INAUGURAL ISLAMIC FINANCIAL STABILITY FORUM

Khartoum, Sudan - 6 April 2010

Forum Theme: Developing Capacity Building to Enhance Financial Stability in the Islamic Financial Services Industry

Capacity Building in the Financial Sector: Strategies for Strengthening Financial Institutions

Paper by:

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The publication is available for download from
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ISBN: 978-967-5687-03-7

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Capacity Building in the Financial Sector: Strategies for Strengthening Financial Institutions

Prof. Dr Volker Nienhaus

The global financial landscape underwent fundamental changes during the last two decades. The two most important drivers of change were the deregulation of the banking industry and liberalisation of the financial markets (especially the opening up of national markets for international capital flows) in many countries around the globe. This led, *inter alia*, via mergers and acquisitions, to the emergence of huge global players with universal banking characteristics and to a rapid increase in global capital movements. The removal of regulations (especially in the United States[1]) also paved the way for financial innovations that carried the basic ideas of securitisation further and boosted the capital market activities of banks. In addition to these developments in the financial sector, trends in the real economy caused changes in the fundamentals of global financial relations: Emerging markets became major targets for international investments, and persistent trade imbalances (combined with very different national savings ratios) led to a constellation where the largest economy in the world – the United States – continued to be a net capital importer, while China and the Middle Eastern countries became the largest capital exporters.

The last two decades were also a period of severe financial crises. Obviously, deregulation and liberalisation did not eliminate crises. On the contrary, there are indications that the timing and sequencing of the transition to free market conditions contributed to the emergence of crises.[2] Therefore, lessons have to be learned and measures to improve the stability of the financial system have to be designed. This holds true in general, but this paper will focus on the capacity building and strengthening of Islamic financial institutions only.

1. Contrasting Perceptions of (Islamic) Banks

It seems that, in finance, the highest profits (and losses) can be earned not from the traditional financing business of banks but from trading activities in the currencies, money and securities markets. Many large conventional banks have streamlined their business profiles accordingly and given highest priority to securitisation and the structuring of financial instruments, and to the trading of such instruments.

[1] Barth and Jahera (2006); Sherman (2009).

[2] Eichengreen (2002); Heffernan (2005); Knoop (2008).

Finance and Trading in Islamic Banks

The growth of securitisation had already begun in the 1980s, but deregulation and liberalisation of the capital markets from the 1990s pushed this business to ever higher levels – both in quantitative and qualitative terms: The volume of derivatives grew at a much faster rate than the real economy, and the complexity of the most innovative structured products (such as collateralised debt obligations and credit default swaps) increased dramatically.

The financing of real activities (consumption or production in the non-financial sector) takes place at the bottom of the pyramid of structured products. But the global players did not earn their huge profits from this, but from the securitisation of debts, as well as from the structuring of papers without any underlying financing of real economic activities and from trading in such financial assets (including currencies). The main actors in trading and financing must have very different qualities:

- Trading requires people who have special skills to anticipate price movements in financial markets, to invest large amounts of money accordingly, and to manage considerable risk. Anticipating price movements cannot be done by technical analysis alone; it also requires a good deal of psychology in order to form expectations about the expectations of other traders. Probably the best deals can be done if one trader meets another trader who has *opposing expectations* regarding price movements, and then both reinforce their expectations by large investments.[3]
- It is obvious that the skills and qualifications of traders are quite different from those of loan (financing) officers, especially if they deal with corporate financing. People in the corporate finance business should be knowledgeable about non-financial markets, and they must be able to assess project proposals, to evaluate business plans and to calculate abilities to pay. In contrast to trading, the best deals can be done here if, instead of having opposing expectations, the financier and the entrepreneur have *parallel expectations* regarding the profitability of a planned venture, and the bank is willing to support these expectations by providing finance for the non-financial business.

If the volume of traded securities far exceeds the market capitalisation of all listed companies, then financial assets are no longer backed by real assets (including claims on corporate property rights). The growth and volume of financial assets became detached from real assets over the last decade.[4]

[3] Kaeppel (2002); Fenton-O'Creevy (2005); Schindler (2007).

[4] The *creation of financial assets* itself does not necessarily create new wealth but may create only additional claims on existing wealth. Moreover, many individual deals have a zero-sum characteristic, meaning that the gain of one party is the loss of the other. Such deals also do not create but redistribute existing wealth. In contrast, *financing of entrepreneurial ventures* is, in general, wealth creating because production or productivity enhancements are facilitated. This does not preclude that individual projects or firms end in a failure, but for the corporate financing business as a whole, it is safe to say that gains will outweigh losses (in the medium to long term).

Trading and financing are obviously different activities, but they are not completely separated from each other. Corporate financing creates long-term illiquid assets in the balance sheet of a bank, while the bulk of deposits are of a short-term nature. This maturity mismatch implies a liquidity risk. It can be mitigated by *securitisation*, which pools heterogeneous and illiquid financial assets and transforms them into liquid standardised financial instruments. The sale of these instruments not only reduces the liquidity risk but also enhances the financing capacity of the bank. As a result, the volume of financing may increase and the costs of financing can decrease. Thus, securitisation improves the efficiency of the financial system and can support wealth creation *in the real sector*. On the other hand, the tradable financial instruments created by securitisation are the "raw material" for trading activities *within the financial sector itself* and have a momentum and logic of their own.[5] If trading within the financial sector takes place on a large scale – as it did over the last decade – the fragility of the financial system and the probability of financial crises increases.

It can hardly be disputed that any advanced financial system needs *both* financing and trading activities. But its strength – with respect to wealth creation in the real economy – depends on the right *balance* being achieved between these two very different activities.

Proponents of an Islamic economic system usually emphasise the *financing* aspect and demand that Islamic banks should concentrate their activities on the provision of funds to firms *in the non-financial sector*. A theoretical justification is the traditional view of banks as financial intermediaries that mobilise funds from the savers (who are conceived as the surplus units of the economy) and provide them to enterprises (as deficit units) to facilitate productive investments. In doing so, the banks perform welfare improving transformations of quantities (small savings into large investments), maturities (short-term savings into long-term investments) and risks (pooling resources and diversifying investments).[6]

But the reality of Islamic finance differs from this model. A review of the headlines of specialised journals and a glance at the topics of training programmes and themes of industry conferences would indicate that *structured products* and transactions *within the Islamic finance industry* attract most of the attention of practitioners and media.[7] Many – if not all – of these products and transactions resemble conventional structures, but usually with an additional layer of complexity due to the *Sharī`ah* requirement of an asset base or asset backing of financial transactions.

[5] Fabozzi (2002); Bailey (2005).

[6] Matthews and Thompson (2005).

