

# **The Global Financial Crisis and Islamic Finance**

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## **Abstract:**

The conventional view holds that the current global financial crisis was caused by extraordinarily high liquidity, reckless lending practices, and rapid pace of financial engineering which created complex and opaque financial instruments used for risk transfer. There was break down of lender-borrower relationship, informational problems caused by lack of transparency in asset market prices, particularly in the market for structured credit instruments. There was outdated, lax or absent regulatory-supervisory oversight, faulty risk management and accounting models; and the emergence of an incentive structure that not only encouraged excessive risk taking but also created a complicit coalition of financial institutions, real estate developers and appraisers, insurance companies and credit rating agencies whose actions led to a deliberate under pricing of risk. Such crisis would not have occurred under an Islamic financial system – due to the fact that most, if not all, of the factors that have caused or contributed to the development and the spread of the crisis are not allowed under the rules and guidance of Shariah. The current global financial crisis is largely seen as a real test of the resilience of the Islamic financial services industry and its ability to present itself as a more reliable alternative to the conventional financial system.

**Key words:** subprime mortgage, global financial crisis, Islamic financial system. Profit-and-loss sharing (PLS), financial stability

# THE GLOBAL FINANCIAL CRISIS AND THE ISLAMIC FINANCE RENAISSANCE

## 1. Introduction

Despite being an evolving industry, Islamic finance has enjoyed a steady and consistent horizontal as well as the vertical growth since the concept was put into practice some 40 years ago. Being able to endure the implications of the global financial crisis and remain relatively positive in the midst of the crisis and eventually to emerge as more equitable and efficient system have raised the profile of Islamic finance and underscored its capacity to bring stability to the global financial system.

There is a general agreement amongst economists, financial scholars and financial experts about the causes and the consequences of the global financial crisis. However, the search for ‘the solution’ to the crisis thus far has proved to be ‘mission impossible’ and remains the subject of an interminable debate. Should governments intervene in markets or should the solution be left “for the market to find a solution”? Government bailouts of existing banking system neither present long term solution to the problem nor give assurance that similar crises will not happen in the future. On the other hand, the current global financial crisis has invalidated the argument promoted by free market advocates that “markets are efficient on their own” and market forces are capable of managing and correcting market inefficiencies should they arise.

World economies are yet to devise prudent strategies on how to deal with the crisis, let alone to recuperate and overcome its vindictive aftermath. The endeavour in this paper therefore is to extend the search for an alternative that is potentially capable of limiting, if not eliminating, the sources of such crises, and bringing stability to the market. Carrying out systemic analysis of the causes of the crisis and measuring these causes against the intrinsic principles of the Islamic financial system reveals that such crisis could have been prevented should Islamic financial

principles were prevalent. The paper concludes that along with the enormous challenges that the crisis has created to the conventional financial system, it has presented the IFSI with abundance of opportunities to demonstrate its relevance.

The paper is divided into five sections. Following introduction in Section 1, Section 2 discusses the causes of the global current financial crisis. Section 3 examines the Islamic theory of finance and how it can or cannot provide a solution to the current crisis. Section 4 provides a critical analysis of what lies ahead for Islamic finance and managerial implications of Islamic finance.

## **2. Financial Crisis**

“Financial crisis” broadly refers to disruptions in financial markets causing constraint to the flow of credit to families and businesses and consequently having adverse effect on the real economy of goods and services. The term is generally used to describe a variety of situations in which investors unexpectedly lose substantial amount of their investments, and financial institutions suddenly lose significant proportion of their value. Financial crises include, among others, stock market crashes, financial bubbles, currency crises, and sovereign defaults.

### **2.1 Causes and consequences of 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. Chart 1 below presents a summary of the most frequently cited factors as being potential contributors to financial crisis.

<b>Chart 1: Causes and consequences of financial crisis</b>		
<b>Causes of financial crisis</b>	<b>Description</b>	<b>Risk/Consequence</b>
<b>Leverage</b>	Borrowing to finance investment	Bubble that leads to bankruptcy
<b>Asset-liability mismatch</b>	The disparity between a bank's deposits and its long term assets leads to the inability of banks to renew short term debt they used to finance long term investments in mortgage securities	Bank runs <sup>1</sup>
<b>Regulatory failure</b>	Improper (insufficient/excessive) regulatory control: -Insufficient regulation: 1) Results in failure of making institutions' financial situation publicly known (lack of transparency) 2) Makes it possible for financial institutions to operate without having sufficient assets to meet their contractual obligations.  -Excessive regulations that require banks to increase their capital when risks rise leading to substantial decrease in lending when capital is in short supply.	-Excessive risk-taking -Financial crisis (of 2008)  Potential deterioration of financial crisis
<b>Fraud, corruption and greed</b>	-Enticing depositors through misleading claims about their investment strategies and manipulating information. -Creating financial assets without any real economic activity -Extreme economic greed overrides basic ethical consideration in investments	Subprime mortgage crisis
<b>Contagion</b>	Where the failure of one particular financial institution to meet its financial obligations (due to lack of liquidity, bad loans or a sudden withdrawal of savings) causes other financial institutions to be unable to meet their financial obligations when due. Such a failure may cause damage to many other institutions and threatens the stability of financial markets	Systemic risk <sup>2</sup>
<b>Money supply</b>	Uncontrolled printing of paper money that is not backed by real asset/commodity (gold)	Higher inflation
<b>Source:</b> Derived from wikipedia, the free encyclopedia. <a href="http://www.en.wikipedia.org/wiki/Financial">www.en.wikipedia.org/wiki/Financial</a>		

<sup>1</sup> Bank runs occur when investors panic and rush to withdraw their money more quickly than the bank can reclaim the proceeds of its outstanding loans (Diamond & Dybvig, 1983).

