At least part of the rationale for the prohibition of interest is that it is accrued by an investor irrespective of the outcome of an investment. For this reason, under Islamic finance principles, profit-sharing (variable return)

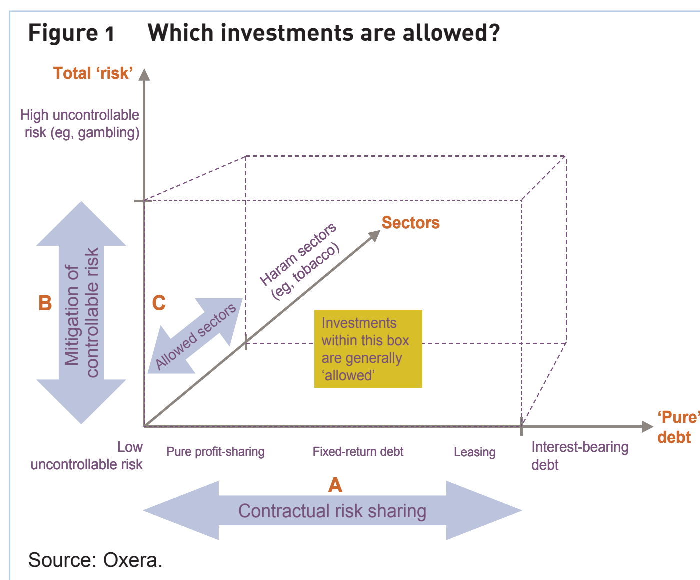
Table 1 The economics of Islamic finance and 'market failures'

Islamic finance principle	Intuitive description	Linkage to 'market failures'?
1. *Riba* prohibited	'Earning money from money', or interest, is prohibited. Profit, which is created when 'money' is transformed into capital via effort, is allowed. However, some forms of debt are permitted where these are linked to 'real transactions', and where this is not used for purely speculative purposes	A real return for real effort is emphasised (investments cannot be 'too safe'), while speculation is discouraged (investments cannot be 'too risky'). This might have productive efficiency spillover benefits ('positive externalities') for the economy through linking returns to real entrepreneurial effort
2. Fair profit-sharing	Symmetric profit-sharing (eg, *musharakah*) is the preferred contract form, providing effort incentives for the manager of the venture, while both the investor and management have a fair share in the venture's realised profit (or loss)	Aligning the management's incentives with those of the investor may (in contrast to pure debt financing) once again have productive efficiency spillover benefits for the economy, through linking realisable returns to real entrepreneurial effort
3. No undue ambiguity or uncertainty	This principle aims to eliminate activities or contracts that are *gharar*, by eliminating exposure of either party to excessive risk. Thus the investor and manager must be transparent in writing the contract, must take steps to mitigate controllable risk, and avoid speculative activities with high levels of uncontrollable risk	This may limit the extent to which there are imperfect and asymmetric information problems as part of a profit-sharing arrangement. Informational problems might, for example, provide the conditions for opportunistic behaviour by the venture (moral hazard), undermining investment in all similar ventures in the first instance
4. *Halal* versus *haram* sectors	Investing in certain *haram* sectors is prohibited (eg, alcohol, armaments, pork, pornography, and tobacco) since they are considered to cause individual and/or collective harm	Arguably, in certain sectors, there are negative effects for society that the investor or venture might not otherwise take into account (negative externalities). Prohibiting investments in these sectors might limit these externalities

Sources: Oxera and Iqbal, M. and Llewellyn, D. (eds.) (2002), *Islamic Banking and Finance*, Cheltenham: Edward Elgar Publishing.

partnerships are, in theory, preferred. However, interest appears to be prohibited principally because earning 'money from money' is not viewed as acceptable—something needs to be done with it, in the real world, to justify a return. Thus, in practice, a common interpretation is that indebtedness per se is not *haram*—only that the earning of *riba* is prohibited. Thus fixed-return products, which 'look like' conventional debt in some ways, but which avoid the payment of interest, are permitted.

Figure 1 Which investments are allowed?



