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ISLAMIC FINANCE & BANKING SYSTEM: A POTENTIAL ALTERNATIVE IN THE AFTERMATH OF THE CURRENT GLOBAL FINANCIAL CRISIS

(Part I)

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Background

Like many previous global financial and economic crises over the last four decades, the current global financial crisis has proved once again the failure of the prevailing global financial architecture which is mainly based on the conventional banking system as a key element. The global financial system has proved to be inefficient to deal with the complex structure of the conventional banking mechanism that, with excessive risk-taking, led to the recent sub-prime mortgage crisis in the United States and, in turn, the credit crunch that evolved into the ongoing global financial crisis. The current global financial crisis has, therefore, turned out to be a crisis of “confidence” in the present global financial system.

In the light of many concerns which have been recently raised on the efficiency of the Bretton Woods system and its major institutions like the IMF and the World Bank, some opinions have focused on the need for urgent modernisation and reforming of the global financial system in a way that might have prevented the crisis. Concerns over the establishment of new financial architecture



also call for involving major emerging and developing countries in the global decision-making process. This implies that economic clubs of industrialised countries like the Group of Eight (G8) cannot deal effectively with global economic and financial issues in the absence of close coordination and collaboration with the developing world.

Indeed, it sounds rational for any organisation with the mandate to monitor the global economy to include representatives of all major economies. In this context, it is worth mentioning that in his views on the weakness of the current global financial system, Robert Zoellick, president of the

World Bank, argued that international organisations that excluded countries such as China, India, Brazil, Saudi Arabia, South Africa and Russia were outdated.

Like in the case of the previous financial crises, many voices have blamed the conventional banking practices for being at the root of the current crisis.

Great panic in fear of the collapse of the world financial system has immediately led to ambitious search for banks rescue plans. The current financial crisis has raised some voices which call for rethinking of other alternative financial systems. Among these alternatives, the Islamic finance and banking system has been debated largely, particularly in many developing countries, including the OIC members.



Today, many people come to argue that the current global financial crisis could have been avoided if the Islamic finance and banking system had been in place instead of the conventional one. Given this state of affairs, this short report aims to present the rationale behind these arguments and explain how the Islamic finance and banking system could avoid what the current conventional system has been doing wrong.

The Conventional Banking System and the Outbreak of the Crisis

It is now well-known that the current financial crisis, which has started in the United States, caused by big financial institutions lending money to risky borrowers (sub-prime) for buying houses. In so doing, these institutions have been violating the conventional rule of lending only to those who have the capacity to repay their loans, or institutions with a good credit rating. The banks thought there was nothing to worry about as house prices were rising so that, in case of foreclosures, they would again make profit by reselling the houses. This scenario was also true for the borrowers who would still be able to repay their loan after selling their houses at higher prices.

However, all started to go wrong when interest rates bounced up as a result of the unprecedented increase in world food and energy prices that led to inflationary pressures. The result was that people were no more willing to buy new houses and even those who already bought houses could not afford to repay their mortgages. In fact, the low-risk or the “prime” borrowers even



preferred to default on their mortgages as their houses worth less than the mortgages. With declining demand for houses accompanied by an increasing rate of foreclosures that resulted in excessive supply of housing, house prices started to fall at a significant rate. Consequently, the banks and other lending institutions began to have shortages of funds to repay their debts.

In fact, the debacle in the United States housing market could have remained only as a mortgage crisis in the economy of the United States. However, the high ratios of leverages and the widespread use of mortgage-based complex derivatives in the global financial market pushed the crisis to other financial markets outside the United States with wider scope of liquidity constraints. Before the outbreak of the crisis, many large banks and financial institutions had borrowed huge amounts, and to repay their debts, they first relied heavily on selling prime mortgage debts to other investment companies and hedge funds. What was worse, however, is that those banks began selling the “sub-prime” mortgages to other financial agents, who, in turn, were selling them to other investment companies.

Initially, they all sold the mortgages of low-risk borrowers, but as they became greedier to make more and more profits, they started selling the high-risk mortgages as well. They were so creative that they produced various derivative financial instruments that consisted of loans and mortgages with different risk levels so as to serve all kind of investors, from risk-lovers to risk-averse ones. In such a setting, those who are willing to take the lowest risk were guaranteed by first claim in case of a default; those taking medium-level risks were promised the next available funds; and those with the

highest risk would get the remainder. The banks were no more worried about their debt they sold as the risks were transferred to debt-buyers.

