THE GLOBAL FINANCIAL CRISIS, RISK MANAGEMENT AND SOCIAL JUSTICE IN ISLAMIC FINANCE

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Abstract

The most salient values of the Islamic financial system are fairness and socio-economic justice. The exuberance of Islam's uncompromising commitment to the well-being of humankind goes beyond its caring for existing generations to ensuring a sustainable future for generations to come. This is evident by giving utmost priority to the environment and preserving earth's valuable–yet limited–endowments and resources, and by limiting public borrowings to available resources hence freeing future generations from the burden of debt. The Islamic system of production and finance based on profit-and-loss sharing (PLS) is more efficient and equitable in distribution of wealth and income. Allocation of funds under risk sharing will be based on the viability and expected profitability of the proposed entrepreneurial undertakings rather than on the creditworthiness of competing entrepreneurs. Furthermore, risk sharing offers both entrepreneurs and investors incentives to be truly engaged in productive economic activities, wherein entrepreneurs will be encouraged by the prospect of seeing their ideas transformed into business entities, and financers will be obliged to assess the risk involved more cautiously,

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and effectively monitor the use of funds by the entrepreneurs. The appropriate implementation of such partnership contracts increases the likelihood of business success, injects more discipline into the financial market by reducing excessive lending, and ultimately will have positive implications for the socio-economic well-being of society at large.

Key words: Profit-and-loss sharing (PLS), Islamic finance system, socio-economic justice, risk management.

I. INTRODUCTION

Increasing numbers of Muslims are earnestly returning to Islam for guidance and spiritual salvation after they have tried, in vain, all sorts of imported ideologies and socio-economic developmental models. Islam is re-establishing its presence and its relevance on more solid grounds, meaning that more Muslims are seeking to abide by the rules and guiding principles of Sharīʿah, particularly in their financial dealings. Unlike the financial system, which is basically focused on the economic and financial aspects of business activities, the Islamic system places emphasis on the moral, ethical and social dimensions to promote equality and fairness for the well-being of communities and society at large. Krichene and Mirakhor (2009) emphasised the social dimension of the Islamic financial system and defined Islamic finance as being "the financial activity of an Islamic economy that mandates social equity".

Being the institutional flagship of the Islamic ethical economy, Islamic banks and financial institutions are expected to operate in accordance with this frame of reference and to assume manifold roles. In addition to being commercially-oriented institutions that undertake lawful and legitimate financial transactions based on interest-free banking and risk-sharing financing, the role of Islamic banking and finance (IBF) is extended to address the core aspects of social and economic justice. Islamic banks provide financial products and services that conform to Islamic law, based on a PLS structure rather than a lender-borrower arrangement. The element of risk embedded within the PLS contracts defines the theoretical justifications as well

as the practical implications of Islamic finance and set it apart from interest-based finance.

Critical review of relevant literature points specifically to three courses of action often taken by investors and entrepreneurs in relation to financial risk in finance; i) take no risk; ii) take excessive risk; and iii) transfer risk. Islam rejects all three approaches to dealing with risk on the following grounds:

i) The concept of "no risk, no gain" dictates that any profit earned on money is the reward of bearing risks of the business which entails the investor to profit from the financial transaction. Thus, Islamic banks are expected to take genuine business risk between the time of purchasing the asset from the vendor and the sale of the asset to the party requiring the goods;
ii) excessive risk (over-leveraging, focusing on loan sales and disregarding loan quality to earn fees, overly complex investments, irrational prospecting, and questionable/lax oversight among others), be it investment bank or retail bank, is considered speculation that eventually amounts to gambling, which is strictly prohibited in Islam; and,
iii) the risk transfer by lending institutions is deemed an unjust and unethical practice since it seeks to ensure that borrowers bear all the risk associated with their investments, thus releasing lenders from their moral and professional responsibilities of monitoring the use of funds.

Instead, Islam promotes risk sharing based on PLS financing as a more equitable means of wealth creation and distribution and to enhance economic stability and expedite economic maturity. The ultimate aim is to realise socio-economic justice, which is a condition for achieving prosperity in this worldly life and in the hereafter.

The primary objective of this paper is to explore causes and consequences of the global financial crisis, and the nature and management of risk in Islamic finance. The paper argues that Islamic finance has a built-in risk management mechanism that enables the global financial system to perform in an orderly manner and avoid such crises. We also argue that social justice does and should take priority in Islamic financial transactions, and as such equity financing should become a more dominant form of financing in the Islamic

financial system. In attaining such an objective, we have incorporated and synthesised contemporary ideas of Chapra (2009), Wilson (2990a, b), Siddiqi (2009), Ahmed (2009). Seif (2009), Laldin and Mokhtar (2009), Hasan (2009), Kayed and Hassan (2009), Krichene and Mirakhor (2009), Khan and Mould (2009) Hassan and Lewis (2007), Hassan and Kayed (2009), and Hassan (2009 a, b, c, d) in this paper. The paper concludes by raising the inevitable question of whether IBF, represented by Islamic financial institutions, has been successful in, or at least has made tangible contributions towards, the fulfillment of the wishes and the hopes of the Muslim masses in realising social justice and economic development.