<sup>2</sup> Systemic risk has far-reaching implications that go beyond the institution in question and even outside the boundaries of the country that houses the failing institution. Financial globalization facilitates risk to be transferred across national boundaries. Therefore, the failure of one participant in financial markets could lead to global financial crises (Kaufman & Scott, 2003). This is evident by the current global financial meltdown caused by the collapse of some US financial institutions associated with the subprime mortgage scheme

Although it is difficult/impractical to single out one factor as being the source of financial crisis, one can rightly argue that the main cause of financial crisis is attributed to a laxity of lending standards often adopted by conventional financial institutions – driven by greed and appetite for higher returns, and facilitated by the absence of adequate and appropriate government regulatory control. This easy approach to lending when practiced over an extended period of time leads to excessive and, in all probabilities, risky lending environment that eventually works against the interests of both borrowers and lenders alike (Kayed and Hassan, 2009).

Why commercial banks tend to act in such inattentive manner and overstretch their lending norms despite their full awareness of the higher risk involved and the damaging consequences of such practices? Chapra (2009) explains the motives of banks for embarking on excessive and imprudent lending by three factors: a) Lack of profit and loss sharing (PLS) between lenders and borrowers leading to inadequate discipline in the financial system; b) Astronomical expansion in the size of derivatives particularly credit default swaps (CDS); c) “Too big to fall” attitude of big banks which grant them assurance that the central bank will bail them out in crises to forestall their collapse.

The decade preceding the current financial crisis was characterized by high volumes of loans, high loan arrangement fees, flexible short-term lending to increase chances of new mortgage and arrangement fees, and punitive exit fees when borrowers wanted to change their mortgage providers before the lapse of maturity period. The substantial profits were used to pay bonuses to loan underwriters and their bosses. This was exacerbated by securitization of mortgages where loans were bundled up and sold to Freddie Mac and Fannie Mae. The banks could then free up their capital and increase the mortgage turnover and earn more selling fees. Banks became short-term lenders, broke long-term relationship with borrowers and ultimately adopted reckless lending. This reckless lending was the primary cause of the current financial crisis. For example;

Northern Rock bank of UK could lend 125% of the value of the property to enable the borrower to furnish and equip the house but the hide-sight was to earn high arrangement fees from high volume of the mortgage (Wilson, 2009a).

To this end, reckless lending culminated into two practices that precipitated the crisis; the use of exotic and complex financial instruments and over-reliance on financial models. According to Laldin and Mokhtar (2009), there are various ways of managing risk among them risk shifting/transfer, risk retention, risk avoidance and risk reduction. Credit derivative instruments such as credit default swaps (CDS) and collateralized debt obligations (CDO) focus on risk transfer. Secondly over-reliance on financial models made risk quantification easy but lead to illusion of precision, flawlessness and a false sense of security among top managers and regulators. The value at risk model (VaR), which measures the maximum loss a firm may suffer on daily basis, was widely and blindly used to the extent that the Securities and Exchange Commission (SEC) required all financial institutions to disclose their risks to investors using VaR in the absence of any other model that could summarize all the risks the institutions faced. (Laldin and Mokhtar, 2009).

The diffident response of various Western governments and in particular the US government to the irresponsible practices of larger financial institutions has reinforced their “false sense of immunity from losses” (Chapra, 2009). The US government for instance has rushed to the rescue and announced its intention to buy toxic bank assets worth in excess of US\$1 trillion, thus not allowing the collapse of troubled financial institutions.

## 2.2 The subprime<sup>3</sup> mortgage dilemma and the current global financial crisis

It is believed that every economic crisis is the product of cheap credit; low interest rates create demand for loans that cannot be repaid when interest rates subsequently rise. Lower interest rates in the United States meant that mortgages became more affordable and in more demand. Banks, driven by sense of invulnerability and the desire to capitalise on existing opportunities to maximise their returns, adopted an easy approach to lending in order to have a bigger slice of the pie by selling more loans, thus making more money in fees and commissions. Chapra (2009) points out that in such an environment “loan volume gained greater priority over loan quality” and ordinary investors were enticed to live beyond their means. But as interest rates began to rise, new home affordability and the ability to repay existing loans have sharply plummeted. The problem was exasperated by the questionable tactics adopted by mortgage brokers who opted to sell their customers on subprime loans, and further by the complexity of products that have been created by intermediary players that sought to pass the entire risk of default to the final purchasers.

There are several factors that have contributed directly or indirectly to the occurrence and the spread of the current credit crisis triggered by the U S subprime mortgage calamities and the fallout of some U S financial institutions. Derivatives and excessive leveraging of U S financial institutions have driven some renowned financial institutions into bankruptcies and brought others to the edge of collapse. Financial globalization has duly played a key role in enabling hasty transfer of systemic risk within and across national boundaries.

Financial markets have been driven by greed that has torn down the world’s financial system.

Speculation has reached intolerable levels. The intense competition and shareholders demands for

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<sup>3</sup> Subprime loan is a type of loan that is offered at a rate above prime to individuals who do not qualify for prime rate loans. The loan is usually stipulated with a relatively higher interest rate because it is often issued to a higher-risk borrower. The term ‘subprime’ was popularized by the media during the "credit crunch (Web definition).

higher returns have encouraged excessive risk taking and lured banks to extend their credit to unworthy borrowers who normally do not qualify for loans under prime lending criteria. In many cases loans were approved without proper evaluation of loan applications or the credibility of the applicants. The nature and the means of delivery of the interest and debt-based conventional banking have caused the financial system to be completely “split-off from the real economy”. Deals and transactions have been concluded and executed on papers, and what have been sold and bought was of no real or economic value (Spiegel online, 2008). Poor enforcement of inadequate regulatory systems and lax on lending standards (easy credit) made it easy for lenders to sign-off as many loans and for borrowers to access loans that were considered beyond their reach without giving serious thought to the possibility of having to default on their loans.

Wilson (2009b) argues that the existence of the sub-prime borrowers was also a major cause of financial crisis. Sub-prime borrowers are characterized by default on mortgage obligations, previous credit, low income hence inability to repay substantial mortgages and insufficient coverage of health insurance. Moralists have questioned the finance rationality of high return concept, which justified charging high interest rate to low income sub-prime borrowers and low rate to high income, rich credit worth borrowers.

