

## **Islamic Finance as a Means of Shaping the Future of Sustainable Finance**

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### **Abstract**

The recent financial crises have proven that the major social impact of the activities of the most major commercial and investment banks is through improper management of transaction, portfolio and reputational risks. Although they and their key stakeholders agree that financiers bear significant responsibility for the environmental and social impacts of the operations they finance, they do not go beyond the recognition of environmental and social responsibilities driven to a large degree by outside pressures of environmental organizations such as Friends of the Earth (FoE) and the Rainforest Action Network (RAN). They challenged the industry with high-profile campaigns that highlighted cases in which commercial banks were “bankrolling disasters”. In 2002, a global coalition of non-governmental organizations (NGOs) including FoE, RAN, WWF-UK and the Berne Declaration came together to promote sustainable finance in the commercial sector. This informal network subsequently evolved into BankTrack, whose vision for a sustainable finance sector was expressed in the Collevocchio Declaration of January 2003.

In this paper we will put forward the main agent in improper management of transaction, portfolio and reputational risks of commercial banks, the interest rate. No economic system can sustain its health and vigor or contribute positively to the achievement of its socio-economic goals without the support of sane and equitable money and banking system. The money and banking system should hence be reformed to eschew the excesses and imbalances which promote inequalities, conspicuous consumption, and unhealthy monetary expansion to the ultimate detriment of all.

**Keywords:** Sustainable finance, Islamic finance, financial crises, interest free finance

### **1.INTRODUCTION**

The rapid growth of Islamic finance and its ethical foundations make it an increasingly serious alternative to conventional finance. Both New York and London have launched indices affiliated to their main Dow Jones and FTSE indices, to provide a benchmark for equity prices for investments in Islamic financial institutions. The UK Government has also played a major role in trying to make the City of London the global centre of Islamic finance by extending support wherever possible, including the abolition of double stamp duty on Islamic mortgages, and the recently announced plans to test the feasibility of issuing Shari’ah-compliant sukuk bonds. The 2007 Budget introduced new measures for sukuk bonds to be issued, held and traded on the UK financial market (Tayyebi, 2008).

Islamic finance claims to be compliant with the principles of Islamic law (Shari'ah). In terms of finance, indeed Shari'ah explains in detail the ethical concepts of money and capital, the relationship between risk and profit and the social responsibilities of financial institutions.

The most well-known aspect of an Islamic financial system is the prohibition of paying or receiving interest on capital. Essentially, any positive, fixed, predetermined rate tied to the maturity and the amount of principal, which is guaranteed irrespective of the performance of the investment, is considered *riba* and is so prohibited.

Contractual risk is also forbidden. In general, this prohibits the selling of goods or services that the seller is not in a position to deliver or the making of a contract which is conditional on an unknown event.

Although the prohibition of interest can indeed be viewed as the nucleus of Islamic doctrine relating to finance, there are a number of other supporting principles which provide guidance for an Islamic financial system (Tayyebi, 2008):

- Advocating risk sharing
- Promotion of entrepreneurship
- Discouraging speculative behavior
- Preservation of property rights.

Given the restrictions outlined above, modern-day scholars have developed principle modes of financing which can be applied to contemporary financial scenarios while adhering to Islamic principles. Some common financial instruments currently being utilized in Islamic finance in various forms are as follows.

**Murabaha:** this is effectively cost-plus financing, as used for trade and asset finance, allowing deferred payment by customers.

**Istisna'a:** aimed at long-term construction projects

**For asset finance Ijara:** this is a quasi-debt instrument, essentially equivalent to leasing.

**Equity-like instruments Musharakah:** this is akin to a joint venture arrangement, through an equity participation contract.

**Mudarabah:** this is essentially an investment fund where one party provides the entire capital, and the other party provides the management. Profit sharing is agreed up-front, although the loss is borne by the provider of the funds alone.

Fixed income investment Sukuk: this is an investment certificate (bond) that represents a proportionate interest in a well-defined pool of assets that yield income and capital returns.