The paper is diviāded into five sections. Section 2 analyses an Islamic financial system and the role of risk management in this system. Section 3 examines risk management from a social welfare angle by emphasising the importance of equity in Islamic finance. An Islamic financial system is more pro-equity than pro-debt unlike a Western *riba*-based system. Section 4 examines the implications of the global financial crisis for the Islamic financial industry. Section 5 concludes the paper.

II. CAUSES AND CONSEQUENCES OF THE GLOBAL FINANCIAL CRISIS

Financial bubbles are generally linked to easy credit, excessive debt, speculation, greed, fraud, and corruption. Easy credit leads to lack of adequate market discipline, which in turn instigates excessive and imprudent lending.

The most frequent causes of a financial crisis are:

a) Complex derivatives and excessive leveraging of US financial institutions have driven some renowned financial institutions into bankruptcies and brought others to the edge of collapse. Financial globalisation leads to hasty transfer of systemic risk within and across national boundaries. Good and poor-quality mortgages were bundled together in securitised packages and entire default risk sold to intermediaries. These mortgage-backed securities were sold to secondary investors and traded in the intermediary

market. This released cash to extend new loans and make more money. The model worked well while borrowers were making their payments. When payments stopped, the model, literally, caved in.

b) Asset-liability mismatch. This is actually a disparity between a bank's deposits and its long-term assets which result in inability of banks to renew the short-term debt they used to finance long-term investments in mortgage securities and eventually trigger bank runs.

c) Regulatory failure. Insufficient regulations make banks less transparent and less accountable to stakeholders (Alexander 2008). Banks will operate without sufficient liquidity to meet contractual obligations. Banks adopted lax lending by selling more loans to earn fees and commissions. Chapra (2009) points out that loan volume gained greater priority over loan quality. As interest rates began to rise, new home affordability and the ability to repay existing loans sharply plummeted. Excessive regulations that require banks to increase their capital when risks are on the rise lead to substantial decrease in lending when capital is in short supply.

d) Fraud, corruption and greed. Extreme economic greed overrides basic ethical consideration in investments. Enticing depositors through misleading claims about investment strategies, manipulating information and creating financial assets without any real economic activity is just a harbinger to financial crisis. Speculation, intense competition and shareholders demands for higher returns have encouraged excessive risk taking through availing credit to unworthy/subprime borrowers (Spiegel online, 2008).

e) Contagion. This arises when the collapse of one bank due to lack of liquidity, bad loans or a bank run causes damage to many other institutions and threatens the stability of financial markets.

f) Money supply. Uncontrolled printing of paper money not backed by a real commodity such as gold will surely cause inflation (Rasem and Kayed, 2009; Hassan, 2009a, b, c, d).

The diffident response of various Western governments was rushed and imprudent purchase of toxic bank assets worth in excess of US$1

trillion to stave off collapse of troubled financial institutions. The common view held by the majority of Islamic financial scholars and practitioners is that the global financial crisis in reality is a crisis of failed morality (Siddiqi, 2008). Failed morality, arguably, is the product and the cause of greed, exploitation and corruption. This ethical failure is coupled with a failure in the relationship between investment originators and investors (Loundy, 2008).

III. THE ISLAMIC FINANCIAL SYSTEM AND RISK MANAGEMENT

Justice in Islam is not just another idiom for fairness and impartiality, and the PLS contracts are not merely theoretical alternatives to the interest-based financial industry that dominates the global financial landscape. Integrating the concept of PLS with the theme of socio-economic justice comprises the cornerstone for building an ethical, highly valued and prosperous society. "O you who believe! Stand out firmly for justice, as witnesses to Allah, even against yourselves, or your parents, or your kin, and whether it be (against) rich or poor, for Allah can best protect both" (The Holy Qur'ān, 4:35).[1]

A. The Concept of Justice in Islamic Finance

The importance of justice as a human value is emphasised in the following Qur'anic verse: "Be just, that is closest to awareness of God" (5:8). The Holy Qur'ān (57:25) also stipulates that a human society without justice will ultimately head towards decline and destruction. Justice can only thrive and flourish if there is a set of moral values which everyone accepts and faithfully complies with. A financial system can promote justice by satisfying at least two moral value-based conditions. First, the financier/lender should share in the risk and reward such that the entire burden of losses is not borne by the entrepreneur/borrower. This is one of the tenets

1 Cited verses from The Holy Quran are referenced according to the chapter's (*surah*) number followed by the verse's (*ayah*) number. Thus the reference (The Holy Quran, 4: 35), for instance, refers to Verse 35 of Chapter 4.

of Islamic finance: "no risk, no gain". The lender, in an attempt to avoid adverse selection and moral hazard by the borrower, will carefully and effectively monitor the use of funds by the borrower. This would inculcate more lending discipline in the financial market. Second, an equitable share of financial resources mobilised by financial institutions should become available to the poor to assuage inequalities of income and wealth. The share of equity and PLS in businesses does not rule out debt financing. Although debt financing is indispensable, it should not be utilised for wasteful consumption and unproductive speculation. Islamic finance allows creation of debt financing only through sale or lease of real assets by means of sales and lease-based models (Chapra, 2009).

