Issues in Islamic and Conventional Finance: Introduction

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Introduction

A well-regulated economic system requires incentives that reward productive and withhold rewards from unproductive activity. Such incentives are put in place by means of legislation and enforced with the help of regulatory agencies. A well-managed system will allocate resources more efficiently than a system in which income may be gained without active participation in economic activity, by lending at interest in particular, which invariably increases the prices of finished goods without, however, adding any value.

Interest-based lending produces a range of important, though rarely highlighted, side effects. They include inefficiency, indebtedness, instability, inflation, unemployment, slow or declining economic growth, and an uneven distribution of wealth.

Despite many adverse macroeconomic effects of debt financing, lending at interest occupies a prominent place in conventional banking and finance and, to a lesser extent, in Islamic finance, in a replicated form. This should be of concern. What should be of even greater concern, in particular to policymakers in Muslim nations, is that to the extent that Islamic finance replicates mainstream finance, it also replicates the latter's *harmful* effects.

The way to address the adverse effects interest-based financing is to utilise risk sharing on a wider scale than has hitherto been the case. This holds true for mainstream as well as Islamic finance. Equity financing not only does not produce the adverse macroeconomic effects produced by interest-based financing. On the contrary, *it mitigates them*.

Equity financing allocates resources efficiently than loan financing because rewards to capital providers are linked directly to the profitability of the enterprises they finance. In loan financing, however, the amount of interest paid to lenders does not depend in any way on the profitability of the enterprises being financed with loans.

The principle that rewards need to depend on productivity (performance) is a central pillar of the free enterprise economy. Its application ensures that payments to a factor of production are proportionate to its contribution to production. This principle characterises all financing on the basis of risk sharing.

This cannot be said, however, about lending at interest. Promising predetermined returns to lenders in the form of interest payments, regardless of the performance of the businesses being financed, does not reflect the principle that reward should be linked to productivity. In an interest-free financial system, however, payments to the providers of capital would be closely linked to the performance of the businesses receiving financing by means of risk sharing.

In an interest-free regime income is earned in exchange for productive activity or in exchange for taking risk, in the form of wages, rents or profits. There would be little prospect of "earn" *interest*. Productive activity is rewarded in proportion to contributions made by different factors of production. All funds would remain in the real sector (the circular flow) when profits, wages or rents are paid.

Risk sharing improves welfare at the macroeconomic level. When financing spending takes place by borrowing at interest, however, repayments of loans invariably leave the circular flow of money, however temporarily. Moreover, they remain outside the real sector until they are re-injected once again into the economy with the expenditure of newly borrowed funds.

Moreover, when financing takes place on the basis of risk sharing, investment takes place within the limits of available income and savings. The use of savings, rather than newly "created" funds borrowed to finance spending, inhibits the formation of asset bubbles. This helps to mitigate the economic swings that come with business cycles.

Financing investment on the basis of risk sharing would also help to reduce inflation. The reason is that when firms raise funds by selling shares, there is no need for them to pass interest expenses on to consumers in the form of higher prices because they have no interest expenses.

Equity financing also helps reduce unemployment. In an environment where the option to earn guaranteed interest income does not exist, parties with surplus capital will be compelled to invest their funds in the real sector. The requirement to earn high profits and to post acceptable collateral would no longer stand in the way of access to investment funds.

Equity financing would in addition enable better sharing of wealth. The reason is that lenders will no longer be able to collect "guaranteed" payments of interest. The one-way, long-term flow of interest income from borrowers to creditors will be arrested. This will reduce the concentration of wealth in the hands of the shareholders of financial institutions.

A major obstacle to a fuller implementation of risk sharing is a limited awareness of the burdens placed upon society by interest-based financing. Thus, it becomes important to highlight the burdens imposed on society, not all of which take a monetary form, of debt or debt-like financing. It is also necessary to propose viable responses to these problems. The work presented here seeks to accomplish precisely that.

Part I identifies a number of issues that emerged in Islamic finance as a result of the replication of debt instruments. These include the type of transaction utilised in the securitisation process and the resulting level of protection available to investors. It concludes by putting the practice of replication in Islamic banking and finance, inclusive of benchmarking profits on Islamic securities, into the spotlight.

Part II provides a comparison between Islamic and mainstream finance. Specifically, it looks at differences between profit and interest, as well as investment and lending. Additionally, I highlight the implications of financing by borrowing rather than by way of partnerships, and explore the question of the ethics of interest-based financing.

Part III identifies and highlights the adverse effects of interest-based financing. These include reduced efficiency in the allocation of resources, indebtedness, systemic instability, inflation, unemployment, stagnating growth and a growing gap between the rich and poor.

Part IV explores at the Keynesian response to the effects of lending at interest. It is generally taken for granted that interest-based financing helps to allocate resources efficiently by "rationing" capital to enterprises sufficiently profitable to pay the rates of interest demanded by financial institutions. However, evidence indicates that interest-based financing, in fact *reduces* the efficiency with which scarce resources are allocated.

Part V explores risk sharing. It highlights in particular the economic benefits to be realised by a wider utilisation of risk sharing. It argues that financing on the basis of risk sharing, far from producing the harmful effects brought about by debt financing, has precisely the *reverse* effects. Financing by way of risk sharing increases output, reduces unemployment, and stabilises prices. It also ensures greater stability, a more even distribution of wealth and dispenses with the need to go into debt. In the case of Islamic finance, a broader utilisation of risk sharing would additionally present-day bring practices in harmony with the requirements of the Shariah. Together, these constitute compelling reasons for adopting risk sharing as the preferred method of financing, whether in conventional or Islamic finance.