The Global financial crisis and the Islamic Finance Solution

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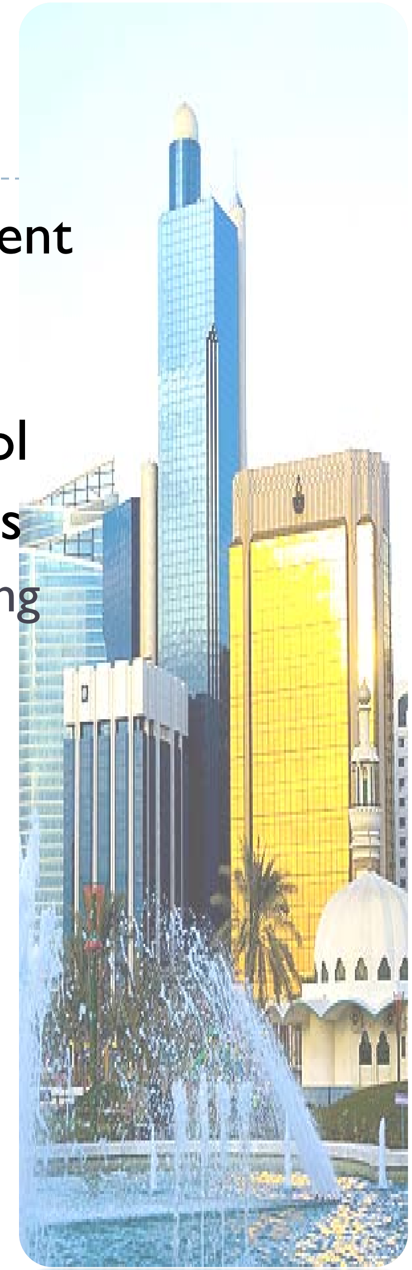
Presentation Plan

- Introduction
- Causes and Consequences of Financial Crisis
- In search of a Solution
- Islamic Finance as an Alternative
  - Islamic theory of finance and the global financial crisis
  - Can Islamic finance be a cure to the current crisis?
  - Key Intrinsic Principles of Islamic financial System
  - The economics of Islamic finance and "market failure"
  - Opportunities and challenges for Islamic finance
- Conclusions

1. Introduction

- Twentieth century, first moved toward more government control and then began to move away
- Current financial disarray at a global level driving the world to move again toward more government control
- Islamic financial Industry renaissance in the early 1970s
  - Affirming its status within Islamic countries and reinforcing its role in the global economy
  - Being able to withstand financial crisis
  - Inherently well equipped to prevent such crisis from developing
- Critical review on relevance of Islamic finance and its potential contributions towards a healthier and more stable global financial industry offered by this presentation.



2. Financial Crisis

- Current disruptions in financial markets causing constraint to the flow of credit to families and businesses
- Adverse effect on the real economy
- Investors unexpectedly lose substantial amount of their investments
- Financial institutions suddenly lose significant proportion of their value

Pre-Crisis Regulatory Environment

- Financial Institutions operated in a deregulated environment
  - Fed—Emphasis on self-regulation
  - Basel II—Market based risk assessment and capital requirements
  - 1999—Gramm-Leach-Bliley Act (repeal of Glass-Steagall Act)
  - 2004—SEC loosened capital requirements for 5 large investment banks (MerL, LehB, GolS, MorS, BeaS)
    - Increased leverage (BeaS had debt/equity ratio of 33:1)
  - Resistance to control OTC derivatives market

Financial Sector—Fundamental Shifts

- Innovation driven—Creation of complex and opaque financial instruments
  - Hedging (risk transfer)
  - Speculation
- Sources of funds for FIs moved from depositors and borrowers to capital markets
  - Securitization process
- The above broke down old relationships, and created a web of new ones
- Created new risks that were not well understood

Making of the Crisis

1. Banks/financial institutions engaged in sub-prime lending (with adjustable interest rates)
2. Loans packaged as MBS/CDO
3. Rating Agencies gave positive ratings to these securities
4. Investors (investment banks, hedge and pension funds, municipalities, schools, etc.) bought these securities
5. Investors bought Credit Default Swaps (CDS) to hedge credit risks
6. Issuers of CDS (Investment banks & Insurance companies) took on the risk of default