For debt to be an effective financing vehicle in Islamic finance, the following four conditions must be fulfilled in order for the transaction to comply with rules of the Sharīʿah:

i) "The asset being sold or leased must be real, not imaginary or notional." This eliminates a large number of derivatives transactions, which merely involve gambling by third parties who claim compensation for losses suffered by the principal party.
ii) "The seller or lessor must own and possess the good being sold or leased." This means that the seller bears a part of the risk and reward of the lease. This avoids short sales and asset-price-decline swings. In sum, this debt financing can only expand in step with the rise of the real economy and not through excessive credit expansion.
iii) "The transaction must be a genuine trade transaction with full intention of giving and taking delivery." This will motivate the creditor in evaluating the risk and it also avoids the unnecessary explosion of the volume and value of transactions.
iv) "Debt cannot be sold, and thus the risk associated with it must be borne by the financer him/herself." Debt cannot outsize the real economy. The financing of the real sector will help expand employment, self-employment opportunities and production of need-based goods and services.

These four conditions cannot shrink the economy by reducing volume and number of transactions since speculative and derivative

transactions are generally zero-sum games with a rare positive contribution to the economy. The restrictions on the number and volume of derivative transactions will curtail the commission earned by speculators and avert the inevitable losses and bankruptcies which culminate in financial crisis (Chapra, 2009).

Justice demands that innovations must be introduced to ensure that disadvantaged subprime borrowers (usually the small, poor and lower middle class) are able to get adequate credit to realise their dreams of home ownership and putting up microenterprises. The ultimate solution to this hurdle is microcredit institutions, which can provide credit to the very poor on a humane interest-free basis (*qarḍ ḥasan*). This could be achieved if microcredit firms are integrated with *zakāh* and *waqf* institutions, which may subsidise the cost of financing for those borrowers eligible for *zakāh*. The microfinance sector may also be scaled up through integration with commercial banks to rationalise the overall high lending costs to small borrowers (Chapra, 2009).

The Islamic financial system can also minimise the severity and frequency of financial crises by injecting greater discipline into the financial system, linking credit expansion to the growth of the real economy, ensuring that creditors undertake careful and thorough underwriting of risk and, finally, by mitigating the problem of subprime mortgage through provision of credit at affordable terms. Islamic finance is still at the embryonic stage and shares a very small fraction of international finance. The use of equity and PLS are still very small while the use of debt financing through sale and lease is preponderant. The Sharīʿah conditions for debt creation are circumvented by use of legal stratagems *(ḥiyal)*. This is partly due to inadequate understanding of the objectives of Islamic finance, non-availability of trained personnel and absence of an efficient Islamic financial system to stem cases of anonymity, moral hazard and information asymmetry. The system should gain momentum and play a pivotal role of enhancing and promoting the health and stability of the global financial system (Chapra, 2009).

B. Risk Management in Islamic Finance

Risk management is the entire process through which a financial institution identifies risk, quantifies those risks and takes appropriate actions either to contain them or mitigate them. The definition links entitlement of income from any transaction with liability to loss (ownership risk). It therefore establishes a close relationship between risk management and risk sharing. Lending is a means of transferring ownership, and the lender cannot have a legitimate claim for interest return on money capital. In trust contracts where financing involves money capital, risk sharing between the lender and borrower is a must.

Seif (2009) explains the essence of risk management. On one hand, it may involve speculation, and on the other hand, it may involve hedging. Risk management can be performed through avoidance of risky assets or shifting of risk to third parties. This is the mode of operation for conventional banking. The packaging and sale of credit risk to hedge funds does not involve exchange of utilities. From the Islamic finance perspective, short sales, futures, options and swaps are all cases of speculation resulting from risk shifting. The use of these complex derivatives was partly the genesis of the current crisis. From the Islamic finance perspective, they are *gharar*-stricken transactions and should be prohibited.

There is no coherent scholarly definition of what constitutes "principles and objectives of risk management"; it is most likely that Muslim scholars will be content with any definition as long as its contractual links preserve and obey the relevant parameters of the Islamic law of contracts. In Islamic finance, risk management revolves around "prudence" in the use of resources to generate utilities while avoiding waste and damage. Aversion to damages (including financial losses and economic waste) takes precedence over generation of utilities. Under risk sharing, the borrower and lender should share risk. In banking, the borrower unjustly bears all the risk associated with the investment and vouchsafes the lender fixed interest income. Shifting risk to third parties benefits the individual firms but has catastrophic consequences on the entire financial market, just as savings may have negative macro-economic upshots (as opposed to spending) on output and employment, but,

ironically, the same saving is beneficial to the individual. However, when the income-earning asset is the subject matter of the sale contract at a fixed price, there is room for Islamic banks to shift risk to the client. This risk shifting, as a component of the overall risk management strategy in Islamic finance, is a win-win strategy as opposed to a win-lose strategy in banking (Seif, 2009).

C. Risk Management and Sharīʿah Screening

From the Sharīʿah point of view, risk management is a must in the principle of blocking the means to evil. Risk management must be through means in compliance with the Sharīʿah criteria and guidelines, which include aversion to any element of usury, uncertainty in contracts and other principles envisaged by Sharīʿah. The process of risk management, which involves identification of the exposure and how to manage it, is common to Sharīʿah and banking. Sharīʿah, however, provides an additional layer of screening divided into two: a) negative Sharīʿah screening which excludes *ribā, gharar* and *maysir*-based transactions; and, b) positive Sharīʿah screening with its emphasis on the attainment of justice, ethics and accountability (Laldin and Mokhtar, 2009).

