



Global financial crisis: an Islamic finance perspective

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Abstract

Purpose – The purpose of this paper is to initially contribute the literature linking the global financial crisis and the Islamic finance model which is competent of playing down the severity and frequency of financial crises, by introducing the financial system based on sharing in the risk. It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses, and the buyer wishes to take delivery. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully. It is important for everyone's future that we study the current crisis in order to develop sustainable financial practices and in quest of a new business model based on sharing the profit and loss.

Design/methodology/approach – The divergence approach is used for exploring possibilities and constraints of inherited situations by applying critical thinking and analysis through the published literature in Islamic finance. This is to create new understandings of international finance and using new banking business model towards better design solutions for the current global financial crisis and preventing more collapse in the future.

Findings – A new business model for the banking system based on non-interest-based transactions but profit and loss sharing should be in practice at the financial system. The financial institutions should encourage business and trade activities that generate fair and legitimate profit. In Islamic finance, there is always a close link 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 which are part of the root causes of the current financial crisis.

Research limitations/implications – This paper is based on published research papers but does not include empirical investigation.

Practical implications – The new business model based on Islamic finance principles will help in financing businesses by using alternative methods to the banking systems or as a different way to run our banking system. The Islamic finance system with proper checks and controls introduces greater discipline into the economy and links credit expansion to the growth of the real economy.

Originality/value – The paper sheds new light on the relationship between the Islamic finance model and a new business model for the financial institutions to be used in order to think through how to prevent future financial collapses and make capital markets work more effectively.

Keywords International finance, Islam, Economic depression, Ethics, Banking

Paper type Research paper



1. Introduction and background

We are currently in the eye of the hurricane. While it certainly does not seem like it, but with job losses, stock market crash, losses in almost all asset classes, bailouts, and bank failures – there is a lurking fear that this might be only the tip of the iceberg. A lot more may come if the crisis spreads further and leads to a failure of credit card institutions, corporations, and derivatives dealers. Lessons to be learned from the crisis may be good for future financial practise. The diagnosis of the causes of the crisis is the key to proper treatment and the root causes of this crisis will be debated for years to come but this study

can list only four which are related to Islamic finance perspective: creating money from money, selling debts – subprime lending, short selling, and absence of risk-sharing.

We have to begin thinking through how to prevent future financial collapses, try making capital markets work more effectively and how the business will be financed by another alternative to the banking systems, or different way to run our banking system. Islamic finance system has proper checks and controls, which introduces greater discipline into the economy and links credit expansion to the growth of the real economy. It is capable of minimising the severity and frequency of financial crises. The Islamic system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing such as *murabaha*, *ijara*, and *sukuk*.

The subprime mortgage crisis in the USA was the result of excessive and imprudent lending. Securitization or the originate-to-distribute model of financing has played a crucial role in this crisis. Mortgage originators collateralized the debt by mixing prime and subprime debt. By selling the collateralized debt obligations (CDOs) where they passed the entire risk of default to the ultimate purchaser, therefore, having less incentive to undertake careful underwriting (Ghafour, 2008). Consequently, a number of banks have either failed or have had to be bailed out or nationalized by governments in the USA, the UK, Europe, and a number of other countries.

No doubt, *riba* (interest, and usury) and *maysir* (gambling, and speculative activities similar to gambling) are the major factors leading to the current financial crisis. Islam's prohibition of *riba* and *maysir* along with Islamic values and morals, and recognizing others interest in one's economic fortunes, if adhered to, could not have lead the world to the present day financial crisis. Keeping individuals and society free from financial and economic crises can clearly be seen as one of the objectives of such institutions.

The chaos that hit the world's financial markets in recent weeks has an important question which highlights the need for enterprises to find alternative finances for their businesses and how to sustain it. The answer is financing our business using Islamic finance mode based on profit and loss sharing (PLS) not interest-based mode. Islamic finance has entered a bright new stage of development, emerging after the global financial crisis as a more equitable and efficient alternative to the Western approach (finance system based on interest).

Because interest-based transactions are prohibited, Islam encourages business and trade activities to generate fair and legitimate profit. In Islamic finance, there is, therefore, always a close link between financial flow and productivity. This essential possession of Islamic finance contributes towards insulating it from the potential risks resulting from excess leverage and speculative financial activities. Another fundamental principle of Islamic finance is the risk and profit-sharing feature of Islamic finance transactions (see below, such as Mudarabah contracts). This profit- and risk-sharing feature of Islamic finance transactions requires a high level of disclosure and transparency in the Islamic finance system. These disclosures allow the market to assign the appropriate risk premiums to companies, thereby enhancing the potential for market discipline to take effect. These features, which are required by *Shariah* (Islamic law) injunctions, provide built-in checks and balances which serve to ensure the financial stability of the Islamic finance system.