Consequently, credit risk spread throughout the financial system by means of those derivatives – mortgage-backed securities and collateralised debt obligations. Considering that the risks were low as



house prices were rising, insurance companies also got involved in this game, insuring banks’ debt and charging the debt-buyers premiums for the mortgage debt sold by the banks. Thus, the mortgage-based derivatives were then interconnecting a number of players in the financial system, which were all contented with high profits. Eventually, when the mortgage sector faced a high ratio of defaults and the banks as well as other lenders fell short of funds to repay their debts,

the balloon inflated by fictitious money coming from the derivatives finally burst into a crisis of confidence generated by greed and overindulgence.

It turned out that the banks could not even distinguish which of their loans were safe, and then interbank lending stopped as the banks could not trust funds from others, suspecting that they were buying fictitious money. As the derivatives had no more any value, institutions holding them turned out to be insolvent. Financial institutions could not find money even for their ordinary transactions or very short-term requirements, which implied that the system was amidst a liquidity crisis leading to widespread insolvency. “Given the central role played in the US subprime market by banks headquartered in the United States and Europe, it was not surprising that they had begun to announce losses” (BIS, 2008, 5). Biggest banks and financial institutions in the United States – Citibank, HSBC, Bear Sterne, and Merrill Lynch– and in Britain –Northern Rock, Royal Bank of Scotland, and Barclay’s Bank– as well as a number of others in many European countries had massive losses.



The Argument on the Conventional Financial System

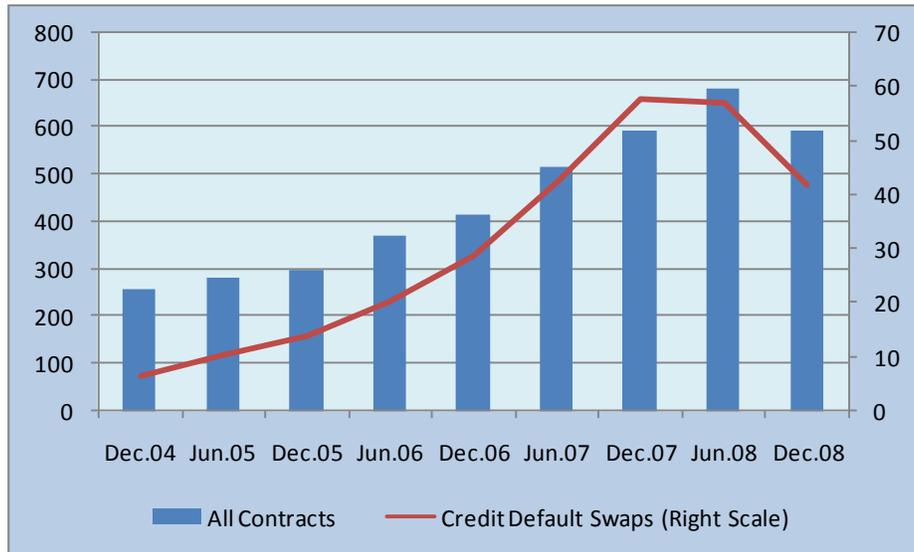
It is then obvious that the non-performing mortgages could have still remained as a problem of the banking sector and other mortgage-related institutions in the United States. However, the overuse of securitisation in the form of credit derivatives and debt trading aggravated the problem to threaten the whole financial system, bringing it to the brink of collapse. The global financial system rests too much on the financial derivatives that depend mainly on transactions that do not involve exchanges of real goods and/or services.



In fact, until the outbreak of the current financial crisis, most of the people were not aware of these derivatives although this kind of financial instruments makes up the largest financial market in the world. Indeed, financial derivatives have no intrinsic value; they are nothing else than bets. In this context, it is worth mentioning that R. Chapman was one of the first economists who raised the issue of the negative impacts of the implications of the financial derivatives bubble when he argued a decade ago that “The point everyone misses is buying derivatives is not investing. It is gambling, insurance and high stakes bookmaking. Derivatives create nothing.” (Chapman, 1998).

According to Bank for International Settlements, the total notional amount of over-the-counter (OTC) derivatives contracts outstanding was \$592.0 trillion at the end of December 2008 (Figure 1), corresponding to almost 10 times the value of Gross Domestic Product (GDP) of all the countries in the world, which is only about \$60 trillion. The most widely traded form of credit derivatives, i.e. the credit default swaps (CDS), have increased significantly in the last few years, and reached to \$58 trillion in December 2007, corresponding to 105% of the world GDP, though this ratio was only 15% in December 2004. This implies that gamblers can bet as much as they want with money that they actually do not have, and that is where the huge increase in risk comes in (Brown, 2008).

Figure 1: Over-the-Counter (OTC) Derivatives
 (Notional Amounts Outstanding, Trillion US Dollar)



Source: Bank for International Settlements, Statistics on Derivatives.