According to Mokhtar and Laldin (2009), negative Sharīʿah screening is achieved in two stages: first, before an investment is made. Unlike conventional financial markets, which are focused on the money market, Islamic banks are focused on the asset market, which creates a natural limit to the quantum of activities that can be undertaken and also limits the exposure the investor could face. The size of the money and derivative market has no relation to real economic activity. Sharīʿah also requires contractual transparency to minimise *gharar* and avoid *maysir*, since undue complexity in contracts will increase the level of *gharar* in transactions. The second stage is when making decisions on how to manage risk. Financial derivatives enable transfer of risk and generation of high, riskless return. It is difficult to find a Sharīʿah justification for allowing a high return accompanied by virtually zero risk. If the risk transfer was even conceivable, questions of what is being exchanged in the transaction, the price, the process of exchange and the aim of the exchange would still have to be answered. While the

negative screens play a central role in regulating the market, they complement the quantitative approach the markets are embarking on. On the other hand, Mokhtar and Laldin (2009) explain that the positive screens, which are intended to complement the qualitative approach to risk management, are not present in markets.

Seif (2009) urges Islamic financial practitioners not only to avoid the conventional risk management strategies but also to re-assert the lost originality of Islamic financial engineering. There should be a re-awakening and concerted effort within the Islamic financial industry to reshape the values, principles, objectives and tools of risk management. The present self-regulatory, self-rewarding and self-assured Islamic system may be replaced with a new regulatory strategy through the creation of an external judicial body to qualify the process of Sharīʿah approval in accordance with the core principles and values of socially responsible investments, ethically viable socio-economic goals, growth-boosting venture capital financing of low-income groups, representation of interests of poverty-stricken Muslims and investing in employment-generating projects.

D. Nature and Management of Risks in Islamic Finance

There are two main issues mutually applicable to finance and Islamic finance: moral hazard and information asymmetry. In Islamic finance, the root cause of moral hazard is the leniency accorded to absconding debtors. It is still an uphill task to pigeonhole debtors into those who genuinely deserve leniency in repayment and those who are unscrupulous defaulters. Peer pressure and shared religious values can compel unscrupulous defaulters to make good their contractual obligations and mitigate moral hazard. Information asymmetry is prevalent with *muḍārabah* and *mushārakah* profit- sharing contracts since the managing company can always overstate costs and minimise the returns to be shared with the depositors. Rigorous auditing can moderate the information asymmetry problem (Wilson, 2009a).

The principles of risk management in Islamic banks are similar to those of the banking system, as substantiated by the Islamic

Financial Services Board (IFSB). Islamic banks have to manage credit risk, liquidity risk, operational risk, FOREX risk and rate-of-return risk. The rate-of-return risk is synonymous with interest-rate risk for banking. Liquidity risks are similar for Islamic banks and banking since both have to guarantee current accounts deposits from which depositors can withdraw their money on demand (Wilson, 2009a).

Despite these similarities, there are several areas where Islamic risk management differs from that of banking. Wilson (2009a) discussed the following areas of risk management that are distinctive to the IBF. First is ownership risk. This risk is substantially mitigated in *murābaḥah* if the commodity is immediately sold to the client at the time of purchase but first-purchaser risks remain even after sale, as the client can potentially sue the bank. However, risks with *ijārah* are significantly greater since the bank has a longer-term ownership of the asset. Second is risk sharing of investment *muḍārabah* deposits. Unlike banking, where interest is guaranteed whether the borrower makes profits or not, returns on investment *muḍārabah* deposits (similar to time and notice deposits) are not guaranteed, and it is only the depositor profit-and-loss sharing which justifies the return. However, the principal invested is not written, and to some degree the profits could be guaranteed through a profit equalisation reserve, which Islamic banks must maintain. The third is opportunity cost of liquidity. This is much higher for Islamic banks than for banking since Islamic banks cannot hold treasury bills and other interest-bearing instruments. They can only have *murābaḥah* overnight deposits with other Islamic banks, which provide minimal returns. The fourth is FOREX risk. Islamic banks, just like conventional banks, hold assets and liabilities in a single currency. Clients can hedge future obligations using hedging methods such as forward contracts, which do not contravene Sharīʿah. However, Sharīʿah-based contracts could also be used by paying a deposit to secure the price/rate for a future real transaction. However, trading in futures and options is prohibited since this is equal to speculation (Wilson, 2009a).

Hasan (2009) points out that businesses can undertake a number of measures to mitigate risk in a financial crisis. First is the documentation of contracts. Firms should have quality

