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

(Part II)

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Behind the Crisis

The world is now facing the worst economic and financial crisis since the Great Depression and the causes and effects of the crisis will likely be debated for years to come. While different individuals and organizations view the crisis from different perspectives, it is useful for setting the stage for the arguments discussed in this report to highlight that the current global economic and financial crisis began with rising defaults in subprime mortgages, bankruptcies, an overextension of credit and then a freezing of credit markets, and excessive financial bets on securitized debt obligations mainly in the United States but also in Europe (CRS Report, April 7, 2009, p.1-2).

The crisis has brought to the public consciousness two obscure financial terms, which are confined to the realm of Wall Street investors but, at the same time, are the key terms for both understanding and resolving the crisis:

Collateralized Debt Obligations (CDOs): a type of structured asset-backed security whose value and payments are derived from a portfolio of fixed-income underlying assets. CDOs are assigned different risk classes or tranches, with "senior" tranches considered to be the safest. Since interest and principal payments are made in order of seniority, junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk (CRS Report, October 2, 2009, p.3-4). Prior to the crisis, CDOs had become a major force in the so-called derivatives market, in which the value of a derivative is "derived" from the value of other assets. However, unlike some fairly straightforward derivatives such as options, CDOs were nearly impossible for the average person to understand. Given that the CDOs based on sub-prime mortgages have been at the heart of the global financial crisis, it is truly amazing how something that an average American has never heard of even today could cause so much trouble for the global economy. The main problem was that "CDOs weren't "real." They were constructs. And one could argue, they were constructs built on other constructs." (Conley, 2009).

Credit Default Swap (CDS): These are a type of insurance contract (a financial derivative) that lenders purchase against the possibility of credit event (a default on a debt obligation, bankruptcy, restructuring, or credit rating downgrade) associated with debt, a borrowing institution, or other referenced entity. The purchaser of the CDS does not have to have a financial interest in the referenced entity, so CDSs quickly became more of a speculative asset than an insurance policy. As long as the credit events never occurred, issuers of CDSs could earn huge amounts in fees relative to their capital base (since these were technically not insurance, they did not fall under insurance regulations requiring sufficient capital to pay claims). In order to cover the risk of defaults on mortgages, particularly subprime mortgages, the holders of CDOs purchased credit default swaps. CDSs provided large profits for the companies involved in the system until the default rate, particularly on subprime mortgages, and the number of bankruptcies began to rise. In a short time, the leverage that generated huge profits turned out to generate huge losses, which was a primary cause of the problems of AIG and other companies (CRS Report, October 2, 2009, p.33-34).

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, 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, 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).

In his 2002 Berkshire Hathaway letter to shareholders, company chairman and CEO Warren Buffett expressed his concern with such highly complex financial instruments, referring to them as "financial weapons of mass destruction" that could harm not only their buyers and sellers, but the whole economic system. Indeed, it became clear that the non-performing mortgages could have 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 threat the whole financial system, bringing it to the brink of collapse.

It is clear that the global financial system leans too much on the financial derivatives that depend mainly on transactions that do not involve exchanges of real goods and services. This high level engagement in nominal transactions with no real value 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. Because of the prevalence of those innovative financial arrangements, fed by greed and overindulgence, the housing debacle in the United States appears to have triggered market dynamics that intensify the impacts of financial shocks and create self-reinforcing, downward economic and financial spirals from which it is difficult to recover.

The Rise of Islamic Banking and Finance

Like in the case of the previous financial crises, many voices have blamed the conventional banking and financial practices for being at the root of the current crisis. As Bookstaber (2007) has argued, today's financial crises do not arise from economic instability or acts of nature, but from the very design of the financial markets themselves: "Market crises are not born from nature. They are not transmitted by economic or natural catastrophe. The machinery of the market itself can take a small event and distort it. The more closely we try to follow the ideal, thereby adding complexity and more tightly coupling the actions of the market, the more frequently crises will occur" (p.257). In this respect, the collapse of many leading Wall Street institutions, notably the Lehman Brothers, and the succeeding economic and financial crisis that have lead to a global economic recession, are encouraging economists world-wide to consider alternative financial solutions. Attention has been focused on Islamic banking and finance as an alternative model.

