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The Looming International Financial Crisis: Can the Introduction of Risk Sharing in the Financial System as Required by Islamic Finance, Play a Positive Role in Reducing its Severity?

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Abstract

The paper discusses the causes of financial crises and, in particular, the most recent one which started in 2007 and lasted for around 19 months. It argues that since one of the major causes of the crises is the unhealthy rise in international debt in recent years, it is very likely that there will be another serious crisis in the near future because the factors that enable the banks to lend excessively continue relatively unperturbed. The paper then argues whether it is possible for the healthy discipline that the fundamental principles of Islamic finance try to build into the financial system can help rein to some extent the excessive credit extension and thereby contribute to a reduction in the severity and frequency of such crises in the future.

Keywords: Islamic Finance, Financial Crisis, Financial System
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1. Introduction

The most recent international financial crisis, which started in December 2007 and lasted for around 19 months until June 2009, was far more serious than any

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experienced since the Great Depression. It swept away around 8 million jobs and led to the foreclosure of 4 million homes. It took around 18 trillion dollars or more than 30 percent of the world gross output, by a number of industrial countries, to stabilize the financial system and to revive the international economy. Regulators responded with new and tighter regulations which are in the process of being implemented. Monetary authorities cut interest rates sharply and expanded liquidity through asset purchases. Nevertheless, the adverse effects of the crisis persisted for quite some time through the continuation of economic slowdown and unemployment.

2. Need for a New Architecture

Since more than a hundred financial crises have been experienced so far since 1945, there is naturally a call for a new architecture to help minimize the frequency and severity of such crises in the future. It is, however, not possible to suggest the design of a new architecture without first analyzing the causes of the crises and, in particular, those of the most recent one. This should help us know why these crises have become an inherent feature of the conventional financial system and why it is very likely that another crisis will soon start looming on the horizon. Once the causes are known, it should become possible for us to know whether it is possible for Islamic finance to help us design some of the major ingredients for the desired new architecture.[1]

There is no doubt that the crises have a number of causes, but the generally recognized most important cause of almost all past crises has been excessive and imprudent lending by banks over a long period.[2] This raises the question of what makes it possible for banks to resort to excessive lending when this is generally recognized to be an unhealthy practice which is not only detrimental to the banks' own long-run interest but is also responsible for hurting the parent country's domestic economy and destabilizing the international financial system.

1 For some background on Islamic banking and finance, see Chapra (1985), Hassan (2016), Zaher, and Hassan. (2001), Shaikh (1997), Rosman; Abd Wahab and Zainol (2014); and Darrat (1988).

2 This was clearly recognized by the Bank for International Settlements in its 78th Annual Report released on 30 June 2008 by stating that "the fundamental cause of today's problems in the global economy is excessive and imprudent credit growth over a long period." See, Bank for International Settlements (BIS), BIS 78th Annual Report (Basel: BIS, 30 June 2008), p.3.

Even according to the G-20 Summit held on 15 November 2008, excessive leverage was indicated to be one of the root causes of "vulnerabilities in the system" (G-20 Summit (2008), "Declaration of the Summit on Financial Markets and the World Economy" (Washington D.C.: White House, 15 November).

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There are a number of factors that make it possible for banks to indulge in excessive lending. The first of these is the inadequate market discipline in the financial system resulting from the absence of risk-sharing. The second is the repeal of the Glass Stegall Act in 1999. It was passed in 1933 to prevent banks from using depositors funds for risky investments. This led to the consolidation of commercial and investment banking and the formation of big banks for whom it is relatively easier to indulge in excessive lending. The third is the ability of banks to create credit which leads to an expansion in the deposits of the banking system several times more than the primary deposits which provide the banking system's reserves held in the form of cash and deposits at the central bank.