New Risk Profile

- With excessive profit-motive driving operations, deregulation invited risk-taking
  - High Leverage (low capitalization)
  - Lax RM practices
  - Under-pricing of risks
- Derivatives—complex securities
  - Transferred one kind of risk, but created newer risks
  - Difficult to assess the risks
- Securitization
  - Broke down relationships between lender and borrower
  - Encouraged risk taking at the originator level
  - Investors did not know the exact nature of assets underlying the securities

From Defaults to Systemic Risks

- Interest rates began to rise—adjustable rate subprime loans started to default
- Holders of MBS/CDO incurred losses
  - Prices of CDOs fell
- Issuers of CDS had to pay-off the losses caused by default
- Losses caused depletion of capital of FIs
- Scramble to get funds
  - Money market froze (as lenders did not know the risks involved)
  - Could not sell CDOs to raise funds
- Lack of financing caused housing market to crumple—further decreasing housing (CDO) prices and increasing market risks
- Credit risks, liquidity risks, and market risks produced systemic risks

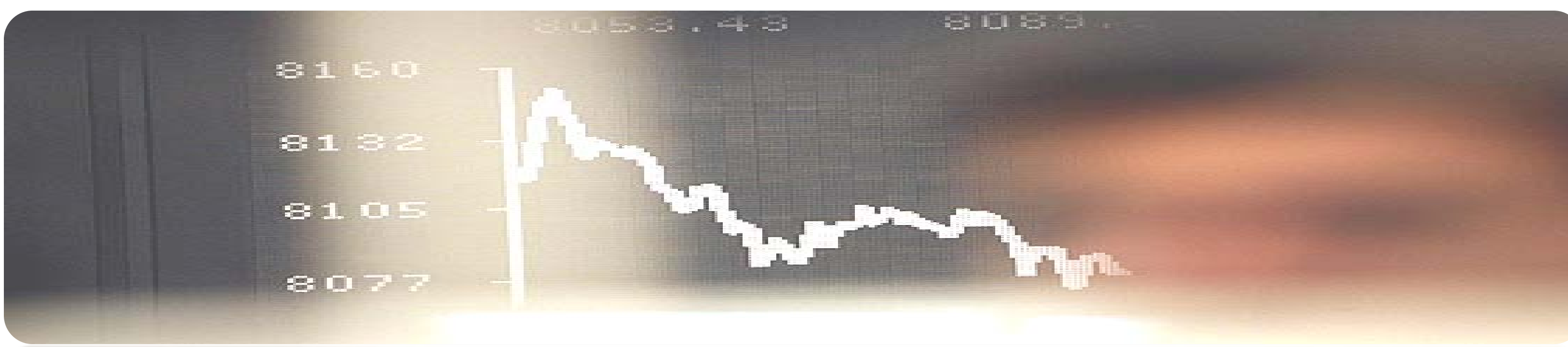
Figure 1: Causes of the US Subprime Mortgage Crisis

Common view by Islamic financial scholars and practitioners

- Global financial crisis in reality is a crisis of failed morality
- Cause of greed, exploitation and corruption
- Failure in the relationship between investment originators and investors
- Failed to communicate potential risks involved in these transactions with the investors (borrowers)

Implications for global economy

- Sharp decline in global equity markets
- The failure or collapse of numerous global financial institutions
- Governments of a number of industrialised countries allocated in excess of $7 trillion bailout and liquidity injections to revive their economies
- Commodity and oil prices reached record highs followed by a slump
- Central banks reduced interest rates in coordinated efforts to increase liquidity and avoid recession and to restore some (confidence) in the financial markets.