Good and poor quality mortgages were bundled together in securitized packages that were deemed able to endure an economic downturn. These mortgage-backed securities were sold to secondary investors and traded in the intermediary market, generating massive earnings for lending institutions and key staff and directors in the form of fees and bonuses. By having more cash in hand, banks were able to extend new loans and thus make more money. The model worked well while borrowers were making their payments. But when payments stopped, the model, literally, caved in.

The complex instruments formed a new financial structure that created risks which was not only difficult to understand but also thorny to assess. Some specific risks arising in the new financial structure are: (i) lax RM practices; (ii) under-pricing of risk; (iii) leverage/under capitalization; (iv) risk transfer; (v) creation of new risk; (vi) difficulty in assessing risk; (vii) breakdown of relationship between lender and borrower; (viii) excessive risk taking at the originator level and (ix) no control over underlying asset (Ahmed, 2009). The Bank of International Settlement (BIS) gave latitude to big financial institutions to craft and internalize VaR to measure the capital they needed to hold. VaR was institutionalized, albeit riddled with limitations discussed above. (Laldin and Mokhtar, 2009)

Alexander (2008) rightly concluded that the blame for the current financial crisis falls on the following three distinct entities 1) lenders and investment institutions for their impatience to sign-off loans on 'giveaway terms' and their (deliberate) failure to ensure the creditworthiness of loan applicants; 2) government for lack of adequate and effective regulation evidenced by its oversight and indifferent attitude when such deceptive loans were made; and 3) borrowers who solicited the loans despite their awareness of the potential failure to meet such financial commitments.

The common view held by 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). It is evident that originators of subprime loans have deliberately failed to communicate potential risks involved in these transactions with the investors (borrowers).

In summary, the widely held view is that the 2007/2008 financial crisis was caused by, among other factors, excessive liquidity in the market, financial engineering which culminated in multifaceted and difficult-to-understand financial instruments, informational asymmetry regarding

in asset market prices, particularly in the market for structured credit instruments, archaic and liberal regulatory and supervisory oversight which spurred excessive risk taking and flawed accounting and risk management models. The complicit coalition of players such as real estate developers and appraisers, insurance companies, credit rating agencies and various financial institutions led to a calculated under pricing of risk and creation of incentive structure that killed the traditional role of financial intermediation. To mitigate the potential for re-emergence of similar financial crises in future, there is need to reduce excessive risk taking through efficient regulation and supervision, increased capitalization of all players in the financial system to reduce leverage, increased focus on systemic rather than idiosyncratic risk, higher standard of proper and detailed disclosure of information by financial institutions on assets and instruments, proper mechanisms not only to avert liquidity risk but also establishment of a trust or fund to buy distressed assets of market players to improve their liquidity, development of incentive structure that ensures that the total risk associated with off-balance sheet items is accounted for and development of accounting rules that would avoid a decline of asset prices and negative bubbles through the feedback loop in the financial system. (Mirakhor & Krichene, 2009)

### **2.3 Implications of the global financial crisis**

What began as a limited subprime mortgage impasse in the US real estate market grew to be the world's biggest financial crisis since the 1930s. The impact of the crisis was felt worldwide. Individuals, regardless of their whereabouts, have been directly or indirectly affected by the crisis as it has hit almost every sector of the world's economy. World economies at large are yet to devise prudent strategies on how to deal with the crisis, let alone to recuperate and overcome its harsh reality.

Needless to say that conventional financial institutions, by and large, were the first to feel the full impact of the crisis that they have initiated. The 2008-year was packed of unparalleled events, which have created mass uncertainty, such as:

- 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.

The financial sector gloom is most evident by the many (forced) CEOs resignations, mass losses and many bankruptcies of what, up to recent times, were considered world-class financial institutions such as HSBC, Merrill, Citigroup, AIG and Lehman Brothers. The setbacks of Dow Jones, NASDAQ, P&P, TSE, FTSE, NIKKE and many other European and Asian markets are factual indicators to the severity of the crisis.

When Lehman Brothers Holdings Inc.'s (LEH) filed for bankruptcy in September 2008, its property assets alone were valued at \$43 billion, making it one of the largest bankruptcies in the real estate history. The unprecedented \$180 billion government bailout of the insurance giant American International Group (AIG)<sup>4</sup> apparently was not good enough to rid the insurance conglomerate from its troubles. Oil prices reached levels beyond the imaginations of oil exporting as well as oil importing countries alike before retreating to \$35- \$40. Yet nobody can really offer any explanation as to why oil prices rose and fell except for maybe them being based on pure speculative markets!

Economists, financial experts and politicians as well do not foresee a near end to the crisis and warn of prolonged hard times to come as the world's major economies are heading towards

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<sup>4</sup> Out of which \$165 billion were paid as bonuses to company executives and directors.

recessions. The conjecture is that volatility and uncertainty in global financial markets are likely to linger causing more unemployment and a downturn in growth.

### **3. Islamic theory of finance and the global financial crisis**

The current global financial crisis has accentuated the urgent need to embark on one of the most radical reshape of the international financial system. The attitudes and the approaches articulated by the advocates and the opponents of both government intervention versus free market economies schools of thought thus far have failed to deliver a viable long-term solution to the crisis or to prescribe a practical mechanism on how to deal with its consequences and implications. So, has the time come to seek out alternatives?

The 1988 Nobel Prize winner, French economist Maurice Allais<sup>5</sup> has foreseen the inevitability of current structural global economic crisis and warned against its consequences. He categorically argued that the way out of such crises is best achieved through structural reforms that go far beyond addressing the symptoms of the crises to devising an efficient monetary system that is truly capable of preventing such crises from happening in the future. The two basic components at the heart of the proposed system are adjusting the rate of interest to 0% and revising the tax rate to about 2%. Incidentally, these are the core elements of Islamic economics; Islam prohibits interest (*riba*) and requires all 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 amongst Muslims. Unsurprisingly, the US reserve has just announced the cut in lending rate to be between 0% and 0.0025% and the demand for meaningful tax cuts is building up.