[7] Some of the recent topics are: the globalisation of Islamic finance (and the commercial and legal risks of cross-border transactions); the *Sharī`ah* compliance of derivatives, structured products and hedging deals; *Sukūk* structures with predetermined cash flows; and the commercial and *Sharī`ah* qualities of swaps and plugs, which shall link the Islamic finance industry to conventional finance in order to broaden the investment universe for Muslims, create an Islamic interbank market and develop liquidity management tools. From a more academic perspective, see, for example, S.S. Ali and Ahmad (2007); Askari, Iqbal and Mirakhor (2009); Iqbal and Wilson (2005).

Financings of ventures in the real economy are reported only if they are unusually large or complex, or arranged by a spectacular consortium, or done for prominent non-Muslim partners, while the ordinary financing business and transactions with small and medium enterprises are not covered by the media.

In summary, it seems that Islamic finance is increasingly emulating or replicating conventional finance. This has provoked an intense debate on "form over substance" in Islamic finance. For critics of Islamic banks, the imitation of conventional *Riba*-based products and techniques is not only a deviation from the ideal; it can also lead to the import of the fragility of the conventional system into Islamic finance.

Formalism

The criticism of a purely formalistic *Sharī`ah* compliance of transactions with *Riba*-like effects is not new, although its intensity has grown over the last few years. This raises the question as to why the earlier criticism had little if any effect, or – more fundamentally – why Islamic banks adopted ideologically questionable practices.[8] If one does not assume ignorance or ill will of CEOs and directors, one has to look for inherent forces that pushed the Islamic banking industry towards financial deals with weak links to real assets or no direct links to activities in the non-financial sector at all. Commercial interests and the need of suitable instruments to generate income from financial transactions underlie this trend:

- It has to be recognised that Islamic banks are not charitable or developmental institutions but *for-profit enterprises*. The growth of the Islamic finance industry over the last decade was especially due to *conventional banks* setting up Islamic windows or subsidiaries or converting their whole business. Shareholders, who have been running conventional banks in the past and will continue to do so in the future, do not enter into the *Sharī`ah*- compliant business for the sake of Islam – particularly not if they are non-Muslims from foreign countries. They enter into this market because they see new *profitable business opportunities* or *threads to their present conventional business*. The CEOs, directors and executives of Islamic windows, subsidiaries or *converted banks* are usually *well versed in conventional banking*, including commodity, currency and securities trading within the financial sector.

- Islamic bankers are well aware that the *highest profits* can be earned from *trading activities in the financial sector.* These have become the benchmark in the banking industry worldwide. If trading is substantially more profitable than financing, this – in principle – holds equally true for conventional and for Islamic banks. However, if the toolbox of Islamic banks comprises only "plain vanilla" instruments for the direct financing of non-financial ventures, they cannot exploit the trading opportunities. If

[8] Another question – which cannot be dealt with in this paper – is why all these products and techniques were approved, or at least tolerated, by *Sharī`ah* boards staffed with eminent *Sharī`ah* scholars.

higher profits are missed because *adequate instruments are lacking*, for-profit enterprises will make all efforts to develop such instruments and techniques.[9] Otherwise, they would be in danger of being squeezed out of the market by more aggressive and innovative competitors.

- It comes as no surprise that bankers take *conventional* products and techniques as the *starting point* for the design of new instruments. Their commercial qualities are well known and should be replicated. To make conventional instruments *Sharī`ah* compliant, or to create *Sharī`ah*-compliant functional equivalents, *legal* engineers have to construct a *formal* link to real assets or to the ownership rights of real assets. However, the aspired *commercial* qualities as trading instruments are best achieved if the mandatory link to the real economy is kept to the *formally necessary minimum* and the "real economy substance" is only *notional*. This keeps the instruments as abstract (unspecific) as possible, which is a precondition for their liquidity and tradability. Otherwise, various market, legal and regulatory *risks* could creep in and dilute the commercial qualities of the instrument.[10] An example of a financial instrument with a merely formal link to the real economy is *Tawarruq*: Neither the bank nor the client has any substantial interest in the asset involved.

- By the combination of complementary sales contracts, notional assets, unilateral promises and similar components, it is possible to design a considerably wide range of (often very complex) tradable financial instruments.[11]

The combination of profit motives, experiences with conventional products and techniques, competition, and the ingenuity of legal engineers called into being a continuously growing range of *Sharī`ah*-compliant replications of trading instruments with only notional links to the real economy – in short: instruments for "transactions in notional assets" (TINAs).[12]

[9] For advanced *Sharī`ah*-compliant financial instruments, see, for example, R. Ali (2008); Ayub (2007); Dar and Moghul (2009); Ismail (2010); Z.A. Rahman (2010); Schoon (2009).

[10] The structuring of *Sharī`ah*-compliant instruments and transactions in notional assets share basic concepts with securitisation: Securitisation creates standardised financial instruments which are detached as much as possible from underlying individual assets. Risk and reward qualities of individual assets are levelled out by pooling, and concrete qualities of individual assets are transformed into abstract qualities of an asset class. The performance of a financial instrument depends on the overall performance of the pool or asset class instead of individual assets.

[11] The specific combination of such elements is often treated as a business secret, and customers do not get a detailed explanation of the complex structure but just its general approval by the *Sharī`ah* board. Transparency with respect to innovative instruments is often lacking.

[12] The trend to trading and to the use of instruments in financial wholesale transactions is reinforced by the particular macroeconomic fundamentals of the Gulf region. Because of large capital surpluses from actual or past oil and gas exports, banks do not have to carry out the traditional role of intermediaries between domestic savers and entrepreneurs. Instead, they have to find profitable employments for the large accumulated foreign savings at home and abroad. The direct financing of numerous projects of non-financial enterprises in the real economies of different countries may not only far exceed the available human resources of Gulf banks; it would also tie up the funds for the long term in illiquid assets in countries with divergent jurisdictions and foreign currencies. This would add to the high identification, evaluation and monitoring costs, and the manifold market, legal and currency risks. On the revenue side, the profitability of investments in real economies will be limited by the internal rates of return or – on the average – by the productivity gains of the financed projects. Even in rapidly growing emerging markets, these rates can hardly exceed the possible returns from financial trading. The combination of high risks, low liquidity and limited profitability is inferior to what can be achieved by global financial trading. This applies to both conventional and Islamic banks.

In spite of their questionable ideological qualities, *Tawarruq* and other TINAs serve two important commercial purposes:

1. TINAs provide *liquidity* to bank clients for unspecified uses. Some people may frown upon the provision of unconditional liquidity, but there is obviously a demand for it, and there are many legitimate (*Sharī`ah*-compliant) uses for liquidity. Of course, there are also non-*Sharī`ah*-compliant uses, such as gambling or speculation. But it cannot be the banks" responsibility to monitor the moral quality or the *Sharī`ah* compliance of the behaviour of their clients.

