The Global Financial Crisis and Islamic Banking

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Abstract: The global credit crunch, food crisis and oil crisis has once again highlighted the fragility of capitalism, as the fallout from the credit crunch and the wider economic crisis continues, demands for alternatives are certain to grow. This paper focuses on financial crisis in the global conventional financial market and points out the various factors that have contributed to the crisis. The Islamic view on such factors is presented and shows how Islamic economic system can help to bring stability which the world needs.

1. Introduction

The world is in the midst of a financial crisis which threatens a worldwide economic recession. The 'Credit crunch' as it has come to be known brought panic and turmoil in the summer of 2007 to the world's financial markets causing the United States' housing market bubble to burst. The crisis threatens a worldwide economic recession, potentially bringing to a halt more than a decade of increasing prosperity and employment for western economies and potentially wiping a staggering $1 trillion off of the value of the world economy(Boeri and Luigi, 2008).

The present financial crisis has had two main effects in the United States. Firstly, the banks have become less willing to lend money, driving up the price of borrowing. The value of bonds issued worldwide against mortgages, for example, has crashed from $1.9 billion for year to $500m in the year 2008. Secondly, some financial institutions have been devastated - most importantly for the private finance initiative(PFI) industry, the monoline insurers that insure the bonds issued to raise money for PFI projects (Cecchetti, 2008a). They had, however, been guilty of buying dodgy mortgage-backed securities and therefore, have lost the high credit ratings they could lend to bond issuers.

The third world has also not been spared, Bangladesh, Indonesia, Malaysia, Pakistan, South America, Africa as well as the Middle East were all sold the idea of free markets, and all of these regions and nations now have capitalistic financial markets where large sums of wealth are the subject of speculation on the state of the economy and future revenue flows.

Like all previous crisis much literature has once again been written about the causes of current crisis. Many economists and commentators, have highlighted the causes of credit crisis due to lack of proper regulation, legislation and transparency (Cecchetti, 2008b; Adrian, and Shin,2008; Goodhart, 2008).

However, the current crisis shares many similarities with previous crisis that have occurred since the Great depression occurred in 1930. There are existing a whole host of specific factors inherent within capitalism that caused the current credit crunch, food and oil crisis. Such factors continue to plague the western economies and all those who have imitated them. Furthermore, this credit crunch has also highlighted the fragility of capitalism and the free-market economy, as the fallout from the credit crunch and the wider economic crisis continues, demands for alternatives are certain to grow.

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Islamic economists(eg, Siddiqui, 2009; Chapra, 2009, Bagsiraj, 2009) continually refer to the global economic crisis as a result of interest rates(Riba) from the great depression to the crisis in the western countries . Huge budgetary imbalances, excessive monetary expansion, large balance of payments deficits, insufficient foreign aid, and inadequate international cooperation can all be related to flaws in the theory of interest, which is also the root of the crisis. Core principles of Islamic economics system are justice, equity and welfare. Islamic economics seeks to establish a broad-based economic well-being with full employment and optimum rate of economic growth. It will bring socio-economic justice and equitable distribution of income and wealth. Islamic economics will also ensure the stability in the value of money to enable the medium of exchange to be a reliable unit of account and a stable store of value..

On the other hand, Islamic banking system strikes a balance between flexibility and oversight. The proponent of Islamic banking system expect that credit cruch could not happen in the Islamic financial institutions, because this system operates based on partnership between the client and the banks. There is a social commitment within the Islamic banking and finance.

The aim of this paper to focus on financial crisis in the global conventional financial market and will point out the various factors that have contributed to the crisis. The Islamic view on such factors will be presented in the form of an Islamic economy which will bring the much needed stability the world needs.

2. Financial Economy vs. Real Economy

The economies in Western countries over the last 30 years have shifted their focus from industry to services. The service sector now represents over 80 percent of the US economy, with the financial sector being the largest service. Rather than work in the real world, participants in the financial industry gamble on what is going to happen in the real world, by betting on how businesses are performing and by betting on their profits. The financial sector is a parallel economy which exists alongside the real economy and produces nothing real.