Creation of credit is what makes it possible for banks to resort to excessive expansion of credit and it is the proportional reserve requirement which makes this possible. The excessively low rates of interest provide an incentive to borrowers to borrow excessively and to banks to offset the loss of income that the low rates cause, by lending excessively through credit creation[3]. In contrast with this, high rates of interest exacerbate debt burdens and create problems for borrowers. Within this perspective a fairer solution for business loans would be risk sharing.

The fourth factor responsible for excessive lending is the mind-boggling expansion in the amount of derivatives, particularly credit default swaps (CDSs), which help reduce the risk involved in lending and thereby encourage excessive credit expansion. The fifth is the Federal Reserve Bank's excessive commitment to liberalism, thereby leaving the market free and not doing anything significant to prevent the crisis from catching momentum. And the sixth is the "too big to fail" concept which tends to give an assurance to big banks that the central bank will come to their rescue and not allow them to fail[4].

The excessive expansion of credit along with a false sense of immunity from losses that the CDSs provide to banks has introduced a fault line in the financial system. There is a proverb in Arabic which says that "whoever is immune from punishment may do what he pleases." Banks do not, therefore, undertake a careful evaluation of the loan proposals. This leads to an unhealthy expansion in the overall volume of credit and contributes to an unsustainable rise in asset prices, living beyond means, and speculative investment. Unwinding later on gives rise to a steep decline in asset prices, and to financial fragility and debt crises, particularly if there is overindulgence in short sales. Jean Claude Trichet, President of the European

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[3] See McLeay, Radia and Thomas (2014), pp 1-8.

[4] See, Mishkin (1997), pp. 61-62.

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Central Bank from 2003 to 2011, rightly pointed out that "a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds".

The subprime mortgage crisis in the grip of which the U.S. became deeply engulfed during the period stretching from December 2007 to June 2009 is a classical example of excessive and imprudent lending. The easy availability of a vast amount of credit triggered a steep rise in home prices followed later on by a decline which promoted mortgage delinquencies, foreclosures and devaluation of housing securities. Securitization, or the "originate-to-distribute" model of financing, played a crucial role in this. The creation of collateralized debt obligations (CDOs) by mixing prime and subprime debt and then securitizing them for sale to an unknowing public 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[5].

Consequently, loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers and speculators increased steeply. According to Mr. Ben Bernanke, Chairman of the US Federal Reserve for two terms from 2006 to 2014, "far too much of the lending in recent years was neither responsible nor prudent. In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly". While the Federal Reserve failed to prevent the 'abusive, unfair or deceptive lending practices' from continuing, the budgetary deficits of the United States provided a substantial proportion of the high-powered reserves that the banks needed for such credit expansion.

Even the check that market discipline could have exercised on the serving of self-interest did not come into play. This is because there was an excessive resort to derivatives like credit default swaps (CDSs) to seek protection against default. The buyer of the swap (creditor) paid a premium to the seller (a hedge fund) for the compensation he would receive in case the debtor defaults. If this protection had been confined to only the actual creditor, there may not have been a significant problem. What happened, however, was that the hedge funds sold the swaps not to just the actual lender but also to a number of others who had not lent themselves but 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. Thus, while a genuine insurance contract indemnifies only the actually insured party, in the case

[5] See, Mian and Sufi, (2008) ; see also, Keys, Mukherjee, Seru and Vig (2008).

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of CDSs there were several swap holders who had to be compensated. This accentuated the risk and made it difficult for the hedge funds and banks to honour their commitments.

The notional amount of all outstanding derivatives is estimated by the Bank for International Settlements to have risen to $683.7 trillion in June 2008, more than 47 times the size of US GNP of $14.5 trillion and 12 times the size of the gross world GNP of $54.3 trillion in 2007.[6] No wonder Warren Buffett described derivatives as "financial weapons of mass destruction." The result was that a large number of banks either failed or had to be bailed out or nationalized by the governments in the US, the UK, Europe and a number of other countries[7]. Without such bailing out by the authorities, the international financial system may have become destabilized with adverse effects on the world economy. To avoid such bailing out at the ultimate expense of the tax payers , it is crucial that the central banks keep a close eye on what is going on and take appropriate action in time to avert the disaster.