2. TINAs can be used for *interbank transactions* for liquidity management purposes. There may be actual regulatory and technical limitations, but in principle deals of any dimension could be structured with any maturity, even overnight.[13] Tools for liquidity management (imperfect as they may be for the time being) reduce the liquidity risks and bring Islamic banks closer to the capacities of conventional banks. The importance of this must not be underestimated in mixed systems where Islamic banks compete with conventional ones.

Thus, TINAs can improve the *financial efficiency* of a *Riba*-free system. One has to admit that they can also be used for less desirable purposes, such as for speculation. However, it is a common problem that tools can be used for a purpose other than the originally intended one. But unless the instrument has a very strong built-in incentive for its “misuse”, this possibility alone cannot be sufficient justification for a ban. For TINAs, such an incentive is not obvious: If people want to speculate with borrowed money, they obviously do not follow *Sharī`ah* rules in their financial transactions. For them, it does not make sense to take the trouble to get funds from an Islamic bank if they are readily available from conventional banks with less complicated contracts.

To sum up, TINAs serve useful purposes, and they have been approved with some qualifications by individual scholars as well as by institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Organization of the Islamic Conferences (OIC) Fiqh Academy.[14] Therefore, when it comes to capacity building and strengthening the Islamic finance industry, priority should be given to training bank personnel in the proper handling of TINAs in the context of interbank liquidity management and international standardisation or harmonisation of contracts in order to reduce transaction costs and legal uncertainties (both with respect to *Sharī`ah* and commercial law) for the further development of a liquid cross-border interbank market.[15] In view of the “form over substance” debate, it should be underlined that the

[13] Central banks could provide complementary tools such as liquidity *Sukūk*, which could also be employed as tools of monetary policy (open market transactions). Banks in need of liquidity could sell *Sukūk* that they own, but this requires that they had purchased these papers previously. If this is not the case, the *Sukūk* approach for liquidity management reaches its limit. Such a limit does not exist for TINAs, which can be produced by the banks on their own.

[14] In addition, an IFSB standard on commodity *Murābahah* is in the making.

[15] An example is the *Tahawwut (Hedging) Master Agreement* (TMA), which was launched in March 2010 by the International Islamic Financial Market (IIFM) in cooperation with the International Swaps and Derivatives Association (ISDA). It “gives the global Islamic financial industry the ability to trade *Sharī`ah*-compliant hedging transactions such as

real issue is not the existence of TINA instruments as such, but their extensive use in the financing business of Islamic banks. Once the infrastructure for the TINAs is in place (e.g. platinum brokers in the London metal exchange are familiarised with Islamic banking practices), they are probably the most convenient form of financing: The documentation is not too complex, the execution is fast and easy (due to well-established routines), the costs of financing are simple to calculate, the risks for the bank are minimal, and – most important – the clients do not have to explain their intentions or business plans and get unconditional liquidity for any intended use. Thus, an extensive use of TINAs in the financing business is due to both a ready supply by the banks and an appreciative demand by the customers. If one wants to get away from the large-scale use of TINAs for ideological reasons, moral suasion will hardly be sufficient: Not only the banks, but also the customers, must be convinced and find an added value in alternative modes of financing. Participatory modes of financing may be instruments that can offer such an added value – at least to some of the corporate customers of Islamic banks.

2. Supporting the "Real" Real Economy

Islamic finance has established itself as part of the global financial industry. Many proponents of Islamic finance would like to see it not be confined to a niche market, but be expanded into mainstream business. To make this happen, Islamic banks must offer commercially competitive products in the financing business – for the simple reason that, for non-Muslims (and seemingly for many Muslims as well), religious or ideological qualities are irrelevant in financial decisions.

Islamic banks have a large arsenal of financing instruments. But the crux with most of them is that their commercial characteristics are very similar to those of conventional instruments, while the underlying contracts look more complicated and less transparent and are less tried and tested in critical situations – in short: more risky. If this is correct – or if this is held to be correct by the general public – then Islamic banks can only gain a competitive edge with these products if they offer lower financing costs or provide better services to entrepreneurial customers.

There is no strong argument why the operating costs of Islamic banks should systematically be lower than those of conventional banks, or that savers (investment account holders) and shareholders are content with systematically lower returns. Therefore, systematically and sustainably lower financing costs are not to be expected.[16]

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profit-rate and currency swaps, which are estimated to represent most of today's Islamic hedging transactions." Parker (2010).

[16] The more complicated contractual structures even suggest the contrary (higher transaction and compliance costs).

Better Services

The absence of clear cost advantages suggests a focus on better services to supplement the financing of projects in the real economy and of entrepreneurial activities. Such services could be manifold, and a search for best practice examples of conventional banks could produce a long list of suggestions. It may begin with support for the start of a business or a new project by an evaluation of its consistency, financial parameters and market prospects, continue with comprehensive financial services for the firm (including, for example, access to national and international exchanges or payment systems with an interface to the client‟s information technology) and its employees (e.g. collective savings plans or group *Takāful* packages), and go to basic legal and tax services, specialised market information, or risk analyses at reasonable fees.

But the search for best practice examples immediately reveals a fundamental weakness of this approach: It is not unique; that is, conventional banks do offer similar services or could copy the successes of Islamic banks. Further, many quality services require industry expertise and dedicated staff, both of which are in short supply.

Financial Innovation: Participatory Modes of Finance

If Islamic banks can claim neither cost advantages nor better services, this underlines the relevance of another option for gaining a competitive edge, namely *financial innovation*, with advantages for both the bank and the client that will not be easily copied by conventional banks.

Writings of Islamic economists point the way to business models that have not yet been implemented in practice on a larger scale: Islamic economists have persistently argued that the true alternative to *Riba*-based financing is *profit and loss sharing* (PLS) or *partnership financing* (*Muḍārabah, Mushārakah*). It is well known that PLS modes of finance are not applied in practice due to severe information asymmetries and the resulting adverse selection and moral hazard problems in mixed systems where profit-oriented entrepreneurs ignore ideological dimensions and decide on the basis of the financial bottom line. Banks will probably find that future banking regulations will limit their leverage, risky derivative deals, and speculative transactions such as short selling. This will impact primarily conventional banks, but if their range of tools and profit opportunities is curtailed, they could turn to the more traditional banking business and thereby intensify the competition in the markets where Islamic banks are active. The threat of losing market share should be a strong impetus for Islamic banks to look for innovative modes of finance. Partnership contracts and participatory finance may be a solution because they offer some specific advantages:

- Other than the *trade-based* modes of finance (such as *Murābahah* or *Ijārah*) where the bank is involved in the purchase or lease of specific *assets*, *partnership* contracts allow the provision of *liquidity* to the client.