Implications for Islamic banking

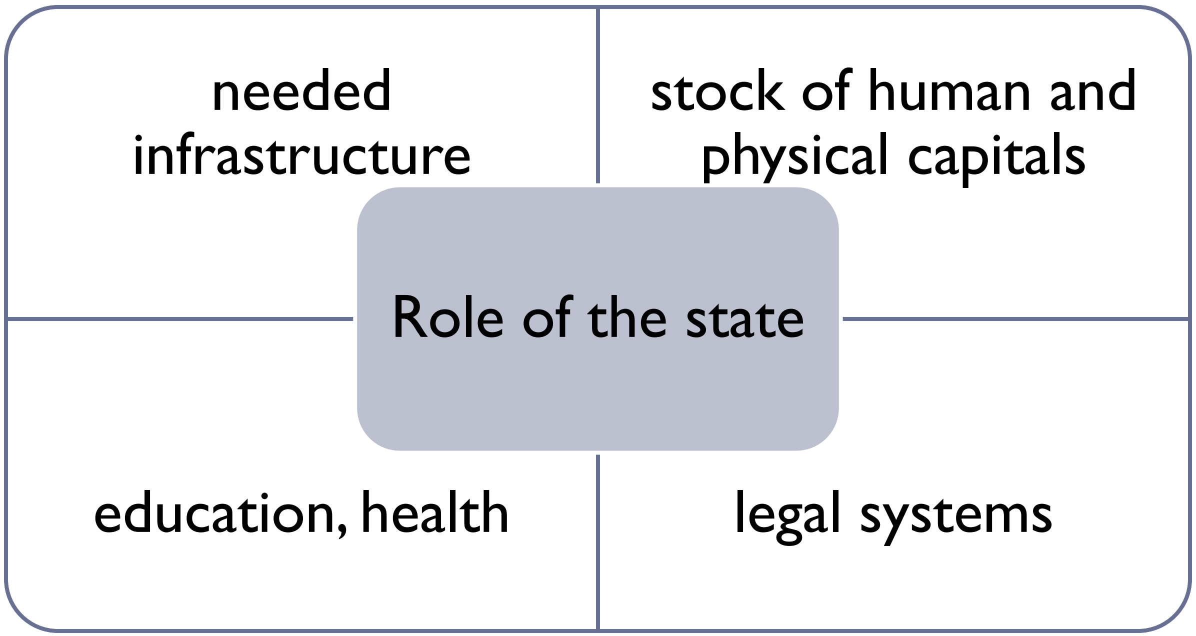
- Islamic banking are examined on two fronts:
  1) Direct impact of the crisis on the Islamic banking sector was minimal due in part to the intrinsic principles
     - Islamic banks were not caught by toxic assets as *Shariah* law prohibits interest
     - Lack of structured products and the reluctance of Islamic banks to exploit sophisticated financial instruments
  2) Potential role that Islamic banking is suited to assume in order to deliver noteworthy contributions to the international financial system
  - Lending under Islamic law is based on the concept of asset backing, where real estate is being the preferred instrument to protect these investments.

3. IN SEARCH FOR 'THE SOLUTION'

- Should governments intervene in markets?
- Should they be kept away?
- Third option that neither of these other two options can offer?

The role of the state in the economy

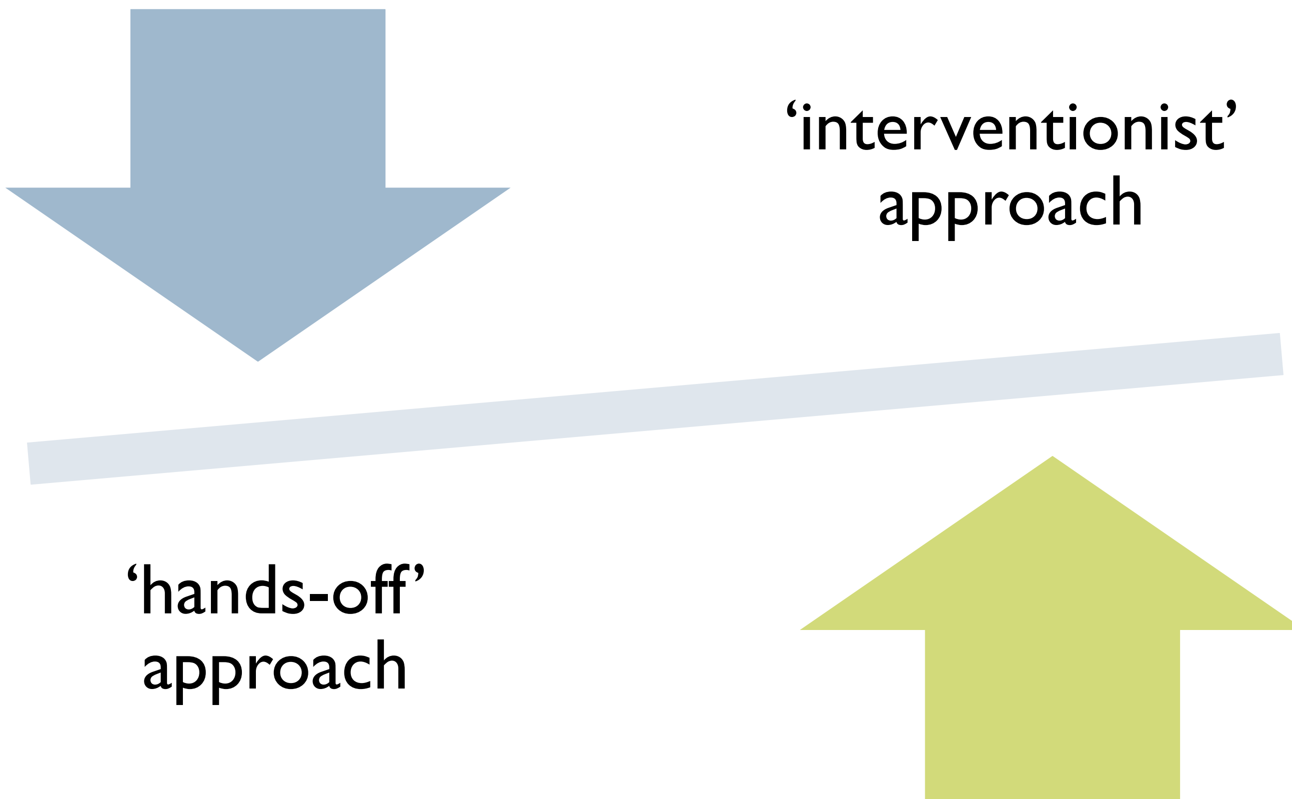
- State policies undoubtedly have a much greater role to play in shaping the path of economic development in any given country