Differences of opinion from Shari'ah scholars on whether certain practices or products are Shari'ah compliant continue. A common set of standards and closer links between regulators and standard setters such as AAOIFI, the IFSB and the FSA are crucial.

The nuances of Islamic jurisprudence and its assimilation with conventional banking require a great deal of expertise. Investment in training and formal qualifications will be vital to attract and maintain the right level of professionals to allow the industry to develop.

As would be expected with a relatively recent phenomenon, there remain legitimate concerns over the mechanics and regulation of Islamic finance. Although, a Congressional Research Service report on Islamic finance in July 2008 notes: 'Some also view the integration of ethics and values into finance as a positive development, with many investors reportedly considering SCF (Shari'ah compliant finance) to be more reliable than conventional financing, given the recent global credit crisis and fears of economic recession', many religious Muslims still are not confident about the Shari'ah compliance of Islamic finance.

The most serious questions around the Shari'ah compliancy of Islamic finance are related to the income smoothing.

Islamic banks are more inclined to set up an allowance for loan loss provision (LLPs) to absorb any future losses (Taktak, et.al. 2010; Ahmed et. al. 1999; Anandarajan et. al. 2003, 2005; Hasan et.al 2004; Ismail et. al. 2002, 2005; Zoubi 2007). To avoid bank runs, Islamic financial institutions are also encouraged by Islamic Financial Services Board (IFSB), and their Shari'ah Boards to use profit equalization (PERs) and investment risk reserves (IRRs) (Sundararajan 2007) to keep stable returns to reward investment account holders (IFSB 2010). They also use devices like deposit insurance (DIs).

Income smoothing devices cause an almost constant return rate seemingly bench marked to the London Interbank Offered Rate, LIBOR. In this research, possible outcomes of the removal of one the most important devices of the income smoothing, profit equalization reserves (PERs) is discussed.

## **2.Income Smoothing by Profit Equalization Reserves (PERs)**

PER is a mechanism act to mitigate the fluctuation of Rates of Return arising from the flux of income, provisioning and total deposits (Child, 2009).

The creation of PER is to ensure that Islamic Banking Institutions (IBIs) Rates of Return remained competitive and stable. During times of low returns to depositors and investors, IBIs can choose to utilize the PER to improve and stabilize the Rate of Return to its depositors and investors. The main purpose is to protect depositors and investors interest as far as possible.

Currently, PER can be allocated up to a maximum 15% of the total gross income every month. The formula for how much PER can be allocated is as follows:

PER (maximum monthly provision) = (15% x gross income) + net trading income + other income + irregular income such as recovery of non-performing financing (NPF) and write back of provisions.

In Malaysia, as per BNM Guidelines, IBIs are only allowed to maintain a maximum accumulated PER of 30% of Islamic Banking Shareholders' Fund.

The IBIs may write back the PER into the total gross income, at their discretion, in the event that the prevailing rates have become less competitive. PER is recognized as a liability in the Balance Sheet and as an expense in the Income Statement.

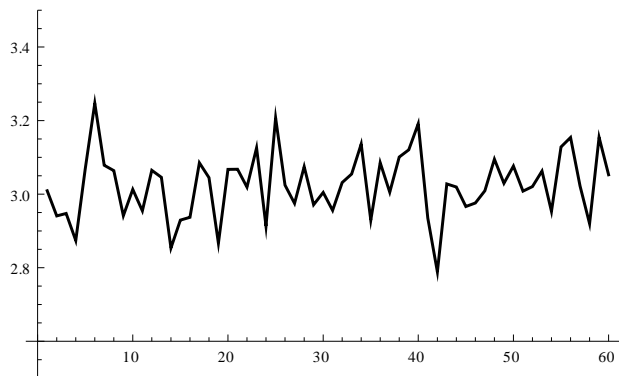
### **3.Misconception by IBIs on PER**

Although IBIs are given the right to allocate some of its income into PER, it is not right for IBIs to treat PER as another source of income as most bankers assume. PER is a way on how an IBI can manage or control its Rates of Returns. By right, any income generated from the utilization of funds i.e. depositors funds, must be returned back in full to customers accordingly. But this may be a partly solution since the depositors due to change by the time, a profit realized by one's investment will be paid to an irrelevant investor.

