

**AAOIFI – World Bank Annual Conference
on Islamic Banking and Finance
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Disclaimer

**The views and opinions I express
in this presentation are my personal views,
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Session 1: Islamic finance in overall economic systems

PANEL ISSUES

1. Shari'a and economic systems – what is an Islamic economic model?
2. What are **key lessons** for Islamic finance from the economic and financial crisis?
3. Can Islamic finance be applied in monetary and fiscal policies to manage economic growth?

PANEL ISSUES

1. Shari'a and economic systems – what is an Islamic economic model?

Growth vs. Development

- In economy, growth relates to the real output, GDP for instance.

“purely quantitative”

- <http://www.differencebetween.net/business/finance-business-2/>

Development pertains to:

- improved standards of living,
- more employment opportunities,
- better saving capacity,
- and the like.

“mostly qualitative”

Economics and Finance

- A **social science** that studies the production, consumption and distribution of goods and services, with an aim of explaining how economies work and how their agents interact.

<http://www.investopedia.com/>

- Finance is **the science of managing funds** keeping in mind **the time, cash at hand and the risk involved.**

Banking

Intermediary function between
Those who has funds (savings)

And

Those who needs funds

Tool

Conventional

Interest

Islamic

Trade or Partnership

The Maqasid Al Sharia

Chapra, p.7

Ghazali incorporates in the Maqasid
Everything that is considered necessary

to preserve and enrich

Faith,

Life,

Intellect,

Posterity and

Wealth

The Maqasid Al Sharia

Whatever ensures
the safeguarding of these five
Serves public interest and
Desireable (al-Ghazali)

***Do Economics & Finance
help safeguarding of these five ?***

To Preserve and Enrich Faith

“INFERENCE”

Fraud can be considered as a sin.

Sin can damage (cover) Faith

Regulations to prevent Fraud

safeguards Faith

COSO Control Environment

To Preserve and Enrich Life and Intellect

Everything done to ensure;

- Adequate Nutrition
- Clothing
- Proper upbringing and education for spiritual development
- Housing
- A Healthy spiritual and physical environment
- Medical Facilities
- Comfortable transport

(Chapra,p.8)

To Preserve and Enrich **Posterity**

- Demographic Studies

To Preserve and Enrich **Wealth**

Economics

Acquisition of Wealth

Finance

Management,
maintenance and
increase of wealth

Falah & Hayat Tayyibah

To achieve *Falah & Hayat Tayyibah*
Economic Development is necessary

which is **“mostly qualitative”**

As well as

Economic Growth which is

“purely quantitative”

Falah & Hayat Tayyibah

Economic and Social Development

- Opportunity for education and health
- Rule of Law
- Equitable Distribution of Income & Wealth

Financial System complying with Islamic Rules

No Risk No Gain

“Trade or Partnership
replace Interest”

PARTIES INVOLVING ISLAMIC FINANCE

Islamic Banking

- Shareholders
 - Investment Deposit Holders
- (Restricted&Unrestricted)
- Mudarabah Customers
 - Murabahah Customers
 - Istisna Customers
 - Ijara Customers

Islamic Money and Capital Instruments

- Sukuk Asset Provider
- Sukuk Issuer
- Sukuk Investor

Governance issues for islamic finance instruments

Mudarabah

Capital owner and Entrepreneur Relations

Applied to

- investment Account Holder and the bank;
- Mudarabah customer and the Bank

in islamic banking

Governance issues for islamic finance instruments

Musharaka

Relationship among the partners came together to make an investment

Apply to

- relationships among shareholders and
 - relationship between the bank and the musharaka customer
- in islamic banking

ISLAMIC FINANCE INSTRUMENTS

- Economies characterized by agency problems (Adverse Selection & Moral Hazard) will be **biased towards DEBT FINANCING**
- The use of debt like instruments is a Rational Response by the Islamic Banks to **information assimetries in the contracting environment which they operate.**

Source: Aggarwal & Yousef, 2000,p.95

Instruments: Murabaha Dominates

PARTNERSHIP

Mudarabah

Musharaka

TRADE (Debt Based)