- Governments provide basic ingredients for private investment and growth

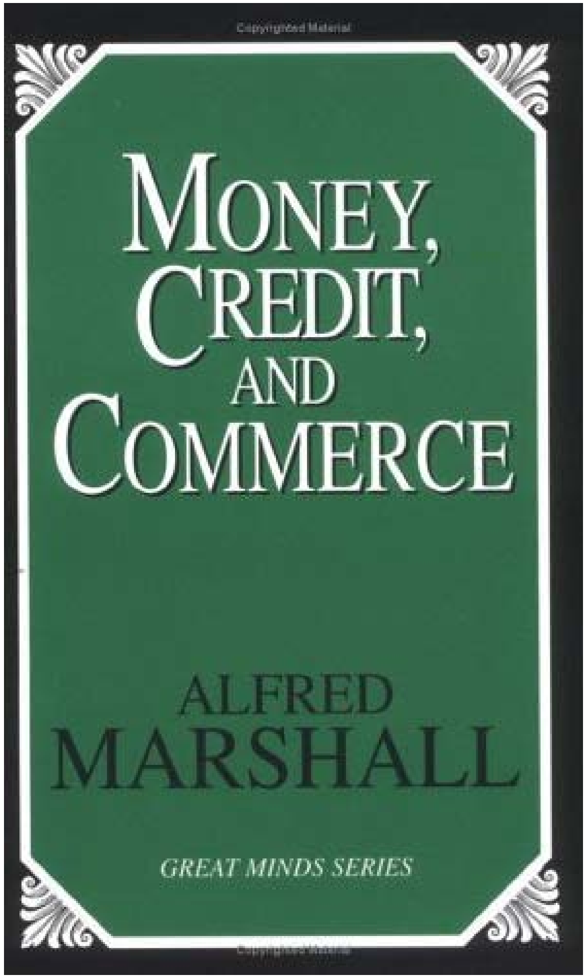
Mainstream economics: Diverging philosophies and converging approaches

Public policy alternatives



Hands-off approach

- Neoclassical economic theory
- Hands-off or *laissez-faire* approach appeals to those who view any interference by the state in the economy to be a disruption to natural economic process
- Market forces are situated to correct any deviation, and views failure as being a part of the process



Hands-off approach

- Neoclassical economic theory advocates:
  - free market
  - external openness
  - outward (export) orientation
  - state intervention being limited to creating the right general conditions and encouraging a productive economic environment
  - invisible hands of the market
- Representatives of neoclassical schools:
  - Freidrich Hayek (Austrian School)
  - Alfred Marshall (Marginalism)
  - Frank Knight (Chicago School)
  - Milton Friedman (Chicago School)