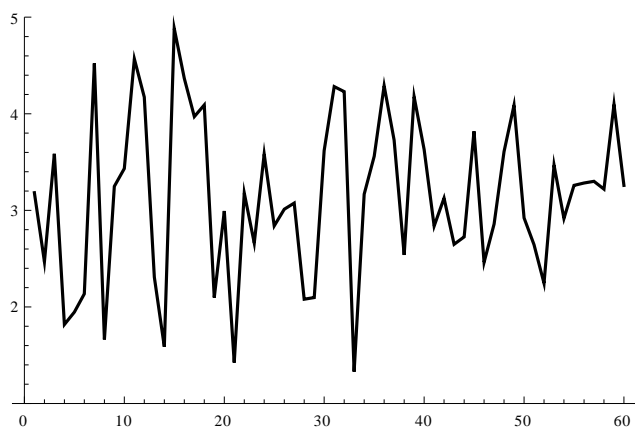
The best is the abolishment of all income smoothing devices.

What Happens if Profit Equalization Reserves (PERs) are Removed?

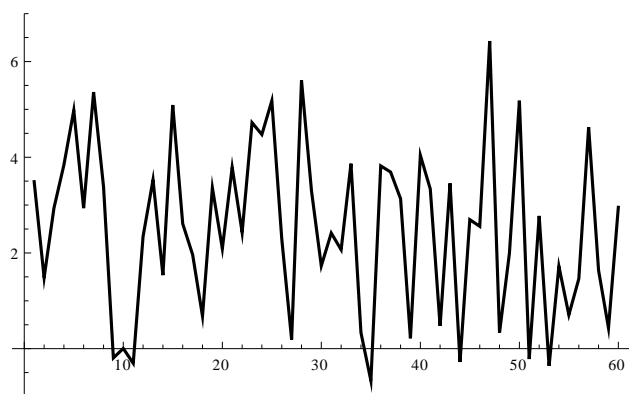
Islamic banks afraid of the bank run, if they reflect the real profits and losses of investments in their periodic profit and loss share dividend distribution reports. It is not possible to have an excess to the exact data of the profit and loss reports of Islamic financial institutions just like others. Since their long term profit dividends are around LIBOR, we may create hypothetical scenarios about the history of the return rates of a certain Islamic Bank, which distributes normally with a mean of LIBOR and with several variances. Let us assume that LIBOR is around 3% in the 120 months of the period of our study:



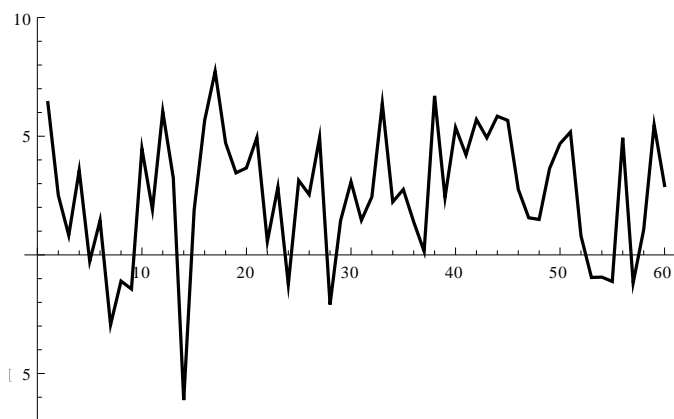
(a)



(b)



(c)



(d)

Figure 1. Return rates of investors in four scenarios with expected value around LIBOR, and with several STDVs; a) 0.1, b) 1.0, c) 2.0, and d) 3.0

Although expected monetary values (EMVs) are almost the same, around LIBOR of these nightmare scenarios for Islamic Bank managers, they are different in the risk they undertake.