documentation of all commercial transactions and engagement with their clients. This would thwart the breakdown of relationships and potential disputes which usually arise during economic meltdown when parties to a contract attempt to reconsider their rights and obligations The Holy Qur'ān establishes an explicit imperative in this regard: "O you who believe! When you deal with each other in transactions involving future obligations, reduce them to writing. And let a scribe draft your mutual obligations faithfully….And do not disdain to reduce to writing your contract for a future period, whether it be small or big. Writing it is more just in the sight of Allah, more suitable as evidence, and more exact in preventing doubts among you" (The Holy Qur'ān, 2:282). The second measure relates to market disruption. It is imperative that both Islamic financial institutions and corporations vigilantly and attentively check all their commercial contracts to ensure inclusion and existence of provisions that allow them to renegotiate their commercial relationships with their clients in the face of unforeseen market disruptions such as political upheavals, natural calamities, credit crunch and increase in inflation and interest rate, among others. For example, *muḍārabah* and *wakālah* arrangements are seemingly more flexible than *murābaḥah*. The third measure concerns debt versus equity. During an economic boom, conventional as well as Islamic firms incur debt and become highly geared to leverage profits and increase turnover. During economic downturns, such highly leveraged firms will report abysmal performance and become technically insolvent. This is due to utter failure to match asset-related cash flows with liability-related cash flows (maturity matching) and pursuing an aggressive financing strategy. High profits are still attainable with equity financing without incurring financial risk associated with leverage. In Islamic finance, equity-financing *muḍārabah* and *mushārakah* provide greater flexibility than debt-based, non-tradable *murābaḥah*. The fourth measure is governing law and arbitration. Lucid inclusion of legal jurisdiction (governing law and Islamic Sharīʿah) of Islamic financial agreements is of necessity, and consideration of non-Islamic jurisdiction is a must. Making Sharīʿah in general the only governing law could introduce uncertainty, as the Sharīʿah can be widely interpreted.

Islamic hedging instruments such as *salam, ʿarbūn* and *salam*-parallel contracts could be developed. However, regulations should be put in place to avert speculative activities in currency and stock trading. This could cushion Islamic banks from market risk. Islamic banks should exercise great caution with new financial innovations. Sharīʿah scholars should identify *gharar* and understand the risk characteristics of all new products such as Islamic hedge funds. The CDOs in banking contain elements of *gharar*. Assets with different risk characteristics are bundled together and rated on the basis of best assets in the portfolio without effective control of financial engineers working for investment banks. Islamic banking continues the focus on retail banking and the classic model of covering financing from deposits rather than from wholesale funding. The IFSB should continue to work with the Bank of International Settlement (BIS) in compiling its own risk management and actively participate in Basel II when it becomes an item on the international regulatory agenda, and IBF should continue to play an increasing role in the global financial system (Wilson, 2009a).

A well-designed regulatory-prudential-supervisory institutional framework should be comprehensive enough to cover all transactions and all financial instruments and innovations. It would also cover all financial institutions operating within the system, without a demarcation line between money and capital markets. That is because it may be less logical to segment regulatory authority in the Islamic financial system, granted that the system promotes almost one-to-one interaction between real sector and finance activities. Such a system should be unified and uniform in covering all Islamic financial instruments, financial institutions and transactions across the globe since the systemic risk due to failure of one Islamic financial institution or instrument is far greater for Islamic finance than in the convectional financial system. That is because even a single failure entails reputational damage to the entire Islamic financial system. It should have sufficient built-in flexibility and dynamism to stay ahead of the innovation curve and minimise the risk of regulatory arbitrage, given the profit-seeking motivation driving the financial sector innovations and financial engineering, and it should have a universal mandate to enforce its rules and standards globally. This will require governments in

countries where Islamic finance is in operation to extend such a mandate to the unified global regulatory agency for the development of oversight standards of Islamic institutions, transactions and instruments (Mirakhor & Krichene, 2009).

Siddiqi (2009) explains that in contemporary capitalism there is no close monitoring of borrowers by lenders. Speculators churn and shove complex financial products into the portfolios of uninformed investors who rule the market. The lightening speed of financial innovations keeps regulators two steps behind the market speculators to the detriment of the investors. To curb this problem, regulators ought to prioritise stability, transparency and fairness in the financial markets rather than protecting business profits. Risk shifting and trading on debts should be restricted. Disillusionment with the economic philosophy of "Greed is good" will most likely yield the benefit of a socially and ethically informed approach to business and finance.

IV. RISK MANAGEMENT AND SOCIAL JUSTICE IN ISLAM

Risk sharing is an arrangement in which the provider of the funds (financier) agrees to a share of his/her profits or rewards. If the user of the funds (entrepreneur) does not make any profits, the financier gets back the capital. Should the entrepreneur sustain some losses, these losses, according to Islam, should be borne by the financier. This is contrary to capitalist societies where the producer solely bears the burden of losses since the financier does not share the risk. A system of production and finance based on risk sharing is more efficient and equitable in distribution of wealth and income for two prime reasons. First, allocation of investable funds will be based on expected profitability/productivity of the projects in question, unlike the capitalist system which bases allocation on the creditworthiness and wealth of the project-sponsors. Second, a system of risk sharing encourages entrepreneurs and innovators who would not be under pressure to generate accelerated growth, which is deleterious to the business environment (Siddiqi, 2009). Likewise, Kuran (2002) argues that "an 'Islamic bank' operating

in the manner prescribed by its charter would work like a venture capital firm. It would lend on a profit-and-loss sharing basis to people with economically promising ideas, rather than simply to established entrepreneurs with plenty of collateral" (Kuran, 2002). Risk transfer on the other hand, involves transfer of risk to third parties who buy risk albeit they don't provide funds for production or organise production. The buyers of risk using derivatives are avid speculators engaged in gambling activity. Unlike producers, fund owners and financial intermediaries who gain through stability of the market and mitigating of risk, speculators' interests lie in instability. Risk transfer or shifting is less efficient, unjust and inequitable since producers who bear all the losses are also made to pay back all the capital borrowed and interest thereof out of their personal wealth, thus adversely affecting the distribution of income and wealth, reducing social cohesion and accentuating conflict in the society. Risk shifting requires little or no trust. While it catapulted capitalism to new heights, it leads to decline of trust in business. The expansion of the real economy through risk shifting triggered proliferation of interest-bearing debts and speculation. The economic growth was propelled by pursuit of private gains, resulting in hegemonic nationalism and environmental deterioration. Regulators could have prohibited risk shifting so that financiers could have followed more conservative and responsible lending policies. Since the interest of the society lies in increased market stability and reduced risk, speculators who invite, magnify and "buy" risks in order to profit engage in anti-social activities (Siddiqi, 2009).