Because of the above features, Islamic finance has experienced major transformations and growth especially since 2000, and its volume has reached almost

\$1.5 trillion up from £5 billion in 1985. It has been one of the fastest growing financial markets over the last five years and is expected to continue expanding at an even faster rate. Over the past two or three decades or so, Islamic banking and finance has emerged as another viable way of financial intermediation, it has gained credibility and has spread worldwide. It is the fastest-growing sector of the banking industry, yet few people know much about it and hardly any finance students are being taught it. But Islamic banking's mysteries are now beginning to be unveiled. There are more than 250 Islamic banks worldwide, small fry in the global economy, but growing at an astonishing 15-20 percent a year.

Islamic banking operates in accordance with the rules of *Shariah*, known as *Fiqh al-Muamalat* (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of *ribá* (interest). Among the common Islamic concepts used in Islamic banking are profit sharing, safekeeping, joint venture, cost plus, and leasing.

Principles of Islamic finance have the linkages between the issues of financial stability, and corporate social responsibility within the global business context. In Islamic finance, the transaction must be genuine with the full intention of giving and taking delivery; and the debt cannot be sold and thus, the risk associated with it cannot be transferred to someone else.

This condition set by the Islamic system would help to eliminate most of speculative transactions because financing extended through the Islamic products can expand only in step with the rise of the real economy and thereby help curb excessive credit expansion and it will also release a greater volume of financial resources for the real economic sectors and, thereby, help expand employment and self-employment opportunities and the production of need-fulfilling goods and services.

Both Muslims and non-Muslims, understand how socially responsible investing works, many are unaware of how many similarities there are between socially responsible investing and *Shariah*-compliant investing. Both use negative screens to exclude companies operating in unethical industries and both exclude largely the same types of companies. Islamic screens exclude those producing alcohol, tobacco, weapons, and gambling. Socially responsible screens generally exclude alcohol, tobacco, weapons, meat processing, gambling, "exploitative" financial services like payday lenders, and those companies with poor labour and environmental records. The similarities are so great because both are looking at a double bottom line: creating profits and avoiding social harm. Islamic finance has potential to grow in popularity among non-Muslims who are looking to invest ethically by the ethical underpinnings of Islamic finance.

Islamic finance prevents selling something you do not own. Practical implications include limitations on the use of derivatives and short selling is generally not accepted – the dangers of which were exposed at this current crisis. Pure speculation and gambling are prohibited. In Islamic finance, the transaction must be genuine with the full intention of giving and taking delivery; and the debt cannot be sold and thus, the risk associated with it cannot be transferred to someone else. Islamic finance model can also reduce the problem of subprime borrowers by providing them loans at affordable terms. This will save billions of dollars that are spent to bail out the rich bankers.

The remainder of this paper is organised as follows. Section 2 provides what is Islamic finance? Section 3 will discuss Islamic finance perspective – what does the Islam say? Section 4 concludes the paper.

2. What is Islamic finance?

2.1 Introduction

Islamic finance started as a small cottage industry in some Arab countries in the late 1970s. It distinguishes itself from conventional finance in its ostensible compliance with principles of Islamic law, or *Shariah*[1] (El-Gamal, 2006). Its growth has been accelerating ever since, in terms of the number of countries in which it operates, as well as the areas of finance in which it has ventured. However, reliable data are not available on Islamic finance at the country, regional, or global levels. In recent years, the industry has attracted a number of Western multinational financial institutions, such as Citigroup and HSBC, which started offering Islamic financial products in some Arab countries (notably, Bahrain and the UAE), and to a lesser extent in the Western world (including the USA and UK, where HSBC offers various Islamic financial products in New York and London, including home financing, checking accounts, etc.). A number of Islamic financial products also involve the acquisition of assets (e.g. real estate, and small corporations) in the west (including the USA) in “Islamically structured” financing deals.

Dusuki and Abdullah (2007) examine how Islamic banking paradigms and model is different to conventional banking. Islamic banks aim to create a fair and balanced society as prescribed by the Islamic economics. Choudhury and Hussain (2005) argue that Islamic banks have emerged since the twentieth century and they rely on the resources based view to offer banking services. All financing instruments are based on the *Shariah* law. The main tenets of Islamic banking include the prohibition of interest and profit sharing. Ghannadian and Goswami (2004) confirm this by stating that the main Islamic banking principles are risk and profit sharing. Other authors such as Pollard and Samers (2007) also emphasise on the prohibition of interest and the absence of interest in all lending.