3. The Islamic Financial System

Within the framework of this background, it may be easier for the reader to appreciate the reform that Islam wishes to introduce in the financial system. The principal pillar of the reform is the imperative of risk-sharing so that the lender and the borrower both share in the risks of banking. 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. Moreover, Islam does not allow the sale of something, which the seller does not own and possess. This removes the possibility of short sales, which increase unnecessarily the volume of sales during a downturn and create an unhealthy decline in the price of assets involved.

Islamic finance should, in its ideal form, help raise substantially the share of equity and profit-and-loss sharing (PLS) in businesses. Greater reliance on equity financing has supporters even in mainstream economics. Prof. Rogoff of Harvard University states that "in an ideal world, equity lending and direct investment would play a much bigger role." He further asserts that "with a better balance between debt

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[6] For derivatives, see Bank for International Settlements (BIS) (2008), p.20; and for the world GDP, see the World Bank (WDI) (2008).

[7] See Antoniades (2015).

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and equity, risk-sharing would be greatly enhanced and financial crises sharply muted”.

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, unavoidable. It should *not*, however, be promoted for nonessential and wasteful consumption and unproductive speculation, and should not rise beyond the ability of the borrower to repay. For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing on the basis of interest. If it is without interest then it is called *qarḍ ḥasan* and is encouraged as an act of virtue. In general the creation of debt which is not *qarḍ ḥasan* will in Islamic finance be through the sale of real assets by means of its sales-based modes of financing. 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:

a) The asset which is being sold must be real and not imaginary or notional;
b) The seller must own and possess the goods being sold;
c) The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and
d) The debt cannot be sold and, thus, the risk associated with it must be borne by the lender himself instead of being shifted to an unknowing third person.

The first condition that the asset being sold must be real should 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 by only the principal party and not by them.

The second condition that the seller must own and possess the goods should help ensure that the seller 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, he 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 Sharī‘ah has, however, made an exception to this rule in the case of *salam* and *istiṣnā‘* where the goods sold are not already available in the market and need to be produced or manufactured before delivery. If a seller cannot sell what he does not own and possess, then how can a bank lend what it does not have. This would require regulation of credit creation by banks. It would also help induce them to increase the mobilization of deposits to be able to lend more Financing extended through the

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Islamic modes can thus expand only in step with the rise of the real economy and increased deposit mobilization. This should help curb excessive credit creation which is generally agreed to be the primary cause of excessive lending and financial crises.

The third and the fourth conditions that the transaction must be a genuine trade transaction and that the debt cannot be sold 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 debt transactions. This will release a substantial volume of financial resources for the real rector and thereby help expand employment and self-employment opportunities. It will also help put a brake on the governments' borrowing from the central bank and thereby bring government borrowing to a level that is in harmony with the goal of economic and financial stability. Mian and Sufi (2014) have argued that mortgage contracts built on the principle of risk-sharing would have prevented the housing bubble from emerging in the US in the first place. The inability to borrow excessively could have also helped inject greater discipline in government spending .

4. Contribution of Government Budgetary Deficits to the Rise in Private Credit

If the discipline that Islam wishes to promote had prevailed in the U.S., it may not have become engulfed in the difficult position that it did recently. The U.S. has been suffering from continued budgetary deficits for a long time. Over the last 75 years (1940-2014), the U.S. has had budgetary deficits over 63 years and surpluses over only 12 years, contributing to a net cumulative deficit of $11,401.3 billion which is 63.5 percent of the U.S. GDP of $17,947.0 billion in 2015. While these budgetary deficits have helped the US economy and society in different ways, they have not only shifted the burden of the present generation to the future but also provided high-powered reserves to banks in the U.S as well as other countries. Along with the budgetary deficits of other countries, these reserves will make it possible for banks to continue their excessive lending which is now generally recognized to be a major cause of financial crises. There is very little likelihood that the U.S. budgetary deficits will decline in the near future because of the unemployment problem, the generous promises made to the electorate by the candidates during the election campaign, the associated need to increase spending for raising the rate of economic growth necessary to fulfill these promises, and the general reluctance of governments to raise taxes. The deficits of other industrial countries are also likely to continue.

