THE ROLE OF ISLAMIC BANKING IN ECONOMIC DEVELOPMENT IN EMERGING MARKETS

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A PRESENTATION AT THE ISLAMIC FORUM BUSINESS LUNCHEON
LA SCALA, LAGOS
NOVEMBER 2007
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The Debt Burden

• War has been declared on our economies and the weapon is debt

• ‘relieved of their annual debt repayments, severely indebted countries in Africa could use the funds to save the lives of 21m children in 3yrs and provide 90m girls with basic education’- (UNDP Human Dev Report 1997)

• Poor nations are told that if they borrow and invest wisely, they will be able to repay their debts and more. In 50yrs the debt has just kept growing:

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<th>1980</th>
<th>1990</th>
<th>2000</th>
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<tbody>
<tr>
<td>Developing country debt ($bn)</td>
<td>525.4</td>
<td>1259.8</td>
<td>2140.6</td>
</tr>
<tr>
<td>Actual payments of interest + principal ($bn)</td>
<td>73.4</td>
<td>140.6</td>
<td>337.8</td>
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*Source: IMF World Economic Outlook 2001*
Real Consequences of Debt

- The physical consequences of debt through basic indicators of wellbeing:

- In 1995, industrialized countries child mortality (no of deaths before age 5 per 1000 live births) = 16

- South Asia figure = 109; sub Saharan Africa = 169
  - (UNDP Human Dev Report 1998)

- Not surprising given that:

- In Tanzania debt repayment = 6 times spending on healthcare

- In Uganda, annual healthcare spending = $2 per person whilst debt repayment = $11.5 per person (Jubilee 2000)
Contradictions

- The multilateral banks promote the borrow/invest/export/repay development model
- Yet, not one developing country has gone into debt with the IMF and World Bank and subsequently paid it off
- The typical response to budget and trade deficits in the developing world is an austerity program- yet the world’s biggest debtor and holder of the biggest trade deficit does not follow this advice
- They argue that debt finance is acceptable if projects are self-liquidating
- If so, why don’t they advance finance to developing countries on a profit sharing basis instead of charging interest?
- There is no discussion of the impact of usury on monetary crises. Instead, the attention is on ‘corrupt dictators’ and ‘inefficient practices’
The Islamic Solution

• The Islamic solution to the problems we face is based on an entirely different philosophy from the ‘profit maximization’ fixation of the capitalist system

• Once when Muslim’s adhered to the rules of Allah, the world was characterized by peace and justice not riba and a debt burden

• Even for non-Muslim’s it was a Golden Age that thrived for almost 1300 years
• Important:
• If the only difference between Islamic and conventional banking practices is whether the business is interest based or not, then the conventional financial institutions can probably deliver Islamic services more efficiently

• A distinct aspect of an Islamic enterprise is the social dimension of its operations

• For Islamic banking & finance to be sustainable, compliance with Shari’ah principles alone is not sufficient. They must be able to provide a comprehensive range of Islamic financial products and services that are not only innovative and competitive but Shari’ah Compliant. Quality and added value is key
Objectives of the Shari’ah

- The very objective of the Shari’ah is to promote the welfare of the people which lies in safeguarding their faith, their life, their intellect, their posterity and their property. Whatever ensures the safeguard of these five serves public interest and is desirable. Al-Ghazali

- The basis of the Shari’ah is the wisdom and welfare of the people in this world as well as the hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the Shari’ah –Ibn al-Qayyim
Islamic Tools for Prosperity

The following tools of Islamic economics have positive social implications:

- Zakat; levy on income and wealth
- Sadaqah
- The distribution of Hima land
- Allocation of state land for grazing
- Awqaf (endowment) funds
- Inheritance law
- **Islamic Banking and Finance**
Social Responsibility

- Harmful goods and activities are not permissible (alcohol, gambling, pork, pornography, arms etc)
- Wasteful use and extravagances undesirable
- Usage which harms public interest or the environment is to be avoided
- Obligation to support the needy
- Ownership creates duty of obligatory charity (zakat)
Monetary System

- No increase in money exchange with or without passage of time (riba)
- Money itself has no intrinsic value without investment
- “Only when the last tree has died and the last river has been poisoned and the last fish been caught will we realize we cannot eat money” – Cree Indian Proverb
- Stability in the value of the money
- Zakat depreciates the value of money and stimulates savings to be invested rather than hoarded; money flow is accelerated
Social Aspects

• A financial system based on sharing profit along with risk lays the ground for financial freedom in society

• Implications of zakah – encouraging investment as it is a tax on accumulated net wealth rather than on income. I.e. a tax on hoarding

• The Prophet (SAW) said, “invest the orphans capital so that it may not be wiped out by zakat”

• The creation of purchasing power amongst recipients

• Redistribution of wealth and income through the mobilization of idle resources to more dynamic recipients
Economic Consequences

- Economic well-being and full employment
- Optimum rate of growth
- Socio-economic justice
- Equitable distribution of income and wealth
- Stability in the value of money emanating from banning the lending of money
- Banning of interest instigating a banking system based on partnership between labour and capital
- Mobilization of savings to investment
Macro Efficiency

- Equity financing and a profit & loss sharing basis does not change the level of uncertainty but it does relieve the burden of interest from the balance sheet.