Islamic finance relies crucially on three sets of individuals with complimentary skills:

- (1) Financial professionals who are familiar with conventional financial products, as well as the demand for “Islamic” analogues of those products within various Muslim communities around the world.
- (2) Islamic jurists (*fuqha* or experts on classical jurisprudence developed mainly between the eighth and fourteenth centuries), who help Islamic financial providers to find precedent financial procedures in classical writings, upon which contemporary analogues of conventional financial products can be built.
- (3) Lawyers who assist both groups in structuring Islamic analogue financial products, while ensuring their compliance with all applicable and relevant legal and regulatory constraints.

Owing to the industry’s small size, a limited number of key players in each of those three categories have emerged as clear leaders.

2.2 Historical roots of Islamic finance

In the late nineteenth century, the Ottomans introduced Western-style banking to the Islamic world to finance their expenditures. While some Islamic jurists approved of modern banking practices, the majority found those practices to be violations of Islamic prohibitions against usury (Arabic term: *riba*, equivalent to the Hebrew *ribit*,

and interpreted in its classical Biblical sense of any interest charge on loans, as opposed to the modern identification of usury with exorbitant interest). This resentment continued through the European colonial period, which lasted into the mid-twentieth century. Islamic revival played a central role in the intellectual and social foundations of independence movements of the mid-twentieth century. To many intellectual founders of the movement, political independence was to be supplemented with economic independence, through the definition of an Islamic economic system (Kahf, 2002).

Early writings on what came to be known as “Islamic economics” focused on macroeconomic developmental issues. By the 1970s, theoretical discussions of Islamic economics had given rise to practical discussions of Islamic finance, which turned juristic in nature: how can Muslims replace (conventional) financial practices (deemed to be usury/*riba* based) with Islamic alternatives. Mid-century literature suggested a PLS silent partnership alternative to interest-based lending. The Arabic name of this contract is *mudaraba*, which is akin to the medieval European *Commenda* contract, and the Jewish *Heter Isqa*, designed similarly to avoid usurious lending in Jewish and early Catholic Law[2] (El-Gamal, 2006). This partnership-based focus survives in some Islamic financial practices (e.g. as a substitute for interest-bearing bank deposits). However, with the help of Islamic jurists and lawyers, Islamic financial practitioners were soon able to provide close analogues to almost all financial products, including various debt instruments and fixed-income investment vehicles. The paper shall summarise some of the most widely used Islamic financial modes of operation in Section 2.3.

2.3 Modes of operation in Islamic finance

Islamic finance has been successful in balancing financial structures with core Islamic principles. This section examines how structural balance has been achieved so far and suggests that a collaborative model will be needed to scale greater heights. The heart of practice of Islamic finance is compliance with religious beliefs. This compliance translates itself in various aspects of operations, products, and service delivery of financial services. In day-to-day handling, compliance manifests across three broad dimensions: structure, process, and documentation.

2.3.1 *Consumer and business loan alternatives.* The juristic-based understanding of forbidden *riba*/usury suggested that Islamic finance has to be “asset based”, in the sense that one cannot collect or pay interest on rented money, as one does in conventional banking. Therefore, the easiest transactions to Islamize were secured lending operations, e.g. to finance the purchase of real estate, vehicles, business equipment). Three main tools are utilized for this type of retail financing.

2.3.1.1 Buy-sell-back arrangements given the classical Arabic name: *murabaha*. Under this transaction, the bank obtains a promise that its customer will purchase the property on credit at an agreed-upon mark-up (interest alternative), then proceeds to buy the property and subsequently sell it to the customer. These are analogous to the Federal Reserve’s use of “matched-sale purchases”. Depending on the jurisdiction and the object of financing, this may or may not impose additional sales taxes, license fees, etc. In the UK, a recent regulatory ruling allowed Islamic financiers (HSBC) to practice double-sale financing without being subject to double-duty taxation. In 1999, at the request of United Bank of Kuwait (UBK), at which the time offered an Islamic home financing program in the USA (called Manzil USA, the program was terminated shortly thereafter), the Office of the Comptroller of the Currency issued an interpretive letter declaring *murabaha*

financing to be “functionally equivalent to or a natural outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking” (www.occ.treas.gov/interp/nov99/int867.pdf). The mark-up in *murabaha* financing is benchmarked (i.e. made to track) conventional interest rates.