Although Islamic banks and financial institutions were not entirely immune to the global economic crisis, they have proved to be somewhat sheltered from the crisis. Compared to most of their counterparts in the conventional financial system which were considered to be well-established and "too big to fail", Islamic finance institutions were better placed to weather the storm, receiving increasing interest from not only the Muslim community but also non-Muslim population around the world.

Indeed, a number of experts and officials of Islamic banks and financial institutions around world have confirmed that Islamic banks have not been much affected from the global economic and financial crisis, and that any effects would be limited due to the nature of Islamic banking –it does not deal in debt trading and detaches itself from market speculation that takes place in industrialized economies of the West. It is, of course, inevitable for them to be affected to a certain degree as they are part of the global financial system and consequently to be influenced by all trends in global financial dealings, even if only in an indirect manner. Accordingly, given that the

current crisis has clearly shown up the weaknesses of the conventional banking and finance system, the resilience of the Islamic institutions to the current financial turmoil has led many analysts, particularly in the developing countries, to come to a 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. In this regard, Islamic finance is expected to spread increasingly at the international level and its number of customers is also expected to grow as people search for an alternative banking system.

Islamic Banking & Finance: The Principles

Islamic finance is an ethical and equitable mode of finance that derives its principles from the Islamic law based on the Holy Quran. It relies on a set of values, ideals, and morals, such as honesty, credibility, transparency, clear evidence, facilitation, co-operation, complementarity, and solidarity, which are fundamental in ensuring stability, security, and safety for all those involved in financial transactions (Shehatah, 2009). In fact, all of these factors intrinsically serve one of the most important objectives of Islam; ensuring and maintaining socio-economic justice in human society. The reflection of this objective on economic and financial aspects of life has been formulated with some principles – set forth by the Islamic law– that characterize the nature of Islamic banking and finance.

The most distinctive element of Islamic finance is the ban on interest, since it is regarded as a form of *riba* (usury), which is explicitly prohibited in the Holy Quran. Interest in all conventional banking transactions come under the scope of *Riba al-nasiah* (deferred ususry), also known as *Riba al-diyun* (usury of debt). It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender the amount originally lent together with an increase on the loan amount, in consideration of the lender having allowed the borrower time for repayment (IIBI, 2009a). *Riba* also is an unjustified increment gained by the seller or the buyer if they exchanged goods of the same kind in different quantities. This is called "*riba al-fadl*" or "*riba-al-buyu*" (trade usury) (Ahmad, A.Y., 2009). Although, in conventional forms of finance, a distinction is often made between acceptable interest and usurious interest (i.e., excessive rates of interest), under Islamic law, any level of interest is considered to be usurious and, therefore, is prohibited. As such, in Islamic finance, there is no direct lending of cash against return of a higher amount of cash[1]. That is why the practices of the modern banking system are in conflict with the principles of Islam which strictly prohibit *riba*.

Islam introduces the profit- and loss-sharing (PLS) system in place of interest to achieve the objective of justice. This requires both the financier and the entrepreneur to equitably share the profit as well as the loss on the basis of their capital share and effort, which translates into "no risk, no gain!" As Chapra (2007a) put it, "It is against the principles of justice that, in the event of a loss, the entrepreneur bears the entire loss in spite of his hard work and entrepreneurship while the

[1] Islamic laws allow cash to be lent, but generally only as "*Qard Hassan*" where only the same amount of cash is required to be returned, if returned at all (Ahmad, J., 2009).

financier gets a positive rate of return without doing anything" (p.325-326). Introduction of risk/profit sharing in the financial system can help induce financial institutions to assess the risks more carefully and to monitor the use of funds by the borrowers more effectively which also contributes to elimination of the asymmetric information problem.

