

Islamic Finance for Asia: Development, Prospects and Inclusive Growth¹

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The global financial crisis of 2008/09 has triggered a lot of soul searching, new thinking and revisionist analysis in search of an alternative paradigm under which the positive aspects of the international financial system can be preserved and promoted while the destabilizing and negative dimensions are averted, or at least their adverse impact is minimized .

It is in this larger context that I wish to explore the possibility of advancing Islamic finance as a possible alternative means of financial intermediation and a reliable instrument of promoting inclusive growth and reducing income inequalities in Asia and the world.

Islamic financial service industry (IFSI) has been growing 50 percent faster than the traditional finance. The average annual rate of growth of Islamic financial assets has been about 20 percent. But the total volume of these assets i.e. \$ 1.8 trn accounts for an insignificant proportional of the global financial assets. It has a long way to go before it makes an appreciable dent.

The two attractive features of Islamic Finance that lends credibility to the stability requirements are (a) the financing is backed by real assets i.e. the financial returns are linked to a real sector activity and (b) there is no fixed, pre-determined rate of return i.e. the investor's return is based on the performance of the underlying asset. Exotic artificially contrived instruments such as Collateralized Debt obligations raised to square and cube root that have been a bane for the global financial system do not find any place in the domain of Islamic finance. These two strong attributes can potentially overcome the apparent shortcomings of the existing financial system and provide stability has proved elusive so far.

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Malaysia is the only country where the share of Islamic financial assets is about 20 percent of the country's total banking assets. This does not yet provide a counterfactual to test the hypothesis of relative financial stability of the Islamic system. Unless Islamic finance emerges out of the niche market status as the dominant mode of finance in any country it is difficult to go beyond theoretical assertions claiming the relative superiority of the Islamic system. However, some preliminary empirical evidence has begun to trickle in. A recent IMF study highlights the factors related to Islamic banks' business model that helped limit the adverse impact of the global crisis on their profitability in 2008. According to the authors, Islamic banks' credit and asset growth was higher than that of conventional banks in 2008 and 2009 contributing to stability. The external rating agencies' assessment of Islamic banks' risk was also generally more favorable than that of the conventional banks. But beginning 2010, the slow down in financing and higher non performing credits in MENA and Pakistan do point to the fluid nature of the business that has not yet reached a steady state.

I do not wish to sound either defensive or self serving but the truth is that the real momentum in IFSI has gathered some speed only in the last decade. The establishment of supporting institutions such as IFSB, AAOFI etc, the infrastructure such as Shariah Boards, short term liquidity arrangements, Islamic indices, rating agencies , and national regulators are still in their nascent stage. Innovation in products has been focused on making the existing products Shariah compliant rather than manufacture and distribute new products with unique characteristics of their own. If we exclude Iran and Sudan the IFSI penetration ratios and coverage in most countries with dual banking systems are just beginning to take off. According to the 2013 Stability Report of IFSB , none of the 24 jurisdictions where Islamic Finance has been introduced can claim more than a small share in their respective banking systems.

I have been arguing consistently for past decade that we do not want Islamic Finance to be GHETTOIZED but GLOBALIZED i.e. it should be very much an integral part of the Global Financial system and gradually enlarging and extending its share by proving its usefulness to the stability and inclusive growth outcomes. It cannot remain an isolated, disconnected and fragmented asset class covering a

small space in the vast landscape of international finance. Unless the non Muslim countries begin to accept and adopt it as a part of their mainstream financial systems the future of IFSI will remain bleak and highly constricted.

It is therefore heartening to note that the UK Government was a cohost of the recently concluded World Islamic Economic Forum in London. The British Government has committed to make London the global hub of Islamic Finance. UK Treasury is issuing a sukuk worth 200 million pounds becoming the first sovereign to issue an Islamic bond outside the Islamic world. As the Chancellor of Exchequer pointed out this will act as a catalyst for corporate institutions to follow suit—further expanding the use of sukuk as an asset class in the global capital markets. Let me add that if the UK example proves successful there would be a multiplier effect in the international sukuk market providing depth to the market.