- In contrast to TINAs, which also provide liquidity, contemporary partnership financing is not asset based but *enterprise based*.[17] It requires the existence of enterprises that apply codified accounting rules and calculate profits and losses on a regular basis (e.g. quarterly).[18]

- While TINAs are suitable instruments for *short-term* liquidity, partnership contracts can provide liquidity to entrepreneurial clients on the basis of *medium- to long-term* contracts.

Partnership and profit- and loss-sharing models are extreme forms of what can be called *participatory finance*: In participatory finance, liquidity is provided on the basis of contracts that link the costs of financing, (respectively, the returns of the bank) to the performance of the financed enterprise. "Classical" modes of participatory finance are equity-like structures such as *Muḍārabah* or *Mushārakah.* They are very risky for the bank because they can result in a partial or complete loss of the provided capital. A bank that sees itself as a trustee of risk-averse savers should minimise the risk when investing their funds; this factually excludes the application of classical PLS modes of finance. What these banks could consider, however, are participatory modes of finance that *limit or eliminate the downside risk* – that is, the risk of losing invested *capital* (and not only forgoing some expected profits) – while the costs/returns of the financing are performance related – that is, *participating in the upside chances*. There are some types of contracts and structured products with such qualities that are deemed *Sharī`ah* compatible. For example:

- In agricultural finance, *sharecropping contracts* have been applied where the landlord provides the land and the tenant all other inputs (seeds, labour, fertilisers, etc.). For example, in *Muzāra`ah* contracts, the landlord receives a share in the crop for the provision of land.[19] In extreme cases, such as when the crop is lost, the landlord will forgo his expected returns, but he will not lose his capital (because the land is not destroyed or lost physically).

- In *Sukūk,* the subscriber could lose some of its capital if the value of the underlying assets drops and the repurchase of the *Sukūk* at maturity takes place at the lower market value. To prevent this, *Sukūk* issuers arrange for a repurchase guarantee at the nominal value on the day of issue. This eliminates the downside risk.

[17] Therefore, partnership financing is not suitable for the financing of consumption.

[18] Under special conditions, financings may be "character based", especially in a microfinance setting that shall be outlined below.

[19] A similar contract is *Musāqah* for the leasing of an orchard to be cultivated by the tenant, where the landlord receives a certain share (predetermined as a percentage) of the fruits. A summary of the legal controversies over *Muzāra`ah* and *Musāqah* is provided by Haque (1977).

Repurchase guarantees with predetermined values have been strongly criticised by some *Sharī`ah* scholars, but previously such *Sukūk* were approved by many scholars who certified their *Sharī`ah* compliance. In addition, it seems that in spite of the serious objections, *Sukūk* are still (or again) issued with predetermined repurchase guarantees. If one does not assume sheer ignorance, this implies that *Sharī`ah* scholars have taken the criticism seriously and either have (fully or partially) refuted it or have found alternative legal structures that lead to the same factual result.

Against the background of historical sharecropping contracts and modern *Sukūk* structures, it is reasonable to assume that it is possible to design *Sharī`ah*-compliant participatory modes of financing which limit the downside risk for the financier and confine the participatory elements to the upside chances.[20]

In support of this view, it should be noted that every *PLS financing* with a positive expected value of yields[21] can be *transformed* into a package of *fixed-term financings*, namely

- one or several trade- or rent-based contracts for the real asset needs, plus
- one or a series of TINAs for the liquidity needs.

Given the possibility of transforming each PLS financing with a positive expected return value into a bundle of fixed-term financings with undisputed *Sharī`ah* compliance, and without any risk of capital losses for the bank, then close functional equivalents can be designed, namely participatory financing instruments without the risk of capital losses (= „profit *without* loss sharing"). The advantage of a participatory instrument without a downside risk is that it can be considerably less complicated than a bundle of corresponding fixed-term contracts.[22]

In its crudest (and probably not *Sharī`ah*-compliant) form, a participatory instrument without a downside risk would be a pure profit-sharing agreement (without loss sharing). Fixed interest would be replaced by a ratio according to which the financier and the entrepreneur will share – for a given period – the future profits of the financed enterprise or project. In the classical *Mushārakah* contract, the profit-sharing ratio can be freely negotiated by the two parties at the beginning of the partnership, but it cannot be changed during the length of time to maturity of the contract.[23] The expectations regarding the distribution of possible levels of profits (and losses) determine, in conjunction with the profit-sharing ratio, the expected costs for the entrepreneur and the yields for the bank.

[20] The design of such an instrument could draw further inspiration from the recent proposals for *Sharī`ah*-compliant hedging techniques and swaps.

[21] Projects with a negative expected value of yields would normally not be financed by a bank – except, maybe, for speculative purposes.

[22] If the *Sharī`ah*-compliant alternative to a conventional loan would involve higher transaction costs due to its more complicated structure, but it does not offer any commercial advantage for the financed entrepreneur, this would put the Islamic banks at a competitive disadvantage compared to conventional banks in a mixed financial system. A fixed-term bundle would not offer a commercial advantage compared to an interest-bearing loan, but participatory finance (with performance-related costs of financing) could do so. This is discussed below.

[23] In a *Mushārakah* partnership, losses have to be borne in proportion to the financial resources provided by the partners.

Ignoring any ideological preference for a financing through an Islamic bank, profit-oriented entrepreneurs may compare the *expected value of costs* with the interest to be paid for a conventional loan or the predetermined costs of a non-participatory finance package.[24] The entrepreneur will opt for the participatory instrument if its expected value of costs per unit of capital is less than the rate of interest. However, if the rate of interest is also the benchmark for the Islamic bank, the bank will not enter into a financing if its expected value of yields per unit of capital is less than the benchmark. This implies that the entrepreneur and the bank will only come to an agreement if their expected values of costs and yields per unit of capital are identical and equal to the market rate of interest.[25] This condition will hardly ever be met *ex ante*, and therefore PLS financing would probably not exist at all in this simple-model world. The perspectives for participatory finance improve considerably if the model is somewhat modified. Initially, it was assumed that *both* the entrepreneur and the bank use the *expected value* for the comparison of financing alternatives. The use of the expected value as a decision criterion implies, *inter alia*, a specific type of risk distribution (distribution of possible profits and losses) and an equal weighting of positive and negative deviations from a mean value. Assume instead that the *entrepreneur* is more *risk averse* and attaches higher weights to losses or below-average positive results, while the *bank* continues to be *risk neutral* and uses symmetric weights. In such a constellation the entrepreneur"s probability distribution for the expected profits may result in a higher expected value than that calculated by the bank, but the entrepreneur nevertheless accepts the participatory financing because it has a kind of built-in relief for cases of lower profits to which the entrepreneur attaches more weight than possible higher profits (of the same amount).[26]

What has just been set forth for profit- and loss-sharing contracts also holds true, in principle, if loss sharing is excluded. Uncertainty of results, combined with a higher risk aversion, explain why entrepreneurs may prefer a participatory mode of finance. However, the monetary value attached to the built-in relief mechanism varies between entrepreneurs because of different risk appetites, profit expectations, costs of alternative financings, etc. Banks also differ with regard to their financing portfolios, risk assessments, investment alternatives, etc. Therefore, the terms of each participatory financing have to be negotiated individually between the entrepreneur and the bank.

