

General Council for Islamic
Banks And Financial Institutions

Affiliated Institution to the OIC
Established under Royal Decree No 23 -2001



المجلس العام للبنوك
والمؤسسات المالية الإسلامية

مؤسسة منتمية لمنظمة المؤتمر الإسلامي
تأسست بمرسوم ملكي رقم ٢٣ لسنة ٢٠٠١م

PRINCIPLES OF FINANCIAL MODERATION

Ten Principles for Creating a Balanced and Just Financial and Banking System

(Comprehensive Summary)

March 2009

PRINCIPLES FINANCIAL MODERATION

Ten Principles for Creating a Balanced and Just Financial and Banking System (Comprehensive Summary)

This paper deals with 10 principles for creating a balanced and just financial and banking system. These principles are as follows:

Principle (1):

Curb excessive credit creation, selling, securitization and disposal.

Principle (2):

Create a balance between modes of financing that are based on profit and loss sharing and those based on credit which does not relate in any way to wealth creation.

Principle (3):

Create a monetary system and a more fair and stable payment mechanisms.

Principle (4):

Utilize a mechanism based on the profit rate instead of using that which is based on interest rate.

Principle (5):

Create efficient and fair instruments for risk management and risk distribution, and to avoid, instead, trading in such risks or betting thereon.

Principle (6):

Build a more effective, just and stable financial and banking system that is linked to real economy.

Principle (7):

Create fair mechanisms to guarantee the financial rights of lenders, but without harming their debtors.

Principle (8):

Rectify the role of financial markets and establish specific controls to rationalize the behaviour of those dealing in such markets.

Principle (9):

Foster governance and transparency in the business activities of financial institutions and their relationships with the parties concerned.

Principle (10):

Activate the role of government in preserving and protecting the monetary and financial system and imposing controls on transactions and markets to create a balanced growth.

Introduction

The world has been infested with crises that have affected the world economy at large and its countries at varying degrees of severity. Despite warnings from such authoritative quarters as the World Economic Forum (WEF) and the IMF, in each decade there is at least one crisis that pops up, which devours within a short span of time the economic achievements and gains that were made over many years. In its report issued in January 2008, the WEF states that constant disruption of systems constitutes a big challenge that adversely affects the world economy. In April of the same year, the IMF (in its Semi-Annual Report on Financial Stability) described the global financial system as fragile.

Specialists of various inclinations have ascribed the roots of the recent mortgage crisis to shortcomings in the financial sector. Despite complexity of the causes which led to the current financial crisis, studies and analyses indicate clearly that housing loans were the main cause, as a result of unsuccessful financial and monetary policies). There were other factors that contributed to the current crisis: the measures taken by the American Administrations during the past two decades, which made the (private) financial sector self-dependent in achieving stability, thus mitigating their supervisory role, especially over financial derivatives and hedging funds; changing accounting standards, where valuation of assets started to be based on their market value and the transformation of public accounting firms into limited liability corporations and the transformation of the role of rating agencies, which turned into advisors that teaches companies how to gain the highest ratings.

The domino-like collapse of many financial and banking institutions as a result of the collapse of other gigantic financial institutions, such as the Lehman Brothers, resulted in the loss of confidence in the entire financial system and paralyzed the liquidity-generating mechanism and in the fast deterioration in the value of the assets of banks and financial institutions connected with housing loans.

Amidst these critical conditions, attention of the world has been captured by a new and young financial industry, whose institutions do not deal in riba (interest) and steer away from gambling and speculation. They also abide by a number of additional built-in controls. Such institutions have been little affected by the crisis, contrary to their conventional counterparts. Interest in the success of such young institutions in facing the crisis and their modus operandi have grown rapidly to learn about the factors which led to the success their far older counterparts could not achieve.

No doubt that the financial crisis has given rise to feelings of common fate among peoples of the globe and to the growing need to sincerely consult and cooperate among them to create a better global financial order.