I would submit that in Asia characterized by rapid economic growth and alleviation of poverty there is growing concern including voiced by the ADB in its analytical and country work about Income inequalities and their pernicious effect on social cohesion . Therefore , Inclusive Growth that is a strong pillar of Islamic finance presents itself as an attractive candidate to address this widespread concern. Let me outline three different ways in which the Islamic Finance can make a contribution in resolving this issue.

The principal tenet of Islamic Finance as enjoined by Quran is justice and Equity. The rules governing property rights, contracts, distribution and transfers of wealth , use of excessive wealth by individuals beyond moderate limits, entitlements of the poor and downtrodden are all aimed at ensuring outcomes that ensure justice and equity. The challenge therefore is how to translate this built in feature of Islamic economic system into action and operations. Individual, Societal material and physical well being along with spiritual well being are to be maximized rather than individual self interest that forms the sole basis of the capitalistic system and guides the financial architecture. An individual, an enterprise or a group, when it borrows from the banks is obliged to repay a fixed amount as interest at a certain given interval of time. It is immaterial whether the

borrower's underlying business is making profit or loss. The risk is concentrated solely in the borrower and the fruits of adversity or good fortune are borne by the individual, firm or the group that has borrowed the money from the financial institution. The origin of inequity can therefore be traced to this particular feature of the conventional system of finance. Under Islamic finance, the supplier of funds or the investor demands the return on investment, ex-post after the business transaction has produced the outcome. As the risk of business in Islamic finance is shared between the supplier and the user of funds the returns on investment whether positive or negative are shared equitably between the two parties in the proportion they had agreed upon. The burden of misfortune of adversity does not fall upon the borrower only and the winner i.e. the supplier of fund does not take it all while the loser i.e. the borrower of fund does not become financially insolvent.

The other distinguishing feature is that the rules governing the Islamic financial system are derived from the Quran and not made and changed by the man or assemblies of men at their discretion. One of the major difficulties in the existing conventional economic system is that the political power in most developing countries has been vested in the hands of a dictator or group of elected leaders who are more interested in their self-aggrandizement rather than the larger collective interest of the majority of the population. This inherent conflict between individual interest of these who wield power and make the rules and the collective interest of the society is a major source of economic and financial exclusion and thus inequality. In Islamic system on the other hand, the collective interest of the society is embedded in the rules in accordance with the teaching of Quran that provides the structure and operation of ideal Islamic economy and its financial system. Islamic jurisprudence is only concerned with the interpretation and not formulation of these rules and that too within the fundamentals of Quran and Sunnah. The discretionary powers of man are therefore highly circumscribed and the scope for any mischief to benefit an individual at the expense of the larger community would always remain limited.

In Islam any amount of wealth that has been accumulated by the efforts of an individual and the family but exceed its moderate needs has to be shared with

others who are not able to do so for some reason or the other. It may be due to lower human ability or absence of useful skills or ill health or any other unforeseen tragic circumstances. Redistribution and social transfers in form of Zakah and Sadaqah are the rights to which the poor, unemployed less privileged and handicapped are entitled. These transfers compensate for lack of adequate income to meet their day to day expenses. Income inequality is therefore mitigated under the Islamic system through the rights of transfer from the well to do and the entitlements of the poor to live a decent life and take care of their basic needs. Distributive justice and maximization of social welfare through the institutions of transfers are the pillars of the Islamic economic system.

This is another matter that we have not yet been able to evolve an ideal economic and financial system in accordance with the teaching of Quran although a lot of lip service has been paid to it by the leaders of many Islamic countries. As the rest of the world is groping to lay its hands on an equitable system of economic production and distribution, the Islamic alternative if implemented in its the letter and spirit can be of interest to non-Islamic world too.

I believe that Islamic finance cannot make major impact unless the larger landscape of the economic system is also altered and practiced in conformity with the values, structure and thoughts of the Holy Quran. The good it is capable of providing for the rest of the humanity in its struggle for sustainable and equitable development, inclusive growth and financial stability can only be achieved if the Islamic economic system is adopted enforced and practiced in the letter and spirits. The risk of not doing so is that the Islamic finance may remain at best compartmentalized and confined to the Muslim of the world failing to integrate into global financial system and thus missing the enormous opportunity to benefit the humanity large in these trying times.