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Islamic Finance & Securitization Law Would Islamic Finance Have Prevented The Current Global Financial Crisis?

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1. INTRODUCTION

The recent financial crisis has encouraged a wide range of individuals to consider whether or not different financing methods could, potentially, have prevented the crisis from taking place, or might have reduced the effects of the crisis, once it had happened. One of the areas of finance that has attracted attention, in recent years, is that of Islamic finance and the equity-based Sharia banking system, which is seen as being an alternative way of running a banking system which may be preferable to the conventional system, when it comes to managing risky situations

Before looking in any detail at the various components of the Islamic finance system and the way in which it could, potentially, assist in maintaining economic stability as well as being socially beneficial, a brief background to what is meant by Islamic financing will be undertaken. It is also noted that the recent financial crisis has given the Islamic financial system an opportunity to expand and attract many other individuals who had not previously looked at Islamic finance as a realistic option.

Fundamentally, the rules associated with Islamic financing are considerably stricter and this, in itself, may attract a wide range of investors who have been somewhat deterred by the lax lending standards associated with the more conventional banking system.

The Islamic finance system was practically unheard of 30 years ago, whereas now it is estimated that Islamic assets have a globally combined value of around $1 trillion (as estimated by the Asian Development Bank). Not only is this a substantial slice of the financial market, but it is also growing at a rate of 10 to 15% per year, indicating that there are certain benefits associated with the Islamic finance system, which have now been recognised by investors, in general, and not simply by those who have a religious affiliation with the system.

The Islamic system of finance prohibits paying interest and every transaction is linked to an asset, thus removing some of the key areas that have caused major difficulties in the conventional finance systems. Although it is completely acceptable for the Islamic finance systems to make a profit, the entire system works in a way that avoids excessive risk taking and is, therefore, a particularly popular choice in the current climate. This is because interest cannot be part of an Islamic finance system, so systems are developed that will allow depositors to have a share of the profit; therefore, instead of being mere investors, these individuals also become shareholders.

There is no denying that the Islamic finance system offers an alternative option and, in the current economic crisis, it is unsurprising that consideration is being given to a finance system that seems to mitigate many of the issues which created the difficulties in the traditional system.

Financial Economy vs. Real Economy

A clear distinction exists between a financial economy and the real economy, which needs to be understood in order to appreciate fully how the recent financial crisis has occurred and also to consider whether or not Islamic finance could, potentially, have prevented the current crisis. The financial economy is, in effect, a fake economy, as it does not involve the production or making of any goods. By contrast, a real economy involves the production of goods or some form of physical labour process.

The financial economy has been particularly difficult to control, in recent times, as it often involves several financial transaction, but with no underlying assets. This type of financial transaction is not allowable under Islamic finance as there has to be an underlying asset whenever transactions are taking place.

Central banks will always recognise the fact that financial stability is central to ensuring long-term strong performance as, when there is financial stability, there will be consumer confidence and there are likely to be more transactions taking place.

Despite this, many of the financial measures used by the central banks look at issues such as inflation and growth which actual links to the real economy creating a discrepancy between what is actually happening, what is being measured and the effect it is having on the economy, as a whole.

Although the importance of financial stability has always been recognised, it has not always taken precedence in the minds of the central banks and the use of other performance measures. However, more recently, and in the wake of the last financial crisis, financial stability has, once again, become much more relevant and the financial markets are under scrutiny, once more.

The importance of the financial economy has also increased slightly, in recent years, with considerably more products being made available, such as derivatives, many of which have no relation to assets and are simply financial transactions, making them potentially very flexible, but also very risky, as there is no underlying asset to pass. Transparency is diminishing and, as the various different products have become more complicated, with many different entities involved in selling on packages of financial products, stability within the financial markets has also suffered. Take, for example, the Enron scandal, which is said to be largely related to the fact that many financial transactions were undertaken off-balance-sheet, showing how the complexities of financial economy can create substantial volatility. On the other hand, although an economy which is involved with true goods and products is somewhat easier to identify, there are still risks associated with the real economy. On the whole, however, there is greater transparency and it is easier for the public, in general, to understand the processes going on and to identify the level of risk being experienced, which they may not be able to with the financial economy.