Murabaha

Ijara

Istisna

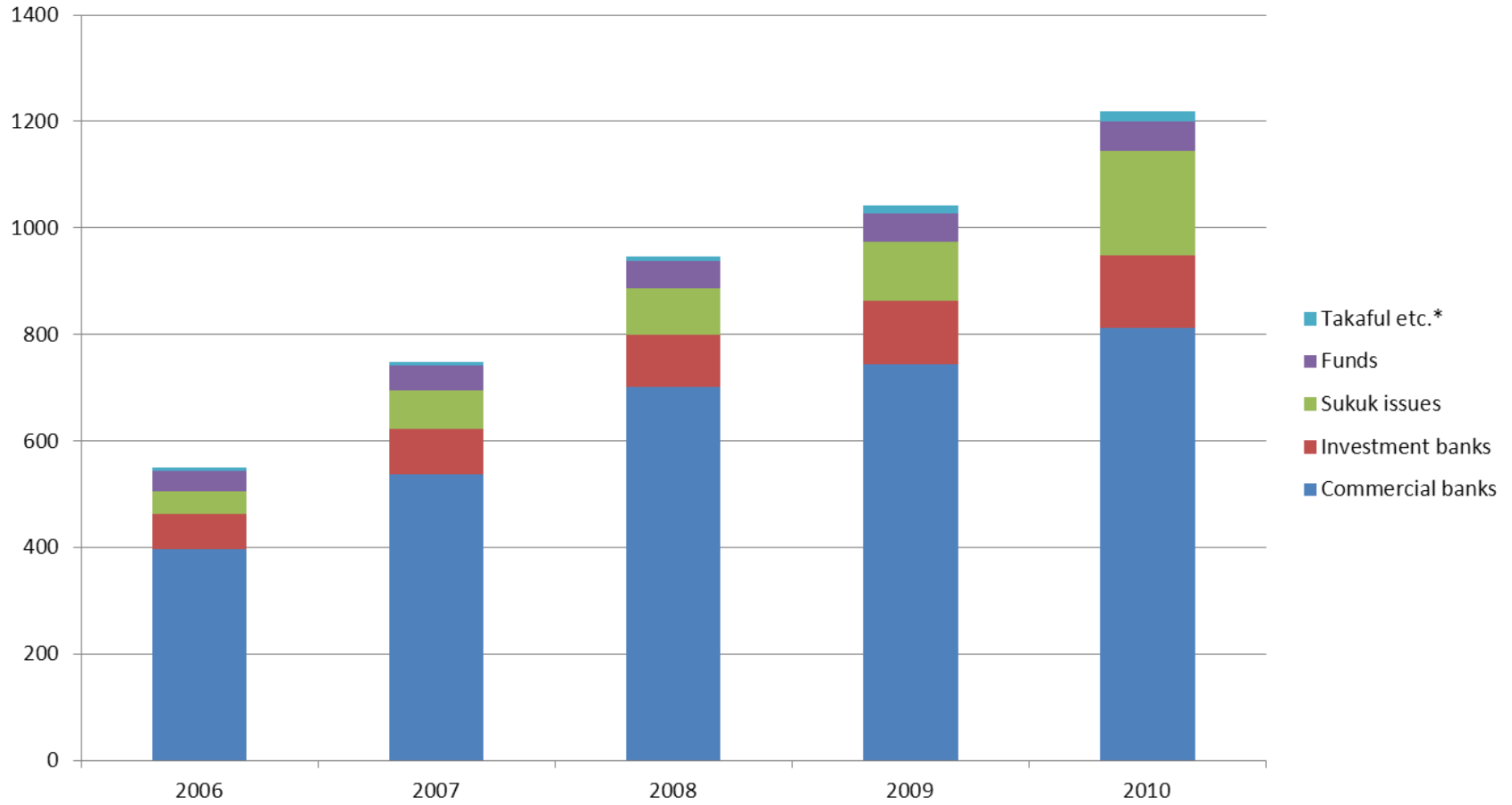
Bai Salam

Istisna

Qard Hassan

(=Benevolent Loan)

