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Conceptual issues in Measuring Islamic Finance National Accounts

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1.0 Introduction

Islamic banking is premised on financial activities that are consistent with the principles of Islamic rulings and its practical application through the development of Islamic economics. The principles are oriented towards moral and ethical values in all dealings and have global appeal. Islamic rulings prohibit the payment or acceptance of interest charges for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles.

In general terms, the core principles of Islamic banking are similar with those of conventional banking. The exception between the two is the fact Islamic banking must operate within the rules of the Shari'ah. These rules transcend conventional banking legal framework and integrate all aspects of social and religious life with the economy. A popular belief looks at Islamic banking as simply an interest-free financial structure. The reality however, is that it is a complete system of social and economic justice. It deals with property rights, the incentive system, and the allocation of resources, economic freedom and decision-making and the proper role of government.

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In order to be Islamic, the banking system has to avoid interest. Consequently, much of the literature on the theory of Islamic banking has grown out of a concern as to how the monetary and banking system would function if interest were abolished by law. Another Islamic principle is that there should be no reward without risk-bearing. This principle is applicable to both labour and capital. As no payment is allowed to labour unless it is applied to work, so no reward for capital should be allowed unless it is exposed to business risks.

By their nature, Islamic financial banks operate very differently from conventional banking. Conventional banks undertake the services of financial intermediation with their output dominated by the act of taking deposits and lending. Islamic banks have some kind of resemblance with mutual funds where investors pull in funds and this dominates their business model. Whether they should be treated as mutual funds as opposed to financial intermediation is not clear and this motivates this paper to raise some conceptual questions on how the System of National Accounts (SNA) should deal with this issue.

This paper discusses theoretical issues regarding potential measurement issues by giving an outline of building blocks of Islamic finance. These are explained to offer some suggestions on how Islamic financial institutions can be treated in the system of national accounts.

2.0 Building Blocks of Islamic Finance, Products and Financing

Equity is a key building block of Islamic finance. The prohibition of interest rates otherwise known as *riba* in Arabic is built on protecting the weaker parties in a transaction that may lead to huge pay-offs. Such equity is demonstrated in the 2.5% levy on cash or in kind wealth (*zakat*) imposed by Shari'ah on all Muslims who meet specific minimum levels of income and wealth to assist the less fortunate and foster social solidarity (Hussain et al, 2015).

At the core of Islamic banking lies the principle of participation that works on the notion of rewarding capital injected into a financial corporation. Ideally, the prohibition of interest does not mean capital should not be rewarded as there is a risk of bank collapse like conventional banking. While conventional financial intermediation focuses on taking deposits and lending out money, the Islamic financial system promotes the concept of participation in a transaction backed by real assets, utilising the funds at risk on a profit-and- loss-sharing basis. The general rule is that all financial arrangements that the contracting parties agree to use are lawful, as long as they do not include an element of interest. Equity-holding and commodity and asset-trading are an integral part of Islamic financing. The two basic categories of financing are profit-and-loss-sharing (PLS), also called participatory modes and purchase and hire of goods or assets and services on a fixed-return basis.

Thirdly, the principle of ownership is quite critical in Islamic finance. It is based on the notion that no one should sell an item they don't own. Specifically, its mode lies on linking financing to ownership of a typical fixed asset with full property rights. It connects financing to the real economy as opposed to speculative earnings of modern banking or returns that accumulate with the passage of time through compounding.

3.0 Islamic Finance in Monetary Statistics

Key issues for consideration are highlighted in the IMF manual for monetary and financial statistics and compilation guide. This manual divides functions of Islamic financial institutions into the safeguarding of deposits and the partnership of financial institutions with shareholders and depositors (called investment account holders) in profit-making ventures. Demand deposit facilities (called *Qard*, *Wadiah*, or *Amanah* deposits) are similar to the safekeeping and transferable deposit functions undertaken in conventional retail banking. Such

deposits (*Qard*, *Wadiah*, or *Amanah*) do not generate interest returns. The Islamic financial institution is obliged to pay the nominal value of the deposit on demand. For national accounts purposes, this always raises the question of how FISIM can be calculated under such financial arrangements.

For purposes of compiling monetary statistics, Islamic deposit facilities are treated in the same way as standard deposits in depository corporations. Current statistical practices classify Islamic financial institutions that have liabilities in the form of deposits or financial instruments that are close substitutes for deposits in the other deposit corporations (ODC) subsector.