2.3.1.2 Lease-to-purchase or diminishing partnership arrangements under the Arabic names *ijara* or *Musharaka Mutanaqisa*. A typical structure requires the bank to create a special purpose vehicle (SPV) to purchase and hold title to the financed property. The SPV then leases the property to the customer, who makes monthly payments that are part-rent and part-principal. Rents are calculated based on market price. The juristic justification of this practice is that principal parts of monthly payments increase the customer’s ownership in the property, and allow him to pay less rent (on the part ostensibly owned by the bank through the SPV) over time, at the request of UBK, the Office of the Comptroller of the Currency examined the typical structure of Islamic lease-to-own (*ijara*) transactions, and reasoned as follows (www.occ.treas.gov/interp/dec97/int806.pdf):

Today, banks structure leases so that they are equivalent to lending secured by private property [...] a lease that has the economic attributes of a loan is within the business of banking [...]. Here it is clear that UBK’s net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender [...].

An added advantage to lease financing is that Islamic jurists allow the SPV to issue certificates securitizing the lease (ostensibly, the certificates represent ownership of the underlying asset, and thus allow their holders to collect rent). In recent years, this has given rise to a booming securitization industry in Islamic finance, as we shall discuss within the context of bond-alternatives. In the USA, both Fannie Mae and Freddie Mac have purchased and guaranteed *ijara*-based mortgages, subject to their note requirements (which required overcoming some legal and juristic hurdles) (El-Gamal, 2006). Those Islamic mortgage-backed securities are currently being marketed as fixed-income investment alternatives for Muslims.

2.3.1.3 Recently, banks in Gulf Cooperation Council countries have been offering consumer finance through a three-party contract known by the Arabic name *Tawarruq* (literally: monetization of some commodity). This is a practice that Islamic banks have used with more sophisticated business clients for a number of years, but only recently introduced for consumer financing. For example, a customer wants to borrow £1,000 using an Islamic juristic-compliant mechanism. Gulf Cooperation Council (GCC) Islamic jurists, relying on an opinion within the *Hanbali* school of jurisprudence, which is dominant in that region, allow the bank to buy £1,000 worth of commodities (e.g. wheat), and sell them to the customer on credit at a mark-up (equal to the interest rate they would have charged on a loan, perhaps plus compensation for the transaction costs associated with multiple sales). The customer may then turn around and sell the commodity to a third party (oftentimes, the same party that sold it to the bank), collecting the desired cash immediately, with a deferred debt equal to principal plus interest. In 2004, at least one other bank in a GCC country announced a new *Tawarruq* facility. Since this type of financing can easily replace lending for any purpose (consumer loans, unsecured loans, etc.), it has allowed a number of conventional banks to announce that they will “Islamize” all of their operations. The most significant announcement was that made by Saudi Arabia’s National Commercial Bank, stating that it planned to Islamize all of its lending practices by 2005.

2.3.2 *Corporate and government bond alternatives.* In its early stages of development in the 1980s and 1990s, a number of bond alternatives were tried with very limited success. Some were based on PLS (e.g. in Sudan and Pakistan), while others guaranteed the principal but did not guarantee a fixed rate of return (e.g. in Malaysia). Once the securitization of leases (discussed in the previous section) became fully understood, a significant number of corporate and government bonds were structured as lease-backed securities (under the Arabic name *Sukuk al-Ijara*)[3].

In 2004, the largest issuance was by the Department of Civil Aviation of the UAE for \$750 million. The second largest was by the Bahrain Monetary Agency for \$250 million. The latter was led by Citigroup, with heavy involvement of the Norton Rose law firm to structure the deal. A third interesting government issuance was by the German Federal State of Saxony-Anhalt for €100 million, which is heavily marketed in the Arab countries of the GCC as the first Western-government issued Islamic bond. The two largest corporate Islamic bond issuances in the first half of 2004 were those of the National Central Cooling Company (of UAE) for \$100 million and Hanco Rent a Car in Saudi Arabia for \$26.13 million (El-Gamal, 2006).

Corporate bond issuances in the early part of 2006 totalled \$10.2 billion, the most notable being the Dubai Ports issuance of the largest *sukuk* to date, a two year convertible \$3.5 billion bond (PLS) which managed by Dubai Islamic Bank and Barclays Bank. In 2005, an estimated \$11.4 billion in corporate *sukuks* were issued, up from \$5.5 billion and \$4.6 billion in 2004 and 2003, respectively. Sovereign issuances in 2006 total \$2.7 billion thus far, up from \$706 million in 2005, \$1.5 million in 2004, and \$1.2 million in 2003.