As it relies on a concept of profit and loss sharing where creditors in any investment become partners to investors, Islamic finance is more akin to equity-based financing rather than debt-based financing. Equity takes the form of either shares in joint stock companies and other businesses or PLS in projects and ventures through the *mudarabah* and *musharakah* modes of financing. This is another built-in stability aspect of the Islamic financial system because it brings an equitable and balanced distribution of wealth in the society.

Greater reliance on equity-based financing does not necessarily mean that debt financing is completely excluded from the system because not all financial needs of economic agents can be met solely under PLS modes of financing. Indeed, debt is indispensable by nature. Nevertheless, debt is created in the Islamic financial system only through the "sale or lease of real goods and services" via the sales-based modes of financing (*murabahah*, *ijarah*, *salam*, and *istisna*). The objective is to enable an individual or firm to immediately purchase the urgently needed real goods and services in line with their ability to make the payment at a later period of time. Although the predetermined rate of return on these modes of financing may make them similar to interest-based instruments, there are significant differences between the two since Islam has certain conditions that would help prevent excessive expansion of debt (Chapra, 2007b, 179-180; Chapra, 2008, 15-16). Some of them are as follows;

1. The asset which is being sold or leased must be real, and not imaginary or notional;
2. The seller must own and possess the goods being sold or leased;
3. The transaction must be a genuine trade transaction (each financial transaction must be tied to a "tangible, identifiable underlying asset) with full intention of giving and taking delivery; and
4. 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.

The first and second conditions will help eliminate most of the speculative transactions that involve *gharar* (excessive uncertainty), which is another fundamental prohibition in Islamic finance. In general, this prohibits selling goods or services that the seller is not in a position to deliver or making a contract which is conditional on an unknown event[2]. Due to the uncertainty and risk involved, it makes a transaction similar to gambling. Thus, thanks to this prohibition, financing extended through the Islamic modes can expand only in line with the growth of the real economy and thereby help curb excessive credit expansion. In this respect, the prohibition on *gharar* is often used to

[2] The Islamic law makes an exception to the second rule in the case of *salam* and *istisna* where the goods are not already available in the market and need to be produced before delivery.

support the criticism of conventional financial practices such as short selling, speculative trading, and derivatives. Actually, the third and fourth conditions will also help eliminate speculative and derivative transactions and also prevent the debt from rising far above the size of the real economy, thus preventing the complexities prevalent in conventional financing operations.

The third fundamental prohibition in Islamic finance, *maysir* –another word for *qimar* or gambling– has to do with the prohibition of *gharar* because the elements of *maysir* are usually present where there are elements of *gharar*. *Maysir* technically refers to an agreement in which possession of a property is dependent on the occurrence of an uncertain event, such as games of chance and gambling. It applies to those agreements in which there is a definite loss for one party and definite gain for the other without specifying which party will gain and which party will lose. Such an activity is prohibited as it is a zero-sum game, just transferring the wealth not creating new wealth.

In addition to abovementioned three major prohibitions (*riba*, *gharar*, and *maysir*), Islam also discourage investment in certain products and industries such as alcohol, pork-based products, pornography, and weapons with a view to promoting ethical investments that contribute to development of the society. In other words, "while permitting the individual the right to seek his economic well-being, Islam makes a clear distinction between what is *Halal* (lawful) and what is *haram* (forbidden) in pursuit of such economic activity. In broad terms, Islam forbids all forms of economic activity which are morally or socially injurious" (IIBI, 2009b).

