



HARVARD-LSE WORKSHOP:

LONDON SCHOOL OF ECONOMICS, LONDON, UK - FEBRUARY 23, 2012

ISLAMIC FINANCIAL INTERMEDIATION: REVISITING THE VALUE PROPOSITION: A SHORT REPORT

The Islamic Finance Project (IFP) of the Islamic Legal Studies Program (ILSP) of Harvard Law School, along with the London School of Economics and Political Science (LSE), co-hosted the sixth annual workshop on Islamic finance on 23 February 2012 at the LSE campus in London.

This year, participants chose “Islamic Financial Intermediation: Revisiting the Value Proposition” as the workshop topic. A diverse group of twenty-seven individuals attended the workshop, including distinguished Islamic legal experts (also referred to as shari’a scholars), academics, Islamic economists, bankers, lawyers, and representatives of standard setting bodies.

S. Nazim Ali, Director of IFP and Acting Executive Director of ILSP welcomed the participants to the workshop and thanked the participants, sponsors and the volunteers for their contributions in organizing it.

George Gaskell, Pro-director of the LSE (Resources and Planning) welcomed the participants to the workshop and assured the support of the LSE administration to this ongoing effort. David Kershaw, Professor of Law at the LSE played an important role in organizing the workshop, but was unable to attend due to unavoidable commitments.

Frank E. Vogel, Founding Director Islamic Legal Studies Program (ILSP) and moderator explained the rules of the house. The workshop then commenced with an overview of the written comments received from the participants.

Harvard-LSE Annual Workshops on Islamic Finance

These annual workshops are a forum for in-depth and multidisciplinary discussion on some of the most pressing issues facing the Islamic financial sector. They are not meant to prescribe a particular course of action or reach definitive conclusions but to provide an open environment for discussion. The topic of the workshop is chosen based on a survey of the participants. Participants are then provided background information on the topic and they are requested to submit their comments. The comments received are compiled and distributed to all participants prior to the workshop. The workshop spans an entire day with several issues discussed in multiple sessions. To facilitate free and open discussion, the views expressed are not attributed to any participant.

Objectives of the Workshop

The objectives of the workshop were: (i) reviewing the understanding of Islamic financial intermediation and narrowing down what is meant by its real value, (ii) testing this understanding of Islamic financial intermediation and its real value against the world’s recent financial shortcomings and Islamic economic thinking about justice, equality, and wealth creation, (iii) discussing and applying Islamic financial intermediation with respect to each of: macro, institutional and consumer levels, (iv) discussing what immediate economic, legal, and regulatory reforms are needed to reposition

the industry toward the value proposition on Islamic financial intermediation agreed earlier, and (v) exploring what Islamic financial principles are required to reposition the Islamic finance industry toward a more sustainable future.

Value Proposition of Islamic Financial Intermediation

The main issue addressed in the workshop was the value proposition of Islamic financial intermediation. It was pointed out that financial intermediation generally refers to moving funds from surplus to deficit units. There is, however, disagreement about whether institutions offering Islamic financial services can be classified as financial intermediaries in the same sense as conventional financial institutions. However, there may be no harm in using the term financial intermediation in Islamic finance as long as the required shari‘a conditions are met.

It was argued that morality is at the core of Islamic finance and its value proposition. Therefore, morality should be expressed by things like serving the real economy, reaching sections of population not served by the financial sector, discouraging debt, encouraging profit sharing, promoting development, and reducing economic inequality.

An alternative view was that Islamic banking is only a part of Islamic finance which in turn is a part of the theoretical construct referred to as an Islamic economic system. Companies offering Islamic financial services are set up to earn a competitive return for their shareholders and other relevant stakeholders such as customers. It is unfair to demand that Islamic banks and Islamic finance try to deliver what is usually expected from governments and development financial institutions. Islamic banking cannot assume the moral responsibility that is meant for others and expectations of morality from Islamic finance should be consistent with the role of Islamic finance.

A counter argument was that some of the expectations from Islamic finance are partly a product of the vocabulary, symbolism, and rhetoric used by the sector and its proponents to promote its business to ordinary Muslims. Therefore, the sector should not disown these expectations of morality after having benefitted from these expectations in profitability and growth. If the sector cannot deliver on the expectations that it creates by using the label “Islamic,” it should perhaps scale down the expectations, explaining that it is merely trying to replicate conventional finance while complying with form-oriented technical requirements of Islamic commercial jurisprudence.

It was highlighted that Islamic commercial banking is operating in a wider economic and financial system that creates obstacles to implementing the theory underlying Islamic finance. For instance, the Islamic economic theory relies heavily on risk sharing as part of its moral appeal but it is difficult to share risk in commercial banking, the largest segment in the sector. Those providing finance (e.g. depositors) are unwilling to accept a loss on their principal and those receiving finance (e.g. industrialists) are unwilling to share their profits. As a result, Islamic banking, like conventional banking, also relies heavily on debt. Islamic economics and finance were conceived in the then newly independent Pakistan as profit sharing arrangements, but later on these ideas were pasted onto commercial banking where they do not seem to fit. Having said that, over the years the stance on debt in Islamic finance seems to have softened. While debt is not preferred over profit-sharing arrangements, it is now more likely to be seen as a legitimate means of financing if the relevant conditions are met.

