



THE ROLE OF ISLAMIC ECONOMICS AND FINANCE IN PREVENTING FINANCIAL CRISES IN CONVENTIONAL FINANCIAL SYSTEMS

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PRESENTATION OUTLINES

- ❖ What is **Islamic Economics and Finance (IEF)**?
- ❖ The **role of money** in the financial system
- ❖ The role of IEF in **reducing the Financial crisis** in Banking system
- ❖ The application of sukuk in the **project financing** and **public borrowings**

Therefore, this presentation demonstrates how Islamic finance copes with issues and challenges of conventional financial system (CFS) and provides some sensible solutions to CFS :

- ❖ **Islamic Banks**
- ❖ **Islamic bond (Sukuk)**
- ❖ **Islamic Stocks**

WHAT IS ISLAMIC FINANCE

- ❖ Prohibition of **Riba**
- ❖ Difference of between **Riba** and **rate of return**
- ❖ Financing **real sector** vs investing in **toxic assets**
- ❖ **Predetermined interest rate** and **predetermined profit sharing ratio**
- ❖ The impotence of **underlying asset** in Islamic finance
- ❖ **Debt system** vs **risk sharing system**

POSITION OF ISLAMIC FINANCE

The advocates of Islamic Finance argue that the Islamic finance is better positioned due to the specific features of Islamic finance (Saiti et al., 2014) such as,

- ❖ **Limit of debt securitization,**
- ❖ **Ethical and ratio screenings,**
- ❖ **Exclusion of financial sectors,**
- ❖ **Exclusion of highly leveraged firms,**
- ❖ **The limit of interest-based leverage,**
- ❖ **Exclusion of using complex and intensive structured financial products, derivatives, and other toxic assets.**

THE ROLE OF MONEY (1/3)

Money is **Medium of exchange** vs **Money is asset**

In the **conventional financial** system:

Money is asset – selling money for fixed interest payments, tradeable commodity

In the **Islamic Financial** system:

Money is Medium of exchange - facilitating our transactions, selling good and services via money;

THE ROLE OF MONEY (2/3)

Mufti Mohammad Taqi Usmani, states in his paper presented to the annual meeting of WEF (The World Economic Forum) in 2010 held at Vegas said, "**Diverting money** from its basic function as **a medium of exchange** and make itself as **an object of trade** that turned the whole economy into **balloon of debts and over debts**"

The problem with the **current traditional capitalistic monetary system** is that it takes money as a **tradable commodity** and its role as a **medium of exchange** has been almost **neglected**. The Islamic view of money is that it is a **medium of exchange** and **not a tradable commodity** (Yahya, 2020).

THE ROLE OF MONEY (3/3)

The **real economy** will **not gain any benefit** from **the trade of money**;

This **accumulation of money** will create only **concentration of wealth** and cause more **disparities** and **inequalities** in the **distribution of wealth** in any society.

If the money does **not circulate in the economy**, then it does not encourage economic activity.

Nut in shell: Money in Islamic economic system is considered as a **means of transaction** and **medium of exchange**. IEF encourages **Profit and loss sharing** rather than the **trading of money as a commodity**.

THE ROLE OF IF REDUCING THE FINANCIAL CRISIS IN BANKING SYSTEM

- ❖ The last four decades have witnessed numerous financial and currency crises, most of which were associated with regional or even global consequences: for example, 2008-09 US financial crisis, COVID-19 and among others.
- ❖ **The financial stability** is one of the main concerns of central banks, financial institutions, investors and among others.

