Islamic Finance:
A Viable Alternative in the Global Financial Market?

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ABSTRACT

Islamic finance has been one of the fastest growing segments in the financial services industry. Fueled by increasing income streams in oil rich countries, a rise in Islamic faithfulness, and a growing middle class in Muslim countries, this segment of the financial services market is expected to continue to grow at record breaking levels. Based on sharia, or Islamic law, Islamic finance prohibits certain types of investments and the paying of interest. With the requirement that risk be shared among parties to a financial transaction, some have proposed that Islamic finance is a safer alternative than traditional Western finance and protects markets from economic failure.

It is estimated that over $500 billion in assets are managed around the world in accordance with Islamic principles. With an estimated 1.3 billion followers of Islam, many in areas of the world where excess funds have been recently accumulating, increased interest has been generated in Islamic finance. Islamic banking centers have been developed in places such as Dubai, London, Kuala Lumpur, Singapore, and Bahrain. According to Standard and Poor's, Islamic banking has been growing by about 10% per year for the past decade. A number of the world's largest banks and financial institutions have begun to offer Islamic financial services, including Citigroup and HSBC. Dow Jones has even created the Dow Jones Islamic Market Index, signifying the importance of this growing financial niche.

According to *The Economist* magazine, about 20% of the world's population is Muslim, but Islamic finance represents only 1% of the world's financial instruments. This gap is seen as an opportunity for growth. Islamic finance based on *sharia*, or Islamic law, prohibits the payment of interest, or usury. Also prohibited are investments in certain industries such as those tied to alcohol, pornography, pork production, tobacco, and gambling. Bonds based on *sharia*, called *sukuk*, do not pay interest, but rather pay the investor based on the profit generated from the asset which underlies the bond. Islamic finance mandates a degree of risk sharing not found in traditional finance.

After the terrorists' attack in the United States on September 11, 2001, the U.S. government froze bank accounts of certain wealthy Muslims. This caused capital flight by others fearful of having their assets confiscated. Much of this money ended up in places like Malaysia where the assets were deemed safer. Rising oil prices increased the cash position of a number of Muslim countries, and a rising middle class in many Muslim countries created the need for an alternative financial system. A financial system consistent with Islamic principles became more necessary, and lucrative. Even business schools have taken note of the trend and have begun offering courses and seminars in Islamic finance.

Not charging interest on loans is a central element of Islamic finance. According to Sheikh Nizam Yaquby, a noted advisor to Western investment firms: "There is no sin the Koran, not even drinking, not even fornicating, not even homosexuality, which could be as abhorrent and serious as dealing in riba (interest)." The prohibition of charging interest is not just linked to Islam. Early Christians prohibited usury, however, over time the definition changed to allow interest to be charged for loans, but not at an excessive rate. Not being able to charge interest on loans has forced Islamic bankers to be more creative in their business. Loans are typically made by adding a profit to the balance, and then dividing the sum by equal payments. Variable rate interest loans are generally not permitted under Islamic finance. Since interest cannot be charged borrowers, other arrangements can be made such as when a house is financed by a bank. The bank may buy the house and value it at its expected appreciated price when the loan has ended. The inflated price is then divided into equal payments over the life of the loan. No interest is paid by the borrower. Shared risk is an important part of Islamic finance. Some business loans are made on the basis of *mudharaba*. A *mudharaba* is a partnership between the lender and the borrower. In this case, no interest is charged the person, or business, needing the loan. Instead, the borrower shares in the profit generated by the loaned funds. The borrower and lender become partners, sharing in the profit or loss of the enterprise.

Islamic finance prohibits the selling of something which one does not own. Short-selling, for example is not allowed under Islamic finance, as well as a number of other more risky Western investment practices such as derivates. Some have proposed that the financial crisis which began in 2008 would have been avoided if the world's financial institutions had followed *sharia*. As a result of the requirement of an underlying asset base, however, Islamic finance is more concentrated in property assets and subject to the market fluctuations of those assets.

Oversight of Islamic finance, and the determination of the appropriateness of investments, is of some concern. Some Islamic banks operate in countries with few regulations, such as in North Africa, and only a handful of people determine what is a proper investment under Islamic law. The availability of religious scholars who also have training in finance, and a good command of the English language, is limited. The shortage of such individuals means that the price of investment advice is quite high, reported to be in the six figure range for each fatwa, or investment decision. With the limited number of skilled Islamic advisors, many of the advisors work for competing firms, creating the perception of a conflict of interest in the minds of some.

Even with the limited number of qualified advisors, and other concerns, Islamic finance is, nevertheless, expected to continue to grow in the years ahead. Islamic finance may appeal to non-Muslims as well, in that some socially responsible investors may like the idea of avoiding investing in “sinful” industries, and feel that their investments are safer in an Islamic style investment arrangement.

Discussion Questions:

1. Do you feel that Islamic finance is a safer alternative to Western finance? Explain.
2. Some critics feel that Islamic finance is only a disguise for traditional finance and the process “rent-a-sheikh” allows for possible manipulation of financial decisions. What is your opinion?
3. Do you feel that Islamic finance can grow beyond its current small niche in the financial market?

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