A number of those issuances were made by SPVs, which buy some properties from the respective governments or corporations using bond-sale proceeds, and then lease the properties back, passing principal and interest back to bond holders in the form of rent. A number of different US and European investment banks are involved in the securitization process (e.g. Citigroup for the Bahraini and German state bonds, Credit Suisse First Boston for the UAE cooling company, and Barclays Bank with the Dubai Islamic Bank for the Dubai Ports Co.) (El-Gamal, 2006).

Lease-backed bonds are long-term securities, for which underlying physical assets allow secondary markets to exist. Shorter-term bonds are also issued on occasion by governments of countries with significant Islamic banking operations (e.g. Bahrain). Those are typically based on forward sales of some commodities, using the Arabic name *salam*, and adhering to the classical juristic ruling that price must be paid in full at the inception of a *salam* sale. By utilizing what is called a “parallel *salam*”, the bond issuer can match a forward purchase with a purchase sale for the same commodities and the same delivery date, but initiated at different times. Thus, corn deliverable in six months can be sold forward today for \$1 million, and then bought forward in three months (using a separate contract with a different counterparty) for \$1.01 million. While residual credit, commodity, and delivery risks may exist in this structure, issuers typically guarantee the contract so that the bond buyers would – in our example – be guaranteed 1 percent in three months. Since the underlying assets for this type of bond are debts, Islamic jurists ruled that they cannot be traded on secondary markets (except at face value, which defeats the purpose). Thus, they were originally envisioned as vehicles primarily for Islamic banks to hold to maturity. Recently, however, Bahrain has introduced some innovative repurchase facilities, to allow Islamic banks to use those bills more effectively for liquidity management.

2.3.3 *Investment vehicle alternatives (e.g. mutual fund, private equity)*. For investment in corporate equity, it was easy to see why Islamic investors should shy away from companies that produced products that are forbidden to Muslims (e.g. beer, pork products), as well as some others that Islamic jurists decided to forbid (e.g. weapons producers). The issue of interest was much more difficult. Most companies either have excess liquidity – in which case they earn interest, or use leverage – in which case they pay interest. Islamic jurists decided to invoke the rule of necessity (the universe of equity securities to choose from would be too small if they exclude all companies that either pay or receive interest). They decided to impose three financial screens:

- (1) exclude companies for which accounts receivables constituted a major share of their assets;
- (2) exclude companies that had too much debt; and
- (3) exclude companies that received too much interest.

After experimentation with different cutoff marks for financial ratios, the set of rules selected by the Dow Jones Islamic indices became globally accepted:

- exclude companies whose receivables accounted for more than 45 percent of assets;
- exclude companies whose debt to moving average of market capitalization exceed 33 percent, many add a third rule related to the first; and
- exclude companies whose interest income exceeds 5 percent (or, for some, 10 percent) of total income (El-Gamal, 2006).

Dow Jones, and later Financial Times, launched their Islamic indices in the late 1990s, and continue to add various other Islamic indices paralleling their other conventional indices, with the smaller universe of equity securities. Mutual fund companies either mimic their screening rules, or obtain licenses from one of the indices, which they use as a benchmark. These types of mutual funds are usually called “Islamic” or “*Shariah*-compliant”. While sales of mutual funds in general have done well in Saudi Arabia and GCC markets, Islamic mutual funds seem to have only a limited marketing advantage over conventional ones.

On the other hand, growing unanimity over the general screens used by Islamic mutual funds has enabled Islamic private equity and investment banking boutiques to thrive. Those institutions typically collect investor funds in GCC countries (investors from Saudi Arabia, Kuwait, and UAE being primary sources of funds). Through local subsidiaries or partners in the west (the USA and the UK being primary destinations for investment funds), collected funds are used to acquire real estate and small companies that pass the above-mentioned screens, or whose debt can be restructured to pass them (oftentimes through lease-based leveraged buy-outs, a popular Western mergers and acquisitions tool of the 1980s and 1990s). There are 134 registered equity funds, six hybrid funds, six *sukuk* funds, two *Takaful* funds (insurance), five leasing funds, and eight real estate funds (as of February 2006, www.failaka.com).

2.3.4 *Insurance alternatives*. The vast majority of Islamic jurists declared the use of, and investment in, insurance companies to be impermissible under Islamic jurisprudence. This prohibition is based on two considerations: the first consideration is that “safety” or “insurance” is not itself viewed as an object of sale in classical

Islamic jurisprudence. Thus, Islamic jurists argued, the insured-insurer relationship is viewed to be one akin to gambling, wherein the insured as buyer pays periodic premium as price, but may or may not receive the object of sale or compensation in case of loss, depending on chance. The second consideration that prompted Islamic jurists to forbid insurance is the fact that insurance companies tend to concentrate their assets in interest-based instruments such as government bonds and mortgage-backed securities.