The real economy consists of housing, land and property, factories, cars and goods, etc. These are tangible goods which can be traded, leased and sold. In other word, they are physical goods which are produced; people are employed to make them. But the financial economy consists of tradable paper with financial values that rise and fall based upon the value people give them, often with no real asset represented.

The financial economy is now valued more than the real economy. The size of the worldwide bond market is estimated at $45 trillion. The size of the world's stock markets is estimated at $51 trillion. The world derivatives market has been estimated at $480 trillion, more then 30 times the size of the US economy and 12 times the size of the entire world economy.

The financial markets have become so divorced from the real economy that investors no longer seek to receive a dividend, but rather, to take advantage of inflated price rises. This has led to speculation of gigantic proportions, including bets on the collapse of economies. Western bankers, economists and politicians have all failed to provide any realistic solution so far.

3. Sub-Prime Crisis and Debt Illusion

The credit crunch began to bite when banks and other financial institutions discovered they had bought hundreds of thousands of home loans made to Americans who could not meet their payments. As a result, the banks have had to write down $476 billion, according to the Institute of International Finance, as huge chunks of their assets proved worthless.

Historically, banks used only the money they received from depositors to lend to borrowers. They were not able to obtain money from other sources other than depositors. However, in recent years, banks have been able to rely not only on depositors but also on the wholesale money markets, where they could borrow money from other banks and then resell it to their borrowers at a higher interest rate. This secondary market was in part made possible by the creation of "credit default swaps" (CDSs). These allowed a bank to effectively insure itself against the risk that a borrower might not pay back a loan. This led to an illusion that loans were now much lower risk and allowed such loans to be bought and sold. This then led to the creation of CDOs (collatoralised debt obligations), which were bought by banks as interest-bearing investments.
The sub-prime lenders then invented another way of making money in a sector which was already highly risky. Many lenders wanted to ensure they did not lose out on possible money-making opportunities in the sub-prime market and they developed a number of complex products. This was achieved by breaking down the value of the sub-prime mortgage market.

In the name of the securitization, debt was sold to a third party, which would then receive the loan repayments and pay a fee for this privilege. Thus debt became tradable, just like a car. The ability to securitize debt provided a way for risk to be sliced, diced and spread, allowing more mortgages to be sold. Since 1994, securitisation rate of sub-prime loans increased 32 per cent to over 77 per cent of total sub-prime loans. This process effectively increased the number of financial institutions with a stake in the sub-prime mortgage market. This was allowed to happen due to the manner in which the original sub-prime loans were securitised.

Many institutions also became owner of mortgage-backed securities(MBSs) which was created our of the repackaging of sub-prime loans. In simple terms, there is where a bank sells a set of debts as one product. In return for a fee, the new holder of this debt obligation receives regular loan repayments. In most cases, such a debt forms part of a pool of mortgage-based debts lumped together into a form of asset or bond, each with different degrees of risk attached to it. Thus, owners of MBSs actually do not know where the payments are coming from or even which sectors they're being exposed to. As of June 30, 2008, the MBS market was worth $6 trillion, more than US Treasury bonds.

The financial crisis has proven very clearly that the apparent strength of modern financial markets was illusionary. The happy-go-lucky mood evaporated instantly, with the write down of losses accompanied by the sackings of executives and followed by more stringent lending for the real victims of the credit crunch. Furthermore, financial crisis was accompanied by rising inflation – as demand for oil and food pushed prices up globally.

This crisis has stunned both the left and the right of the political spectrum and the different economic schools of thought. Many economists and policy makers have suggested more regulation and transparency, with only a few highlighting the role greed and speculation played.

4. Understanding Islamic Economics

Islam neither endorses the capitalist nor the communist financial model. However, both the capitalist and socialist systems share certain elements with Islam, such as encouraging people to work, to be productive and earn as much as they can. Islam promotes an awareness of the hereafter in the hearts and minds of believers and instructs them not to be overcome by greed or excessively attached to money.