Source: Oxera.

Figure 1 provides a simplified interpretation of the (personal or corporate) financing contracts that may generally be permitted according to the principles of Islamic finance, splitting these into three concepts. Concept A—contractual risk sharing—relates closely to principles 1 and 2 in Table 1; concept B (mitigation of controllable risk) relates to principle 3; and concept C (allowed sectors) relates to principle 4. Outside of the box are *haram* investments—including interest-bearing debt; poorly specified or high uncontrollable risk activities or contracts; and investments in sectors regarded as unethical. Other investments, which lie within the box, may be permitted, depending on the country concerned and the views of *Shariah* scholars involved in scrutinising financial contracts. In practice, scholars may reside within a supervisory committee, be part of a board of scholars employed by a financial institution or firm, and/or be part of a *Shariah* advisory service.

Figure 2 breaks down concept A into commonly used contractual forms (comparing the Islamic forms with the closest 'Western' equivalents), and illustrates how, for a given asset, moving from a fixed-return to variable-return contract exposes the investor to increased contractual risk. As regards concept A, under Islamic finance principles, profit-sharing products are preferred, especially the *musharakah*, sometimes considered the 'purest'

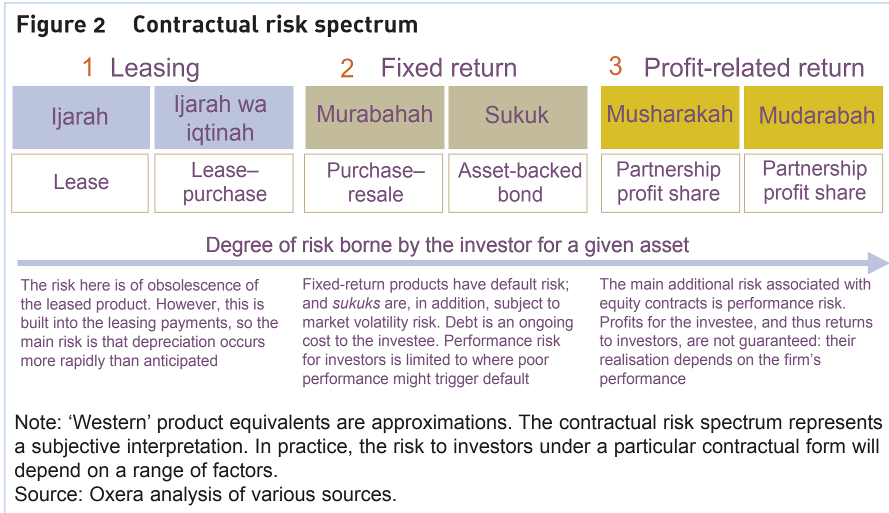


Figure 2 Contractual risk spectrum

Note: 'Western' product equivalents are approximations. The contractual risk spectrum represents a subjective interpretation. In practice, the risk to investors under a particular contractual form will depend on a range of factors.
Source: Oxera analysis of various sources.

form of Islamic financing. Here, the entrepreneur shares in any losses as well as potential profit, providing incentives for effort on the part of the entrepreneur, and fairness in the sharing of potential returns between the entrepreneur and the investor. In practice, due to informational problems that may occur, these are less widely used than fixed-return debt products, such as *murabahah*. Various authors have attempted to explain this apparent anomaly between theory and practice. The (somewhat limited) economic literature on the subject cites the following reasons for this divergence:

- the higher transaction costs involved in writing profit-sharing performance-contingent contracts;
- informational problems in monitoring performance;
- the potential for the misreporting of profit by the entrepreneur ('moral hazard').[6]