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<sup>5</sup> Prize was awarded to Maurice Allais “for his pioneering contribution to the theory of markets and efficient utilization of resources”. See (Winners of the Bank of Sweden Prize in Economic, 2008).

### 3.1 The potential of Islamic finance as an alternative model for global system

A host of Muslim scholars and practitioners strongly argue that Islamic finance “has the potential to become an alternative model for global system” (Ayub, (2007; Öztürk, 2008; Rafique, 2008; Vandore, 2008; Aglionby, 2009; Chapra, 2009; Yudhoyono<sup>6</sup>, 2009). Their arguments are based on the following pillars of the Islamic theory of finance.

Islamic Finance is a model that “is based on themes of Community Banking, Ethical and Socially Responsible Investments and Affinity Marketing” (Khan, n.d.). The most salient values of Islamic finance are fairness, socio-economic justice and its uncompromising commitment towards the well-being of future generations through the caring for the environment and preserving earth’s valuable resources. The philosophical reasoning underlying the principles of the Islamic financial system is the implementation of a financial system (wealth accumulation and wealth distribution) that is fair, just and unbiased towards the rich minority at the expense of the poor majority. The ultimate aim is to spread socio-economic justice amongst all people regardless of their whereabouts. The principles of Islamic finance advocate fairness in payoffs and reward structures and embrace socio-economic justice amongst all. Islam preaches ‘moderation’ in all aspects of people’s lives, and commands them to live within their means. Accordingly, Ibn Taymiyyah (d. 1328), a highly respected scholar, says: “Hence, justice towards everything and everyone is an imperative for everyone, and injustice is prohibited to everything and everyone. Injustice is absolutely not permissible irrespective of whether it is to a Muslim or a non-Muslim or even to an unjust person”.

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<sup>6</sup> Susilo Bambang Yudhoyono, the Indonesian president while addressing 1,550 delegates from 36 countries at the opening of the fifth World Islamic Economic Forum (WIEF) held in Jakarta, Indonesia on 2 – 3 March 2009. Delegates gathered in Jakarta to debate the global financial crisis.

From the foregoing discussion of the causes of current financial crisis, the tenets of Islamic finance indicate how it has potential as a viable alternative global financial system. First, *Shariah*-compliant banking proposes uncompromising moral guidelines for dealing with money. Supply of money must be proportionate with the prospects of real growth in the economy in order to provide for a sustainable development and more equitable distribution of wealth. A host of intellectuals are forcefully arguing for the “return to some form of commodity [i. e., gold] currency peg” in order to reinstate value for money and streamline its supply. The printing of trillions of dollars and other currencies without proper backing in an attempt to restore a sense of economic equilibrium will undoubtedly lead to a much higher inflation rate due to excessive liquidity, large deficits in fiscal and monetary policies and eventually drive interest rates to new heights, as central banks endeavor to restrain excessive spending (Lewis, 2007; Kent, 2005; Kindleberger, 2005; Lietaer; 2002; Vadillo, 2002).

Second, all activities in Islamic finance are permitted (*halal*) except those, which have been specifically forbidden (*haram*) by *Shariah* due to their harmful and destructive implications. The most fundamental pillar of Islamic finance industry is the concept of *Shariah*-compliance, which dictates that the financial approach of Muslims should be governed by two major sets of rules. Firstly, unlike in conventional finance, Muslims are strictly prohibited from investing in or dealing in economic activities that involve interest, uncertainty, and speculation, regardless of their form or shape or the pretexts that are often used to justify them<sup>7</sup>. Secondly, Muslims are discouraged and forbidden from investing in businesses that are illicit (*haram*) activities. This include production and distribution of goods and/or services that stand against the tenets of the

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<sup>7</sup> Interest (*riba*): the Arabic word for "Usury", which means predetermined, guaranteed interest (rate of return). Islam considers interest to be unjust return because it is money gained without due efforts or productive work. Thus, Muslims are explicitly prohibited to neither give nor receive interest “But Allah hath permitted trade (*bai*) and forbidden usury (*riba*)” (The Holy Qur’an, [Al-Nisa] 2: 275).

Uncertainty (*Gharar*): means selling something, which has not yet been obtained. Islam commands that the subject matter of the transaction has to be clear and existing to avoid future “dispute, hatred and devouring others’ wealth wrongfully” El-Gamal, 2006, p. 59).

Speculation (*Maisir*): is gaining something by chance rather than by productive effort, which is a common practice in the conventional finance in the form of speculative activity. Islam prohibits money hoarding, transactions involving extreme uncertainties, gambling, and excessive risk.

Islamic value system such as alcohol beverages, pork-related products, drugs, gambling, conventional insurance, war profiteering and indecent entertainment.

Third, 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 without doing work or sharing the risk involved in every business undertaking. *Riba* further creates wealth without actually being the outcome of productive economic activity or as the result of an increase in commodity supply. Islam therefore considers all interest-based financial arrangements to be unfair, unjust and morally unjustifiable and all money generated by such transactions to be unearned money. “And because of their much hindering from God’s way, and of their taking *riba*, though they were forbidden it; and of their devouring people’s wealth wrongfully. We have prepared for those among them who disbelieve a grievous punishment” (The Holy Qur’an [Al-Nisa] 4: 161). Interestingly, all major religions (Judaism, Christianity and Islam) and other ethical systems such as Buddhism and Hinduism were united in denouncing interest as unethical and immoral practice.