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These deficits will give rise to a boost in the reserves of banks around the world and enable them to increase their lending to both the public and private sectors. This may make it even more difficult to control financial crises. However, it is heartening to note that governments around the world have adopted a number of regulatory responses to prevent the recurrence of crises in the future or reduce their intensity if they do happen to occur again. Time alone will indicate whether these regulatory responses are adequate to prevent the occurrence of crises in the future without removing the principal weakness of the financial system which is the absence of risk sharing.

5. The Potential of Islamic Finance

The Islamic financial system carries the potential of helping reduce the severity and frequency of financial crises by getting rid of the major weaknesses of the conventional system. Firstly, it introduces a moral dimension into the financial system, which can help check some of the unscrupulous ways in which lending and borrowing have tended to expand, particularly during the period 2007-2009. Secondly, it introduces greater discipline into the financial system by requiring the financier to share in the risk. Thirdly, 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 not only owns but also possesses and the buyer wishes to take delivery. Fourthly, it requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby helping ensure that he evaluates the risk more carefully.

Islamic finance is, however, still in its infancy[8]. The first full-fledged Islamic bank was the Dubai Islamic Bank established in 1985 while the conventional financial system has been in existence for nearly 200 years. There has, however, been a relatively rapid progress since then. The latest available data indicate tentatively that the total assets of all Islamic banks amounted to $1.8 trillion in 2015. Islamic finance thus shares a relatively very small proportion of the total assets of not only all international commercial banks but also of all commercial banks in Muslim countries.[9] It, however, continues to make substantial progress by growing at around 15 per cent per annum. It is generally expected that the system will continue to maintain its growth momentum for at least sometime in the near future and thus be strong enough to complement, at least to some extent, the efforts now

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8 See Chapra (1985), Hassan (2016), Zaher and Hassan. (2001), pp155–99, Shaikh (1997) pp 117–27, Rosman, Abd Wahab, and Zainol (2014) pp. 76–90.

9 The world's largest bank (The Industrial and Commercial Bank of China) had assets of $ 3.21 trillion, and the world's ten largest banks had total assets of 24.2 trillion (data accessed on 28 March 2017 through the internet).

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being made by the saner elements around the world to promote the health and stability of the global financial system.

The significance of Islamic banking should not, however, be gauged from its small size at present or even in the near future. It lies rather in the concept of risk sharing which, if adopted internationally, carries the potential of helping control excessive lending by banks in general and thus helping reduce the magnitude and frequency of financial crises. This has become vindicated to a certain extent by the performance of Islamic banks during the 2007-2008 crisis when all of the Islamic banks were able to survive even though their income was affected as a result of the economic decline. However, those in the GCC countries were even able to enhance their credit growth relative to conventional banks.

6. Activation of Some Common Elements of Both Systems

The activation of some of the generally accepted 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. These are:

a) The proportion of equity in total financing needs to be increased and that of debt reduced.
b) It is important to ensure that the credit extended to any borrower does not exceed the ability of that borrower to repay.
c) Credit needs to be confined primarily to transactions that are related to the real sector so as to ensure that credit expansion moves more or less in step with the growth of the real economy and does not promote destabilizing speculation.
d) Islam does not allow the sale of debt. This should help motivate the lenders to evaluate their credit extension more carefully and thus help reduce the excessive expansion of debt. However, if the debt instruments, and in particular collateralized debt obligations (CDOs), are to be sold in the conventional system, then there should be full transparency about their quality so that the purchaser knows exactly what he is getting into. It would also be desirable to have the right of recourse for the ultimate purchaser of the CDOs so as to ensure that the original lender has an incentive to evaluate the debt carefully.
e) While there may be no harm in the use of credit default swaps to provide protection to the lender against default, it needs to be ensured that the swaps do not become instruments for wagering. Their protective role should be confined to only the original lender and should not cover the other