Given this state of affairs, it is widely accepted that the main reason for the current financial crisis was the high level engagement in nominal transactions with no real value. This implies that the conventional financial system has weak interactions with the real economy and, thus, highly influenced by speculative transactions in the financial market, regardless of the actual supply-demand conditions or production trends in the economy.

Of course, the current global financial crisis is not the first one and does not seem to be the last given the current structure of the global financial architecture. As Stiglitz (2003, 54) emphasized, “... international financial crises or near-crises have become regular events... It is becoming rarer for a country not to have a crisis than to have one, and by some reckonings, there have been 100 crises in the past 35 years”.

Islamic Finance & Banking System: A Potential Alternative

The current global financial crisis is widely considered as the worst one since World War II. It seriously affected a number of most successful institutions operating in the international financial market, including even some of those which were considered to be well-established and “too big to

fail”. On the contrary, the Islamic throughout the world have proved to crisis. Accordingly, given that the the weaknesses of the conventional resilience of the Islamic institutions led many analysts, particularly in the conclusion that Islamic finance and banking system could provide the solution to the weaknesses of the conventional financial system and could be a feasible alternative.



banks and financial institutions be somewhat sheltered from the current crisis has clearly shown up banking and finance system, the to the current financial turmoil has developing countries, to come to a

Islamic finance requires that financial transactions must be in line with the Islamic law, Shariah. Accordingly, these transactions must be free from *riba* (interest or usury), *gharar* (uncertainty), and *maysir* (gambling). Moreover, “financial dealings in Islamic banking and finance are guided by the ultimate objective of achieving the ideals of equitable justice where priority is given to equity-based financing rather than debt-based financing” (Kassim and Majid, 2009).

Given that ensuring justice in human society is one of the central principles of Islam, its fulfilment in financial transactions requires that financial institutions should equally share the profit as well as the loss so as not to shift the entire burden of losses to the entrepreneur (Chapra, 2008, 14). In this setting, financial institutions need to evaluate the risks more cautiously and to monitor more effectively the use of funds by the borrowers. This implies that the lender (bank), acting as an agent for the borrower, has full information on how the borrower is using the loan, leaving no room for asymmetric information.

On the contrary, the process of lending in the conventional banking system is subject to the problem of asymmetric information and moral hazard. The borrowers typically know more about their own business than the lenders. As borrowers are in a position to hide information from banks, they can easily use the loans for other purposes than they specified on the agreement, posing unknown risk on the banks through misreporting their income flows; an issue which was not considered seriously by the reckless banks in the United States before the mortgage crisis.

On the other hand, the Islamic financial system does not allow the creation of debt through either direct lending and/or borrowing. It rather requires the creation of debt through the sale or lease of “real assets” through various Shariah-compliant sales- and lease-based modes or instruments of financing such as murabahah, ijarah, salam, istisna and sukuk. The aim is to help individuals as well as firms to buy urgently needed real goods and services at present considering their ability to repay at a later time. In this context, it is worth mentioning that the Islamic financial system has certain conditions that would help prevent excessive expansion of debt, which, according to (Chapra, 2008, 15-16), can be summarised as:

- The asset which is being sold or leased must be real, and not imaginary or notional;
- The seller must own and possess the goods being sold or leased;
- The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and
- The debt cannot be sold and thus the risk associate with it cannot be transferred to someone else. It must be borne by the creditor himself.

Under these conditions, it is clear that the strength of the Islamic economy is based on the fact that the Shariah-compliant financial instruments are based on real economics rather than speculations and other wrong practices. Once the debts are no more traded, the financial market cannot be stretched beyond what the real economy can bear. Thus, eliminating the derivatives and their transactions that are basically speculative and do not add value to the real economy avoids the chain reaction of any debt failure, which was a primary cause of the collapse of major financial institutions during the current financial crisis. Consequently, the absence of all these conditions indeed was among the main reasons that contributed to the current financial crisis. That is why many experts and analysts have come to support the implementation of the principles of Islamic finance.

Having faced the threats of the global financial crisis, a number of banks across the world are now building up their Islamic finance units, tapping into an emerging industry estimated at \$700 billion to \$1 trillion in asset size and growing annually by 15 to 20 percent (Reuters, 2009). Today, investments through Islamic finance systems are acceptable in a significant number of countries –both Islamic and others– such as Indonesia, Malaysia, Turkey, Japan, China, England, and USA, and continue to

expand to many other countries as an alternative or complementary to the conventional financial and banking system. As Wilson (2009) argued “Islamic banking provides a viable alternative to conventional banking and is less cycle prone. The spread of Islamic finance into western markets demonstrates that it now being treated seriously by regulators and finance ministries.”

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