Although the discussion, so far, has been somewhat negative towards the financial economy, it is in fact an essential part of ensuring that the real economy thrives. This is largely because manufacturing companies also require financial backing in the form of capital or investments; therefore, without the financial economy, the real economy would not be able to thrive.

Financial Economics vs. Islamic Economics

There is a distinction between traditional financial economics and Islamic economics and these differences may be at the root of why Islamic economics would potentially offer great opportunities to deal with the current financial crisis, in a way that will encourage long-term growth, in the future. Whilst the traditional world of financial economics is undergoing a period of change, as a result of the recent financial crisis, it is worth noting that Islamic economics never went down the materialistic route, in the same way as the traditional economic behaviours did. Moreover, Islamic economics has not taken the same approach as the more traditional economics and, as a result, many of the principles associated with traditional economics have not emerged in the Islamic system.

Islamic economics is naturally linked to religious beliefs; however, it does not look to abolish private property in the same way that communism did, but rather recognises that every individual irrespective of their age, sex, race or religion should be equally entitled to maintain their own private property. Islamic economics recognises that the market is there to allocate resources efficiently; however, it does not accept that this market is sufficient to ensure that social interest will be safeguarded. Therefore, whilst there is an underlying focus on justice and moral values, it is not assumed that this is happening naturally and it accepts that there needs to be strong governance structures in place to support this.

Islamic economic principles take a much more integrated approach, recognising that families, society and government are linked to the market. In this context, concerns are raised within the Islamic communities that, whilst there is a need for the existence of self-interested behaviour, to a certain extent, within the market, Islamic economics places a much greater emphasis on ensuring that moral boundaries are set, so that there are overall benefits to society. Within the more traditional field of economics, it is generally accepted that peoples' behaviours, preferences and tastes are given and cannot be changed, substantially, whereas Islamic economics believes that it is capable of shaping individual behaviours and uplifting moral standards. This means that consumers under Islamic economics should consider their own moral values, before even entering into the financial markets and being involved in establishing some form of price equilibrium.

Essentially, both types of economic systems involve the allocation of resources; both systems also emphasise the need to fulfil material needs. Islamic economics, however, goes one step further and also places fulfilling spiritual needs as equally important as fulfilling material needs. The theory behind this is that, according to Islamic economics, the market itself may not be able to fulfil the material needs of all humans; for example, where there are scarce resources, it makes no difference how efficient the market is, if there are insufficient resources to go around. Therefore, it is necessary to look towards other avenues such as spiritual needs, in order to gain true efficiency. Accordingly, Islamic economics recognises that individuals may need to sacrifice for the good of others. However, this does not work well with economic principles as it is difficult to see why a rational individual would sacrifice their own self-interest for the sake of others with whom they have no links; this is a particular difficulty when it comes to the practical operation of Islamic economics and requires distinct governance rules, in order to ensure that this type of sacrifice does take place.

It can be seen, therefore, that whilst Islamic economics recognises that self-interest does exist, it takes a much more long-term view of self-interest and suggests that, where individuals make a sacrifice for the benefit of others, this will ultimately be in their own self-interest. Three main economic principles from traditional economics have not made their way into Islamic economics and, by identifying these three concepts, the distinction between the two schools of economic thought can be summarised. The three concepts are the rational economic man; positivism (i.e. being neutral between the two ends); and pare to optimum, suggesting that an efficient point will always be reached.

Islamic economics is not as different from traditional economics as might, initially, be suggested; however, there are some fundamentally different thought patterns and beliefs that could, potentially, offer greater efficiency for the financial markets.

Financial Crisis and Islamic Banking

The recent financial crisis has, once again, highlighted how fragile traditional economics are and how the world of capitalism has created considerable economic volatility. It is suggested that Islamic banking could, potentially, have alleviated the extent of the financial crisis. Moreover, whilst the points above identified the differences between traditional and Islamic economics suggest certain different underlying thought patterns that exist within Islamic economics, this section will analyse the way in which Islamic banking could, possibly, have altered how the recent financial crisis was dealt with.