The Islamic economic and financial system is based on a set of values, ideals and morals, such as honesty, credibility, transparency, clear evidence, facilitation, co-operation, complementarity and solidarity. These morals and ideals are fundamental because they ensure stability, security and safety for all those involved in financial transactions. Furthermore, the Islamic Shariah prohibits economic and financial transactions that involve interest (riba), lying, gambling, cheating, gharar (risk or uncertainty), monopoly, exploitation, greed, unfairness and taking people's money unjustly.

5. Financial Economics vs. Islamic Economics

Islam has a completely different philosophy for the economy that results in a very different society from a capitalist one. The overall direction of the Islamic economic system is to secure the satisfaction of all basic needs for every individual completely, and to enable them to satisfy their needs as much as possible. From this perspective, Islam looks at people individually rather than the whole of society. This means economic polices will look to cater for all rather than just leaving satisfaction to the market. This may be achieved by a host of rules Islam has to ensure wealth distribution and by government involvement in the economy to ensure that it moves in the direction Islam has designated.

While both systems accept money to be a store of value and a medium of exchange, the financial market-based economic system permits money to be treated like any other commodity which can be traded for a profit/interest.

In contrast, most Islamic scholars require money to be fully asset backed and also consider it impermissible to allow money to be traded for money except at par. From the Islamic perspective, a key consequence of permitting both creation of credit money and interest-based lending is to allow banks and other financial institutions to generate massive amounts of wealth at the expense of the rest of society, especially the poor, resulting in the inevitable charge that the economic system persistently favours the rich over the poor.

6. Financial Crisis and Islamic Banking

A financial crisis of the present kind would not happen if the requirements of Shariah were properly implemented; for example, the issue of risk-sharing. If commercial banks were required to share the profits and losses of their clients, whether in business investments or mortgages, they would be much more careful when choosing which deals to finance. This is because their financial returns would depend on the performance of the projects.

A banking system based on true Islamic principles would prohibit both the paying and receiving of interest as well as the artificial creation of money via the process of fractional reserve. In the fractional reserve banking practice, banks lend more money than they actually have in deposits. This creates a big problem in the economy, as very little equity can be used as collateral to borrow large sums of money; this is what creates a financial bubble.

In the Islamic economy, Islamic banks act as venture capital firms collecting people's wealth and investing it in the economy, then distributing the profits amongst depositors. Islamic banks act as investment partners for those who need money to do businesses, becoming part owners of the business. The banks should only be able to recoup their original capital by selling their share of the mortgage/business at the prevailing market value. As real partners, Islamic banks should have no objection to owning real assets and hence should be ready to share the consequential risk. This scheme, although seemingly inconsequential, could constitute a major relief to Islamic banks' clients, as they would no longer live under the burden of debt and fear of repossession.

7. Challenges Facing Islamic banking

The Islamic banking and finance industry is still in its infancy stage, and it certainly faces many challenges due to the fact that Islamic banks operate in an economy that is driven and manipulated by interest. In a financial economy, the banking sector is supported and regulated by the central bank. The central bank's regulation and policies are created for conventional commercial banks and it acts as lender of last resort. Unfortunately, most Islamic banks do not enjoy such privileges.

Another challenge facing Islamic banks is that they work under operational procedures that are different from those of the conventional banks; the resulting noncompatibility prevents the central banks from controlling or giving support to Islamic banks if a liquidity gap arises.

Since the Islamic finance industry is working under the secular system, it may suffer from the same systemic problems that contemporary conventional financial institutions are facing. For example, due to lack of proper regulation, Islamic banks do not genuinely engage in risk-sharing, which means defaulting clients of Islamic banks suffer the same consequences as clients of interest-based banks. If Islamic banks engage in money creation, they also will suffer the same inflation and boom-bust cycle that is evident in Western economies.

8. Risk Sharing

Conventional banks' lending secured by collateral substantially divorces bankers from their clients' risks, and causes heavy conflicts of interest. Conventional banks also skew the provision of funds to those who are already rich. Poor people with good ideas but no collateral often fail to attract finance under this system, with the result that wealth inequality increases from one generation to the next. Islamic banks' risk-sharing finance should do away with such conflicts and bring greater stability to economic activity. If the value of an Islamic bank's liabilities were determined by the performance of its assets, there would be no sub-prime crisis.