Fourth, money generated from “rent-seeking activity” such as charging interest creates new but artificial capital, which is by no means the life-blood of the markets. Ahmad (1996) pointed out “The essence of the market is entrepreneurship” and explained that “trade, not banking is the primary function of markets”. Islam encourages business and productive economic activities that generate fair and legitimate profit thus reinforcing the positive relationship between financial flow and productivity. “This intrinsic property of Islamic finance contributes towards insulating it from the potential risks resulting from excess leverage and speculative financial activities” (Öztürk, 2008). The outcomes of several empirical studies have highlighted the merit of interest free banking over interest based banking in relation to financial stability and economic efficiency (Darrat, 1988; Robertson, 1990; 1998; Vogel & Hayes, 1998; Mills & Presley; 1999). The current financial crisis saw trillions of dollars evaporate from the world economy. The

extent of the financial meltdown has incited some Muslim scholars to construe such losses of virtual wealth as being God's fulfilled promise that "Allah will deprive usury of all blessing and will nourish deeds of charity"(The Holy Qura'an [Al Baqarah] 2:276).

Fifth, in the 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. The concept of PLS entails that when entering into a partnership (*musharakah*) contract, both parties share the risk (and returns) and have vested interest in seeing the partnership agreement come to a satisfactory ending.

Sixth, "Religious orientations aside, all those who care about the ethical content of their financial transactions are likely to be inclined towards Islamic finance in that there is much more to Islamic finance than the mere elimination of *riba*" (Venardos, 2005, pp 119-120; Iqbal, 1997). Social responsibility, sustainability and morality in business are emerging issues that are increasingly attracting the interest of scholars, politicians, economists, social activists, as well as investors. Interestingly, while these issues are now topics of debate in the West, they are embedded within the Islamic ethical code of conduct and are considered fundamental tenets for devout Muslims.

The rules of *Shariah* unconditionally prohibit Muslims from taking part in any transaction that might involve fraudulent, dishonesty, exploitation, and ambiguity "Woe to those that deal in fraud" (The Holy Qur'an, [Al-Mutaffifin] 83:1). The Prophet Mohammad (Peace Be Upon Him, PBUP) emphasised the significance of honesty, specifically in business dealings. Ibn Majah narrated that the Prophet (PBUH) said "if anyone sells a defective article without drawing attention to it, he/she remain under Allah's anger". These noble values are treasured and shared by many Muslims as well as non-Muslims who insist in investing in social responsible portfolios despite the fact that such investment might have a lower rate of return. Therefore, it would be fair

and sensible to claim that each and every financial activity that complies with the *Shariah* rules and guidelines is a socially responsible activity.

Seventh, Islamic financial institutions, in providing interest-free financial services and investment opportunities, are under religious and moral obligations to assume leading developmental role in promoting productivity and entrepreneurship. Sallah (1990, p. 128) rightly argued, “Being an Islamic institution with responsible mission, the [Islamic] bank must act with more developmental orientation”. While the prevailing objective of conventional banks in a capitalist market economy is maximizing profit by unjustly charging optimal interest rate, Islamic Financial Institutions are expected to demonstrate their true spirit and prove their viability as partners in development rather than instruments of exploitation.

Finally, the 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.

Chapra (2009) believes that this concept “should help introduce greater discipline into the financial system”. Realizing the affirmative linkage between sharing the profit and sharing the risk involved in any business transaction undoubtedly would motivate financial institutions to adopt a more cautious approach to lending and careful underwriting practices. Being a partner, rather than merely a lender, compels the financier (lending institution) to assess risks more carefully and to effectively monitor the use of funds by the entrepreneurs (borrower). The double assessment of risks by both the financier and the entrepreneur “should help inject greater discipline into the system” and restrain excessive lending and borrowing as well (Chapra, 2009).

### 3.2 Could Islamic Finance Withstood these shocks?

The aftermath of global financial crisis did not leave Islamic finance unscathed. The eventual emergence of global recession has affected Islamic financial Institutions. To cite a few examples AMLAK, the Dubai based Islamic mortgage provider, is in financial woes and Investment Dar of Kuwait has defaulted on its sukuk obligations. Retail Islamic banks have encouraged consumer indebtedness. However, Islamic Finance remained relatively positive and resilient despite the gloom and volatility of the prevailing global financial environment. It has been strongly argued that if global banking practices adhere to the principles of Islamic finance (entrepreneurship and transparency), then, the global crisis, would have been prevented or the impact significantly curtailed. This argument is built on the fact that most, if not all, the factors that have caused or contributed to the development and the spread of the current global financial crisis are not allowed under the rules and guidance of *Shariah* (Figure 1).