THE MAIN CAUSES OF CRISIS IN BANKS AND SOLUTION FROM ISLAMIC ECONOMICS

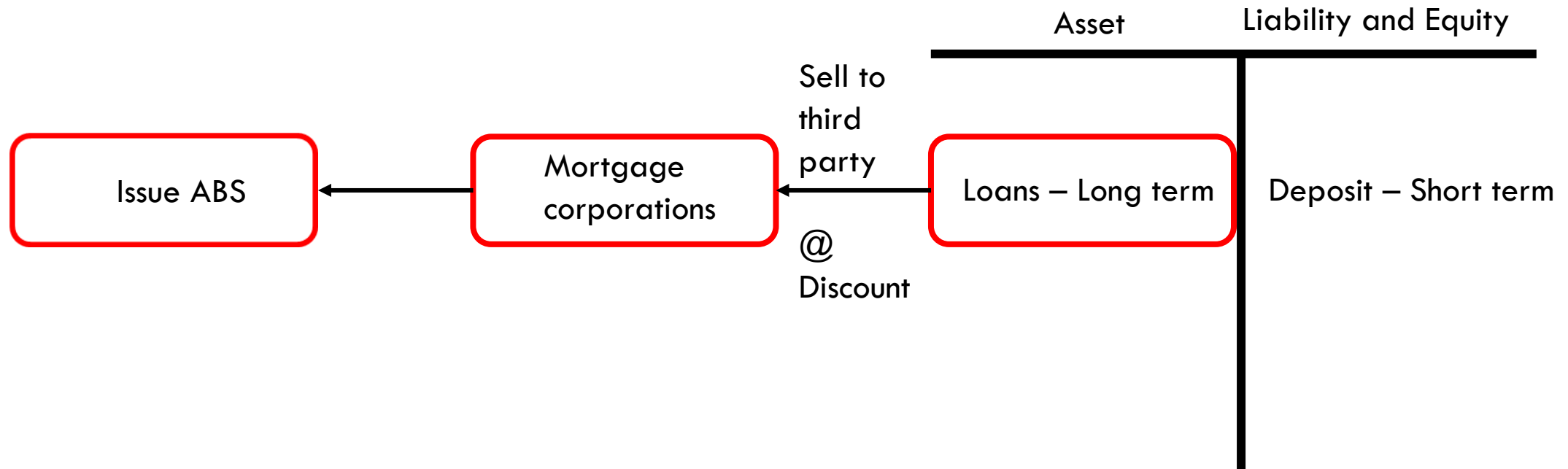
- ❖ **Debt Securitization** - One of the main causes of the global financial crisis which started in August of 2007 is the securitization. The crisis began with the real estate market in U.S.A. but soon spread all over the world.

Allowing debt securitization – Financial system will be more vulnerable – leading to crisis

- ❖ **Islamic Economics and finance:** Islamic finance discourages debt securitization, Saiti and Abdullah (2015) cited that even amongst jurists lack of consensus (ijma) regarding the validity of selling a debt to a third party.

Limiting debt securitization – financial system will be more stable – preventing crisis

WHAT IS DEBT SECURITIZATION?



THE MAIN CAUSES OF CRISIS IN BANKS AND SOLUTION FROM ISLAMIC ECONOMICS

- ❖ **The main focus is financial asset growth:** Conventional banks only focus on financial asset growth.

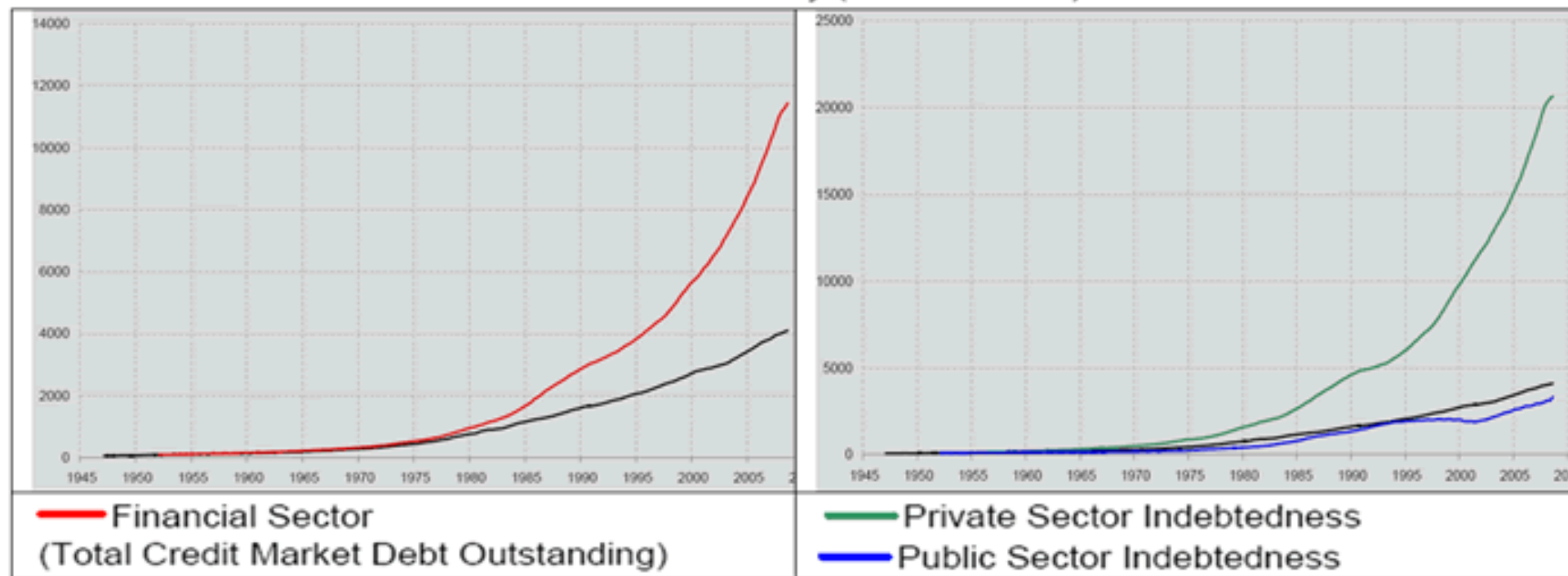
Mere Financial Intermediary – financial sector and real sector are diverging – leading to financial crisis

- ❖ **Islamic Economics and Finance:** Kahf (2010) argued that the Islamic banks suppose to not just mere financial intermediaries, they should support development of real sector.