### 3.1 Risk Profile of Investors

To predict the investor response to these scenarios, EMVs are not sufficient, and we must run a field work with the questions derived from the underlying probability distributions of these scenarios which also take the risk averseness of the investors (Khan et. al. 2001; Sundararajan 2005, 2007).

#### Which business you invest?

Table 1. Investments in the below gave 30 times at most r1%, 70 times r2% return in their 100 months history.

Investment	r1%	r2%	Choice
1	2.95	3.05	
2	2.50	3.50	
3	2.00	4.00	
4	1.50	4.50	

None			
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The distribution of choices between alternatives gives the risk profile of potential investors in the society of the Islamic Bank which it operates in. If this research reveals that many investors are still eager to invest under higher risks of Investment 3, and 4, the Bank managers should not hesitate to abolish profit equalization reserves (PERs).

### 3.2 Utility of Profit Shares for Muslim Investors

Because of the prospective utility understanding of human beings, and interest rate averseness of Muslim investors, we may expect a utility profile for Muslim investors as follows. Islamic Bank managers must run a field work with the questions relevant for eliciting potential investors in the country if not globally.

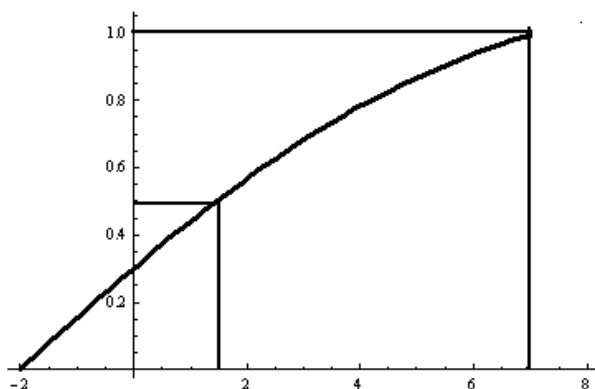


Figure 2. Utility profile of a Muslim investor. To this hypothetical investor, the highest possible return rate 7% has the utility 1. The lowest acceptable return rate -2% (2% loss) has the utility 0, and the midpoint of 0.5 utility is given to 1.5% return rate.

### 3.3 Decision Trees for Muslim Investors

For the Muslim investors, do not have any incentive in deviating from investing at an “interest rate free” business, to an “interest rate paying” one. A Risky Islamic Bank’s Profit Loss Sharing accounts return rate history reveals that the next time bucket may give annual 4.5% profit share with probability 0.7, and annual 1.5% profit share with probability 0.3, while a traditional commercial bank gives the LIBOR of 3%. The expected monetary value (EMV) of Profit Loss Sharing Account is 3.6%, while invest g the capital in a traditional commercial bank gives LIBOR for sure. Although Islamic Banks EMV is higher, EMV is not so effective on the decisions since it does not take the risk factor into account. If the risk factor is counted, any risk adverse investor without Islamic values may be indifferent between the two options. Risk profiles of decision makers are represented in their utility profiles. We can demonstrate it better on a decision tree:

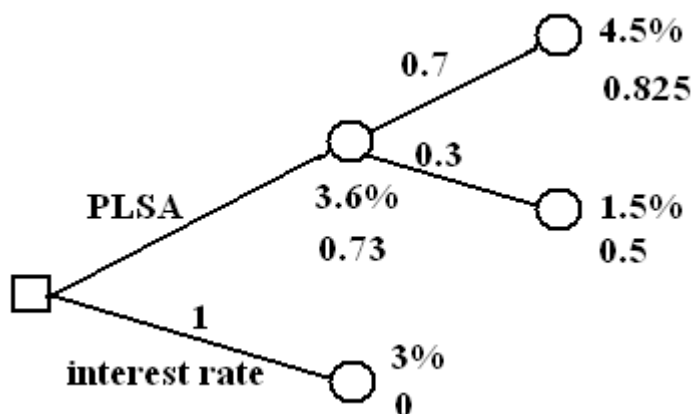


Figure 3. Decision tree for a Muslim investor.