If the basic logic and mechanism of participatory financing is accepted, the search for more *Sharī`ah*-compliant forms of contracts could begin. As a starting point, one has to study carefully what – in contemporary commercial and economics terms – has been shared in the historical *Muzāra`ah* and *Musāqah* contracts. This will bring about a deeper insight into the *Qur'anic* principles that underlay the affirmative stance of earlier

[24] The comparison with the interest rate for a loan is a simplification. A profit-oriented entrepreneur could make such a comparison with fixed-cost financing also if exclusively *Sharī`ah*-compliant instruments were available.

[25] The reference to the market rate of interest is again a simplification. In a purely Islamic system, the benchmark rate would be derived from fixed-term asset-backed financings.

[26] Similar results can be derived by other modifications of the simple model, such as different probability functions for the profit and loss distribution assumed by the entrepreneur and the bank, different risk preferences, risk-mitigating effects of the pooling of contracts by the bank, etc.

Muslim jurists. Contemporary scholars should then apply the *Sharī`ah* methodology to unfold the implications of the carved-out principles under the changed contemporary socio-economic conditions.[27] The result may be that participatory financings with the sharing of the value added of a venture,[28] or with revenue sharing, could be considered *Sharī`ah* compliant, but other participatory contracts (and more complex structures) are conceivable.[29]

Participatory finance with limited or excluded downside risks would be a financial innovation that could support Islamic banks in a stiffer competition with conventional banks. It has some qualities that make it attractive. For example:

- Entrepreneurs can benefit from the built-in *relief* for periods of weak performance, and banks can benefit from the built-in *gains* in periods of strong performance.
- Participatory finance fills a gap in the *toolbox* of Islamic banks: It allows the provision of *liquidity* to enterprises on the basis of *medium- to long-term* contracts (with options for built-in adjustments to changing market conditions).
- Participatory finance (in its classical PLS mode) enjoys a high *ideological* standing and underlines the distinctiveness of Islamic finance. Its introduction would contribute to the bridging of the present gap between ideology and practice and thus contribute to a more coherent appearance of Islamic economics and finance.

Participatory finance will establish a new link between finance and enterprises, and create new avenues for the profitable employment of funds in the real economy. This can be seen as a strengthening of the Islamic finance industry. However, the banks can only exploit the potential benefits of this mode of finance if they strengthen and enhance their capacities in the assessment of business prospects in non-financial markets. This includes capacities for industry forecasts, as well as competencies for the evaluation of strengths and weaknesses of individual enterprises. Some of these qualifications can be found in banks that are active in stock trading, but the capacities are most probably insufficient. Further, the necessary expertise may not be at the level of the financing officers who have to negotiate participatory financing terms with entrepreneurs. Thus, participatory finance poses a formidable challenge to recruitment policies, training facilities, communication channels and IT infrastructures of Islamic banks. It requires capacity building in an area that is unfamiliar to many banks – especially to those which are focused on trading and deals within the financial sector. However, a screening of banking practices in countries where banks (and not capital markets) are the major

[27] These changed socio-economic conditions include, for example, the fact that we live in a world with well-organised commodity and stock exchanges (which facilitate TINAs), with enterprises with limited liabilities (which may induce moral hazard), with a highly developed conventional financial system (with which Islamic finance has to compete), with recurring asset price bubbles (which cause large financial losses), etc.

[28] This has been proposed by Nienhaus (1986).

[29] Many parameters could be considered for the fine tuning of performance-linked sharing ratios, the adaptation to individual risk preferences, etc. All this, however, is beyond the scope of this essay.

source of corporate finance, especially to small and medium-sized enterprises (such as Germany), can provide support and best practice examples.

3. Financial Inclusion

So far, measures for capacity building in the financial sector and strategies for strengthening financial institutions have been considered within the parameters of the existing global financial system. However, this financial system has serious limitations, especially in developing countries, because it makes beneficial financial services available only to a minority of people. Poor people – who, unfortunately, still constitute the vast majority of the world's population – have only limited or no access to services of banks and insurance or *Takāful* companies. This is not a new insight, but over the last decade the political call for *financial inclusion* has become louder, and the initiatives of multilateral institutions to bring financial services to the poor have been intensified. It seems that the financial inclusion movement is slowly gaining momentum, since a growing number of profit-oriented global financial players have recognised – and started to tap – the vast commercial potential that lies at the "bottom of the pyramid". A predecessor of the financial inclusion campaign is the *microfinance* movement, which began in the 1980s.

When Islamic banking was introduced to Egypt (in Mit Ghamr, a town in the Nile delta) in 1963 by Ahmed El-Naggar,[30] he combined elements of traditional banking with what today would be called microfinance. Inspirations for his new type of financial institutions came from the concept and practice of German savings banks: Their approach is to mobilise – and also to invest – savings locally, thus creating self-sustaining circular flows of resources that strengthen the local economy. Mit Ghamr was very successful in mobilising savings because the rural population rapidly accepted the new bank as a trustworthy institution.[31] This was due mainly to a successful adaptation of the banking activities to the specific socio-economic and cultural conditions and religious beliefs of the rural population.[32] Such a process requires a deep commitment of the bank personnel on all levels and *dedicated leadership* of the top management.[33] This success factor poses probably the most serious challenge for capacity building.

[30] Ahmed El-Naggar was an intellectual, as is Muhammed Yunus who started Grameen Bank in Bangladesh in the late 1970s, and for both the establishment of the bank was initially an experiment in applied development economics.

[31] See El-Naggar (1978); Ready (1967).

[32] "To be most effective, development institutions must not be separated from the environment in which they operate. Their leaders should consider the cultural context in which they operate, so that the institutions reflect the people's needs and aspirations, and are consistent with their beliefs and spiritual virtues." El-Naggar (1978), p. 223.

[33] "An important ingredient of the project's success was that the local Islamic Bank was based on intimate contact and mutual trust and confidence between the villagers and the inspired and qualified leaders and personnel of the Bank. The Bank gave the right opportunity to a group of devoted Egyptian intellectuals to participate effectively in the socio-economic development of local communities in their own country. … In a community development organisation such as the Islamic Bank the main task will be to attract individuals already committed to public service, and then training and retraining them in an atmosphere from which they themselves derive the satisfaction of inspiring others." El-Naggar (1978), p. 233.