By this way, the gap between financial and real sector developments would be narrowed.

**UNITED STATES: REAL ECONOMY AND FINANCIAL SECTOR
INDEX BASE 1952 = 100**

— Real Economy (Nominal GDP)



Source: Kemp/Reuters¹⁴

THE MAIN CAUSES OF CRISIS IN BANKS AND SOLUTION FROM ISLAMIC ECONOMICS

- ❖ **Low Central Bank Reserve Ratio:** there is no international standard or limit how much banks keep the reserve with central banks. The central banks are free to set the reserve ratio. If this ratio is small, the banks can create more money. Put differently, this increases the nation's money supply.
- ❖ It is quite alarming that the private banks create 97% of the money and only 3% is created by the government and is called sovereign money (Bramhall, 2014).

Money Expansion – Credit Expansion – Credit Crisis

THE MAIN CAUSES OF CRISIS IN BANKS AND SOLUTION FROM ISLAMIC ECONOMICS

- ❖ **Islamic economics and Finance:** there are several suggestions from Islamic Economics, for example:
- ❖ Siddiqi (2008) made a suggestion that the profit and loss sharing ratio can replace the bank rate policy.
- ❖ Hasan (2008) argue that Islamic banks should keep higher reserve ratio, for example, like 20%.
- ❖ Cizakca (2011) argues that there is 100% reserve requirements for demand deposits and no reserve requirements for investment deposits.

**Limit excessive money supply – Limit credit expansion –
Limit Credit Crisis**

THE CURRENT FINANCIAL ISSUES IN INFRASTRUCTURE FINANCING AND PUBLIC BORROWINGS

- ❖ The **financing of development infrastructure remains a challenge** for **developing** economies
- ❖ Infrastructure projects typically require **heavy upfront investment.**
- ❖ Funding – either, **foreign borrowing by the government** or bringing in **a private partner** who can help raise the funds
- ❖ Many nations have hit **very high levels of debt.**

THE CURRENT FINANCIAL ISSUES IN INFRASTRUCTURE FINANCING AND PUBLIC BORROWINGS

For unlike private entities, which can raise funding through either **debt or equity**, **governments cannot issue equity**.

So, **debt financing** is often the only alternative.

- increases leverage, debt capacity
- macro vulnerability, rate risk, contagion
- currency exposure

SUKUK ALTERNATIVES

- ❖ The world is facing **excessive levels of debt**, not much room for more debt funding
- ❖ **Rising interest rate** environment poses serious cause for concern given the build-up in debt
- ❖ **Equity financing** is not an option for governments. Very expensive
- ❖ **There is a need to explore solutions without leverage and to move away from over-reliance on debt**

SUKUK ALTERNATIVES

Ismath Bacha & Mirakhor (2018) – in order to fund the development infrastructures, **most of Muslim countries suffer from external debt.**

Even though those countries **need substantial development infrastructure**, however, they cannot fund them domestically due to **inadequate resources.**

Therefore, these governments **often borrow from foreign countries** or **international financial institutions.** The borrowing country faces numerous challenges such as