Concept B concerns the total risk of the investment. As explained in Table 1, contracts must not expose either party to undue risk. In practice, the investor and investee should take steps to identify and mitigate controllable risks, and investments should not be overly speculative (high uncontrollable risk). This has been linked to the distinction between entrepreneurship and pure gambling: in the traditional economic approach to choice under uncertainty, no distinction is made between lotteries (pure gambling, which requires no skill) and risky investments (requiring some degree of skill). Here, all that matters is the 'expected utility' that these choices might generate, given future contingencies and (crucially) the individual's attitude to risk.[7] From an Islamic finance perspective, however, it is possible to make a distinction. An entrepreneur seeks to identify and mitigate controllable risk, taking account of future contingencies, and leaving the investment to any remaining uncontrollable factors; whereas pure gambling is the opposite of entrepreneurship, because the individual relies purely on luck, even though they might believe that they can control uncontrollable risk. Thus, while the entrepreneur's sphere of controllable influence increases over time as they learn realistically how to deal with risk, the pure gambler's sphere of influence shrinks, as the individual's payoffs increasingly become a function of external circumstances.

Arguably, this approach recognises the 'endogeneity' of attitude to risk, and habituation in behaviour patterns—(un)realistic behaviour today leads to (un)realistic behaviour in the future. Entrepreneurship (and innovation) also have positive effects for society, whereas pure gambling might generate excessive speculation and instability in the economy.

Concept C identifies sectors in which (at least direct) investments are not permitted. As explained in Table 1, these are sectors in which, from an Islamic perspective, there may be individual or collective harm. In some respects, there are similarities with products offered by conventional financial institutions in the 'ethicals' market.

As stated above, differences in interpretation may affect which products might be 'allowable' in practice, and there is some debate about the degree to which Islamic finance products are fully consistent with the 'spirit' of principles (such as those outlined in Table 1) versus the 'letter of the law'.[8] What is important, however, is whether the conduct concerned is consistent with the underlying rationale for why the rules were introduced.[9] Some have also identified that the differences in the interpretation of scholars across countries may lead to problems where institutions have cross-border operations, and that common standards for Islamic finance products may need to be developed.[10]

The potential impacts on corporate finance

The growth of Islamic finance in the UK could have a number of effects on the economy. There is merit, therefore, in the development of a framework for assessing the benefits and costs of Islamic financing methods and instruments. One approach might be to examine how Islamic finance affects each of the four functions of a financial system: intermediation (channelling funds from savers to borrowers); asset and liability creation (eg, debt and equity); non-intermediation services (such as insurance); and real resource allocation (efficiency). Another approach might be to examine the potential impacts on various aspects of the

UK economy (including consumer, prudential, systemic, competition and economic impacts), the competitiveness of London as a financial centre and socio-cultural impacts.

The remainder of this article examines some of the potential *economic* impacts of Islamic finance in terms of *corporate finance*. As Islamic finance principles prohibit interest-bearing debt and, in theory, favour profit-sharing (equity) contracts, the range of permissible financial instruments—the capital structures—available to firms is constrained, albeit in part of the market. A first question, therefore, is 'does capital structure matter?' or 'what are the benefits and costs of (interest-bearing) debt?'

In this regard, basic corporate finance theory states that the choice between debt and equity financing makes no difference to the cost of financing—the weighted-average cost of capital—for a company. While debt is always cheaper than equity (since, should a company get into difficulties, debt providers are repaid before shareholders), taking on more debt simply exposes the remaining equity to more risk, increasing the required return demanded by shareholders: overall, the cost of financing remains unchanged.[11] However, in practice there may be benefits and costs arising from taking on more debt. A potential benefit could be that performance-contingent equity contracts, relative to fixed-return debt, can be more costly and difficult to monitor. Where this is particularly problematic, managers provided with too much equity financing upfront may simply waste it on bad projects—a 'free cash-flow' effect. Here, debt limits the free cash flow available. Furthermore, debt is tax-deductible (as a cost to the business), whereas profits (paid on equity) are not.

However, too much debt can create problems. Equity forms a buffer in the event of poor performance, so reliance on debt can hasten financial distress, raising both the cost of equity and debt. Counter to potential free cash-flow problems, equity generally imposes stronger incentives for management to perform well, as returns to equity, unlike debt (except in the event of bankruptcy), are contingent on profit performance. Investors may take account of these 'endogenous' incentives in deciding on the required return.