- Risk is allocated more equitably in the Islamic finance system.

- In the interest based business, the borrower makes most of the gains from a positive outcome but must bear the risk of loss alone.

- Speculation is curtailed as margin trading and derivatives are not allowed.

- Banks, savers and investors can absorb their modest share of loss without disturbing the whole system through bankruptcy.

- In a PLS system the net positive or negative outcome of the business will be shared between money capital and human capital. A positive return adds to the wealth of society.

- Economist Tobin’s view is that in an interest-free economy, the rate of return on capital will be higher than in an interest based economy as in the PLS or equity capital, investors seek investments with higher returns.
Islamic Banks - A Viable Alternative?

- Islamic banking has gained a foothold in Muslim countries and internationally in the financial markets.

- In an emerging market economy, the financial system is a means to an end. It needs to be in a position to support the real sector.

- **Q:** Does Islamic banking offer a better financial architecture on economic grounds?

- Yes, as it reduces the dichotomy between financing and the use of funds leading to integration of real and financial sectors of the economy.

- The direct linkage between financing and application of funds under Islamic banking means an end to untied cash as found in interest-based economies. Thus an important cause of the mismatch between aggregate demand and supply in the economy will be removed.

- This means less demand–pull inflation.

- Linkage of financing to economic activity will help ease supply constraints resulting in employment generation.
**Effects of Islamic Banking on the Economy**

- Better integration of the real and financial sectors of the economy

- Better business ethics – banks will only entertain economically viable financing requests

- Instead of being lenders, Islamic banks will provide financing by coming in as traders (murabaha), lessors (ijara) or partners (mudaraba; musharaka)

- Islamic banks will stay away from financing prohibited activities e.g. producing alcohol etc

- There will be greater transparency in their transactions with clients – depositors as well as fund-seekers- due to compliance with the avoidance of gharar (ambiguity) resulting in clear contracts for every transaction

- Greater economic stability – it is well known in traditional finance literature that interest based debt finance is an important source of economic instability when compared with equity finance
Integration of the Real and Financial Sector

Interest based solution: financial institution as lender

Islamic solution: financial institution as trader

F = Financial institution; C = Customer; S = Supplier
Required Financial Institutions

- Structure of the Islamic Finance Industry
  1. normal banking institutions—Commercial banks, finance companies, leasing companies
  2. development finance institutions
  3. microfinance institutions
  4. mutual funds, Investment banks, investment companies, Islamic Funds, venture capital firms, real estate companies, PFAs
  5. insurance institutions - Cooperative insurance – takaful, retakaful
     - World gross takaful premiums in 2005 was $5.6bn mostly Saudi & Iran

- Financial innovation required in critical areas:
  - Financial products yielding stable income flow for pensioners etc
  - Liquidity instruments for the financial sector (CBN, NDIC, Banks, Fund Managers, PFAs)
  - Regulatory and legal framework – including tax
The Global Islamic Finance Industry

- Consists of ≈ 300 financial institutions managing more than $250 billion (S&P estimates $400bn)

- One of the fastest growing financial sub-sectors at 15 -20% annual growth

- Industry evolving and expanding both financially and geographically

- Inclusive paradigm : open to Muslims and non-Muslims that seek ethical financial solutions
The Global Islamic Finance Industry contd.

- Financial institutions in the form of commercial banks, investment banks, investment and finance companies, insurance companies etc.

- Different models: private institutions in conventional economy, national Islamic banking systems and dual banking models.

- Different forms: wholly Islamic institutions, Islamic subsidiaries of conventional bank groups, Islamic windows within conventional banks.
Conclusion

• The most controversial aspect of Islamic economics which sets it apart from the conventional system is the prohibition of riba and hoarding and the imposition of zakat.

• The abolition of riba has economic and social consequences:
  • It aims at eliminating injustice and promoting brotherhood and cooperation between capital and labour.
  • It promotes productive enterprises as a means of raising productivity and employment.
  • Islamic finance can fulfill its promise with coherent efforts and a well planned strategy to instigate Islamic economics principles on the macro and micro level.

• Key words: cooperation, collaboration, synergies, institutional framework.

• We should expect not only greater competition from amongst ourselves but also from interest based banks. They are already offering Islamic financial products and this competition will grow.
Conclusion cont'd.

- Over the last 4 decades, Muslim bankers and religious leaders have worked to develop financial instruments similar to ethical investing to conform to Islamic law

- Today, Islamic banking is at the centre of media hype

- Some of us have great hope for this system of fair profit and risk sharing banking

- Non-Muslims are equally attracted to this form of banking

- Islamic banking presents Muslims with an opportunity to demonstrate the power of their values

- Islamic banks are known for caring and investing in the communities they serve

- To unleash the potential of emerging markets, Islamic banks must become the catalyst of economic change through such programmes as microfinance, SME lending

- The history of Islamic banking is not finished; we are amidst an evolutionary process

- The opportunity for the Islamic Finance industry is to develop into an important component of the international financial system that can enhance the prospects for balanced global growth and shared prosperity

- One thing is clear, the future is exciting for Islamic banking and finance
“Establishing an Islamic bank is not a tale of wealth but a true story about creating value. This value is humane and financially viable” – SH. S. Ben Iouta (Islamic banking pioneer)
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