Considering the utility profile of the hypothetical Muslim investor in Figure 2, the utility of profit share rate of 4.5% has the utility 0.825, while the utility of profit share rate of 1.5% has the utility 0.5. Therefore the expected utility of Islamic Bank's Profit Loss Sharing account is 0.73, while the utility of a traditional commercial bank investment is zero.

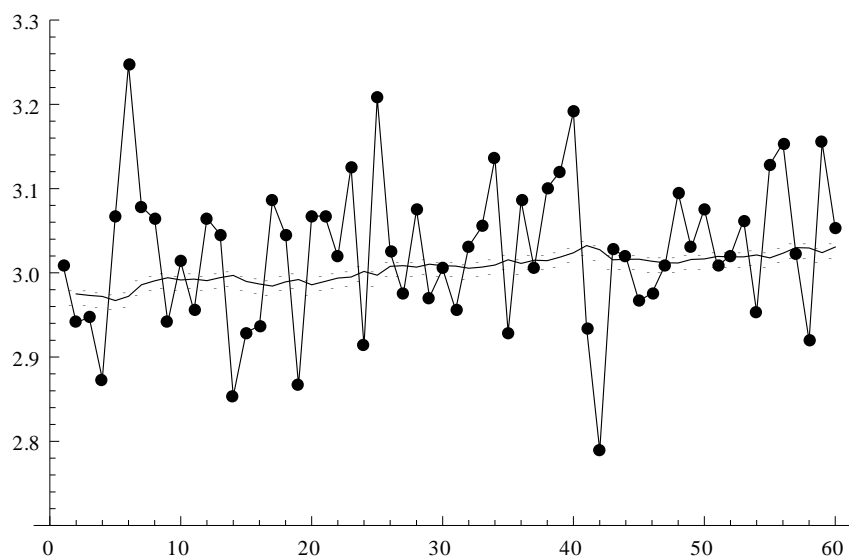
The other most important factor related to the bank runs is the prospective utility perception of investors.

### 3.4 Prospective Utility Perception of Investors

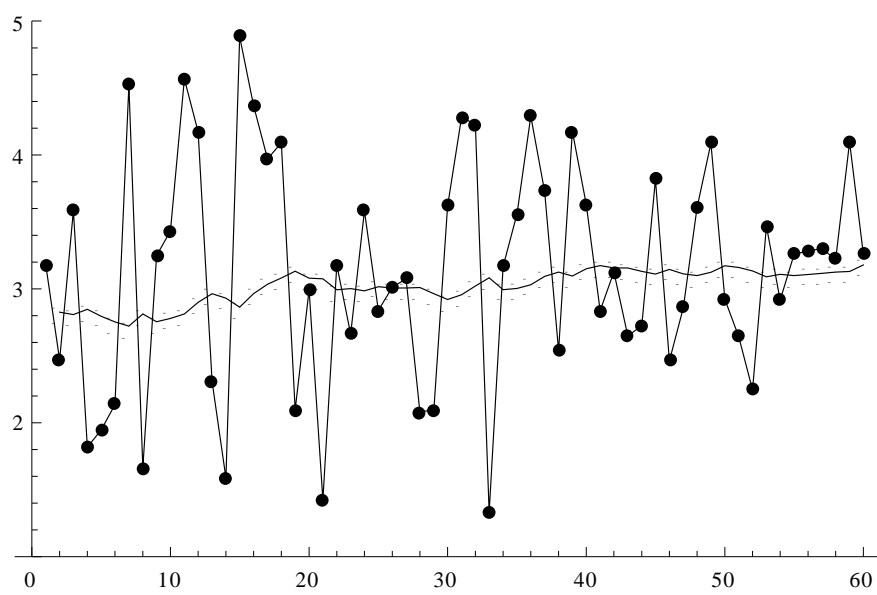
Prospective utility is widely used by investors. They tolerate temporal losses, if there is a potential higher profit possibility. To understand how prospective utility understanding works, we may use exponential smoothing (Brandimarte, 2011).