This paper has taken into account these and other developments. The principles we are about to commence explaining were derived from the rules that govern the operations of this new breed of financial and banking institutions. The paper has also benefited from successful and efficient experience, practices and standards of the existing system.

Saleh Kamel
CIBAFI Chairman
General Council for Islamic Banks
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Ten Principles for Creating a Balanced and Just Financial and Banking System

Principle (1)

Curb excessive credit creation, selling, securitization and disposal.

Develop controls for debt creation, assignment and disposal in such a manner as not to render debts into tradable commodities to get rid of their risks, but to make them a means of achieving effectiveness and efficiency in markets and re-distribution of portfolios over time, without this leading to severance of the relation between the financial and the real sectors.

Borrowing, if based on a real income or asset that would ensure the financial interests and rights of both the creditor and debtor, has always been practised and can never be obliterated. However, borrowing by economic entities, especially individuals and families of limited income, in excess of their financial abilities is extremely harmful. They most often end up in bankruptcy and the imposition of restraint in the disposal of his assets.

Financial markets have turned at present into a big casino, where debts and risks are traded. Thus the phenomenon of debt securitizations has become widespread. By such process of securitization, financial institutions have acquired an important instrument that would enable them to re-finance it. They benefited from profit maximization, not only that accruing from interest rates, but also from the big commissions they charge on increasing securitization.

Thus credit expansion without real consideration of the borrowers' ability to pay their debt has resulted in a phenomenal increase in the size of the debt of financial sector in the centre of the crisis, the United States, where it increased from 22% of GNP in 1991 to 117% in the third quarter of 2008.

Rectification of such deficiency or imperfection requires stopping lenders absolving themselves from their obligations and re-assignment of the risks associated with loans extended to others through the selling of such debts. The competent supervisory bodies should impose on creditors the maintenance of some of their loans in order to retain a continued sense of responsibility for their behaviour. Securitization of real assets is a more viable and appropriate alternative that would lead to a more stable economic order.

At the level of individual, strict criteria should be adopted that would legally link the ability to borrow and the person's solvency. Also a specific ratio of debt-to-capital should be imposed on companies to prevent them from excessive borrowing.

Principle (2)

Create a balance between modes of financing that are based on profit and loss sharing and those based on credit which does not relate in any way to wealth creation.

Enact laws and create facilities that would encourage financing which is based on partnership in all its forms and which limit credit creation which encourages economic entities to engage in excessive borrowing, thus making them amenable to be adversely affected by shocks.

It is clear from the successive crises witnessed by the world that the most important and main factors behind the recurrence of such crises is the failure of borrowers from repayment of the principal and interest. As the purposes for which money was borrowed are subject to the vicissitudes of time, borrowing people end up in default.

Financing which is based on profit and loss sharing is a far more viable alternative to interest-based financing.

A study prepared by the IMF on 19/02/2009 has shown that the current taxation system is biased towards credit-based financing, a matter which encourages economic entities to resort to excessive borrowing.

Other modes of financing which could be of great benefit are shared ownership, diminishing participation leading to final ownership. Excessive resort to leveraging should also be controlled. An alternative is to resort to investment leverage, which raises the companies 'and corporations' financial abilities through partnership-based and not credit-based instruments.

Principle (3)

Create a monetary system and a more fair and stable payment mechanisms.

Create an international monetary system, whose foundations and institutions should be built by all international parties concerned, and to impose controls over issuance of all forms of money in such a manner that would facilitate commodity and services exchange in such a way that would achieve a reasonable degree of stability and fairness among people.

While economists and legal specialists agree that money enjoyed historically basic functions and characteristics, which distinguished it from other com-

modities (mainly as a receptacle of value). Money also functions as a means of the stability of purchasing power.

However, money has recently been subjected to the same laws designed to commodities, where a price has been attached to it in the form of an interest rate, thus giving rise to such ailments such as inflation and speculations in the currency exchange market, which leads to acute fluctuations in exchange rates.