Hands-off approach

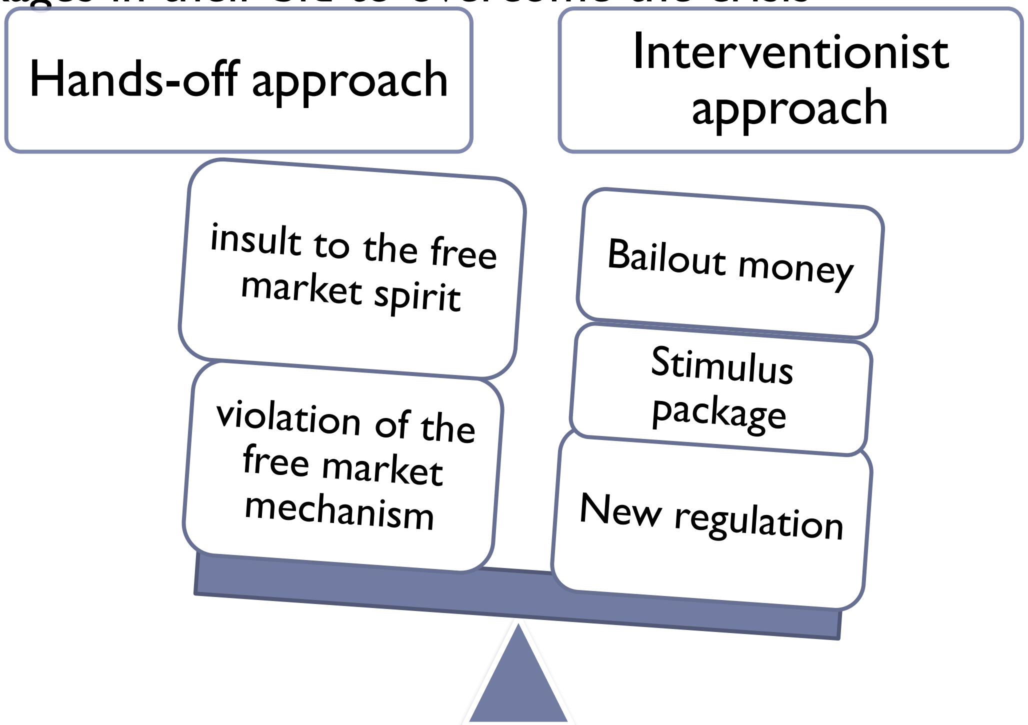
- Consensus that the crisis is a product of "the market system" itself
- Rather than the outcome of external shocks such as "wars, revolutions, and above all political interference
- Current global financial crisis negate the essence and the premise of free market economics that markets are inherently stable, hence made it possible for John Keynes to be brought back to life

Interventionist approach
The day Keynes was brought back to life

- John Keynes's analysis of the Great Depression, which redefined economics in the 1930s
- Core of Keynesian Theory is that a government's intervention is needed to stabilise a national economy
  - increased government spending during downturn could stimulate the economy by making more money available
  - Keynes :"Enhanced equilibrium theory is designed to keep the economy flying straight in normal conditions"
  - Active fiscal policy
  - Deficit spending

Bailout: A traditional Western approach

- Allocation of about $7 trillion of public funds in the form of rescue and stimulus packages in their bid to overcome the crisis