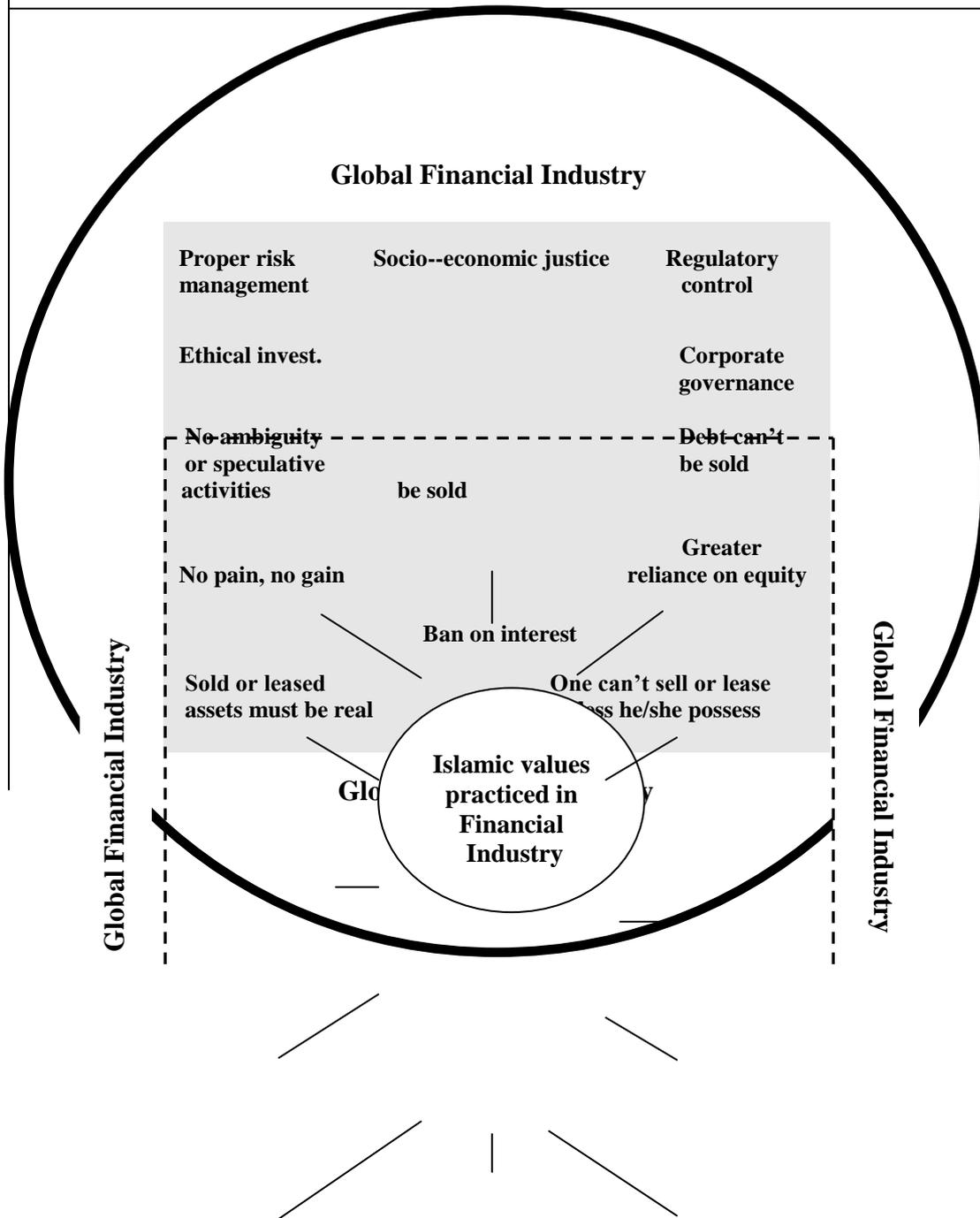
Theoretically, it would be impossible for a crisis resulting from subprime mortgage, inadequate assessment of risk, complex financial instruments to shift risk, speculation and short selling, excessive leverage, lax regulatory framework and excessive lending among others, to take place in the Islamic capital markets sector for the following reasons. First, it is against *Shariah* principles to sell a debt against a debt. There is a very simple but fundamental rule in Islamic trade, one can't sell or lease unless he/she possesses real assets. As Islamic finance prohibits the pure sale of debt and risky speculative financial business transactions, it demands that financial transactions be consistent with 'fair play', justice and transparency. All parties to a contract are required and entitled to a full disclosure of the pros and cons of the business transaction in order to have a better assessment of the risk involved.

Second, Islamic finance is based on equity capital rather than debt. Lending transactions are based on the concept of assets backing. Consequently mortgage loans under such system would have been backed by solid asset structure that safeguards the banking industry against possible loan

defaults. The enormity of loan defaults, should they occur within Islamic financial setting, will in no way threaten or compromise the health and proper functioning of the banking system. In the present crisis, trillions of dollars have been trading without backing of assets. One can strongly argue that the current financial crisis would have been prevented if such transactions were conducted in conformity with the Islamic finance model, where “virtual money” has no place in its accounting books. Islam preaches ‘moderation’ in all aspects of Muslims’ lives, and commands Muslims to live within their means. Therefore the majority of Muslims would not have rushed to draw loans that they are in no position to repay – just because an opportunity has arisen.

Third, Islam takes particular interest in fostering close relationship and trust between originators (financial institutions) of Islamic financial products and investors. This honest relationship suggests that a high level of transparency will be shared between the parties involved in a business transaction. Investors therefore will be compelled to open up to their financiers, who in turn will be inclined to authorise loans only to worthy borrowers based on genuine need and identifiable business activity. The significance of nurturing positive relationships between the financier and the investor is gaining wide acceptance in Islamic as well as non-Islamic financial landscapes. In an astounding move, the Vatican has recognized the implication of bringing banks closer to their clients and accredited Islamic finance for being the frontrunner in this regard. The Vatican urged conventional banks to consider the ethical rules of Islamic finance “to restore confidence amongst their clients at a time of global economic crisis” (Totaro, 2009).

**Figure 1: Intrinsic Principles of Islamic Financial System Potentially Capable of Safeguarding against Financial Crises**



Fourth, another major factor that contributed to the current financial crisis is the absence of an adequate and effective regulatory control system that monitors and consequently ensures the interests of investors. The Islamic regulatory control system stipulates that potential investors and all stakeholders are cognizant of opportunities and risk in the business contracts. Risk must be explicitly communicated to all stakeholders, and financial institutions are under obligation to conform to comprehensive disclosure and transparency standards<sup>8</sup>.

Fifth, an 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. Full disclosure and transparency will definitely work toward enhancing the prospective for market discipline by providing built-in mechanism which serves to control imprudent lending and ensure financial stability of the Islamic financial system (Öztürk, 2008). *Mudarabah* and *Musharakah* are also seen as effective instruments for managing risk, where partners tend to take a balanced approach towards business transactions by weighing the prospects of gain against the risk of loss. This avoids speculations and preventable uncertainty (*gharar*).

Sixth, to prevent subprime lending, Islam regards the relationship between the lender (financial institution) and the borrower (investor) as a partnership, wherein the lender has a continued stake in the transaction. Default risk cannot be shifted or sold off. Both lenders and borrowers have mutual interest in the transaction and “subprime” deals are highly unlikely to occur. Siddiqi (2008) strongly argues that “risk shifting is gambling” and further explains that each and every loan made by a lending institution is subject to credit risk. Banks sought to protect themselves against risk of default by selling these risks to a third party in a zero sum game. Unlike PLS contracts where both parties are exposed to gain and loss, risk shifting assures only one party

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<sup>8</sup> Islamic Financial Services Board (IFSB) is one of the many professional bodies that have been working to meet the various needs of the growing Islamic financial industry. IFSB is in the process of bringing together a set of ‘Transparency and Market Discipline Standard’.