Islamic Banking & Finance: Modes of Financing[3]

Today, there is an increasing number of financial products and services approved by Islamic scholars as being compliant with the principles of Islamic finance, by which Islamic financial institutions can attract funds and provide financing facilities in an Islamic way. As previously mentioned, some of them (*mudaraba* and *musharaka*) rely on the PLS system while many others (*murabaha*, *ijara*, *salam*, and *istisna*) are based on sales or lease transactions. Below is brief information on these modes of financing:

- *Mudaraba (Trust Financing)*: An investment partnership with profit-loss-sharing implications. One or more partners as investors (*Rab al Amal*) provide 100 percent of the capital to an entrepreneur (the partner who provides entrepreneurship and management, known as *Mudarib*) to undertake a business activity. Profit is shared between the partners on a pre-agreed ratio; any loss is borne only by the investing partner(s) alone. For the *Mudarib* the loss is the share of the expected income for the efforts put into the business activity. The investors have no right to interfere in the management of the business but can specify conditions that would ensure better management of the capital money.
- *Musharaka (Joint Venture)*: An investment partnership with profit-loss-sharing implications. Unlike *mudaraba*, all the partners contribute capital towards the financing to undertake a

[3] Definitions of the Islamic modes of financing listed under this title have been obtained mainly from the Glossary of Financial Terms, Institute of Islamic Banking and Insurance [http://www.islamic-banking.com/].

business activity. The partners share profits on a pre-agreed ratio while losses are shared according to each partner's capital contribution. The business activity may be managed by all, some, or just one of the partners.

- *Murabaha (Mark-up Financing)*: A contract of sale between a seller and a buyer; the seller sells certain specific goods to the buyer at a cost plus an agreed profit mark-up for the seller. The seller must disclose the cost of goods and the profit mark-up. The financing mode adopted by Islamic banks takes the form of *Murabaha Muajjal* which literally means a credit sale; it is a contract in which the bank purchases goods required by a customer and, after taking delivery, then resells the goods to the customer with an agreed profit mark-up on the disclosed purchase price; it allows the customer, as buyer, to pay the higher price of the goods at a future date in a lump sum or in installments. By paying the higher price to the bank, the customer has effectively obtained goods on credit from the bank without taking out a loan on interest to purchase the goods direct from the supplier.
- *Ijara (Leasing):* A form of leasing contract in which there is a transfer of ownership of service (for use of an asset) for a specified period for an agreed upon lawful consideration. Instead of lending money on interest, *ijarah* allows a financial institution to earn profits by charging rentals for the use of the asset. Under this scheme of financing an Islamic bank purchases an asset as per specification provided by the client. The period of lease and the lease rental fee are set in advance and may be determined by mutual agreement according to nature of the asset. During the period of the lease, the asset remains in ownership of the bank (as lessor), but the client (as lessee) has the right to use it. At the end of the lease period, the leased asset will be returned to the lessor. There are some other variants of leasing which incorporate the transfer or option to transfer ownership of the leased asset from the lessor to the lessee at the end of the lease period.
- *Salam (Advance Purchase):* Advance purchase or a type of sale in which the full price of the goods is paid in advance and the goods are delivered later at a specified date in the future. It is similar to a modern forward sale contract. The object of the sale must be tangible goods that can be defined as to quantity, quality and workmanship.
- *Istisna (Commissioned Manufacture):* It is a contract of sale of a specified goods that can be sold before manufactured product comes into existence; an order to manufacture (for purchase) allowing the buyer to pay the price progressively in accordance with the progress of a job or project or against delivery in stages. It is a condition in *istisna* that the seller provides either the raw material or the cost of manufacturing the goods. There is an obligation on the manufacturer to deliver the goods on completion according to the buyer's specifications.

It should be noted here that in an Islamic finance transaction, the financier takes an element of risk; ownership of an asset and the consequent non-payment by the client of the asset's sale price. Any default penalties imposed to encourage payment on time do not accrue for the benefit of the lender but get paid to charity. There are other inherent risks in the transaction but the idea is that this risk-taking is what allows the Islamic financial institution to make a profit on the financing transaction (Ahmad, 2009).