Unfortunately, risk-sharing techniques do not predominate in the world of modern finance. In fact, the intention is often the opposite. Entrepreneurs and conventional bankers like to increase excessive risk, and then insulate themselves from it, in order to increase their return on capital. In this way, an entrepreneur can borrow from a bank at fixed interest and then invest in a business that makes profit. The entrepreneur retains profit out of the borrowed money. Such incentive encourages entrepreneurs to borrow heavily and grow their business operations. One consequence of this approach is that a few large organisations have come to dominate the business landscape. The heavy indebtedness of such corporations means that a moderate rise in interest rates combined with a moderate fall in revenues can quickly erode an entire profit margin. This is one reason that share prices can change so dramatically over relatively short periods. Furthermore, interest charges on bank finance are a cost item in the production process and, therefore, act to increase the price of goods and services. The interest payments that society receives from the conventional banking system are funded by society itself.

9. Money Creation

The most powerful destabilising factor of all in modern markets is the activity of money creation by the conventional banking system. By creating money out of nothing and putting it into circulation, central banks and commercial banks have together caused a succession of speculative bubbles that can be traced back more than 300 years in the Western world. When newly created money is spent on assets such as property and shares, their prices naturally tend to rise. Conversely, when banks reduce the rate of money creation, buyers disappear from markets and prices begin to fall. The ability to create money is therefore a hugely powerful political and economic tool, and one that is almost always abused in due course.

There are two Islamic regulations in particular that work to prevent money creation by the banking system. These are the law of 'trust' and the prohibition of interest(riba). By issuing "promises to repay" that are in excess of their cash reserves, and by lending these promises at interest, modern banks have contravened both of these regulations in order to earn profit.

10. Demand for Alternatives

The current crisis shares many similarities with previous crises that have occurred since the Great Depression of the 1930s. There exists a whole host of specific factors inherent within capitalism that have caused the current credit crunch and food and oil crisis. Such factors continue to plague Western economies and all those that have imitated them. Furthermore, this credit crunch has also highlighted the fragility of capitalism and the free-market economy. As the fallout from the credit crunch and the wider economic crisis continues, demands for alternatives are certain to grow.

In the midst of such an unprecedented crisis, Islamic banking and finance is witnessing phenomenal growth, with the global value of Islamic finance approaching $1 trillion. According to an estimate by the Asian Development Bank, the average annual growth of the Islamic banking and financial sector is more than 15 percent. Islamic banking and finance is now among the fastest-growing financial segments in the international financial system. This has lead to much research and interest.

A few commentators have already predicted that the Islamic banking and finance industry may have a remedy and this fast-growing industry can come forward to solve the credit crisis. While the relatively small size of the Islamic finance industry may make this unrealistic at the moment, there exists an unprecedented opportunity to present the details of the Islamic economic system as well as the solutions Islam has for some of the current problems.

11. Significant Challenges

The global financial crisis is hitting the developing countries too. Although Muslim world are not the centre of the crisis, the Middle Eastern region is, unfortunately, being severely affected by it. They are first victims, due to their political de-stability. Their economies are victimised when exports declined and uncalled for demand from industrialised and emerging economies contracts.

The governments of the developing countries will face significant challenges managing the short-run difficulties of the financial crisis while also maintaining conditions for long-term growth. With regards to monetary policy, the challenge will be when and how much to ease.
Exchange rate flexibility coupled with deeper local currency debt markets open, at first, space for a counter-cyclical monetary policy. In practice, the room for manoeuvring will not only

depend on inflation but also on how much stress the domestic currencies and financial systems are facing.

On the other hand, in case of fiscal policy, the challenge will be to manage the inevitable fall in tax collection (which is related with the economic downturn and the fall in commodity prices), and to protect key expenditures – education, security and infrastructure. These can prevent an unwanted rise in poverty levels and hinder future growth.

So what should prudent governments do under these unique circumstances?

Firstly, the developing countries needs to temporarily increase well targeted support to the poor. Once households are pushed below the poverty line or pushed further into poverty, their chances of escape are dramatically reduced.