Let us consider the above four rate of return data, as time series. Along the time, investors use these data to formulate their prospective expectations for the next time bucket. The graphs in Figure 2 reveals that temporal losses do not discourage investors, taking the past data into consideration, they are ready to give time to the Islamic Bank managers to compensate these losses.

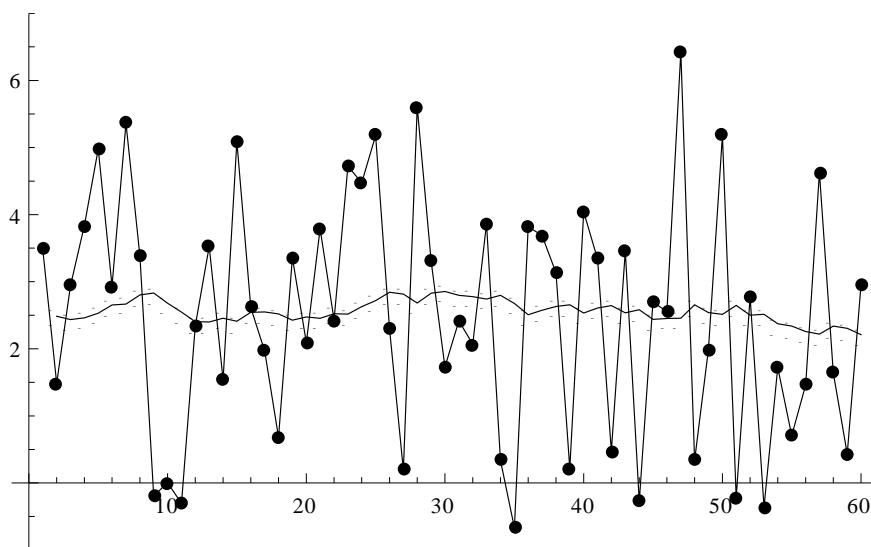




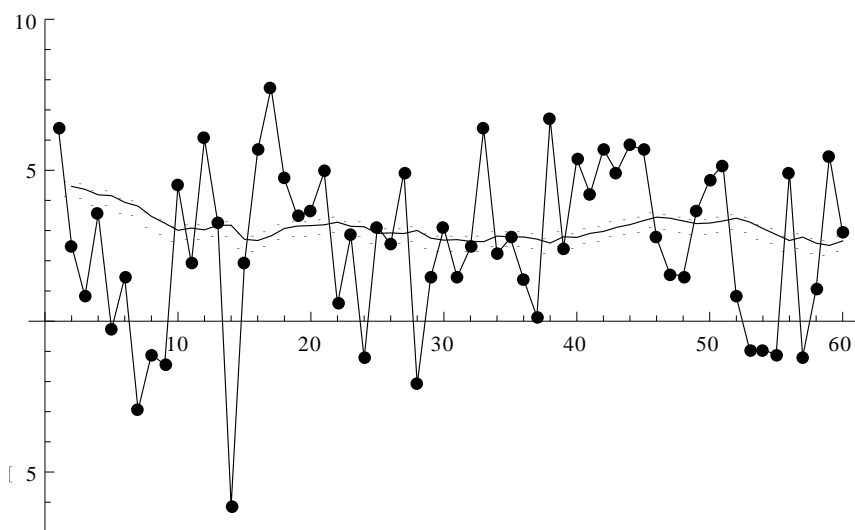
(a)



(b)



(c)



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Figure 4. Prospective utilities of investors (squares) in the view of realizations of the variable return rates in Figure 1.

#### 4.CONCLUSION

When they smooth their accounts, Islamic bank Managers and their Sharia Boards think that, if they reflect the real profits and losses of investments in their periodic profit and loss share dividend distribution reports, they will confront with the bank run. In this article it has been shown through hypothetic scenarios that, Bank managers should not hesitate to abolish profit equalization reserves (PERs) and other account smoothing devices to save the image of Islamic Banking as an interest rate free alternative to the traditional banking. Of course prior confirmations of these hypothetic scenarios are necessary through serious field researches.

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