What contributed to the escalation and deterioration of the situation was the creation of complex and inciting means of payment, such as credit cards which enable the holder to create credit whenever he so wishes.

Principle (4)

Utilize the mechanism based on profit rate instead of using that which is based on the interest rate.

Create suitable mechanisms as an alternative to the interest rate mechanism which has proven to be ineffective in making an optimal allocation of resources, and which has negative effect on the distribution of national income. Among these alternative mechanisms is the use of the profit rate as an alternative.

Many scholars have admitted that the interest rate mechanism hamper development and lead to many negative results that are harmful to society. Most important among these is distortion of wealth distribution and tilting the balance in favour of big projects and companies at the expense of small and medium-size projects, which might prove to be more productive. Thus wealth is concentrated in the hands of the rich and the solvent, as they get more loans at a far less cost.

Interest rates lead to rise in prices as the cost of borrowing is calculated as part of the cost of the product produced. They also lead to shrinkage in investments and cessation of capital formation.

Using an alternative in the form of profit and loss sharing is far more profitable and equitable. While the lender with interest does not partake in any risk as long as he guarantees repayment of his principal and interest, we find that the alternative proposed removes all financing risks which stand on the way of production expansion. Besides this alternative helps in ensuring stability of the banking system.

Principle (5)

Create efficient and fair instruments for risk management and risk distribution, and to avoid, instead, trading in such risks or betting thereon.

Design mechanisms and instruments for risk management and distribution, not for increasing such risk or trading in it. This could be done by ensuring that their advantages outweigh their disadvantages, and in such a manner as to ensure the benefit of the entire society and not only the parties that deal in such instruments.

Financial derivatives have been created to serve as instruments for managing risks. However, they are not now used for the purpose for which they were created; dealers in these instruments have become traders in these instruments who do not intend to secure protection against risks, but financial gain. Thus they have become instruments for gambling and speculation.

Based on this, complex financial derivatives should be re-considered and innovation and development process should be put under control to make them concentrate on financial transactions involving real assets that have real exchange value.

Principle (6)

Build a more effective, just and stable financial and banking system that is linked to real economy.

Build an efficient multi-functional financial institution to transfer financial resources among the economic entities in an efficient manner that is based on investment intermediation and not on financial intermediation, a matter which would contribute to achieving a sufficient degree of justice and stability to achieve economic goals that would provide prosperity and material wellbeing to the entire society.

The financial system represents a canal that facilitates the exchange of real and productive commodities and services and the transfer of financial resources effectively and in a balanced manner. However, it is observed that the last few decades witnessed growth and development of the assets and operations of this system without any link with real assets of economic activity.

The financial system has become the servant of the big and the wealthy to the detriment of the masses, to whom risks were transferred.

Principle (7)

Create fair mechanisms to guarantee the financial rights of lenders, but without harming their debtors.

Seek to ensure the rights of lenders through the creation of instruments and means that would achieve this objective, but without harming debtors, in order to revive confidence among financial institutions.

While the issue of guaranteeing the financial rights of lenders by all legal means meets no objection, objection is mainly made to the method of applying this principle. For example, some financial institutions resort to sequestration of property put as a mortgage and eviction of people from their homes. Any observer would notice that these measures did not achieve any positive results. On the contrary, they led to a decrease in prices and deterioration of the value of mortgage.

This paper suggests establishment of a national fund for the benefit of insolvent debtors that would ensure payment of debt installments of each person who contracted a debt as a result of obtaining financing or a loan for consumption purpose or to establish a small or medium-size project, provided that the person's ability to repay his loan at the time of contracting.

Principle (8)

Rectify the role of financial markets and establish specific controls to rationalize the behaviour of those dealing in such markets.