Secondly, the developing countries need to prepare for the turnaround. Countries that are better able to manage the dangers posed by the crisis, while seizing its opportunities, will be better positioned to resume rapid growth and gain a larger presence in world markets. This means, for example, continued Islamic investments in trade facilitation and logistics, as well as, the investment climate for business, including for Small and Medium Enterprises(SMEs).

Thirdly, and for those countries that have the fiscal space, temporary responsible increases in expenditures, including infrastructure, can boost domestic demand particularly through public private partnerships. These increases, however, must be consistent with sound macro management to avoid inflationary pressures.

Finally, the effectiveness of governments and Islamic financial institutions will play a crucial role in weathering the storm. Governments can redouble efforts to remove obstacles to growth and create a better business environment by increasing transparency, respecting and strengthening property rights, putting in place a well functioning judiciary, and reducing crime and violence. This is crucial as the private sector is the engine of innovation and productivity – and best placed to create jobs.

12. Conclusion

The financial crisis has proven very clearly that the apparent strength of modern financial markets was illusionary. The happy-go-lucky mood evaporated instantly, with the write down of losses accompanied by the sackings of executives and followed by more stringent lending for the real victims of the credit crunch. Furthermore, financial crisis was accompanied by rising inflation – as demand for oil and food pushed prices up globally. This crisis has stunned both the left and the right of the political spectrum and the different economic schools of thought. Many economists and policy makers have suggested more regulation and transparency, with only a few highlighting the role greed and speculation played.

The modern financial economy differs from Islamic economics in many critical respects, of which the nature of money is one. Whilst both systems accept money to be a store of value and a medium of exchange, the financial market based economic system permits money to be treated like any other commodity which can be traded for a profit/interest.

By way of contrast, most Islamic scholars require money to be fully asset backed and also consider it impermissible to allow money to be traded for money except at par. From the Islamic perspective a key consequence of permitting both creation of credit money and interest based lending is to allow banks and other financial institutions to generate massive amounts of wealth at the expense of the rest of society, especially the poor, resulting in the inevitable charge that the economic system persistently favours the rich over the poor.

Islam neither endorses the capitalist nor the communist financial model. However, both the capitalist and socialist systems share certain elements with Islam, such as encouraging people to work, to be productive and earn as much as they can. Islam promotes an awareness of the hereafter in the hearts and minds of believers and instructs them not to be overcome by greed or excessively attached to money.

A true Islamic principles prohibits both the paying or receiving of interest(riba) as well as the artificial creation of money via the process of fractional reserve. This fractional reserve creates a huge problem in the economy as very little equity can be used as collateral to borrow large sums of money; this is what creates a financial bubble. In the midst of such an unprecedented crisis Islamic baking and finance is witnessing phenomenal growth with the global value of Islamic finance approaching $1 trillion. This has lead to some research and interest. In the Islamic economy, Islamic banks act in the line of venture capital firms collecting people's wealth and investing it around the economy, then distributing the profits amongst its depositors.

In an Islamic economy only the wealth the bank has in its possession can be lent thus removing the ability of banks to create money. Islamic economy require money to be fully asset backed and also consider it impermissible to allow money to be traded for money except at par. From the Islamic perspective a key consequence of permitting both creation of credit/ money and interest based lending is to allow banks and other financial institutions to generate massive amounts of wealth at the expense of the rest of society.

Proponents of Islamic banking and finance industry have already predicted that the industry may have a remedy and this fast-growing industry can come forward to solve the financial crisis. While the relatively small size of the Islamic finance industry may make this unrealistic at the moment, there exists an unprecedented opportunity to present the details of the Islamic economic system as well as the solutions Islamic finance has for some of the current problems.

It is high time for introduction of universal Islamic values to the market players, economists, commentators and the general public. They should be shown that Islam is much more than the prohibition of interest(riba) and alms (zakah), but is a comprehensive system to fulfil society's basic necessities (food, clothing and shelter). Islam makes people and their needs, rather than production, the central question. In presenting Islamic economic policy, all the Shariah rules supplement each other. This means Islam is more than capable of being applied and, in fact, has a successful history of dealing with economic problems.

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