The credit crisis began, back in 2007, in the United States housing market, although the collapse of the housing market in the US soon became a global issue and resulted in a worldwide economic recession. Two specific effects have resulted from this economic crisis, the first being that banks are less willing to lend money and therefore the cost of borrowing has gone up, substantially; and secondly, the value of bonds issued against mortgages has dropped, dramatically.

When looking at the recent economic crisis, Islamic economists refer to the economic crisis as being a result of interest rates and large imbalances, based on capitalist behaviours. As Islamic finance does not involve the use of interest rates and there has been a link suggested between the economic crisis and interest rates, Islamic economists, immediately suggesting that Islamic finance would not have allowed a similar economic crisis to emerge. The central concepts within Islamic finance of justice, equity and welfare and placing such a great emphasis on social and economic justice, as well as a fair and equitable distribution of income and wealth rather than purely being self-interest and capitalist in their behaviour.

There is a strong argument that a financial crisis of the present type would not have taken place, if Shari'ah principles had been properly followed, particularly in relation to risk-sharing; for example, where the commercial banks were required to share profits and losses with their clients, it is likely that they would have been much more careful when looking at which deals they should finance, as their own financial returns would depend almost entirely on the performance of the projects.

Islamic principles would have prevented both paying and receiving of interest, as well as creating artificial monetary instruments, with many of the issues that are seen to be at the centre of the financial crisis simply not being present. In the traditional banking sector, the banks will lend more money than they actually have, in reality. Again, this situation would not have arisen, if the Islamic finance system was being used. With the traditional financial systems it is possible to move the relatively small amount of equity as collateral to borrow substantial amounts of money and the financial bubbles that have emerged, as a result of this have been seen as instrumental when it came to the financial crisis. These types of bubbles would simply not emerge in Islamic banking and therefore there is definite strength in the argument that Islamic banking could have, at least, assisted in mitigating the financial crisis.

Islamic banks, however, work in a different way which is more like a venture capital firm which collects investments from individuals and then invests them in the economy, sharing profits amongst those who have invested. This partnership style arrangement means that Islamic bank are sharing the profits and have a vested interest in ensuring that the risk is well-managed, thus creating a more stable system.

Despite the perceived benefits of the Islamic banking system could have offered the economy, it still faces considerable difficulties, largely due to the fact that traditional economics relies heavily on the concept of interest, and removing the concept of interest from the banking system is not an easy task. Islamic banking is very much in its infancy and, as such, it does not have a sufficiently extensive system to offer a complete solution to the recent financial crisis and, while many of the principles associated with Islamic finance could assist, it is unlikely to replace traditional banking, any time soon.

Challenges Facing Islamic Banking

Although there are some substantial benefits associated with the Islamic banking system and, indeed, it is experiencing unprecedented growth, even in difficult economic times, it has yet to gain the same market share as conventional banking, with the Islamic banking system still facing a number of major challenges.

One of the biggest challenges facing the Islamic banking system is that there is no Shari'ah compliant legal framework. Islamic banks require a wide range of supporting institutions; and therefore the lack of legal framework to support the relationship between these institutions and Islamic banks themselves creates a real barrier, in terms of allowing the Islamic banking market to grow. Nevertheless, Islamic law does offer its own framework which can be used for managing financial contracts and transactions. However, there is no set of commercial banking company laws which are entirely aimed at the Islamic banking system; this is a real weakness, in terms of allowing the Islamic banking system to grow as it simply does not have the legal structure which gives other entities a feeling of comfort and safety, thus making institutions reluctant to deal with Islamic banking institutions.

The types of factors which would need to be controlled within an Islamic legal system are linked to the challenges which are identified, below. A separate set of Islamic banking courts would be required to as currently disputed cases relating to Islamic banks are subject to the same legal system as the conventional banks; yet, they are completely separate and therefore to subject Islamic banks to conventional courts is simply impractical for all involved.

Financial accounts also need to be adapted to take into account the different workings of Islamic banking. For example, Islamic banks do not show certain assets on their balance sheet, if they are financed through Ijara and Murabah, due to prohibitions under section 7 of Banking Ordinance 1962, preventing banks from holding assets. A revision of these systems needs to be had, in order to take into account the way in which the systems have changed, over the last few decades. Relying on Banking Ordinance 1962 to establish the rules associated with Islamic banking is simply impractical and, without changes in the laws, Islamic banking faces an uphill challenge to fit in with conventional banking arrangements that are so substantially different from the way in which it operates.