Thus, in theory, there may be both economic costs and benefits in prohibiting interest-bearing debt, and in encouraging profit-contingent equity-style contracts.

As regards costs, the market for Islamic finance, though growing, is still fragmented and relatively small. To put this into perspective, in 2005, the combined market value for domestic equities worldwide was estimated at $40,974 billion, which makes even the upper estimates of Islamic finance (both debt and equity) very small in comparison.[12] This may result in higher costs per transaction, although cooperation with 'conventional' banks may mitigate this to a degree, while providing a means for attaining critical mass.[13]

Murabahah debt contracts have higher set-up costs compared with conventional debt products.[14] However, information disclosure may mitigate this cost.[15] Perhaps more importantly, where equity-style contracts are concerned, 'pure debt' has lower transaction and monitoring costs than equity.[16] There may also be incentive compatibility problems if information is poor (see the discussion above regarding concept A). Effective information disclosure may again mitigate these problems. Moreover, trust in undertaking transactions being integral to Islamic finance (including, but not limited to, forbidding *gharar*) may also alleviate such information problems.[17]

The more widespread use of profit-sharing financial contracts (such as *musharakah*) could have a number of benefits, and trust may again help to align incentives in financial contracts. Such contracts may incentivise investors and entrepreneurs to mitigate controllable risk in contracts, thereby improving efficiency. The increased effort of managers post-signing could increase productive efficiency. Such contracts might also be used to finance small innovative UK businesses, for which there is currently a 'financing gap'. Linking financial transactions more closely to 'real' resources under Islamic finance could improve overall allocative efficiency, and reduce purely speculative activity. Greater use of equity-style transactions may also reinforce stability in the financial system, given its role as a buffer.

Islamic finance may have other wider benefits for the UK, such as a greater choice for consumers and enhanced competition. Innovation in the sector may lead to benefits for the 'ethical' and 'conventional' markets, and London could become a key centre for Islamic finance, improving the UK's competitiveness.

Concluding comments

Not only do financial institutions such as banks and stock exchanges appear to be working towards growing the the Islamic finance market, but so too are governments. For example, the recent UK Budget contained provisions to facilitate a comparable tax treatment for *sukuks* with respect to conventional securitisations, and proposed clearer guidance for *musharakah* contracts.[18]

Islamic finance clearly has a number of benefits; in economics terms, these can be related to tackling certain 'market failures'. Further empirical research is required in order to understand the current trends and the potential costs and benefits.

Glossary of terms

Gharar	Exposure to excessive risk and danger due to uncertainty about outcomes of the transaction, thereby exposing either of the two parties to unnecessary risks.
Halal	Activities permitted by Shariah law.
Haram	Activities prohibited by Shariah law.
Ijarah	An Islamic lease agreement. Instead of lending money and earning interest, ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer.
Ijarah wa iqtinah	Extends the concept of ijarah to a hiring and purchase agreement.
Mudarabah	An investment partnership, whereby the investor provides capital to another party/entrepreneur to undertake investment activity. Profits are shared on a pre-agreed ratio, but any losses are borne by the investor only.
Murabahah	Rather than lending money, the capital provider purchases the commodity from the supplier and resells it at a predetermined higher price to the capital user. The capital user repays the latter in instalments.
Musharakah	A direct equity participation contract. Profits are shared via an agreed ratio, but losses are shared in proportion to the investment by each partner.
Riba	Interest. It literally means ‘increase’ or ‘addition’, and refers to the ‘premium’ that must be paid by a borrower to a lender along with the principal as a condition for the loan.
Shariah	Refers to the corpus of Islamic law based on divine guidance, as given by the Qur’an and the Sunnah, and embodies all aspects of the Islamic faith including beliefs and practices.
Sukuk	Similar to a conventional bond, but is asset-backed. A sukuk intends to provide proportionate beneficial ownership in the underlying asset, which is leased to the client to yield a return.
Takaful	Similar to a conventional insurance contract. A group agrees to share certain risk by collecting a specified sum from each individual. In the event of a loss to anyone of the group, this loss is met from the collected funds.
Tawarruq	The reverse of murabahah. An individual who needs money buys something on credit from the bank on a deferred-payment basis, and then immediately resells it for cash to a third party, thereby obtaining cash without taking out an interest-based loan.