Development of the Islamic Finance Market

The international market for Islamic finance has grown 10 to 15 percent annually in recent years, expanding to become a trillion dollar industry although it was almost non-existent three decades ago. Islamic finance historically has been concentrated in the Persian Gulf and Southeast Asian countries, but the jump in popularity of Islamic finance is now drawing the interest of companies outside the Middle East, expanding it globally to both Muslim and non-Muslim countries that seek this kind of financing.

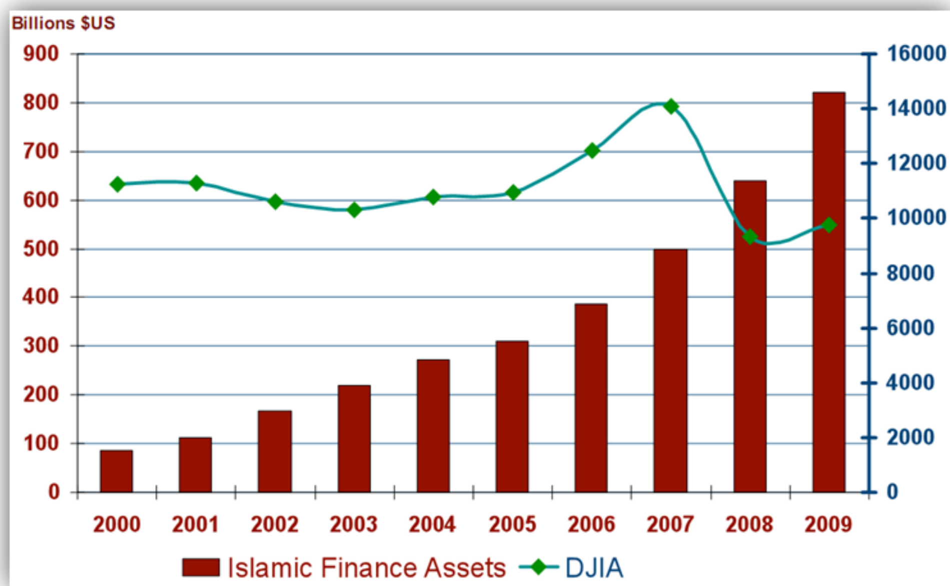

Figure 1: Growth History of Islamic Finance
Source: S. Timewell & Joseph DiVanna, (2009a), "Inside the 2009 Rankings", a presentation on The Banker's *Top 500 Islamic Financial Institutions* report.

Islamic banking assets continued double-digit growth in 2009, even as conventional bank growth stagnated, according to The Banker's world-renowned Top 500 Islamic Financial Institutions survey. The 2009 survey revealed that the assets held by fully Islamic banks or Islamic banking windows of conventional banks rose by 28.6% in 2009 to $822bn from $639bn in 2008 (Figure 1). Although the Dow Jones Industrial Average Index (DJIA) fell significantly in 2008, the rapid growth of Islamic finance assets was not interrupted. It is also impressive that at a time when asset growth in the Top 1000 World Banks slumped to 6.8% from 21.6% the previous year, Islamic institutions were able to maintain the 28% annual compound growth achieved in the past three years. However, despite its dramatic growth, the *sharia*-compliant aggregate asset total is still less than 1% of the Top 1000 World Banks aggregate asset total (The Banker, 2009).

The GCC countries have the largest share of *shariah*-compliant assets, 43% of the global sum in 2009 amounting to $353 billion. They also took the lead in asset growth, with an annual increase of 34.5% in 2009. The other countries in Middle East and North Africa (MENA) have closely been following the GCC countries, adding up to $315 billion of assets in 2009. Though relatively smaller, Islamic finance assets in Asia was almost three times the sum of those in Australia, Europe, and America (Figure 2).