Difficulties also arise when dealing with monthly payment agreements; this is the Islamic equivalent to a traditional mortgage where the property is jointly owned by the bank and the individual, with the individual effectively paying rent to the bank, every month, as they cannot pay interest. This is a complex arrangement and the legal system is just not in place to deal with this. Arrangements such as these will only become widely popular, when there is a strong legal structure in place to manage the risks for every party (both the customer and the bank).

Essentially, Islamic banking is based on the principle of profit and loss and if something happens within the market and the bank itself suffers a loss, this gets transferred directly onto the depositor. This can create a feeling of uncertainty from depositors and can make individuals reluctant to take on board Islamic principles, when they themselves may be suffering the loss. With traditional banking, it may well be the case that the customer ends up paying for losses within the industry; however, it is not necessarily directly passed on to the customer in the same way as the Islamic system does.

Furthermore, there is also a lack of prudential regulation, and the lack of framework regulation within the Islamic banking sector is perceived to be a real weakness, banking sector from growing, substantially. As there are several different methods in which Islamic banking operates, the need to have a specific set of regulations aimed at dealing with these unique financial tools is essential. Similarly, the way in which risk is managed is completely different within the Islamic banking sector and is so different from the conventional banking sector that a new framework dealing specifically with the Islamic banking arrangements is crucial. Failure to do this is one of the central challenges being faced by the Islamic banking sector.

Risk Sharing & Money Creation

A central concept of Islamic finance is that of risk sharing and the use of money creation. It is this ability to risk share that arguably makes the Islamic finance world really appealing to the financial markets. In contrast, interest is prohibited under Islamic finance; therefore, any methods that are used to show this cannot use any form of interest-based contract. Charging interest, according to the Quran is one of the worst things that an individual can do and therefore all contracts will move away from creating an interest-based situation.

By prohibiting interest, the Islamic finance system creates a broad range of instruments that allow the banks to operate in order to offer financial products to customers in a way that does not involve using interest. Essentially, this means that the bank needs to earn a profit which is directly linked to the risk that the bank is taking. Where there is no risk involved any gains made would represent interest and not profit, thus creating problems for the Islamic bank. With this in mind, it could be seen that Islam actually encourages the concept of entrepreneurship. When looking at this, in contrast with traditional banking arrangements, the entrepreneurs risk losing their money whereas, the financier would have a secure return through the use of interest. However, in an Islamic banking arrangement, both the bank and the individual are taking risks; in other words, risks may be shared between the entities and may vary; but, fundamentally the bank is taking a risk alongside the entrepreneurs. Essentially, the basic principle of Islamic law and banking suggest that, in order for an individual to make some form of return, this involves entrepreneurial activity and, therefore, the individual must take on board at least some of the risk associated with the project, in order to justify their profit. Arguably, this demands that the bank takes on at least some of the risk alongside the other party, making the banking arrangements much more secure. Therefore, the bank will pay much more attention to the types of risks that it is undertaking; as, if it takes on a project that is too risky, it will suffer as much as the entrepreneur, something which does not happen in the traditional banking arena.

Although a wide range of instruments have been developed for use by Islamic banks, anything which uses a profit and loss based instrument would be deemed acceptable from an

Islamic point of view. Any form of exploitation is considered unacceptable under Islamic banking principles and, therefore, when risk is shared, it must be done in a fair way.
In having these types of arrangements in place, there is a much greater vested interest on the part of the banks to analyse the types of investments that their clients are making and to ensure that risks are quantified appropriately and mitigated, where possible, in a way that the traditional banking system does not require. Rather than focusing on self-interest and capitalism, at all times, the Islamic banking system looks much more towards longevity and fair allocation of risk and resource, so there is no exploitation taking place.