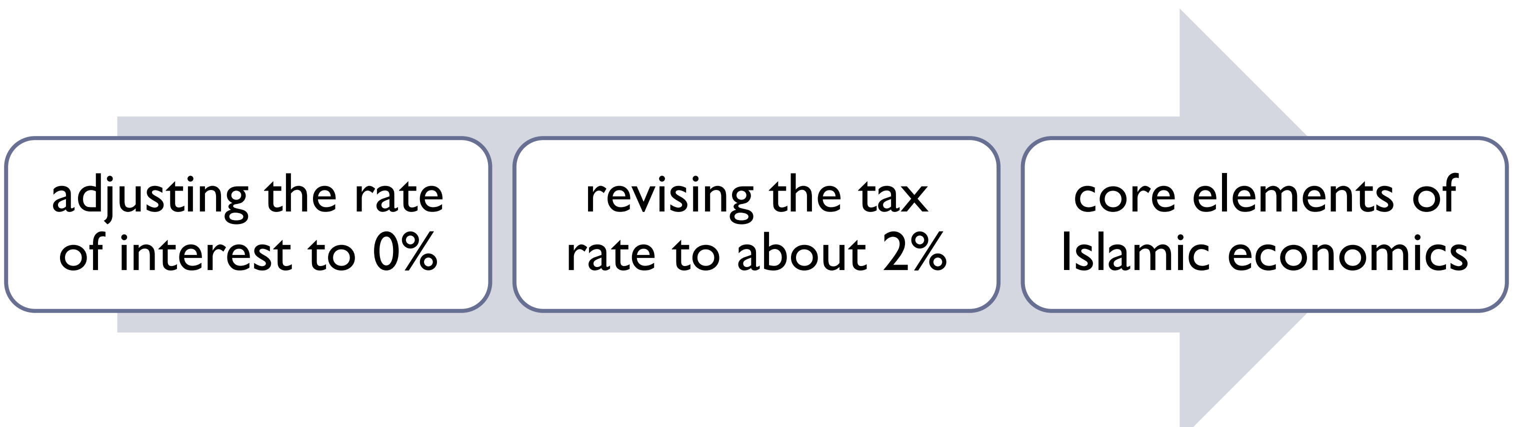
- Discussion clearly indicates that neither the interventionists nor the hands-off advocates are able to offer a prudent and rational solution to the current global financial crisis

Has capitalism failed?

- Current global financial crisis provoked some intellectuals to revisit the new/old question of whether capitalism has failed
- Paul (2002) and Alexander (2008). They maintain that "Capitalism did not fail" and that is simply because "we haven't had capitalism"
- Current failure of the financial markets inspire the nascent Islamic financial industry to present an alternative paradigm
- By offering a new vision and creative ways to manage assets, invest wealth, and engineer innovative *Shariah*-based financial products *Shariah*-based as opposed to *Shariah*-compliant

4. Islamic finance as the alternative

- Advocates and the opponents of both schools of thought (government intervention and free market economies) thus far have failed to deliver a viable long-term solution to the crisis
- Nobel Prize Winner, French economist Maurice Allais believes that the way out of such crises is best achieved through structural reforms



Islamic finance

- Islam prohibits interest *(riba)*
- Muslims who possess minimum net worth above their basic needs *(Nisab)* to pay *Zakah* (2.5% of the assets that have been owned over a year)
  - *Zakah* is a major economic instrument premeditated to spread socio-economic justice in the society.

Islamic theory of finance and the global financial crisis

- *Shariah* rules and regulations:
  - *Islam establishes a unique system that protects individual investors and financial institutions from potential risks*
  - *Islamic finance is governed by* Shariah *rules*
  - *Forbid:*
    - *usury* (riba)
    - *gambling* (maisir)
    - *ambiguity* (gharar)
    - *stipulate that income must be an outcome of productive economic activities based on the principles of profit-and-loss-sharing contracts*

Islamic theory of finance

- Based on themes of Community Banking
- Ethical and Socially Responsible Investments
- Socio-economic justice
- Wealth accumulation and wealth distribution that is fair
- Supply of money therefore must be proportionate with the prospects of real growth
- Reinstate value for money and streamline its supply – currency peg

Islamic theory of finance

- Financial approach of Muslims should be governed by major sets of rules:

Muslims are strictly prohibited from investing in or dealing with economic activities that involve interest, uncertainty, and speculation

Muslims are, not only discouraged but also, forbidden from investing in businesses that are engaged in illicit *(haram)* activities

Islamic economics

Islam prohibits paying or receiving any predetermined fixed rate of return on borrowed/lent money; Charging interest *(riba)* tends to drive the poor into more poverty and create more wealth for the wealthy