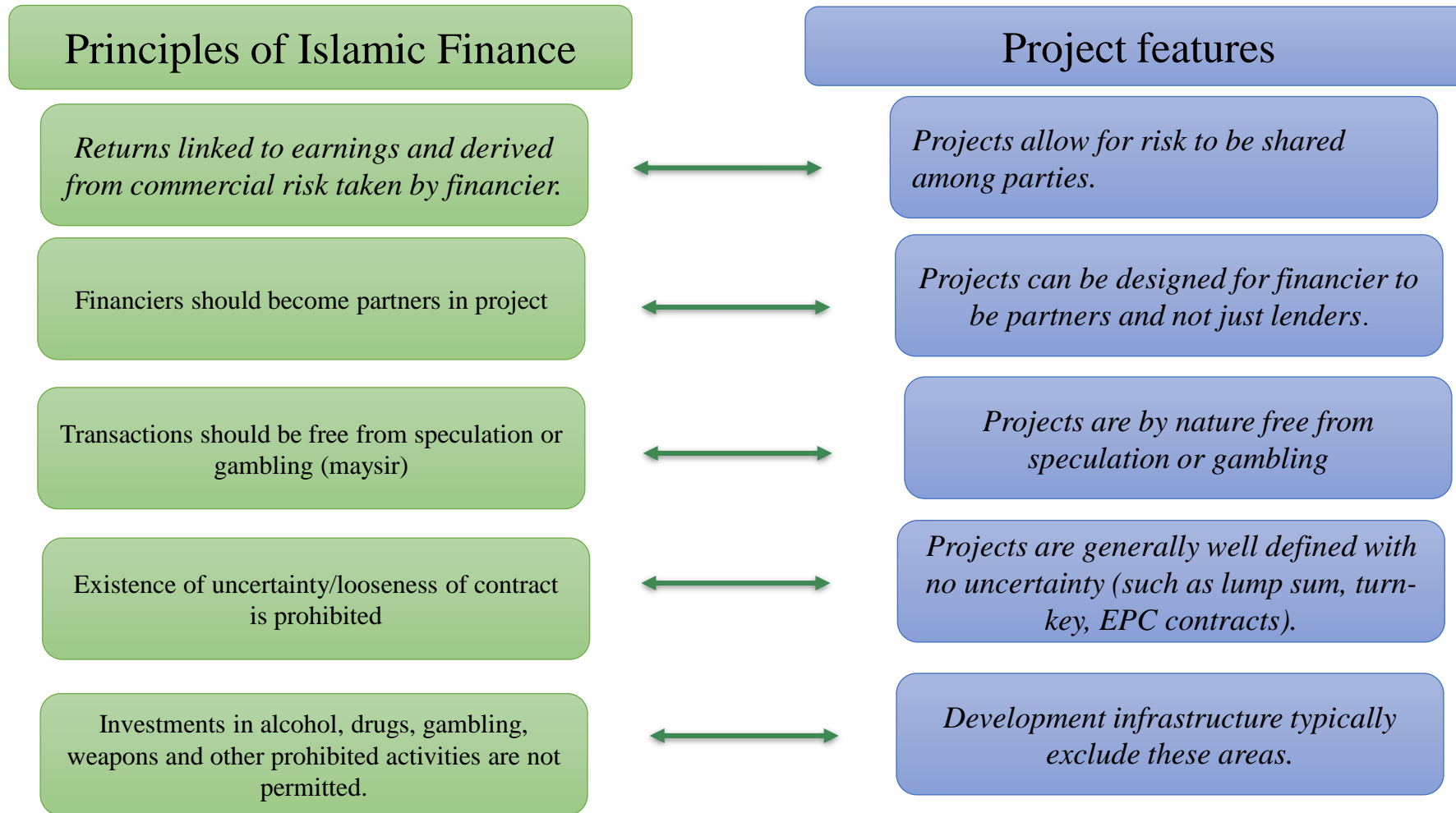
i) **the fluctuation of home currency** while the borrowing denominated in foreign currency;

ii) **leverage and economic fluctuation of a country** increased due to such borrowing;

iii) also **those countries face commodity price vulnerability** due to heavily reliance on commodity exports.

They argue that the recent **innovation of Islamic Bond** (sukuk) can be **reduce such external borrowing, leverage and vulnerability.**