Islamic economics and finance aspire to promote the type of economy that sustains all members of the society. Life-sustaining activity is not equal to profit-making activity. It does not allow manipulations that create profit for a few through information asymmetry, monopolistic practices, and exploitation of the weak through outright fraud. Siddiqi (2009) points out that more work still needs to be done in areas of corporate governance to protect the rights of all stakeholders in a joint stock enterprise, in transparency in the flow of information, and in welfare-oriented market regulation which protects investors, labor consumers and the whole society.

Khan and Mould (2009) argue that the present debt crisis should be examined as a fundamental question of social justice, a concept that is paramount in Islam. Social justice includes three aspects, namely a fair and equitable distribution of wealth; the provision of basic necessities of life to the poor and the needy; and protection of the weak against economic hardship. The debt burden, however, is increasing inequality between rich and poor countries and is tantamount to exploitation since poor countries cannot provide the most basic services for their citizens. Striving for social justice involves the struggle against poverty and inequality. Prophet Muḥammad (peace be upon him) said, "He who sleeps on a full stomach while his neighbor goes hungry does not [truly] believe (Ibn Abī Shaybah)."

Khan and Mould (2009) argue that social justice is so focal to Islam that *zakāh* (almsgiving), meaning 'to purify' or 'cleanse' in Arabic, is one of the five pillars of Islam. The purpose of *zakāh* is to promote equality by redistributing wealth from the rich to the poor. It also keeps wealth clear of greed and selfishness. Muslims are also encouraged to make voluntary contributions, or *ṣadaqah,* to help the poor and needy and for other social welfare purposes (Khan and Mould, 2009). The Holy Qur'ān warns: "Wealth should not only circulate between the rich amongst you" (59:7). According to Islamic teachings, if creditors fail to alleviate the burden of debt, then debtors are eligible for *zakāh*. Through *zakāh*, Muslims are exhorted to assist the poor, the indebted and other potentially vulnerable groups (orphans and travelers). The Holy Qur'ān states: "The alms are only for the poor and the needy, and those who collect them, and those whose hearts are to be reconciled, to free captives and the debtors in need, and for the cause of Allah and the needy travelers" (9:60).

Risk management and social justice in Islam is not confined to individuals and communities within a society; it is, rather, extended to cover relationships between diverse countries. Contemporary economics has produced enormous disparities in wealth creation and distribution amongst nations: poor countries are burdened with loans and punitive interest charged by the lenders, who are never willing to share the risk. This contravenes two fundamental principles of Islamic finance. Islam abhors charging of interest and commends

sharing of financial risk. This seeks to avoid the concentration of wealth on the lender and the economic exploitation of the weak borrower. The core belief in Islamic finance is that money should not in itself be an earning asset. While capitalism considers money to be capital, Islam views capital to be the portion of wealth that is used in prolific economic activity. Money is a measure of value and a means of exchange, and it is not a commodity for speculation. Thus it remains potential capital until it is invested in productive economic activity together with other means of production (land, labour and entrepreneurship) (Khan and Mould, 2009).

Khan and Mould (2009) argue that interest is considered an unjust and exploitative instrument of financing since the lender is assured a return without doing any work or sharing in the risk, while the borrower, in spite of hard work, is not assured of a positive return. The prohibition of interest is therefore a mechanism to establish justice between the lender and borrower. Of particular relevance are situations when the debtor's misery of unpaid debt is aggravated by interest charges: "O believers! Do not live on usury that is compounded over and over again. Have fear of Allah so that you may prosper" (The Holy Qur'ān, 3:130).

However, the fact remains that the financial system, which is based on the institutions of interest and speculation, is deeply rooted in every aspect of modern life. Khan (2008) prudently states that: "Interest cannot be eliminated without providing interest-free loan facility to loan seekers just as illiteracy cannot be eliminated without providing schooling facility to every child." He further explains that PLS arrangements are not appropriate in all situations, especially where there is genuine need for a personal loan not intended for business purposes. This argument highlights the need to revive the spirit of *qarḍ ḥasan* within the formal and informal institutions of the Muslim *ummah.*

Being a practical religion that is neither limited by physical boundaries nor subject to time constraints, Islam fully appreciates human circumstances and recognises that they would be at times subject to financial hardships and inconveniences. Islam therefore permits and even encourages assuming debt within affordable limits. If debts are incurred responsibly, then prompt and full repayment is important. Debt is thus a serious matter and should

not be undertaken except in cases of real necessity. Incurring debt to fund luxury and extravagance is contrary to core Islamic values that condemn excess and waste. The Qur'an has, in very strong words, condemned and prohibited extravagance and prodigality: "Eat and drink, but do not be wasteful, for God does not love wasteful people" (The Holy Qur'ān, 7:31) (Khan and Mould, 2009).