(seller of the risk or the buyer) gain the losses incurred by the other parties without the creation of additional wealth.

Seventh, in the wake of the many corporate failures due to unethical accounting and business practices, investor trust has been eroded. Islamic finance provides a moral and practical option for those keen in investing in socially responsible and ethical investment portfolios. One can justly argue that fraud, corruption and greed are not limited to non Muslims. Muslims as well are engaged in such unethical practices. But what differentiates the ethical boundaries of Islamic finance is that ethics are entrenched in Islamic institutions. The concept of ethics in Islam gains its legitimacy from divine commands that establish operational guidelines, which permeate all spheres of Muslim life. The western business ethics are neither based on, nor sanctioned by, an accepted source of ethical ideals (supreme religious might). They also lack authority and the power of generalisation because they are man-made guiding principle, based on trial-and-error. Consequently, they are limited to their respective environments at certain point(s) in time.

Chart 2 links key principles of Islamic finance to 'market failures' and suggests that the likelihood of market failure will be significantly reduced, if not eliminated, when these principles are adhered to and put into practice in all financial transactions.

<b>Chart 2: The economics of Islamic finance and ‘market failures’</b>		
<b>Islamic finance principle</b>	<b>Intuitive description</b>	<b>Linkage to ‘market failures’?</b>
<b>1. <i>Riba</i> prohibited</b>	‘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	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
<b>2. Fair profit sharing</b>	Symmetric profit-sharing (eg. <i>Musharakah</i> ) 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)	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
<b>3. No undue ambiguity or uncertainty</b>	This principle aims to eliminate activities or contracts that are <i>gharar</i> , 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	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.
<b>4. <i>Halal</i> versus <i>haram</i> sectors</b>	Investing in certain <i>haram</i> sectors is prohibited (eg, alcohol, armaments, pork, pornography, and tobacco) since they are considered to cause individual and/or collective harm.	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
<b>Source: (Iqbal &amp; Llewellyn, 2002 cited in Oxera, 2007, p. 2).</b>		

It is evident from the above that many assumptions have been made, most notably that Muslims always practice Islam and abide by its teachings in financial activities and daily life. The merit of this assumption is largely questioned and contested. Muslims actions are not always in harmony with the ideals they preach. One of the compelling evidence is the authenticity when applying *Murabaha* contracts in Islamic finance

#### **4. Opportunities and challenges for Islamic Finance Practitioners**

The premise that the current financial crisis presents Islamic finance with abundant of opportunities to confirm its presence and demonstrate its relevance as an effectual economic authority in the international market is evidenced by its emergence as a more equitable and efficient alternative to the existing system. While the global banking industry is facing profound difficulties of closures and bankruptcies, Islamic banking defies the trend by embarking on new global undertakings<sup>9</sup>. A number of new Islamic banks had been formed in recent months including the United Arab Emirates' first Islamic commercial bank and the Ajman Bank; more than twenty existing Islamic banks had extended their operations into new countries such as Botswana, Iraq, Kenya, Syria, and South Africa.

While accepting that some issues pertaining to the globalization of Islamic banking are still pending and in need for further research and consideration, Wilson (2007) upheld that Islamic banking presents the West with an opportunity and concluded that “Islamic banking is here [in the West] to stay” and that “the West should promote Islamic Banking”. 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.

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<sup>9</sup> Joseph DiVanna, managing director of UK-based consulting and advisory firm Maris Strategies – addressing the fifth World Islamic Economic Forum (WIEF) held in Jakarta, Indonesia on 2 – 3 March 2009

Leading German, British and French financial institutions are seeking to secure funds from the promising Islamic investment market in order to alleviate the growing liquidity shortage in their financial markets (Böhmler, 2007; Hassan & Lewis, 2007).

France is taking an exceptional interest in Islamic finance as it has affirmed its intention “to make Paris a great center for Islamic finance”<sup>10</sup>. The French Senate has agreed to tap into this multi-billion<sup>11</sup> dollar market and is considering harmonising the French law by implementing revisions required at a financial level to adapt French laws to the Islamic financial regime<sup>12</sup>. Following the footprints of London, where the first Islamic bank opened its doors in September 2004, it is expected that several Islamic banks would open branches in Paris in 2009.

In unparalleled move, the Vatican has acknowledged the uniqueness of Islamic finance and its capability of rendering vital contributions to the stability of the international financial market in a time of global economic crisis. Thus, it has voiced its approval of Islamic finance, and called upon conventional banks to consider the ethical rules of Islamic finance in order to forge an honest and transparent relationship with their clients. This testimony does not only go against, but also invalidates, the argument that the Western interest in Islamic finance is only motivated by the desire to cash in on the petrodollars.

So, is Islamic finance yet strong enough to meet the challenge posed by the current credit crunch?

The positive feedback to Islamic finance from various corners of the world in the time of the crisis could be interpreted as a vote of confidence in the Islamic financial industry. Economists as well as politicians envisage that the current global financial crisis is set to create a ‘New International Economic Order’ and to restructure the global economic institutions. Coupled with

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<sup>10</sup> Christine Lagarde, the French Finance Minister as she inaugurated the second French forum on Islamic banking, November 2008

<sup>11</sup> Estimated by French authorities at \$500 to 600 billion with projected growth of 11% a year.

<sup>12</sup> The French Senate said its initiative was in line with recommendations from a report on Islamic finance prepared by the Financial Affairs Commission, May 2008.

the emergence of the G20 as a major international economic policy maker that outdistanced the G7<sup>13</sup>, and given that three developing Muslim-led countries (Turkey, Indonesia and Saudi Arabia) are amongst the top 20 economies should encourage Islamic finance to exploit existing opportunities and demonstrate its worth by offering momentous alternatives to the international economic community.