Trade, not banking is the primary function of markets

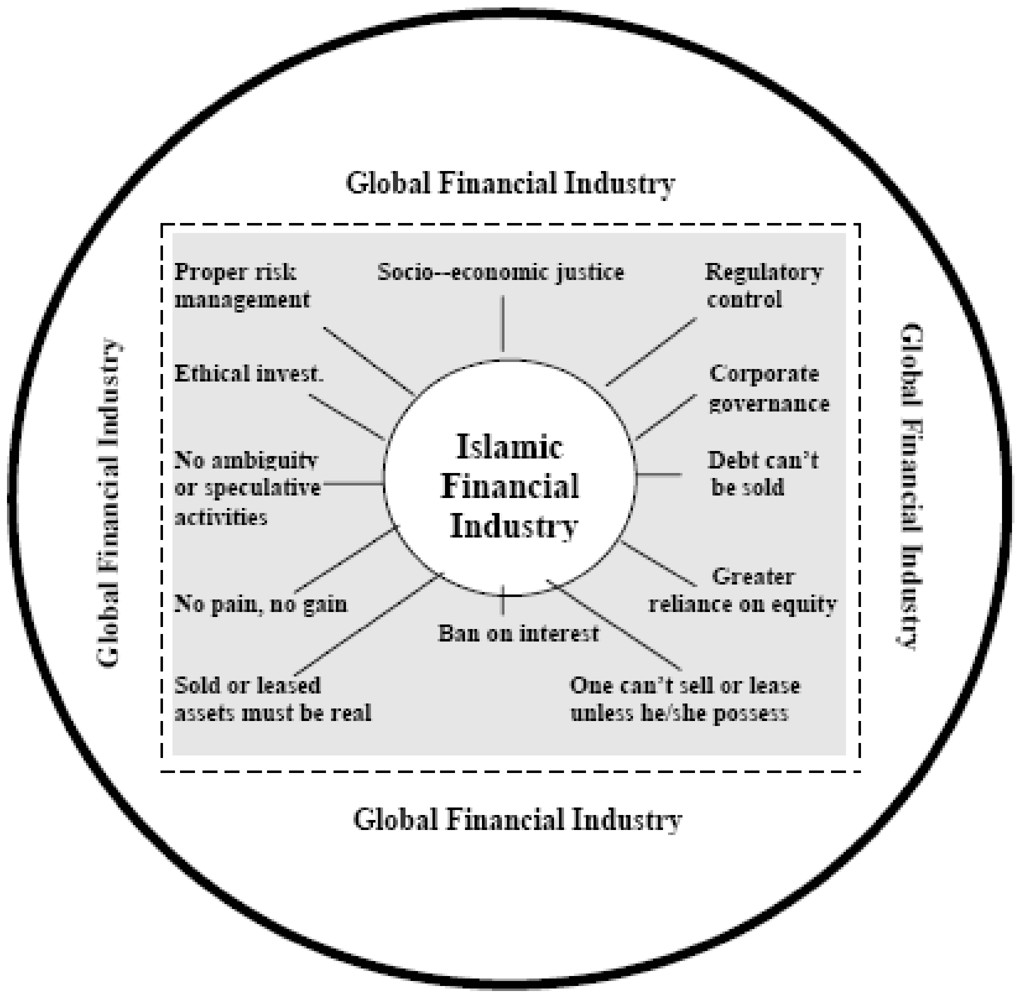
Islamic theory of finance

- Absence of interest-based financial transactions under Islamic finance, financial relationships between financiers and borrowers are best understood within the framework of profit-and-loss sharing (PLS) contracts
  - both parties share the risk (and returns)
- Islamic finance advocate fairness in payoffs and reward structures and embrace socio-economic justice amongst all
- Principle of 'no pain no gain' embedded in the Islamic financial structure entails that no one has the right to rewards (profit) if they do not equally share the risk of incurring loss

Current financial crisis would not have occurred under an Islamic financial system

- If global banking practices adhere to the principles of Islamic finance, which are based on noble ideas of entrepreneurship and transparency, global crisis would have been prevented
- Shariah principles:
  - *Not to sell a debt against a debt: one can't sell or lease unless he/she posses real assets*
  - *Islamic finance is based on equity rather than debt, and lending transactions are founded-on the concept of assets backing: mortgage loans under such system would have been backed by solid asset structure*

Figure 2: Key Intrinsic Principles of the Islamic Financial System



Current financial crisis would not have occurred under an Islamic financial system

- Shariah principles continued:
  - *Islam takes particular interest in fostering close relationship and trust between originators (financial institutions) of Islamic financial products and investors*
  - *Absence of an adequate and effective regulatory control system that monitors and consequently ensures the interests of investors. Potential investors are well versed about the prospects (opportunities and risks) that their investments are subject to when entering into new contracts - Risk must be explicitly communicated !*
  - *Honest implementation of Profit-and-Loss Sharing (PLS) transactions (such as* Mudarabah *and* Musharakah *contracts) in accordance with the spirit of Shariah entails full disclosure and transparency*
  - *Islam regards the relationship between the lender (financial institution) and the borrower (investor) as a partnership*