V. THE IMPLICATIONS OF THE CURRENT GLOBAL FINANCIAL CRISIS FOR ISLAMIC BANKING AND FINANCE

The current financial crisis has given credence to the Islamic scholars and economists who pointed out the inherent frailty and faults of the financial system and who reaffirm that the root of the crisis was inadequate market discipline resulting from lack of profit- sharing models of financing, from expanded use of derivatives and from the policy of "too big to fail". Others argue that moral failure led to exploitation and corruption, characterised by overextended leverage, complexity of products and speculation through risk shifting (Wilson, 2009b).

The implications of the global financial crisis for IBF are examined on two fronts: the immediate impact of the crisis on IBF, and the potential role that Islamic finance is suited to assume in the long term in order to deliver noteworthy contributions to the international financial system. The direct impact of the crisis on the Islamic banking sector was minimal due in part to the intrinsic principles that, to some extent, administer the operation of the Islamic financial sector. Emmanuel Volland, an analyst with the rating agency Standard & Poor's, explains, *"Islamic banks were not caught by toxic assets as Sharīʿah law prohibits interest"* (Khalaf, 2009).

Furthermore, the lack of structured products and the reluctance of Islamic banks to exploit sophisticated financial instruments enabled these banks to thus far remain positive and to accommodate the stern impact of the current challenging global financial environment (Ambah, 2008). In his appraisal of the cautious approach adopted by Islamic banking, Amr al-Faisal, a board member of Dar al-Mal al-Islami, commented, "*We are more conservative and sober in*

our investments. That used to be considered a handicap. Now it's considered the height of wisdom. Successful banks have always been conservative lenders" (Ambah, 2008).

Although Islamic finance has not felt "the full impact" of the global credit crisis, the immediate fallout from the crisis is evidenced by the fall in equity valuations and the plunge in the real estate market across the Gulf States with all that that entails for the Islamic banking sector–bearing in mind the intense engagement of the Islamic banking sector in the real estate industry (Richter, 2008; Khalaf, 2009). The fall in property prices in the Gulf States is therefore a cause of major concern for Islamic banking, given the asset-based nature of Islamic finance, where real estate is the preferred instrument to protect these investments (Singh, 2009). According to Standard & Poor's (S&P), the Islamic financial sector has also suffered a sharp decrease in the value of *ṣukūk* (an Islamic financial certificate, similar to a bond in Western finance, that is supposed to comply with the Sharīʿah) issued in the year 2008 to the sum of about $15.5 billion, down from about $47.1 billion in 2007 (Khalaf, 2009; 'Malaysia leads in Islamic finance', 2009). Despite the strength and the soundness of the fundamentals of the Islamic *ṣukūk* industry, uncertainties in the global financial markets are, by and large, having an adverse impact on the Islamic financial services industry ('Islamic assets in GCC', Asia top $700b in '08', 2009).

As for the long-term implications, Standard & Poor's believes that while the immediate future for Islamic financial institutions is uncertain, they have strong long-term prospects. The resilience of Islamic banking and its ability to navigate to safe shores depends largely on the competence of the human capital in charge of Islamic banking and its sincerity in reflecting and integrating the ethos of Islamic teachings into all aspects of the financial industry. In his attempt to explain the shortcomings of the Islamic financial system that are most likely to prevent it from assuming a leading role in the international financial market, Chapra (2009) argues that the Islamic financial system is still in its infancy. It is not fully prepared at the present time to play a significant role in ensuring the health

and stability of the international financial system.[2] Islamic banks still need to diversify their funding sources beyond retail deposits and develop and diversify into new and existing products such as Islamic hedging, derivatives, and liquidity and risk-management instruments. However, the Islamic financial system is on the right track and is expected to sustain steady growth and progressively establish itself as an influential and constructive key player in the international financial market. Contrary to this view, Loundy (2008) argues that the "immaturity" of the Islamic financial industry has, in part, saved [the industry] from a subprime-like mess so far and wonders what will save it when the industry grows up.

Although the impact of the current global financial crisis on the Islamic banking sector has been tolerable, there is no assurance that the Islamic financial services industry, at its current status, is immune against such crises. Ahmed (2009) warns that Islamic banks are susceptible to the same fate of the conventional financial system if not well monitored. Furthermore, Islamic financial institutions are often criticised for being run under a conventional framework (Ahmed, 1992; Asutay; 2008; IBF Net, 2009), and that the Islamic financial industry "is a mirror of the CBS" [commercial banking system] (Al-Haddad & El-Diwany, 2008), and it is therefore likely to suffer from the same systemic problems faced by the commercial banking system (CBS). This is evidenced by Islamic banks' avoidance of truly engaging in risk-sharing financial arrangements.

Ahmed (2009) identifies three factors that could trigger a financial crisis in the Islamic financial sector. At the institutional level, the Islamic regulatory system is at its embryonic stage, fragile and still evolving; hence it is no better than that of the dominant financial system. At the organisational level, excessive profit taking and risk taking is difficult to prevent unless the Board of Directors (BOD) and top management impose prudent risk-management practices. At the instruments level, there is rapid growth of complex Sharīʿah-compliant financial innovations such as tradable *ṣukūk*, which have

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2 "This is partly due to a lack of proper understanding of the ultimate objectives of Islamic finance, the non-availability of trained personnel, and the absence of a number of shared or support institutions that are needed to minimise the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations" (Chapra, 2009).

features similar to those of CDO and MBS, and Islamic return swaps where the underlying permissible assets can be swapped with returns on subprime CDOs.