The opportunities and challenges for Islamic finance are enormous. Iqbal and Mirakhor (2007, p. 297) concluded that Islamic finance is being concurrently challenged on three different fronts: theoretical, operational, and implementational. Each of these challenges has profound implications for the development and the future direction of the Islamic financial industry. Firstly, 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? On the operational front, the focus is on making available the means and procedures necessary for honest implementation of Islamic finance. Among the many operational challenges are innovation, financial engineering, intermediation, risk management, and supportive infrastructure. However, implementation remains the most serious challenge facing the Islamic financial industry. It involves transformation of Islamic financial model into working policies and enabling institutions?

The industrialised countries have realized that achieving 0% interest rate is crucial milestone in order to stimulate their economies and counter the effect of the global financial crisis. Current interest rates in the majority of these countries are floating around the 0% mark. However, interest charges and speculation remains deeply rooted in every aspect of conventional financial system. Khan (2008) prudently states that “Interest cannot be eliminated without providing interest-free loan facility to loan seekers just as illiteracy cannot be eliminated with providing schooling

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<sup>13</sup> G7: “The Group of 7” refers to the industrialised countries of the USA, Canada, Japan, France, the UK, Germany, and Italy.

facility to every child”. He further explains that the PLS arrangements are not appropriate in all situations especially where there is genuine need for a personal loan not intended for business purposes.

The aim of creating an interest free global financial system with the prospect of replacing the existing conventional system is still miles away, and involves massive groundwork in the legal, accounting and regulatory structures. However, there is no compelling reason as to “why the Islamic system cannot be offered in parallel with conventional system and be promoted as the proffered system” (Khorshid, 2008) based on its ethical principles and other unique characteristics.

There is no absolute assurance that Islamic finance, once mature, will weather a similar financial crisis in the future unless it commits itself to being *Shariah*-based (the substance) rather than *Shariah*-compliant (the form). Such commitment compels the young evolving Islamic financial industry to embark on vigorous, first class and steady research with the aim of developing its own sophisticated intermediary markets or alternatives – while remaining faithful to the spirit and the essence of Islamic finance.

The fact remains that financial aspects comprise only one component of the overall system that governs the values, attitudes, and the behaviour of any given society. This basically means that in order for the Islamic financial system to deliver and perform its intended developmental role, it must be a part of an overall homogenous and inclusive Islamic system where political, educational, social, religious and economic institutions complement each other and work as a whole towards the same set of goals. Furthermore, is it conceivable to reap the benefits of the Islamic financial system without having to implement the whole of Islam to life and society – taking into account that “a whole is always greater than the sum of its parts”? The inevitable question that must be asked, therefore, is whether or not the viability of Islamic finance can be or

should be judged in the absence of a true “Islamic state where the whole realm of socio-economic human behaviour is engineered according to Islam”(Aziz, 1999).

In financial crisis, when Islamic finance clients default, the managers can take a series of pre-caution to minimize disputes that may arise. The parties involved in the disputes should acknowledge and represent within the agreement, after taking professional advice from a shariah qualified scholar/board, that the contract is shariah compliant. The parties cannot renege on their obligations on the basis that the arrangement violates Shariah. The parties agree that any dispute arising out of or in connection with the agreement is resolved in accordance with shariah principles through arbitration. The appointed arbitrators are shariah scholars knowledgeable and experienced in matters of finance and Shariah. The arbitrators shall interpret and apply shariah principles with reference to a particular authoritative shariah text. If the parties fail to resolve a dispute through arbitration, after attempting to do so for a certain period of time, the dispute shall be referred to a regular court and there is no guarantee that such court shall apply shariah principles in their judgment as has been found in many cases in Malaysia and UK (Hasan, 2009)

## **5. Conclusions and Managerial Implications**

Although it would be impractical to single out one factor as being the source of financial crisis, one can rightly argue that the main cause of financial crisis is attributed to a laxity of lending standards often adopted by conventional financial institutions – driven by greed and appetite for excessive returns, and facilitated by the absence of adequate and appropriate government regulatory control. This easy approach to lending when practiced over an extended period of time leads to excessive and, in all probabilities, risky lending environment that eventually works against the interests of both borrowers and lenders. The current global financial crisis, which was triggered by the US subprime mortgage crisis, was aggravated by the questionable tactics adopted by mortgage brokers who opted to sell their customers on subprime loans, and then by the

complexity of products that have been created by intermediary players who sought to pass the entire risk of default to the final purchasers. Facilitated by financial globalization, the collapse of some US financial institutions associated with the subprime mortgage scheme activated systemic risk across national boundaries causing the current global financial meltdown.

This paper neither can claim to have suggested an easy way out of the current global financial crisis nor to have presented inclusive answers to the many questions it has raised. However, evidence at hand strongly suggests that Islamic finance is well endowed to deliver noteworthy contributions towards a more healthy and stable international economy. The paper has argued that an honest implementation of Islamic theory of finance is potentially capable of solving, and in all probability averting, such crises from happening — simply because most, if not all, of the factors that have caused or contributed to the development and the spread of the crisis are not allowed under the rules and guidance of *Shariah*. The papers concluded by asserting that opportunities for Islamic finance are enormous, and so are the challenges. It also signals the transformation of Islamic financial paradigm into working policies and enabling institutions to be the most serious challenge facing the Islamic financial industry.

What role can managers and policy makers in Islamic finance industry make? Managers and the oversight boards in Islamic financial institutions need first to educate and inform their employees, clients and all stakeholders on the virtues and principles of Islamic finance. This should then permeate to the society if the government, through the ministry of education, introduce Islamic finance courses at different levels of education. The bottom up and top bottom approaches should complement each other. Regulatory authorities should have a common framework universally applicable to all Muslim countries. This will then form a bulwark of operational infrastructure to lay a firm foundation of spreading and practicing Islamic finance to the global stage. The regulatory authorities, experts in Sharia'h law and teachings need to address the issues of

intermediation, risk management and financial engineering within the framework of Islamic finance. Islamic finance Policy makers must also strive to transform Islamic finance model into working policies and build enabling institutions to overcome the challenge of implementing Islamic finance at global stage.

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