With the very early end of the Mit Ghamr experiment in 1967, the developmental focus and poverty orientation was lost in Islamic finance for quite a while,[34] and non-Muslim initiatives took the international lead in the establishment of microfinance institutions and in the promotion of financial inclusion[35] – in particular, the UN system (especially the United Nations Capital Development Fund, or UNCDF) and the World Bank.

Some non-Muslim institutions that looked into Islamic banking principles[36] concluded that *Sharī`ah*-compliant instruments such as partnership financing or asset-backed modes of finance (where no additional collateral, other than the financed object itself, is required) are very suitable for microfinance. Unfortunately, too often the ideology was taken for the practice, and this created the false impression that Islamic banks apply partnership financing or provide asset-backed financing without collateral on a large scale.[37]

This misconception implies a potential for frustration once it is realised that the practice of most Islamic banks today is quite different. More important, it may create the expectation that the existing banks are the right institutions for microfinance. The technical ability – that is, the availability of a toolbox with suitable instruments – is a necessary but not a sufficient condition for a microfinance engagement. It further requires at least a mandate of the shareholders, a dedicated management, physical accessibility for the target group (e.g. through mobile branches, business points, local representatives or cell phones), and – certainly not the least of all – staff with understanding and sympathy for small savers and micro-entrepreneurs. In short, Islamic microfinance is viable (as a relatively small number of existing Islamic microfinance schemes demonstrates), but it requires separate financial institutions. There are encouraging examples, but the number of Islamic microfinance institutions is still quite limited.[38] However, the Islamic Financial Services Board (IFSB) and the Islamic

[34] The director of the Institute of Islamic Banking and Finance of the International Islamic University Malaysia published a paper in 2007 under the title "Islamic Microfinance: A Missing Component in Islamic Banking"; see A.R.A. Rahman (2007); see also A.A. Khan 2008, A.A. Khan and Philips (2010).

[35] The Islamic banks established since the late 1970s had a clear commercial orientation, and even the Islamic Development Bank only recently took up the issue of microfinance in the broader context of the *Islamic Financial Sector Development* initiative of the IDB and IFSB.

[36] The most quoted (very brief) study was published by the *Regional Bureau for Arab States* of the United Nations Development Programme in cooperation with the department for the *Middle East and North Africa Region* of the World Bank: Dhumale and Sapcanin (1999); see further the case study of the Hodeidah Microfinance Programme in Yemen for the UNCDF by Al-ZamZamı and Grace (2002).

[37] This is the rather idealistic conclusion of the aforementioned study: "Islamic banking, with its emphasis on risk sharing and, for certain products, collateral-free loans, is compatible with the needs of some micro-entrepreneurs. And because it promotes entrepreneurship, expanding Islamic banking to the poor could foster development under the right application. … Viable projects that are rejected by conventional lending institutions because of insufficient collateral might prove to be acceptable to Islamic banks on a profit-sharing basis. Islamic banking offers loan products based on intangibles such as a businessperson's experience and character. Microfinance programs have extensive experience with character-based lending, as most micro-entrepreneurs lack acceptable collateral. Thus there is potential compatibility between the needs of micro-entrepreneurs and the practice of Islamic banking." Dhumale and Sapcanin (1999), p. 13.

[38] SESRTCIC (2008).

Development Bank (IDB) now pay more attention to this subject and have included it in a joint publication on *Global Financial Stability Framework*.[39]

A successful microfinance development will not only contribute to the *alleviation of poverty*; it will also broaden the *entrepreneurial class* and *create employment*. The Mit Ghamr experiment showed that trustworthy institutions are able to change the savings behaviour of the rural population from savings in *real assets* to savings in *financial assets*. Real assets must be produced or imported, and this absorbs national resources that are no longer available for productive investments. In contrast, financial assets can be produced with minimal resource inputs, and the balance can be channelled into productive investments through the intermediation of the financial system. The broadening of the national deposit base makes countries where capital is scarce more independent from international capital flows. The increased availability of domestic savings can also be seen as a strengthening of the financial system because it reduces the need for and risks of capital imports.

Comprehensive financial inclusion goes beyond microfinance. It covers a broader range of activities (including, for example, educational initiatives such as financial literacy campaigns) and a broader range of financial services. In addition to payment and savings services and micro-financing, it may also include, for example, consultancy for entrepreneurs, micro-insurance or micro-*Takāful* schemes, and – at a later stage – access to capital markets. It is now widely recognised that the provision of financial services to poor people can be commercially viable.[40] What is still less widely recognised is that financial services can greatly enhance the purchasing power of the poor (although the number of companies that provide goods and services for new small entrepreneurs, as well as for poor people whose living conditions are gradually improving, is continually growing).[41] Poor people have become bankable, and with growing demand and experience, new business models for the interaction of *microfinance institutions* and *banks* (as well as micro-insurance or micro-*Takāful* schemes, and insurance or *Takāful* companies) have emerged. In view of the very large number of poor people worldwide, huge new markets for adapted financial services, investment and consumer goods could emerge if successful financial inclusions will boost productivity and employment and, in consequence, the purchasing power of the poor.

The Islamic banking industry in general is still reluctant to exploit the opportunities in these areas. But there are good reasons why the industry should take a closer look – not the least at practice examples of profit-oriented conventional banks:

- Poverty is a widespread problem in many Muslim countries, and Islamic teachings consider *poverty alleviation* as an individual and social *obligation*. Therefore, it is not

[39] IFSB, IDB and IRTI (2010), p. 50; see also Obaidullah (2008); Obaidullah and Khan (2008); Obaidullah and Latiff (2008).

[40] For example, Aghion and Morduch (2005); Matthäus-Maier and Pischke (2006); Dieckmann (2007); Sundaresan (2008).

[41] Rhyne (2009), Mahajan 2009.

unreasonable to expect that institutions that explicitly refer to Islam in the definition of their own identity make efforts to contribute. Since microfinance is a viable and even profitable way to reduce poverty and improve living conditions, the necessary sacrifice for Islamic banks is only minimal.

- Islamic banks could take advantage of their image as financial institutions with an *ethical commitment* and create trusted microfinance units faster and maybe with lower costs than secular actors. If the commitment of top management, staff and shareholders is serious, they may also be in a better position to solve the leadership problem to which Ahmed El-Naggar had already referred.

- Islamic banks are familiar with types of *contracts* that are *particularly suited* for microfinance. The Islamic banks know from experience the relevant legal and commercial features and the risks involved. This expertise could help in running a successful microfinance bank. The same holds true for *Takāful* operators and micro-*Takāful* schemes.