Concentrate on the design of the bodies, programmes and by-laws of the financial market in such a manner fit to control the execution of its transactions at a high level of efficiency, honesty and fairness. The activity of the financial market should be directed towards a bias in favour of really productive activities, avoiding speculations and fictitious transactions, risks and other similar make-belief transactions.

One of the basic requirements of correcting the role of financial markets lies in arriving at a rational behaviour on the part of dealers in these markets, by limiting the haphazard fluctuations in the prices of stocks and proving attractive investment portfolios that encourage long-term investments.

Financial markets should be subject to strict control and to protect them from speculators. Disposal of what is not owned by the seller or that which does not exist should be prohibited. The same should apply to short-term sale transactions based on on margin.

Principle (9)

Foster governance and transparency in the business activities of financial institutions and their relationships with the parties concerned.

Activate and apply the principles of transparency and governance in financial institutions and lay down regulations that would ensure the rights of all parties dealing with these financial institutions in order to foster and promote more confidence in the role they play and reduce conflict of interests in the work of some importance institutions, such as rating agencies and public accounting firms.

Absence of governance and transparency and non-clarification of the facts associated with the activities of financial institutions and their results and the signification of financial instruments they use daily. All this has transformed the economy and financial transactions into riddles that are very difficult to understand.

One of the things the financial crisis has highlighted to a great instance has been the great role played by the credit rating agencies in fooling people through the ratings they grant to clients that pay them large fees in return for the high ratings granted to them.

A possible solution to the problems played by credit rating agencies is to make these agencies subject to public control and to have their activities reviewed from supervisory entities.

The paper emphasizes the importance of developing and activating the principles of transparency and governance in financial institutions to ensure protection of the interests of all parties that deal with them.

Principle (10)

Activate the role of government in preserving and protecting the monetary and financial system and imposing controls on transactions and markets to create a balanced growth.

Government must play a principal, not an auxiliary role in taking good care of the monetary and financial system and in monitoring transactions and markets. It should also provide a suitable environment for the private sector to enable it effectively contribute through initiatives and innovations, which would benefit those initiating them, provided that this is not done at the expense of the public economic interests of society.

Dependence on, and belief in the sanctity of the interests of the individual to the extent that would turn it into a law and a priori on which the economic system must be based has proven to be wrong. So has the belief in the «efficiency of the market» and the «hidden hand».

The time-honoured belief that the market «corrects itself» in the face of any crisis has proven to be wrong, and the Great Depression Crisis is an example. Therefore the government must intervene in the market to facilitate the work of individuals and institutions, while protecting at the same time public interests.

This document stems from a belief that sound principles for achieving economic stability and guaranteeing social justice require the intervention of the government, which should play a basic role in striking a happy balance between the individual's interests and those of the public.

The above requirement is supported by what was stated in the 20th Annual Report of the World Bank, which says «time and again, history has shown that a good government is not a mere luxury but a vital necessity». Without it, sustainable development would become difficult to achieve.

Conclusion

The greatest challenge facing the world at this decisive moment is the restoration of lost confidence in the system and its institutions and the fostering of comfort among the various economic entities, whose gains over many years have evaporated. This can not be achieved by sporadic and partial measures here and there; it requires the laying down of rules and principles that are of great effect in the long run and not only on the short one. Restoration of confidence can not be done by the various financial incentives alone. Nor a low rate of interest.

In spite of the importance of the 10 principles mentioned in this paper, one should emphasize a central point, namely that any economic and financial system should rest on an ethical foundation to achieve balance among all the participants in economic activities.

The median balanced position being advocated in this paper will enable us to manage an economy free of crises; it will unleash the powers of creative people and arrest the activity of those manipulators and egoists. It would as well ensure the interest of society at large and meet the needs of the poor and needy strata of society.

In conclusion, the achievement of such a median and moderate position requires a strong will and decisiveness on the part of the parties concerned. Would those concerned understand how serious the situation is in order to contribute to the concerted efforts for the benefit of the humanity at large?