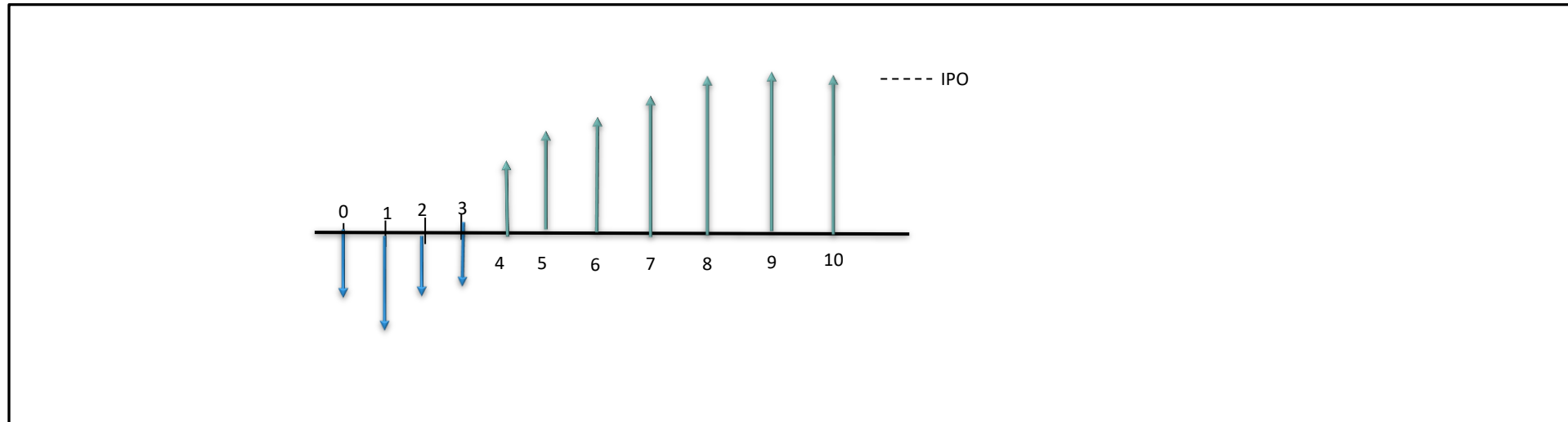
SUKUK IN PROJECT FINANCING



Source: Mobilizing Islamic Finance for Infrastructure, PPP – Report 2017. World Bank, PPIAF, IDB

Obiyathulla Ismath Bacha, *Development without Debt: Thoughts from Islamic Finance*, International Conference on Infrastructure, Growth and Development, 6th – 7th Sept. 2018, EBRD & UCL, London.