It was further explained that the unwillingness of parties providing and receiving finance to share business risk is due to the dominant conventional commercial banking with which all parties have become accustomed to. Commercial banking has little, if any, room for depositors and borrowers to share the risk of business outcomes. A wide range of factors—such as banking regulation, deposit protection insurance, tax deductibility of interest, higher capital adequacy charge for equity exposure—support the practice of conventional banking. For those working in the Islamic financial sector, it is a safe strategy to continue to replicate conventional finance because if they try to innovate more authentic solutions and fail, it could cost them their jobs.

It was contended that conventional commercial banking relies heavily on collateralized lending and therefore it channels financing to those who can furnish the collateral and thus deepens economic inequality. Islamic finance was meant to channel financing to the entrepreneurs who may not be able to furnish the collateral. However, Islamic finance has not been able to move away from collateralized lending because the system designed for conventional finance does not let it do so. Until the playing field is leveled, the niche of Islamic finance cannot offer the risk-sharing in financing which was meant to be a part of the moral value proposition.

A counter argument was that while there are important obstacles to realizing the moral value proposition of Islamic finance, Islamic financial institutions are not even doing what they can do within the current financial and economic system. For instance, conventional financial institutions

seem to be far ahead of Islamic financial institutions in corporate social responsibility even though morality is supposed to be at the core of the value proposition of Islamic finance. AAOIFI already has a standard on corporate social responsibility but that is not being widely followed in the sector. Moral finance is the need of our times but despite its emphasis on morality, Islamic finance is conspicuous by its absence at the relevant forums, such as the World Economic Forum. Perhaps, by replicating conventional finance instead of offering something more consistent with its underlying theory, Islamic finance has created the perception that it has nothing new to offer.

It was also pointed out that if they want to, Islamic banks can use new methods, such as mobile banking, to include the financially excluded. Investors may seek protection of their principal but it is possible that they would be willing to sacrifice some economic return for social causes. The Islamic financial sector has not come up with the products to create opportunities for such impact investing whereas this is being done in conventional socially responsible investing. The dominance of conventional finance and a debt based system is no excuse for not doing what can be done within the current system to put into practice the morality in Islamic finance theory. Many agreed that this moral value proposition should go beyond technical compliance with Islamic commercial jurisprudence. Without this moral value proposition, the growth experienced by the Islamic financial sector will not be sustainable.

It was explained that the Arab Spring is both an opportunity and a challenge for Islamic finance. It is an opportunity because in the Arab Spring countries, the financial system focused on the economic and political elite while largely neglecting the entrepreneurial class. It is also a challenge because there is a risk that Islamic finance may fail to deliver and its reputation will be hurt. If Islamic finance offers the same sort of financing to the same class of people who are already well served by conventional finance, nothing will be gained and much will be lost.

Ideas for Making Progress on Value Proposition of Islamic Finance

During the course of discussion, different participants proposed a wide range of ideas that in their view would directly or indirectly help the Islamic financial sector offer the value proposition that is expected from it and further its progress. While there was no consensus on the desirability or feasibility of these ideas, they are being listed here in no particular order for the benefit of the readers of this report.

1. More emphasis on institutions other than commercial banks, such as investment companies, mutuals, cooperatives, social banks, and alternative methods such as peer-to-peer banking and mobile banking;
2. Greater engagement with stakeholders, particularly shareholders of Islamic financial institutions, to amend the charters of Islamic financial institutions to sacrifice some returns for social goals;
3. Establishment of an international association of shari'a scholars to pursue objectives such as continuing education of shari'a scholars, increasing transparency of juristic rulings (fatwas) and underlying rationale, implementing a code of ethics, and enhancing the reputation of this profession;
4. Introduction of investment products that offer both an economic and a social return reflecting the needs and priorities of the Muslim world, such as education and low-cost housing;
5. Greater engagement with regulators to bring about the regulatory changes needed for the growth and development of the Islamic financial sector as the global financial crisis has resulted in a loss of prestige for conventional finance and regulators may be more willing to consider Islamic finance as a morally superior alternative;
6. Revision of the AAOIFI standards that are in need of revision, their translation in relevant languages, and easier access to these standards;
7. More opportunities for training of shari'a scholars in analyzing the macroeconomic implications of their legal rulings and more forums where shari'a scholars and economists can engage in such discussions;
8. Effective mobilization and utilization of zakat funds through professional management and international institutions to promote economic fairness, justice, and wealth distribution;
9. More internships for students of Islamic finance in the Islamic financial sector to comprehend the practical issues encountered by the industry and to develop into a valuable human capital for the industry;
10. Building of bridges between Islamic finance and socially responsible investing whereby experts from socially responsible investing companies are invited to participate in Islamic finance events and Islamic finance experts can learn from the innovations in socially responsible investing, such

- as social impact bonds, to align economic and social return; and
11. Establishment of a think tank like structure for serious ongoing multidisciplinary dialogue to find solutions for the progress of Islamic finance which, among other ways, could be financed through the purification proceeds from the Islamic financial sector.

<u>Harvard-LSE Annual Workshops on Islamic Finance</u>	
2012	Islamic Financial Intermediation: Revisiting the Value Proposition
2011	Reappraising the Islamic Financial Sector
2010	Islamic Financial Ethics and Ethical Governance
2009	Microfinance: Toward a Sustainable Islamic Finance Model
2008	Sukuk: Economic and Jurisprudential Perspective
2007	Tawarruq: A Methodological Issue in Shari‘a -Compliant Finance