Ahmed (2009) highlights the urgent need to create appropriate rules, supporting institutions and incentive structures at all levels. At the institutional level, there is a need to mitigate excessive profit seeking and risk taking through: a) separation of commercial and investment banking; b) imposing restrictions on excessive leverage; c) stringent capital requirements; d) more transparency and accountability; e) setting up investment criteria to prevent excess risk taking; f) trading *ṣukūks* in well regulated exchanges; and g) requiring originators of assets to retain some of the assets and their associated risks. At the organisational level, he further argues that there is a legitimate need for good governance whereupon the BOD should define the risk-return parameters, introduce prudent risk-management culture and practices, enhance transparency and information disclosure, ensure maintenance of credit standards at all times and maintain adequate capital to cover risk. At the instruments level, Islamic finance should avoid and reverse the trend towards the financial system. In particular: a) Islamic banks should understand the incentive structures and risks of different instruments; b) Sharīʿah boards, being the custodians and gate-keepers of Islamic finance, should approve and monitor Islamic products to reduce the risk of such products/instruments, including *ṣukūks*; and c) Sharīʿah boards should provide Sharīʿah governance guidelines to reduce Sharīʿah compliance risk (Ahmed, 2009).

VI. CONCLUDING REMARKS

Islamic finance is being championed as an ideal alternative to interest-based finance and an authentic means to advance socio-economic justice. It has been strongly argued that if an Islamic financial model can take the economy to new heights, that model must be based on the values of PLS contracts which encourage better resource allocation and promote more effective risk management. However, while the PLS model dominates the theoretical literature on IBF, the practices of Islamic financial institutions have been subject to intellectual criticism and have at times been accused of having “deliberately

and systematically avoided PLS modes" (Ahmed, 1992; Al-Haddad & El-Diwany, 2008). This is a reflection of marginalisation of PLS instruments in IBF, bringing the issues of fairness and social justice into serious question.

While discussing the socio-economic values underlining the Islamic financial system, Iqbal Khan, a leading scholar in the field of Islamic finance, has signalled the following values that IBF aspires to achieve:

- *Profit-and-loss (PLS) sharing and risk sharing is preferred alongside creating more value addition to the economy;*
- *Community banking: serving communities, not markets;*
- *Responsible finance, as it builds systematic checks on financial providers and restrains consumer indebtedness; along with ethical investment and corporate social responsibility (CSR) initiatives;*
- *Alternative paradigm in terms of stability by linking financial services to the productive, real economy; and also it provides a moral compass for capitalism;*
- *Fulfils aspirations in the sense that it widens the ownership base of society, and offers "success with authenticity". (Khan (2007, cited in Asutay, 2008, p. 1).*

Asutay (2008) critically examines the above objectives and prudently argues that although these values (the ideals) fit well into the theme and objectives of Islamic moral economy (IME), they do not gain ground when compared against the realities of the Islamic financial services industry. He concluded that IBF has failed, or done little, to: i) uphold and promote its preference for equity-based PLS and risk-sharing financing as an alternative to debt financing; ii) provide tangible socio-economic development at the community level throughout Muslim-populated countries, evidenced by the extremely insignificant social lending (*qarḍ ḥasan*) extended by Islamic financial institutions; iii) render meaningful contributions to local economies and to advance economic development through the creation of a productive real economy; iv) positively affect social capacity building and broaden the productive base of the economy through partnership PLS agreements, in order to fulfil its objective of being a community banking model; and, v) establish

itself as responsible finance by linking financial services to the real (productive) economy–considering that the majority of financial transactions carried out by Islamic financial institutions are debt-based in nature as opposed to equity financing.

Such a conclusion led Asutay (2008) and others to question the resilience of the Islamic financial industry and the commitment of Islamic financial institutions and to ask whether these institutions have lost their distinctiveness by detaching themselves from their social foundations "in pursuit of profits".

The social failure of IBF, evidenced by the widening gap between promised expectations and actual performance of IBF, needs to be systematically addressed within the context of the social role that IBF is set to play. Despite the fact that Islamic finance is deeply rooted in the commercial and value-producing economy, the focus of the Islamic principles of interest-free finance remains, being issues of fairness and socio-economic justice, rather than efficiency barely defined quantitatively in terms of profit and rate of return. Social well-being and not profits should be the criterion for appraising the efficiency of risk management in Islamic finance. Lessons from the painful financial crisis may be a good recipe for a shift in paradigm of risk management.

Given the absence of enabling institutions and lack of political will, the main challenge facing the Islamic financial services industry is developing a mechanism that allows the salient values and merits of Islamic finance to be revealed to a global economy dominated by banking and finance. The irrational assumptions that first, Islamic finance is an independent system that does not require an economy based on an Islamic setting, and second, an Islamic economy can exist without any Islamic socio-political framework, have no merit and go against the fundamentals of rational thinking (Farooq, 2009). The viability of Islamic finance cannot and should not be judged in the absence of a "true Islamic state" where its religious, political, social, educational and economic institutions complement each other and work as a whole towards the realisation of common values and aspirations.

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