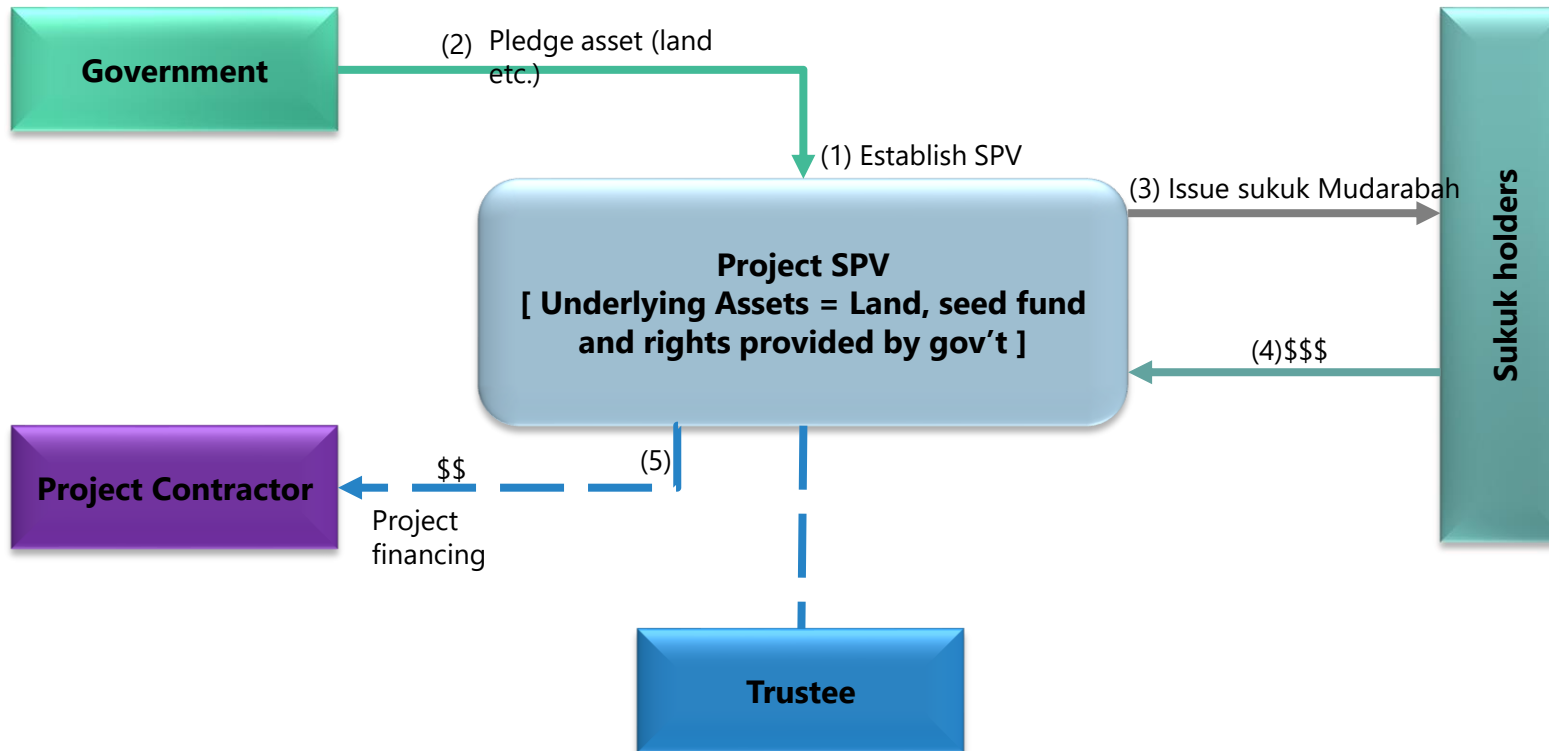
EXPECTED CASH FLOWS/NET PROFIT OF PROJECT



The government now needs to determine how to fund the needed **FUND**.
could issue 10 year convertible **Istisna-Mudarabah sukuk**
a convertible "Islamic instrument" with a construction and **profit/loss sharing contract**.