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purchasers of swaps who wish to wager on the debtor's default. For this purpose the derivatives market needs to be properly regulated to remove the element of gambling in it.

f) All financial institutions, and not just the commercial banks, need to be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk. This is necessary because individuals and firms often lose sight of the systemic risks they are creating in their effort to maximize their profit,

g) Respite needs to be given, in accordance with the teachings of Islam and a number of other religions and value systems[10], to debtors who are in strained circumstances. This will help avoid the causing of misery and agony to them by auctioning off their assets at heavily discounted prices at a time when a recession is prevailing in the economy and making it difficult for the borrowers to repay. The giving of respite to such debtors could have also helped reduce the rapid downward slide in asset prices caused by the forced auction of their assets at heavily reduced prices for the benefit of the creditors and bargain hunters.[11] The respite could have even helped dampen the severity of the recession to some extent.

7. Prognosis for the Future

If most of the reforms indicated above do not get internalized in the conventional financial system, it is very likely that the future crises may turn out to be more severe than any experienced in the past. This is because, while the trillions of dollars of liquidity injected into the economy have helped overcome the recent crisis and revive the economy, they have also increased the reserves of banks. These reserves will make it possible for the banks to lend more extensively, giving boost to the familiar cycle of excessive lending followed by a rise and then fall in asset prices, leading ultimately to a recession. The additional liquidity that has been injected into the economy has already been a major factor in more than doubling the cash assets of U.S. commercial banks to around $ 10.6 trillion in 2015 from $ 5 trillion in the year 2004. This will enable the banks to lend even more aggressively, particularly when

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10 The Qur'ān specifically states, "If he [the debtor] is in strained circumstances, then give him respite until ease comes. However, if you forgive the loan, then it is better for you" (al-Qur'ān, 2:280). See also Bible (Luke, 7: 41-43)

11 The conventional financial system seems to be biased in favour of the creditor without due concern for the debtor even when his inability to repay on time is not necessarily due to his own fault. It is rather the result of a recession, which has engulfed the whole economy. In such a situation, why should it be only the debtor to suffer and the creditor to go scot-free. All that is required of the creditor is to give some respite to the debtor until ease comes.

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interest rates are also at their lowest level and the banks' senior management is pushing for higher salaries and bonuses. Such lending is likely to generate the well-known phenomenon of an asset price boom followed by a crisis necessitating once again the pumping of further liquidity into the system to overcome the crisis.

Therefore, instead of relying primarily on the standard monetary policy instruments, the more desirable approach would be to concurrently introduce greater discipline into the financial system to check excessive and imprudent lending. The *Economist* magazine had rightly observed recently that "the world needs new ways of thinking about finance and the risks it involves." The Bank for International Settlement has also made a similar observation by emphasizing the introduction of a 'new normal' in financial markets. It is here that risk-sharing required by the Islamic financial system can make a valuable contribution to the international financial system.

Adoption of the risk-sharing principle carries the potential of playing a positive role in reducing the excessive lending by banks. This should help contain the severity of the financial crisis that is looming large in the horizon as a result of the bulge in reserves that persistent fiscal deficits of the US and other major industrial countries are providing to international banks. The extra reserves carry the potential of enabling these banks to expand their credit excessively at a time when interest rates are also low and the banks desire to use these extra reserves to expand credit to be able to meet, among other things, their senior management's demand for higher salaries and bonuses and their shareholders' demand for higher dividends. The result of this is not difficult to visualize. Credit will probably continue to expand excessively and the future crises may consequently tend to be more severe than the recent one unless a discipline is introduced into the financial system by means of risk-sharing which is one of the main characteristics of Islamic finance.

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