- It is often claimed that the main source of funding for Islamic banks should be deposits from the general public instead of interbank or capital market instruments. Then financial inclusion has great potential to change the savings behaviour of large segments of the population towards *more savings in the financial sector*. The Mit Ghamr experiment had shown that savings could grow much faster than local investment opportunities. Therefore, the microfinance institutions as the initial recipients of the additional savings could pass on the excess liquidity to an Islamic bank for profitable investments. Depending on the contracts, this could factually lead to an enlargement of the deposit base of the Islamic bank (and a bank may even consider the establishment of a microfinance unit for exactly this purpose).

- If financial inclusion is successful in creating *new entrepreneurs*, some of them may grow out of the limits of microfinance. Islamic banks that have set up their own microfinance units or cooperate with independent ones can provide the advanced financial services for the new small or even medium-sized enterprises.

- Non-financial enterprises that penetrate markets at the bottom of the income pyramid need financing for their ventures. Many of these ventures can be very innovative – with much uncertainty and high first-mover risks and rewards. These companies – which could be small local firms or large global players – may prefer a bank with its own *expertise and experience* in their unusual business environment (e.g. via a microfinance subsidiary).

- If a large *untapped market potential* at the bottom of the pyramid will be activated by financial inclusion policies, it may pay to be among the *pioneers*, to establish a market presence very early, and to build a strong brand name in this new segment. Islamic banks should consider the predictions and then make an informed choice.

- Governments and international agencies that run programmes for poor people need financial services, and they also will prefer banks with relevant links, expertise, experience and infrastructure.

- Islamic banks from capital-surplus Gulf countries with high liquidity could find *new investment opportunities* that give them a sufficient financial profit plus non-financial rewards from their involvement in poverty alleviation initiatives and developmental projects. This could strengthen their credibility as socially responsible investors.

Microfinance has become part of the financial system, and successful financial inclusion initiatives will integrate it even further into the formal banking systems. A very promising initiative to create more public awareness and to promote the innovative design of *Sharī`ah*-compliant products for Islamic microfinance clients is a contest jointly launched by a group with a remarkable composition, namely CGAP (Consultative Group to Assist the Poor, housed by the World Bank), Deutsche Bank, the IDB and Grameen-Jameel.[42] The title of the contest is "Islamic Microfinance Challenge 2010: Innovating Sustainable, Scalable, and Market-Driven Models"**.**

If Islamic microfinance and Islamic banking converge as indicated above, it becomes important to find a suitable system of *supervision and regulation* that takes into consideration the specifics both of microfinance and of Islamic banking. So far, practices differ considerably between different countries, and the specifics of Islamic finance have only rarely been taken into account. The topic has been taken up by the Islamic Research and Training Institute (IRTI) (although not yet in a very elaborate way); it is also on the agenda of the Consultative Group to Assist the Poor (CGAP), which recently launched a *Financial Inclusion Regulation Center*.[43]

4. Financial Sector Reforms

The general direction of financial sector reforms since the 1990s was deregulation and liberalisation, and it was propagated and pushed globally by the International Monetary Fund (IMF). Deregulation and liberalisation paved the way for financial development and innovation, which improved the efficiency of the financial sector. But this alone does not eliminate all potential market failures in the financial sector (caused mainly by information asymmetries, intransparencies, moral hazard and speculation); and without *adequate regulation*,[44] financial sector crises still can occur and have occurred.[45]

[42] "Grameen-Jameel is a social business established in 2007 as a joint venture between Grameen Foundation and Grow Well Limited, a subsidiary of Abdul Latif Jameel Group." www.grameen-jameel.com.

[43] www.cgap.org/p/site/c/regulation_center.

[44] "To make sure that financial development does not mean greater economic insecurity, domestic financial regulation has to be refocused around policies that solidify the fundamentals of the financial system without restricting the ability of individuals to engage in financial innovation." Knoop (2008), p. 244.

[45] Rochet (2008).

From the history of financial sector crises in general, and banking crises in particular, one can conclude that banking crises in the post-war era were often triggered by a preceding crisis in the foreign exchange, stock exchange or real asset market.[46] A typical sequence of events is the build-up and bursting of a *price bubble*, which devaluates assets, induces loan default, causes bankruptcy of borrowers, tightens liquidity, and spreads through the whole banking sector. An important ingredient for a banking crisis triggered by a price bubble is that the build-up of the bubble was largely financed by *loans* from the *banking sector*.

The IDB, IRTI and the IFSB have put together eight building blocks to strengthen the stability of the Islamic financial system:[47]

1. The development of a comprehensive set of cross-sectoral prudential standards covering banking, *Takāful* and capital markets.

2. The development of a liquidity management infrastructure.

3. The strengthening of financial safety net mechanisms (*Sharī`ah*-compliant lender of last resort facilities, emergency financing mechanisms and deposit insurance schemes).

4. The development of a reliable crisis management and resolution framework (comprising bank insolvency laws, arrangements for dealing with non-performing assets, asset recovery, bank restructuring and bank recapitalisation).

5. The implementation of accounting, auditing and reporting standards, supported by adequate governance arrangements.

6. The development of a macro-prudential surveillance framework and financial stability analysis to address system-wide stress resulting from common exposures of financial institutions,

7. The strengthening of the rating processes to improve the transparency of risk profiles.

8. The stronger involvement in capacity building and talent development to address the human capital deficiencies in the Islamic finance industry.

It is pointed out that all such measures should take into consideration the specifics of Islamic banks. However, some consequences of such specifics require a closer examination.

[46] Allen and Gale (2007); Kindleberger and Aliber (2005); Laeven and Valencia (2010); Reinhart and Rogoff (2009).
[47] IFSB, IDB and IRTI (2010).

Deposit Insurance

After the introduction of deposit insurance schemes,[48] bank runs have become very rare in conventional banking.[49] But a *Sharī`ah*-compliant deposit insurance cannot protect the *full balance* of investment account holders who conceptually have to bear a commercial risk. It is possible that the investment account holders *lose* substantial parts of their capital, while the Islamic bank still earns an *income* from fees and other activities that keeps it going. Thus, a deposit guarantee that becomes effective only in the case of bankruptcy will not help out in this case.

This implies that the guarantee should become active irrespective of a bank failure – that is, when losses surpass a certain level. There would be, however, two problems with such a scheme:

- Due to the very limited effectiveness of market discipline, such a scheme would encourage banks to take *more* risk and thus make losses *more* probable (unless it is combined with some disincentives and sanctions).
- If the level of losses that triggers the guarantee is so *low* that depositors will accept allocated losses without withdrawing their funds, the scheme will most probably be so expensive that it cannot be financed. But if the triggering level of losses is *high*, depositors will react before the guarantee becomes effective: In view of a decreasing value of their bank balances, it is very rational for the depositors to withdraw their funds from unrestricted investment accounts as soon and as much as possible and to keep them in cash until a better employment becomes available.