The alternative they proposed is marketed under the Arabic name *Takaful*, which has recently begun making inroads in Islamic countries, after years of slow growth. The main idea behind *Takaful* is similar to mutual insurance, wherein there is no commutative financial contract that allows one to interpret premium payments as prices and insurance claim fulfillment as an object of sale. Rather, policy holders are viewed as contributors to a pool of money, which they agree voluntarily to share in cases of loss to any of them. Early *Takaful* companies were in fact structured as stock insurance companies, but the language of “voluntary contribution” to insurance claimants was used to argue that the contract was not a commutative one. Inroads have recently been made by Bank Al-Jazira of Saudi Arabia by modifying its insurance to better approximate Western-style mutual insurance, and the model appears to be boosting its underwriting success. Regardless of structure, both types of *Takaful* companies do not invest in conventional government bonds and fixed-income securities. However, as seen elsewhere in this section, Islamized analogues of those securities have become increasingly available in recent years, further contributing to the industry’s growth. Despite the industry’s growth, it has not yet reached a critical size that would support the equivalent of re-insurance, or “re-*Takaful*”, companies to emerge. Consequently, Islamic jurists have invoked the rule of necessity to allow *Takaful* companies to sell their risks to conventional re-insurance companies, with the provision that they should work to develop a re-*Takaful* company as soon as possible.

2.3.5 Bank deposit and fixed income security alternatives. In the Islamic world, Islamic banks can only accept fiduciary deposits, for which they cannot pay interest, since interest would be considered usury/*riba* once the principal is guaranteed. On the other hand, they are allowed to accept “investment account” funds, which they may invest on behalf of the account holders, and share profits and losses thereof. This clearly gives rise to a moral hazard problem, and a regulatory issue regarding protection of investment account holders who are neither protected as creditors (first claimants), nor as stock-holders with representation on boards of directors. Attempts by significant juristic bodies to justify interest-bearing bank deposits have been strongly rejected by most Islamic jurists, especially the ones to whom Islamic bank customers look for guidance (El-Gamal, 2004).

2.4 Principles of Islamic finance

The beliefs of Islam encompass all aspects of a Muslim’s life, determining the articles of their faith and the relationships between man and God, and between human beings. They also determine their moral and behavioural code, as well as giving the framework for their daily activities. Islamic law or *Shariah* – as revealed in and derived from the Quran and Sunnah (the sayings and practices of the Prophet Muhammad) – governs all economic and social activities and undertakings of Muslims.

The Islamic economic model has been developed over time, based on the rulings of *Shariah* on commercial and financial transactions. The Islamic financial framework,

as seen today, stems from the principles developed within this model, some of which are outlined below (Ainley *et al.*, 2007):

- The Islamic economic model emphasises fairness. This is reflected in the requirement that everyone involved in a transaction makes informed decisions and is not misled or cheated. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific *Shariah* rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society (www.islamic-banking.com/ibanking/whatib.php).
- Islam encourages and promotes the right of individuals to pursue personal economic well being, but makes a clear distinction between what commercial activities are allowed and what are forbidden. For example, transactions involving alcohol, pork-related products, armaments, gambling, and other socially detrimental activities.
- One key *Shariah* ruling on economic activities of Muslims is the strict and explicit prohibition of *riba*, most usually described as usury or interest. *Shariah* scholars consider exchanging interest payments within the conventional banking system as a type of *riba*. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct (the right to use an asset), for example, rental income (Bahrain Monetary Agency, 2002).

3. Discussion the link between the global crisis and Islamic finance model

3.1 *The root and the primary cause of the crisis*

It is not possible to design a new architecture without first determining the primary cause of the crisis. The generally recognized most important cause of almost all crises has been excessive and imprudent lending by banks over a long period.

This raises the question of what makes it possible for banks to resort to such an unhealthy practice which not only destabilises the financial system but is also not in their own long-run interest. There are three factors that make this possible. One of these is inadequate market discipline in the financial system resulting from the absence of PLS. The second is the mind-boggling expansion in the size of derivatives, particularly credit default swaps (CDSs), and the third is the “too big to fail” concept, which tends to give an assurance to big banks that the central bank will definitely come to their rescue and not allow them to fail (www.newhorizon-islamicbanking.com/index.cfm?section=academicarticles&action=view&id=10733).