Global Assets of Islamic Finance



Source: Islamic Finance, The City UK, May 2011, Zawya, Bloomberg, IIFM

Global Islamic finance assets by sector

Sharia Compliant Assets USD bn

	<u>2011</u>
Banks	1200
Funds	60
Takaful	25
Other	<u>4</u>
Total	1289

Source: The Banker, Ernst & Young, cited in UKIFS-Islamic Finance March 2012

Break up based on Sukuk Structure

source: Emad Al Monayeya, 2012

YTD Sep 2012	<u>(USD Bn)</u>	
Murabaha.....	29,736	
Ijarah.....	<u>16,616</u>	
Total	46.352.....	59%....263 issues
Musharaka.....	13,834.....	17 %
Bai Bithaman Ajil.....	9,677	
Wakala.....	4,402	
Al Wakala bel-Istihmal.	1,229	
Mudarabah-Murabaha.	1,203	
Wakala-Mudarabaha.....	800	
Others.....	<u>1,565</u>	
General Total	79.062	

Observation

- The Murabaha and Ijara structure are still the preferred choice of sovereign issuers
- Musharaka based Sukuk is only 17 %

What is needed

- Prevent Excessive Expansion of Debt
 - Provide Greater Reliance on Equity Financing

In Conventional Finance

- There is a Bias towards Debt Financing
- There are efforts to decrease the disadvantage of Equity Financing of Corporations

Tax disadvantage for Corporations raising funds by Equity Financing

- Debt Financing

- Interest Expense is deductible for tax purposes

- Equity Financing

- Taxable Income is higher compared to co. making debt financing

Tax Biases to Debt Finance:

Assessing the Problem, Finding Solutions

“Tax systems typically favor corporate debt over equity, especially because interest payments are deductible for corporate income tax purposes while equity returns are not”

“This leads to a tax-induced bias toward debt finance”

PANEL ISSUES

2. What are **key lessons** for Islamic finance from the economic and financial crisis?

key lessons for Islamic finance from the economic and financial crisis

Two key facts emerge

- **Fact 1:** Crises are credit booms gone bust.
- **Fact 2:** More credit intensive booms are followed by deeper recession

(**Moritz Schularick**, Credit Overhangs)

key lessons for Islamic finance from the economic and financial crisis

1. Infrastructure for growth of Equity Financing should be fortified
2. Regulators are expected to introduce various measures to further safeguard financial stability and long term sustainability of Islamic Banking Industry.
3. More attention to be paid to strengthening the industry's:
 - **Risk Management Framework**
 - **Corporate Governance Framework**
 - **Shariah Board's Roles**

GIFF p.149

PANEL ISSUES

3. Can Islamic finance be applied in **monetary and fiscal policies to manage economic growth?**

Islamic finance can be applied in monetary policies to manage Liquidity in the Economy

- How can Islamic Financial instruments be used by CBs?

1- CBs can invest sukuk for reserve purposes

2- CBS can use sukuk for liquidity management

Sukuk global issues

Sukuk issues have expanded strongly
in the past three years,

62% increase in sukuk issuance
to **\$84bn in 2011**

from \$52bn in 2010

Recovery

from a low point of \$20bn in 2008

to \$33bn in 2009

SukukMade a strong start to 2012

with **\$20bn of issuance in January**

Source: Zawya Sukuk Monitor, cited inUKIFS-Islamic Finance March 2012

Turkish Central Bank Experience

OMO depending on
interest based treasury bonds
can not be used by participation banks

**INEQUALITY OF OPPORTUNITY BETWEEN
CONVENTIONAL AND PARTICIPATION BANKS**

CRITICAL FOR FINANCIAL STABILITY

Turkish Central Bank Experience

The “Rent Certificates”(Sukuk Ijara)
issued by Turkish Treasury

will be accepted as equivalent of
interest based treasury bonds for OMO ,
being eligible collateral

Turkish Central Bank Experience

**CBRT is member (shareholder) of the
IILM,**

thus the short term sukuk

which will be issued by IILM

will also be accepted as collateral for OMO

Conclusion

**Although there is an emergence of
Economic Activities complying with Islamic Rules
especially in Banking and Finance Industries,
we can not talk about
a full fledged model of Islamic Economics yet**

Conclusion

- Financial System complying with Islamic Rules is developing rapidly
- This Financial System is dominated by “Debt Based Financial Instruments” rather than “Equity Based instruments”
- Academic research shows that excess credit expansion results with financial crisis

Conclusion

A special effort is needed to increase the weight of Equity Based instruments in the Financial System complying with Islamic Rules

Economic entities claim to be Sharia compliant should improve their Corporate Governance Ethics; Transparency and Accountability are values not alien to Islamic World View

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THANK YOU....

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