With these key principles, I raise two questions. Firstly can Islamic banks survive without interest? Secondly can they be considered as investment funds that operate like mutual or equity funds where the depositors are essentially equity holders of some kind? Before these questions are answered it is important to reflect on the conceptual aspect in the 2008 SNA.

4.0 Measurement Issues and the SNA

The system of national accounts (SNA) recognizes various financial services. These include central banks, deposit taking institutions, money market funds, non-money market funds, financial risk management activities, pension funds, money lenders and financial auxiliaries. The principal activity of financial firms is provision of financial services. One key delivery mechanism is through financial intermediation. In this regard, financial corporations act a “clearing house” that connects deficit spenders and surplus units in the economy through deposit taking and giving out loans. In the process of financial intermediation, such corporations undertake risk managements services in line with existing laws to protect themselves as well as meet regulatory dictates. Furthermore, they undertake other activities such as buying bonds, investing in equities. All these form part of their output.

Financial services may be paid for directly or indirectly. Direct services include fees on credit cards, overdraft fees, fees paid to brokers for selling and buying shares on behalf of their clients amongst others. These are considered as direct sale of a financial service. Output of most financial corporations such as brokers, money market funds and non-money market investment funds amongst others is measured on the basis of explicit fees such as account fees, exchange fees, performance fees² etc.

Similarly financial services are delivered through interest on loans and deposits, otherwise known as financial intermediation indirectly measured (FISIM). Financial intermediation services are market output in nature and involve charging higher interest rates on loans and paying lower interest rates on deposits. The difference forms the output of financial intermediation services indirectly measured (FISIM). While the process of taking deposits and giving out loans appears a direct one with interest charged or paid, some activities associated with this intermediation are indirect. This includes risk management processes and costs of such transactions. In lieu of such a complexity, the 2008 System of National Accounts (2008 SNA) recommends the measurement of FISIM as follows:

$$FISIM = FISIM_L + FISIM_D = \left(\frac{r_L - rr}{100.0} \right) Y_L + \left(\frac{rr - r_D}{100.0} \right) Y_D \quad (1)$$

where: $FISIM_L$ = FISIM on loans, $FISIM_D$ = FISIM on deposits, r_L = lending rate, r_D = deposit rate, rr = reference rate, Y_L = average stock of loans, Y_D = average stock of deposits

² More details on measurement of output of various financial services is given in Chapter 3 of the Handbook on National Accounting Series F No. 113, Financial Production, Flows and Stocks in the System of National Accounts produced the United Nations Statistics Division and the European Central Bank available on <https://www.ecb.europa.eu/pub/pdf/other/handbookofnationalaccounting2014en.pdf?ebedd86643c52c4bbfedd3135cf6e21a>

The reference rate (rr) is not observable and must be determined according to circumstances of an individual country. One approach is to consider use of a single general rate such as the inter-bank lending rate. Alternatively, it can also be derived as a weighted average of loan and deposit rates with recourse to different loan and deposit products that prevail in a respective country. Similarly a simple arithmetic average of deposit and loan rates can also be computed. If different currencies are involved, it is important that specific rates are used for loans and deposit for any individual currency.

Other financial services tend to be non-market in nature and their output is estimated as a sum of costs. Such activities include regulatory services of financial corporations, supervisory activities such as monetary policy and exchange control amongst others.

5.0 FISIM and Islamic Banking

For respective financial services a production account is compiled that records all output. The output of financial services can be explicit or indirect. In the 2008 SNA, FISIM is based only on loan and deposit-like instruments handled by banks and similar financial institution. The 2008 SNA defines FISIM as:

“Financial intermediation is the activity of matching the needs of borrowers with the desire of lenders. It is carried out by financial institutions preparing alternative sets of conditions under which clients can borrow and lend” 2008 SNA, 17.228.

Within the SNA, all financial intermediation is carried out by financial institutions. Nonetheless, the SNA recognizes that some financial institutions are not financial intermediaries and provide services that are auxiliary in nature to intermediation such as advice to clients. The key issue is whether the Islamic financial institutions should be treated as financial intermediaries.

Islamic financial institutions do take deposits but do not pay any interest on the deposit accounts. If a client were to borrow, they simply do not charge any interest and the loan is zero rated. Using this argument it is clear that financial intermediation using the 2008 SNA approach concepts is possible but raises the question of how an Islamic bank should be classified. It is important to consider, for compilation purposes, how the income statement of an Islamic financial institution looks like.