Riba prohibited

- **Intuitive description**
  - 'Earning money from money' or interest, is prohibited. Profit, which is created when 'money' is transformed into capital via effort, is allowed. However, some forms of debt are permitted where these are linked to 'real transactions', and where this is not used for purely speculative purposes
- **Linkage to 'market failures'?**
  - A real return for real effort is emphasised (investments cannot be 'too safe'), while speculation is discouraged (investments cannot be 'too risky'). This might have productive efficiency spillover benefits ('positive externalities') for the economy through linking returns to real entrepreneurial effort

Fair profit sharing

- **Intuitive description**
  - Symmetric profit-sharing (eg. *Musharakah)* is the preferred contract form, providing effort incentives for the manager of the venture, while both the investor and management have a fair share in the venture's realised profit (or loss)
- **Linkage to 'market failures'?**
  - Aligning the management's incentives with those of the investor may (in contrast to pure debt financing) once again have productive efficiency spillover benefits for the economy, through linking realisable returns to real entrepreneurial effort

No undue ambiguity or uncertainty

- **Intuitive description**
  - This principle aims to eliminate activities or contracts that are *gharar*, by eliminating exposure of either party to excessive risk. Thus the investor and manager must be transparent in writing the contract, must take steps to mitigate controllable risk, and avoid speculative activities with high levels of uncontrollable risk

- **Linkage to 'market failures'?**
  - This may limit the extent to which there are imperfect and asymmetric information problems as part of a profit-sharing arrangement. Informational problems might, for example, provide the conditions for opportunistic behaviour by the venture (moral hazard), undermining investment in all similar ventures in the first instance.

Halal versus *haram* sectors

- **Intuitive description**
  - Investing in certain *haram* sectors is prohibited (eg, alcohol, armaments, pork, pornography, and tobacco) since they are considered to cause individual and/or collective harm.
- **Linkage to 'market failures'?**
  - Arguably, in certain sectors, there are negative effects for society that the investor or venture might not otherwise take into account (negative externalities). Prohibiting investment in these sectors might limit these externalities

Opportunities and challenges

- Current financial crisis demonstrates that Islamic finance is an effectual economic authority
  - Islamic banks had been formed in recent months including the United Arab Emirates' first Islamic commercial bank and the Ajman Bank
  - Twenty existing Islamic banks had extended their operations into new countries such as Botswana, Iraq, Kenya, Syria, and South Africa
- Germany, France, and Japan, amongst many other non-Islamic countries, have recognized the potential contribution of Islamic banking towards restoring credibility and stability to the international financial market

4.3 Opportunities and challenges

Opportunities

- Positive feedback to Islamic finance from various corners of the world
- New International Economic Order: G20 with 3 Muslim countries (Turkey, Indonesia, Saudi Arabia)

Challenges

- Theoretical challenges are concerned with explaining what makes Islamic finance unique?
- How does the Islamic financial system, based on PLS contracts function?
- What are the features and the advantages of the Islamic equity-based financial system?

Outcome

- Industrialised countries have realized that achieving 0% interest rate is crucial milestone in order to stimulate their economies
- PLS arrangements are not appropriate in all situations especially where there is genuine need for a personal loan not intended for business purposes

5. CONCLUSION

- Aspects comprise only one component of the overall system that governs the values, attitudes, and the behaviour of any given society

Islamic finance and its prospective is a viable alternative to the ailing global financial system

micro and macro economic concerns has been strongly shaken

evolving new global economic order

is Islamic finance – in its current state – in a position that enables it to defy conventional finance?

immaturity, size and shortage in skilled human capital and consequently lack in innovative products

play more constructive role in ensuring the health and stability of the international financial system

5. CONCLUSION

- Transformation of Islamic financial paradigm into working policies and enabling institutions is a long-term evolutionary process
- Private and public sectors at country level and the cross-country coordination between member states of the Organization of Islamic Conference (OIC) undoubtedly will play a crucial role

- Future of Islamic financing looks exceptionally promising, one should not be under the illusion that such transformation would happen without vision and hard work particularly in terms of human capacity building and innovative financial engineering

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