3.2 *The subprime mortgage crisis*

The subprime mortgage crisis, in the grip of which the USA finds itself at present, is a classical example of excessive and imprudent lending. Securitization or the “originate-to-distribute” model of financing has played a crucial role in this. The creation of CDOs by mixing prime and subprime debt made it possible for mortgage originators to pass the entire risk of default of even subprime debt to the ultimate purchasers who would have normally been reluctant to bear such a risk. Mortgage originators had, therefore, less incentive to undertake careful underwriting. Consequently, loan volume gained greater

priority over loan quality and the amount of lending to subprime borrowers and speculators increased steeply. In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly. The check that market discipline could have exercised on the serving of self-interest did not come into play. Even the supervisors failed to perform their task effectively by not taking serious notice of the unfair practices at an early stage and nipping them in the bud.

The result is that a number of banks have either failed or have had to be bailed out or nationalized by the governments in the USA, the UK, Europe, and a number of other places. This has created uncertainty in the market and prolonged the credit crunch, which made it hard for even healthy banks to find financing. There is a lurking fear that this might be only the tip of the iceberg and a lot more may follow if the crisis causes a prolonged recession and leads to defaults on the part of credit card institutions, corporations, and derivatives dealers.

When there is excessive and imprudent lending and lenders are not confident of repayment, there is an excessive resort to derivatives like CDSs to seek protection against default. The buyer of the swap (creditor) pays a premium to the seller (a hedge fund) for the compensation he will receive in case the debtor defaults. If this protection had been confined to the actual creditor, there may not have been any problem. What happened, however, was that hedge funds sold the swaps not to just the actual lending bank but also to a large number of others who were willing to bet on the default of the debtor. These swap holders, in turn, resold the swaps to others. The whole process continued several times.

3.3 What does the Islam say? The Islamic financial system

One of the most important objectives of Islam is to realise greater justice in human society. According to the Quran, a society where there is no justice will ultimately head towards decline and destruction (Quran, 57:25). Justice requires a set of rules or moral values, which everyone accepts and faithfully complies with. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions based on moral values. One of these is that the financier should also share in the risk so as not to shift the entire burden of losses to the entrepreneur, and the other is that an equitable share of financial resources mobilised by financial institutions should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities and, thus, help reduce inequalities of income and wealth.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. For this purpose, one of the basic principles of Islamic finance is "no risk, no gain". This should help introduce greater discipline into the financial system by motivating financial institutions to assess the risks more carefully and to effectively monitor the use of funds by the borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the system, and go a long way in reducing excessive lending.

Islamic finance should, in its ideal form, help raise substantially the share of equity and PLS in businesses. Greater reliance on equity financing has supporters even in mainstream economics.

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all the financial needs of individuals, firms, or governments cannot

be made amenable to equity and PLS. Debt is, therefore, indispensable, but should not be promoted for nonessential and wasteful consumption and unproductive speculation.

For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing (*murabaha*, *ijara*, *salam*, *istisna*, and *sukuk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his/her ability to make the payment later. It has, however, laid down a number of conditions, some of which are (www.newhorizon-islamicbanking.com/index.cfm?section=academicarticles&action=view&id=10733):

- The asset which is being sold or leased must be real, and not imaginary or notional.
- The seller or lessor 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.
- The debt cannot be sold and thus the risk associated with it must be borne by the lender himself.

The first condition will help eliminate a large number of derivatives transactions which involve nothing more than gambling by third parties who aspire to claim compensation for losses which have been actually suffered only by the principal party and not by them.

The second condition will help ensure that the seller (or lessor) also shares a part of the risk to be able to get a share in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. This condition also puts a constraint on short sales, thereby removing the possibility of a steep decline in asset prices during a downturn. The *Shariah* has, however, made an exception to this rule in the case of *salam* and *istisna* where the goods are not already available in the market and need to be produced or manufactured before delivery. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion.

The third and the fourth conditions will not only motivate the creditor to be more cautious in evaluating the credit risk but also prevent an unnecessary explosion in the volume and value of transactions. This will prevent the debt from rising far above the size of the real economy and also release a substantial volume of financial resources for the real sector, thereby helping expand employment and self-employment opportunities and the production of need-fulfilling goods and services. The discipline that Islam wishes to introduce in the financial system may not, however, materialise unless governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability.

While a restriction on such transactions will cut the commissions earned by the speculators during an artificially generated boom, it will help them avert losses and bankruptcy that become unavoidable during the decline and lead to a financial crisis.