Sources: Adapted from Iqbal, M. and Llewellyn, D. (2002), op. cit., 'Glossary of Arabic Terms', pp. xii–xvi, and HSBC Amanah glossary, available at http://www.hsbcamanah.com/hsbc/amanah_banking/glossary.

[1] See El Qorchi, M. (2005), ‘Islamic Finance Gears Up’, *Finance and Development*, quarterly publication from the IMF, December; and Iqbal, M. and Llewellyn, D. (eds.) (2002), *Islamic Banking and Finance*, Cheltenham: Edward Elgar Publishing, Chapter 1, ‘Introduction’, p. 1.
[2] FSA (2006), ‘Islamic Banking in the UK’, briefing note, March.
[3] Lumonaco, R. (2007), ‘Islamic Finance and Wealth Management’, London Islamic Financial Services Summit, March 29th.
[4] El Qorchi, M. (2005), op. cit., and Khan, I. (former CEO of HSBC Amanah), lecture at the London School of Economics, January 2007.
[5] Datamonitor (2005), ‘Islamic Mortgages in UK’, Datamonitor brief, July.
[6] See Iqbal, M. and Llewellyn, D. (2002), op. cit., Chapter 1, ‘Introduction’.
[7] Al-Suwailem, S.I. (2002), ‘Decision Making under Uncertainty: An Islamic Perspective’, Chapter 2 in Iqbal, M. and Llewellyn, D. (2002), op. cit.
[8] See Al-Awan, Malik Muhammad M. (2006), ‘Globalisation of Islamic funds’, *Islamic Banking and Finance*, **11**; and Shaykh Haytham Tamim (2007), ‘Designing Financial Products According to Sharia’, transcript of the London Islamic Financial Services Summit, March 29th, http://www.cityandfinancial.com/conferencedocumentation.
[9] Analogously, in UK conventional finance, there is currently a move away from rules-based to principles-based regulation—in part due to the complexity of prescribing credible specific rules in a fast-moving marketplace.
[10] See Al-Awan, Malik Muhammad M. (2006), op. cit.; and Bi, F. (2007), ‘Harmonisation of the British Islamic Finance Practice with other Regions’, transcript of the London Islamic Financial Services Summit, March 29th.
[11] Modigliani and Miller, in their seminal paper, examined whether one capital structure is more optimal than another. In this early paper, capital structure does not matter to a company. Modigliani, F. and Miller, M. (1958), ‘The Cost of Capital, Corporation Finance and the Theory of Investment’, *American Economic Review*, **48**, June.
[12] World Federation of Exchanges (2006), ‘Annual Report and Statistics 2005’, March, p. 43.
[13] Abalkhail, M. and Presley, J. (2002), ‘How Informal Risk Capital Investors Manage Asymmetric Information in Profit/loss-sharing Contracts’, Chapter 6 of Iqbal, M. and Llewellyn, D. (eds) (2002), op. cit.
[14] Iqbal, M. and Llewellyn, D. (2002), op. cit., Chapter 1, ‘Introduction’.
[15] Ahmed, H. (2002), ‘Incentive-compatible Profit-sharing Contracts: A Theoretical Treatment’, Chapter 3 of Iqbal, M. and Llewellyn, D. (eds) (2002), op. cit.
[16] Iqbal, M. and Llewellyn, D. (2002), op. cit., Chapter 1, ‘Introduction’.
[17] See, for example, Wilson, R. (2002), ‘The Interface between Islamic and Conventional Banking’, Chapter 10 in Iqbal, M. and Llewellyn, D. (eds.) (2002), op. cit.
[18] HM Treasury (2007), ‘Building Britain's Long-term future: Prosperity and Fairness for Families’, press notice, March 21st.

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