In conclusion, in view of the specifics of Islamic finance it is extremely doubtful whether a deposit guarantee can *prevent a run on an Islamic bank*. As alternatives (or very important first lines of defence), Islamic banks must build reserves to smoothen the returns (profit equalisation reserves) and to absorb temporary losses of a moderate size (investment risk reserves), and they may use shareholders‟ funds as an additional line of defence. But as recent crises have shown, losses can easily reach a dimension that far exceeds these buffers, but still without driving the Islamic bank into bankruptcy.[50] The two recent examples of extraordinary losses as consequences of sharp drops in real asset prices were the *dot.com crash* in 2000[51] and the *sub-prime crisis* of 2007/2008. Although Islamic banks were not directly involved, or only marginally so,[52] important

[48] Barth, Lee and Phumiwasana (2006).

[49] "The bank run on England's Northern Rock bank in 2007 was the first run on a British bank in 140 years, surprising even the most well-connected financial observers." Knoop (2008), p. 183.

[50] A conventional bank where deposits are liabilities may well go bankrupt in such a situation. Depositors then are compensated by the deposit insurance. Deposit insurance schemes have proved to be effective in the last conventional banking crises because there was no general run on banks, but from that one cannot draw immediate conclusions for an Islamic banking crisis.

[51] Shares are considered as real assets because they represent partial ownership in enterprises.

[52] Islamic banks have been affected by more local market crashes, such as the Souk Al-Manakh stock market crash in Kuwait in 1987 or the recent burst of the real estate bubble in Dubai. In these cases, governments have bailed-out banks, but this cannot be taken for granted for all future crashes: Resources may be limited and adverse incentives have to be restricted.

lessons must be drawn from these crises for the regulation of Islamic financial institutions.

Bubbles

First, it must be noted that these crises *started* in the *real sector* and with *asset classes* that are of great importance for investments of Islamic banks.

Second, there is a growing pressure on Islamic banks to reduce their involvement in TINAs and to enhance their direct financing in the real economy by asset-backed instruments. But as long as profit perspectives of stock market trading and deals in bullish real estate markets are as high as those of conventional financial trading activities, it cannot be ruled out that pressure on Islamic banks towards more asset backing will drive them not to more corporate finance but to more of these trade-like asset-backed transactions in stocks and property. This would increase, not reduce, their exposure in bubble-prone markets.

Sukūk could become another asset class for Islamic banks‟ trading activities if the *Sukūk* market were to grow in volume, liquidity and secondary trading in the future, but this may take quite a while.

If Islamic banks withdraw from TINAs and turn to the real economy on a larger scale, then additional demand will be channelled into markets with limited supply.

- The impact of an additional demand in the *stock market* would not be dramatic as long as the pragmatic filters for the "*Sharī`ah* acceptability" of stocks are not very restrictive. At present, the majority of traded stocks (worldwide) meet the selection criteria. But the situation could change rapidly once the pragmatism comes under scrutiny and the lax criteria for *Sharī`ah* acceptability are *tightened*. In this case, a growing demand for stocks would meet a shrinking supply. A possible result could be a price bubble of *Sharī`ah*-acceptable stocks.

- Suppose that the success of Islamic finance continues and investors in the Gulf shift more funds from conventional to Islamic banks that invest a large proportion of the additional funds in the most preferred asset class – that is, national or regional *real estate* (from holiday villas over family homes and rented flats to office space). Because large amounts would be involved, this can have an impact on real estate prices and start a price rally that ends in a bubble.

What follows is that "more financing for the real economy" (without further qualification) would not necessarily enhance the resilience of the Islamic financial system. It could even have a destabilising effect if it becomes a major cause for price bubbles of systemic relevance.[53] Price bubbles in the prime asset classes of Islamic banks pose a specific challenge for central banks and regulatory authorities. In the past, it was not their task to identify and prevent asset price bubbles (of a dimension that could threaten the stability of the financial system), and they are also lacking suitable instruments.

But because Islamic banks may be more seriously affected by (partially self-induced) bubbles, and the existing rescue mechanisms (including deposit insurance schemes) cannot work as effectively in Islamic finance as in conventional banking, central banks and regulators should have second thoughts: Certainly, they should not directly control the investment strategies of Islamic banks, but they could consider imposing stricter rules to limit sectoral risk concentrations and to improve asset diversification in the interests of investment account holders.

In summary, the limited effectiveness of deposit guarantee schemes and the danger of self-induced real estate price bubbles have implications for the formulation of policies to implement the building blocks to strengthen the stability of the Islamic financial system, in particular for:

- the cross-sectoral prudential standards with respect to capital requirements and risk weights for bubble-prone real assets;
- the urgency of an adequate liquidity management infrastructure, because Islamic banks are by no means immune to runs, and while they are more remote from bankruptcy due to excessive debts than are conventional banks, they are more seriously threatened by illiquidity;
- the financial safety nets, due to the peculiar status of investment account holders and their deposits;
- effective crisis management, which may require a closer monitoring of bullish price developments in selected asset (and maybe also stock) markets; and
- the macro-prudential surveillance that has to take into account that financial crises are very often triggered by bursting asset price bubbles.

If a commercial perspective dominates the business strategies of Islamic banks,

- trading activities in the financial sector,
- innovations for the creation of more tradable financial assets, and
- a focus on real asset markets with the potential for profits from trading

[53] It should also be noted that a close tie of finance to real assets is by itself not a guarantee for wealth creation in the real economy. While wealth creation can be assumed as a result of the financing of entrepreneurial activities in the non-financial sector, this is hardly the case for the financing of (private or public) consumption. Stock trading can have a wealth creation effect if the traders absorb new stock issues and reduce the costs of financing for listed companies; however, if the trade is in existing stocks, the effects are wealth redistribution, rather than wealth creation. Trading of existing real estate or real estate under construction or in the planning can stimulate production, but this has a positive wealth creation effect only if it does not lead to overproduction.

will continue. More finance for non-financial enterprises and comprehensive financial inclusion have a high normative value, but they will hardly emerge by themselves. Increasing competition from conventional banks, a growing demand for socially responsible investments also in non-Muslim countries, an ongoing intellectual debate on form over substance, combined with new ideas for innovative forms of participatory financing, and a regulatory regime that takes into account the specific risk profiles of Islamic banks, may all together move Islamic finance gradually more towards the ideals of an Islamic economic system as outlined in the literature. This requires capacity building in many different areas, as indicated above, but it will also contribute to a strengthening of individual Islamic banks as well as of the whole Islamic finance industry as an integral part of global finance.

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ISBN 978-967-5687-03-7