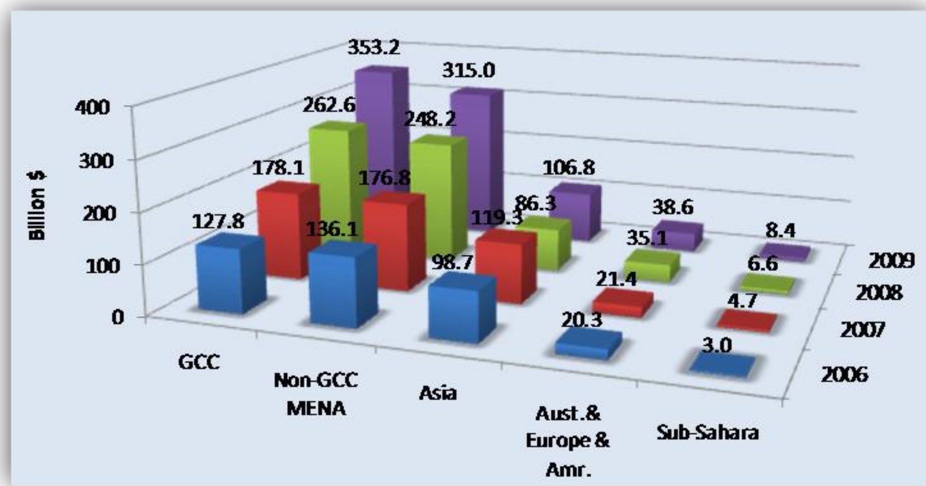

Figure 2: Growth History of Islamic Finance by Region
Source: S. Timewell & Joseph DiVanna, (2009b), "Interpreting 2009's Data", a presentation on The Banker's *Top 500 Islamic Financial Institutions* report.

The *sukuk* (Islamic bonds) market has also been recording an impressive average growth of 40 percent per annum. The increasing demand has been stimulated by the high levels of surplus savings and reserves in Asia and Gulf regions. Asia has a savings rate which is higher than any other region in the world and is expected to remain between 30 and 40 percent of GDP for many years to come.

Challenges

There are various supervisory authorities committed to oversee the overall compliancy of the financial instruments offered by the Islamic financial institutions, such as the *shariah* supervisory board, as well as national regulatory authorities. In this regard, a distinctive feature of an Islamic financial institution is the requirement for a *shariah* board with expertise in finance and Islamic law to carry out a detailed examination of a proposed transaction or product to ensure it complies with *shariah*. The board often issues a Fatwa (an Islamic juristic opinion) in order to approve such transactions or products. However, with a number of variations in regulations across markets and countries, standardization remains a significant challenge for practitioners, regulators and depositors. although there has been effort towards standardisation through international and domestic regulatory bodies.

For the global acceptance of Islamic finance, the harmonisation of standards and practices is important. The international standard setting organizations such as Islamic Financial Services Board (IFSB) and to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) needs to be supported so as to formulate appropriate standards that would strengthen the Islamic financial system at the global level. The Bahrain-based AAOIFI, established in 1990 to govern global Islamic financial banking practices, lacks an enforcement mechanism to support its recommendations. Since the standards are voluntary, their adoption rate is relatively low. Fewer than 10 of the 56 Member States of the Islamic Development Bank have agreed to abide by the AAOIFI's established standards of practice (CAU, 2009).

Product diversification and the need to offer relevant products to rapidly changing demographics of global clients are also a key element in the expansion of Islamic finance. However, the scarcity of *shariah* scholars is often cited as the most significant obstacle to the growth of Islamic finance. These specialized professionals must assess and approve each financial transaction, product and service with respect to its adherence to Islamic law. Given that there are inadequate qualified individuals in the world, developing new financial products and services becomes increasingly difficult. This also brings about an additional challenge that most of these scholars are members of more than one supervisory board, raising concerns about confidentiality and potential conflicts of interest.

On the other hand, concerning the Islamic modes of financing, Chapra (2007b) highlights that the share of PLS modes has so far been relatively small in the financing operations of Islamic banks, and that of sales-based modes is predominantly high. Although the sales-based modes are widely accepted to be different from interest-based financing and are allowed by the Islamic law, the prohibition of interest may not generate its potential socioeconomic benefits unless the share of PLS modes increases considerably in total financing.

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