

2012 LSE-Harvard public lecture on Islamic Finance

# Global Calls for Economic Justice: the potential of Islamic finance

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2012 LSE-Harvard public lecture on Islamic finance – London, 22 February 2012



## Global Calls for Economic Justice: The Potential of Islamic Finance

Prof. Dr. Volker Nienhaus



1. Economic Justice: Concepts and Calls
2. The Potential of Islamic Finance
3. Realities of Islamic Finance
4. Drivers of Conventionalisation
5. Activation of Potentials

## [Discussion of] Principles (abstract) in

- Religious teachings
  - Christianity
  - Islam
  - ...
- Political philosophy
  - Natural law
  - Libertarianism
  - ...
- Economic theory
  - Welfare economics
  - Public Choice
  - Game theory
  - ...

## [Calls for] Action (concrete) by

- Religious movements (e.g. liberation theology, Muslim brotherhood)
- Human/Civil rights movements
- Green parties

20<sup>th</sup> century

- Political uprisings (Arab spring)
- Occupy movements (OWS)

2011

for

against

- Participatory justice (opportunities, procedures)
- Distributive justice (outcomes)

- Employment and income opportunities
- Minimum wages/living standard
- Fairness, dignity
- Financial system reform
- Poverty alleviation
- Social security
- Health, housing, education

- Growing inequality (total wealth US 20/87%)
- (Youth) Unemployment
- Political system (authoritarian, inactive)
- Unbridled capitalism (excessive debt, socialising losses, impoverishment of the middle class)

## Islamic economic system

### Islamic banking

Shari'ah

#### Prohibition of

- *Riba*
- *Gharar*
- *Maysir*

- Finance for real economy
- Support for entrepreneurs
- Mobilization of savings
- No reward without risk
- Participatory finance (no collateral, SMEs)
- No speculation

### Islamic capital market

- Equity (stocks, VC)
- *Sukuk*

- Solidarity (*Takaful*)
- *Zakat*
- *Waqf*

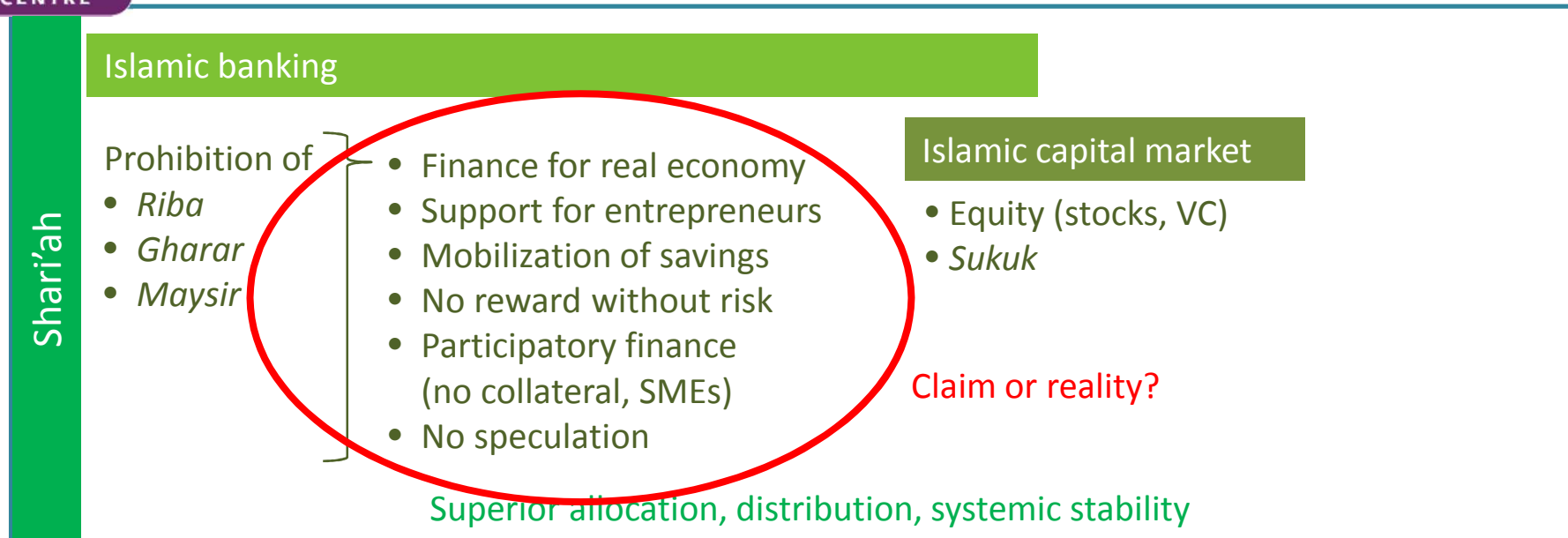
- Private property with social obligation
- Fair competition
- Basic infrastructure and social services

Superior allocation, distribution, systemic stability

- Participatory justice (opportunities, procedures)
- Distributive justice (outcomes)

- Employment and income opportunities
- Minimum wages/living standard
- Fairness, dignity
- Financial system reform
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- Growing inequality (total wealth US 20/87%)
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Shari'ah

## Islamic banking

Prohibition of

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questionable

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## Islamic capital market

- Equity (stocks, VC)
- *Sukuk*

Yes, but not always, and

- Predominantly short-term trade finance (little impact on employment, income generation, and poverty alleviation)
- Longer-term finance mainly for real estate (= investments in bubble-prone and often speculative markets)
- Increasingly project financing for public infrastructure (little impact on domestic SMEs)
- Little corporate finance, very little SME finance, hardly any participatory finance
- Sophisticated techniques to minimize the risk that results from the use of trade/rent contracts for financing purposes (e.g. customer as agent, purchase orders,
- No financing without collateral
- No evidence for additional net savings (deposits transferred from conventional banks)

## Islamic banking

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- *Sukuk*

### Results of contractual engineering:

- Finance (largely or completely) detached from the real economy (e.g. *tawarruq*, commodity *murabaha*, Islamic repos, asset based securities)
- Development of Shari'ah compliant functional equivalents of conventional structured products (options, swaps, plugs)
- Prototypes of securities (derivatives) suitable for trading within the financial sector
- Inadequate corporate governance structures (no voice for ultimate risk bearers: investment account holders, *takaful* participants)
- Systemic risks not fully recognized (e.g. threat of bank run due to ineffective deposit guarantee schemes)

→ Significant divergence between claims and realities of Islamic finance



Shari'ah

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Inroad of conventional financial institutions into a profitable market segment

- Conventional mindset
- Structuring expertise
- Profitability of trading
- Shareholder value orientation

Shari'ah scholars in board positions:

- Main role: legal advisors
- Board positions attractive (reputation, compensation)
- Appointment by BoD/shareholders
- Micro-legalistic approach
- Lack of macro-systemic understanding
- Pragmatism in the name of *maslahah* (public good)

*Status quo as a challenge; ways forward?*

Shari'ah

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More distinctiveness from conventional finance and authenticity with a systemic perspective

### Product development

- Participatory finance with limited downside risk
- Participation certificates
- accounts with transparent risk/return profile

### Regulation

- Reconsider systemic stability qualities of IF
- Consumer protection
- Shari'ah governance system

### Market discipline

- Best practice examples
- Performance analysis
- Islamic benchmarks
- Competition (intra- and inter-sectorial)

### Public awareness

- Islamic economists
- Financial literacy
- Specialised media
- Rating and ranking
- Academic study programs and research

Growth potentials as ethical finance and socially responsible investment, contributing to economic justice (instead of complicated and restrained replication of conventional finance)

Islamic economic system



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