The injection of a greater discipline into the financial system may tend to deprive the subprime borrowers from access to credit. Therefore, justice demands that some suitable innovation be introduced in the system to ensure that even small borrowers are also able to get adequate credit. Such borrowers are generally considered to be subprime and their

inability to get credit will deprive them from realising their dream of owning their own homes and establishing their own microenterprises.

Thus, Islamic financial system is capable of minimising the severity and frequency of financial crises by getting rid of the major weaknesses of the conventional system. It introduces greater discipline into the financial system by requiring the financier to share in the risk. It links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses, and the buyer wishes to take delivery. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully. In addition, Islamic finance can also reduce the problem of subprime borrowers by providing credit to them at affordable terms. This will save the billions that are spent after the crisis to bail out the rich bankers.

4. Conclusion

Because interest-based transactions are prohibited, Islam encourages business and trade activities that generate fair and legitimate profit. In Islamic finance, there is therefore always a close link 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 which are part of the root causes of the current financial crisis.

Another fundamental principle of Islamic finance is the risk and profit-sharing feature of Islamic finance transactions (such as *Mudarabah* or *Musyarakah* contracts). It is this profit and risk-sharing feature of Islamic finance transactions that requires a high level of disclosure and transparency in the Islamic finance system. These disclosures allow the market to assign the appropriate risk premiums to companies, thereby enhancing the potential for market discipline to take effect. These features, which are required by *Shariah* (Islamic law) injunctions, provide built-in checks and balances which serve to ensure the financial stability of the Islamic finance system.

Because of these features, Islamic finance has experienced major transformations and growth especially since 2000, and its volume has reached almost \$1.5 trillion. It has been one of the fastest growing financial markets over the last five years and is expected to continue expanding at an even faster rate.

Its rapid evolution is particularly evident in four dimensions of its development. First, today Islamic finance is viewed as a competitive form of financial intermediation, drawing significant participation by non-Muslims. The total assets of the Islamic financial system have surpassed \$1 trillion, a five-fold increase over their magnitude just five years ago. Islamic finance is now among the fastest growing financial segments in the world, with an estimated annual growth of 20 percent.

Second, with the emergence of more diverse Islamic finance institutions and the development of Islamic finance markets, the scope of Islamic finance business has been expanded to include private equity, project finance, the origination and issuance of *sukuk* (bonds), and fund, asset, and wealth management activities.

The third dimension in which there has been significant evolution is in the regulatory and legal framework of Islamic finance, which is shaped by the distinct features of Islamic finance transactions. This has ensured that the growth and development of Islamic finance is accompanied by the corresponding development of this framework.

Fourth, the international dimension of Islamic finance has rapidly gained significance as it evolves to become an increasingly important part of the international financial system and as it becomes poised to contribute to greater global financial integration. The expansion of the network of links among intermediaries and markets in various regions will contribute towards a more efficient allocation of financial resources across borders and thus contribute to enhancing global growth prospects.

The consequence of the crisis could be that as Gulf sovereign funds become more important, Islamic banking could play an increasing role in global financing, its expansion relatively unaffected by the financial crisis. This, of course, does not mean that *Shariah* compliant finance can suddenly present itself as a comprehensive alternative to capitalism. Instead, the current shift in perspective in the west ought to be viewed as an opportunity for Islamic financial institutions to have joint investments with governments and other financing sources, including multilaterals, in funding the public works program to help generate economic activity.

Since the current architecture of the conventional financial system has existed for a long time, it may perhaps be too much to expect the international community to undertake a radical structural reform of the kind that the Islamic financial system envisages. However, the adoption of some of the elements of the Islamic system, which are also a part of the Western heritage, is indispensable for ensuring the health and stability of the global financial system.

Islamic finance is still in its infancy and shares a very small proportion of international finance. The use of equity and PLS is still very small while that of debt-creating modes is preponderant. The system is, thus, not fully prepared at present to play a significant role in ensuring the health and stability of the international financial system. It is, however, expected that the system will gradually gain momentum with the passage of time and complement the efforts now being made internationally for promoting the health and stability of the global financial system.

Notes

1. *Shariah* literally means “the way” and is the Arabic term for Islamic law as a way of life, comparable to the Hebrew Halachah. *Fiqh*, commonly translated as jurisprudence, is the interpretation of *Shariah* for specific circumstances by specialized *fuqha*, or jurists.
2. On *Mudaraba/Commenda*, see Udovitch (1970). On the *Isqa* (alternatively spelled *Iska*) contract, see Stern (1982). Sample *Iska* forms are available at: www.jlaw.com/Forms/iska_d.html
3. *Sukuk* is the plural of *sakk*, an Arabic precursor of cheque, meaning certificate of debt or bond.

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