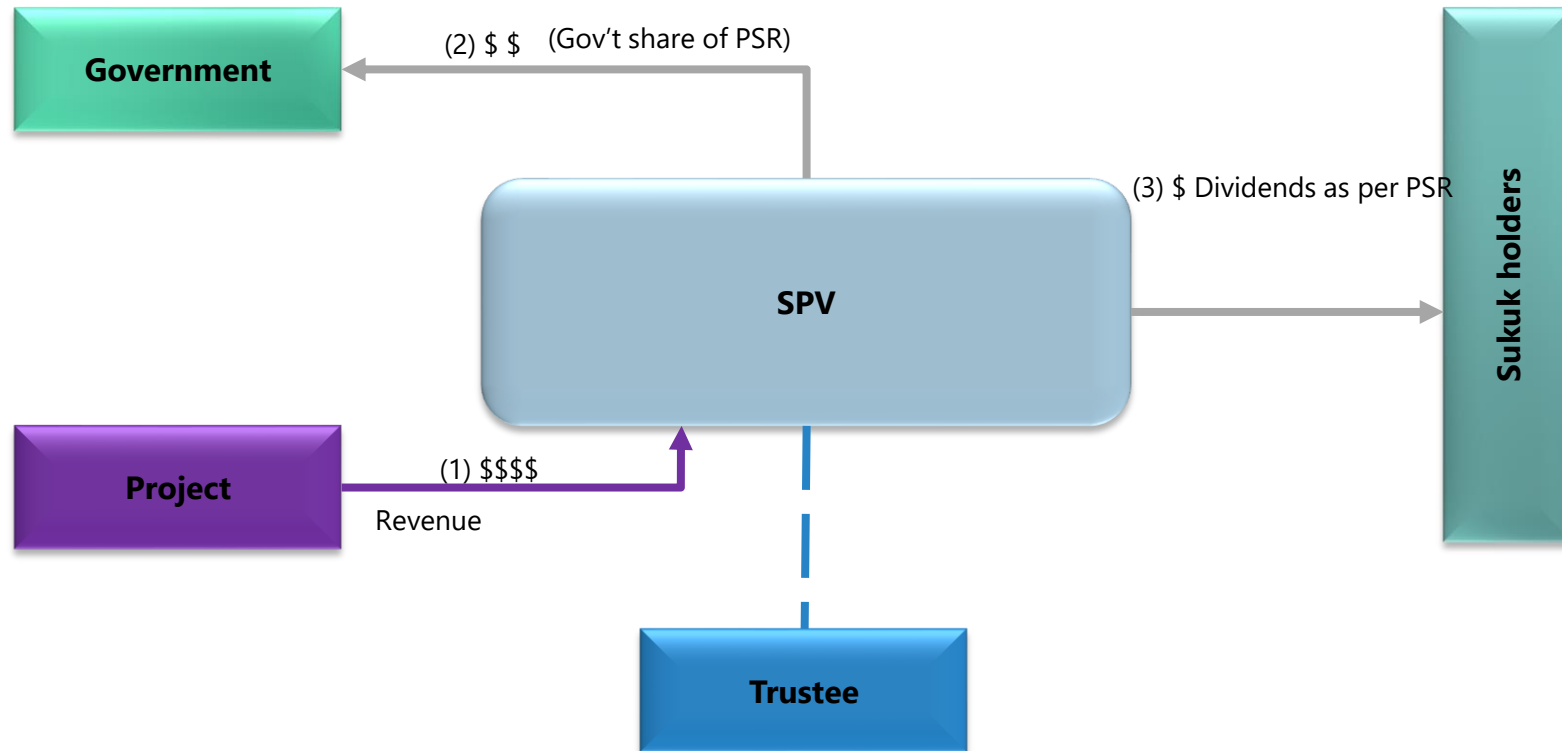
The Sukuk Issuance Process

Stage 1: Year 1 - 3



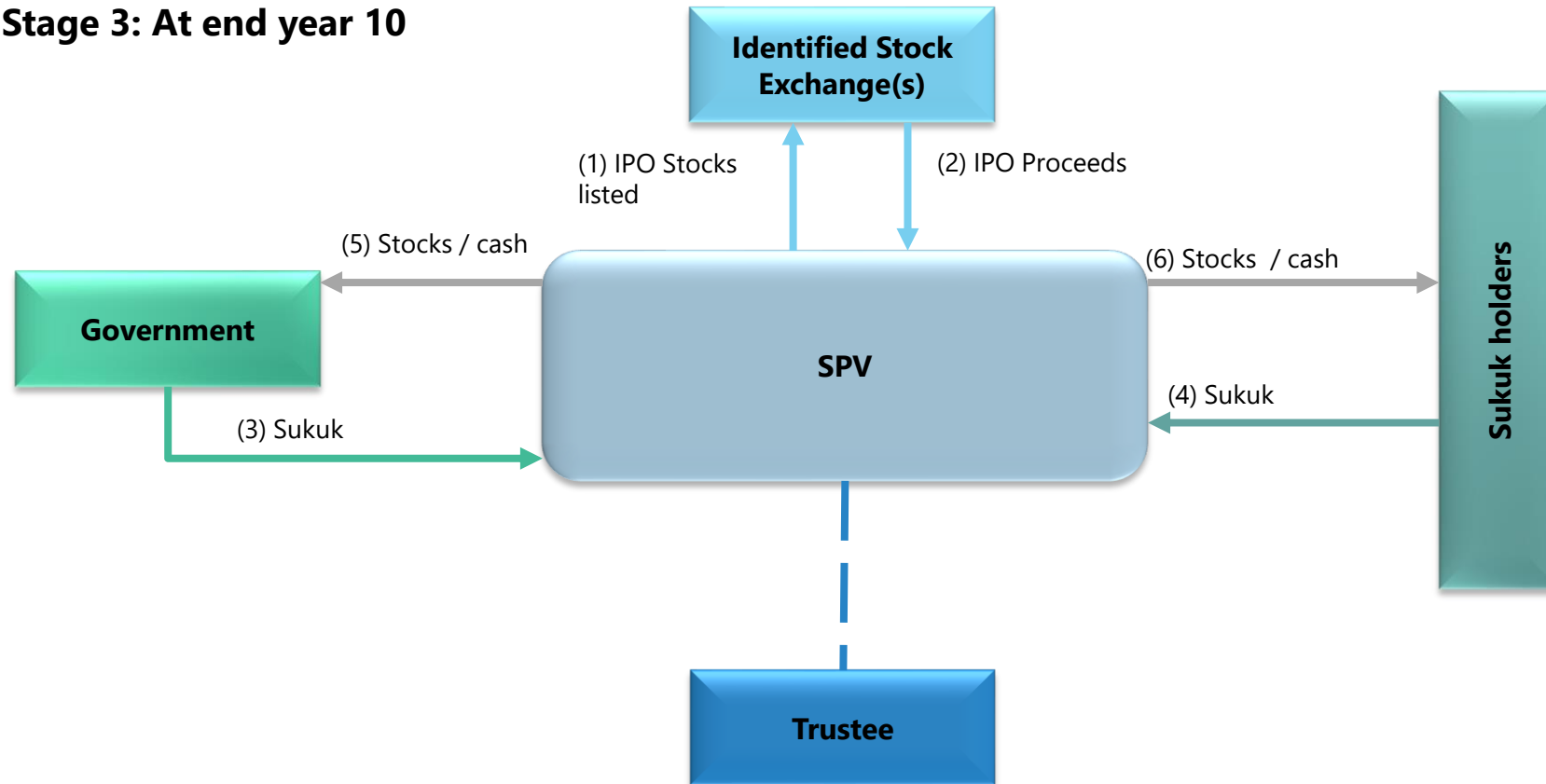
Revenue Generation & Distribution

Stage 2: Year 4 - 10



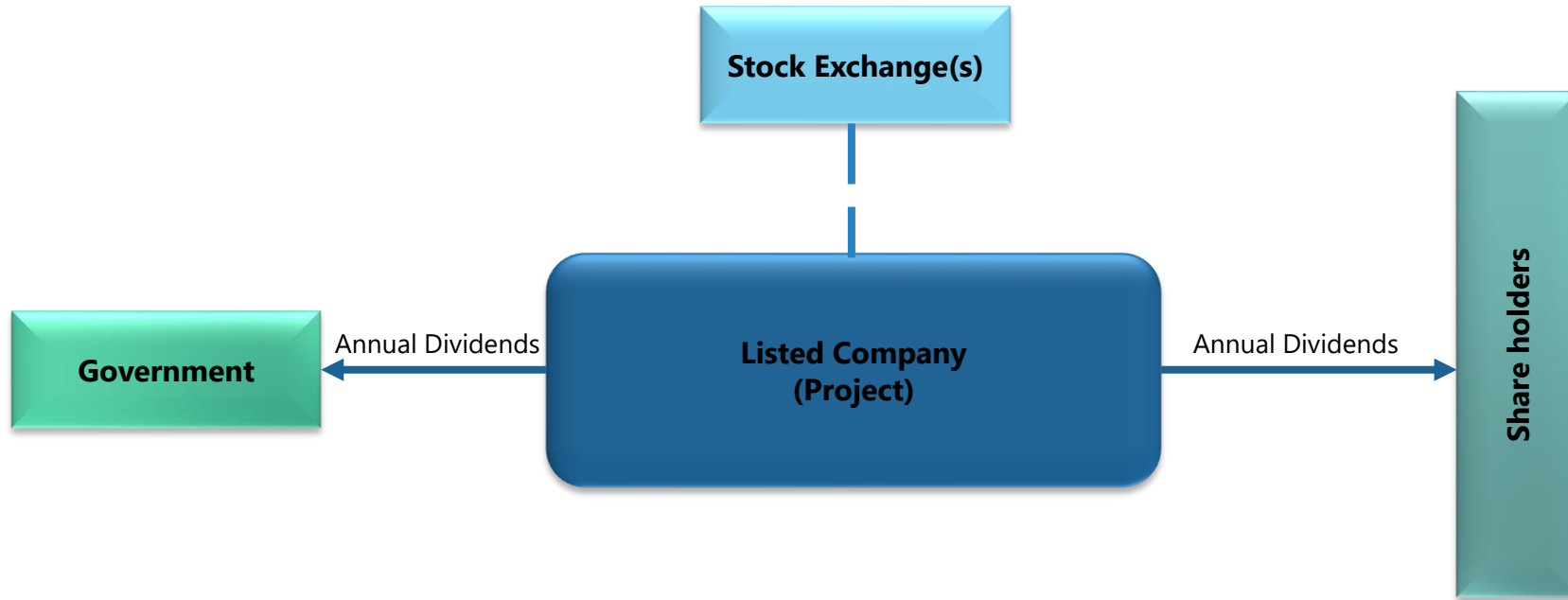
The IPO Process

Stage 3: At end year 10



Post IPO – Listed Company

Stage 4: Post IPO



THINGS THAT COULD CAUSE A STOCK MARKET CRASH

According to literature, the main causes of stock market crashes are:

- ❖ Excessive leverage
- ❖ Speculation
- ❖ Investing in toxic financial assets
- ❖ And among others.

SHARIAH-COMPLIANT STOCKS

1. Conventional finance (*riba*)
2. Gambling/gaming (*maysir*)
3. Prohibited goods & services
 - Pork, alcohol, prostitution
4. Conventional insurance (*gharar*)
5. Entertainment deemed non-permissible
6. Tobacco manufacturing or sale
7. Stock-broking or share trading in non-Shari'ah approved securities

LIMITING EXCESSIVE DEBT LEVERAGE BY DEBT FINANCING SCREENING

Dow Jones	$\frac{\text{Short Term + Long Term Debt}}{\text{Trailing 24 month Average Market Capitalization}} \leq 33\%$
Meezan, Pakistan	$\frac{\text{Total interest bearing debt}}{\text{Total assets}} \leq 45\%$
SC Malaysia	$\frac{\text{Interest Bearing Debt}}{\text{Total assets}} \leq 33\%$
FTSE Shari'ah Index	$\frac{\text{Debt}}{\text{Total assets}} \leq 33\%$
S&P Shari'ah Index	$\frac{\text{Debt}}{\text{Trailing 36 month Average Market Capitalization}} \leq 33\%$
MSCI Islamic Index	$\frac{\text{Debt}}{\text{Total assets}} \leq 33\%$

CONCLUSION

In the case of Islamic banking, the Islamic banks advocate **the limit of debt securitization, higher reserve ratio** and **financing of real sectors** rather than just mere financial intermediaries. Therefore, it can reduce the vulnerability of financial system.

In the case of sukuk, Sukuk projects can be design a way that **financier to be partners and not just lenders** and allow for risk to be shared among parties.

Islamic stocks are better positioned due to the specific features of Islamic stocks such as, **ethical and ratio screenings, exclusion of financial sectors, exclusion of highly leveraged firms, the limit of interest-based leverage**, and, finally, **exclusion of using complex and intensive structured financial products, derivatives, and other toxic assets.**



Thank you

Q&A

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