Islamic banks receive deposits from customers that can be deemed as investment account holders (IAH). These account holders do not earn interest income. The two basic categories of financing are profit-and-loss-sharing (PLS), also called participatory modes and purchase and hire of goods or assets and services on a fixed-return basis. These resources are put together and invested with profits shared on agreed formula for all parties to the transaction. For an Islamic bank, its receipts are construed as Investment returns that are attributable to account holders under the PLS arrangement. Islamic banks use different financial tools to undertake investment on behalf of account holders such as issuance of credit cards where no financing or interest is involved³, custodial services for valuable possessions/documents, bank transfers, trade credits, leasing, equity participation etc. Some instruments do not have conventional bank equivalents. Unlike conventional banking, there is no common interest rate applicable to deposits that determine the depositors' returns (Krueger, 2017). An income statement of an Islamic bank will generally have a pull of income that reflects returns from various investment schemes that IAC holders earn.

³An Islamic bank can charge a commission or fee for issuing the card; all types of fees payable by the cardholder should be transparent and determined up-front between the bank, the card-issuer and the card-holder. A credit card-holder can claim free credit if any amount paid by a credit card is settled before a certain date stipulated by the issuer. If the amount is not repaid before the stipulated date, then the client should pay a fixed commission as an interest charge on the outstanding amount. This commission charged is normally not linked to the unpaid amount.

Is FISIM possible with Islamic banks under the 2008 SNA principles? Once Islamic banks earn from their investment initiatives, they basically do two things. They pay the investment account holders and pay some of the funds to the profit reserve account that helps guarantee payments of nominal value of deposits on demand. These expenses could be a “proxies” for interest payments to depositors. In this case FISIM could simply be the difference between investment income that is the equivalent of interest income in conventional banking. The problem however, is that these returns are not guaranteed and come from various instruments some of which are non-interest bearing. Consequently it becomes very difficult to deduce which aspect is actually financial intermediation within the 2008 SNA framework.

An alternative to dealing with this problem is to break down investment income on the basis of interest bearing instruments while the payment part remains the same. This is conceptually more appealing but could be very difficult to measure. These two scenarios raise a question as to how Islamic funds should be treated with respect to the 2008 SNA. The 2008 SNA does not give specific directions on how these institutions should be treated. It is apparent that investment incomes for an Islamic bank is derived from various instruments and those losses/profits are shared among investment account holders. This leads us to think critically about the most relevant conceptual aspect of the 2008 SNA that best fits the business of Islamic banking.

It appears from their nature and mode of business that Islamic banks are not deposit taking institutions even though the IMF compilation guide for monetary and financial statistics for reporting purposes considers all money in the investment accounts of these banks as deposits for reporting purposes. Their business model is founded on profit-loss sharing (PLS)

arrangements that take deposits from clients that are classified as equity holders, just like mutual funds.

One point of consideration is to think of Islamic banks as investment funds where funds are pooled by the various account holders and agreements made in line with rules of the Shari'ah. The 2008 defines investment funds as "*collective investment undertakings through which investors pool funds for investment in financial assets*". These investment funds can be categorized as money market or non-market funds with the former focused on short term market securities some of which may not be Shari'ah compliant. Non-market funds often invest in longer term assets, often fixed assets such as real estate. Such types of funds bear close resemblance to non-interest bearing assets and therefore very much in the frame of Islamic banking. It appears that mostly, Islamic banks might be close to non-market investment funds as opposed to financial intermediaries much as there might be some indirect services that they may be providing.

6.0 Conclusion

There is a close resemblance between conventional deposit taking corporations and Islamic banking. Both institutions take funds from "depositors". In conventional banking, the financial institution is a meeting place for lenders and borrowers. The financial institution facilitates this meeting by taking deposits and lending them out and charging higher interest on loans and paying lower rates on deposit accounts. The difference is FISIM. On the other hand, Islamic bank deposits are best described as a pool of funds by investors with collective loss/profit sharing arrangements by depositors and the institution. Pooled resources are invested and returns shared to all parties. Interest is not paid on these "deposits".

The key to making a decision of how each Islamic banking unit is treated requires an analysis of its individual business and the instruments it trades in. The basis of sharing arrangements is equally critical because there is a chance for indirect interest payments that should be considered and form a basis whether FISIM should actually be compiled. Without deep individual assessment, there is a risk that individual institutions can be wrongly classified.

6.0 References

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