Demand for Alternatives

There is no denying that the recent financial crisis has involved a wide range of entities looking at different ways in which the financial markets can operate, so as to prevent a financial crisis of the same magnitude from happening again. Surprisingly, and based on many of the factors mentioned above, Islamic financing has been viewed as a potential alternative. Crucially, it is no longer looked at as something that is only appropriate for a specific religious group, but is also recognised as being a system that can be beneficial to all users of the financial markets. As well as the recent financial crisis triggering renewed interest in the Islamic banking sector, there have also been several changes within the Islamic banking sector in itself over the last few decades, which has made it more appealing to the general public. Firstly, there has been a shift in the demographics, with a substantial increase in Muslim middle class individuals; this has resulted in a much greater demand for general consumer products within the Islamic banking industry which, in turn, allows it to appeal to a broader groups of individuals, with the banks themselves spending time creating products and services which have more general appeal. Secondly, there has also been a strong influence coming from increased globalisation, in general, and the Muslim identities becoming much better known, with many more countries being prepared to look at Islamic banking as an option, even if they themselves are not from a Muslim country. The transnational religious communities are also becoming more influential, and individuals are simply more in the know than they were, even two decades ago. Consumers, today, are more willing to explore new and innovative options in a way that they possibly would not have contemplated, prior to the financial crisis. This all leads towards the Islamic financial industry having the opportunity to grasp this increasing market, both from within the Muslim community and also from other parties who are actually interested in these types of products and looking at new ways of financing arrangements, particularly those who are no longer able to use conventional banking, either because they have been priced out of the market or because it no longer offers them the services and products they require.
When looking at the characteristics of Islamic banking customers, it can be seen that it is still dominant within the Muslim community; however, there is no longer an exclusion, with Islamic banking and it is now becoming a real option for non-Muslim customers. Globalisation is also useful, in terms of making these Islamic banking arrangements available outside of their immediate home countries; and again, this broadens their appeal to such an extent that Islamic banking is looking like a viable alternative. Furthermore, many consumers have little or no confidence in the traditional banking arrangements and are therefore much more open-minded to different arrangements, such as those being offered by the Islamic banking industry.
However, the Islamic banking industry faces major challenges, if it is to appeal to a much wider range of market participants.

Significant Challenges

There are, currently, several challenges facing the Islamic banking sector; however, the global financial crisis has given the Islamic banking sector a potential opportunity to gain a greater market share; but, nevertheless, it is not entirely immune from the financial crisis. Moreover, the Middle Eastern region has also been affected by the financial crisis and although the Muslim community is not the centre of the financial crisis, the crisis is certainly having a negative impact and creating a degree of instability.

In fact, many of the Islamic based jurisdictions are suffering, substantially, due to their own political instability; therefore, their economies are more prone to suffering when the financial crisis is hitting the area. Furthermore, the governments in these countries also face much bigger challenges when it comes to dealing with the short run difficulties, as they do not always have the wealth of experience or depth of resources to deal with short-term volatility, in the same way as the larger jurisdictions.

A particular challenge that faces the developing regions is the fact that they have a significant percentage of people who are very close to the poverty line. In times of economic difficulties, it is important for these governments to ensure that these individuals do not fall below the poverty line as, once this happens, it can be incredibly difficult to climb out of the poverty trap. This requires quick reactions from the governments of the developing countries and also the financial systems which work within the region, for example, the Islamic banking sector needs to work, quickly, in order to identify areas of concern and to ensure that assistance is offered in the correct place to the correct people.

Care also needs to be taken, to ensure that the Islamic banks are in a position to make the most of the recovery, when it does happen, by capturing as much of the market as possible, particularly from those that are disillusioned with the conventional banking systems. This volatile period within the financial markets, as a whole, offers both opportunities and challenges for the Islamic banking sector. However, provided they are able to structure themselves in such a way that they can maximise the benefits to the banks when the recovery does happen, it is highly likely that the Islamic banking sector will be able to gather many new customers, both from traditional Muslim backgrounds and also from other global locations that are looking for realistic alternatives to the conventional banking system.

A major challenge that faces the Islamic banking sector, when it comes to appealing to other jurisdictions, such as the UK, is that it needs to become more user-friendly, as many individuals are simply unaware of how Islamic banking works; this lack of knowledge often leads to people steering clear of functions that they would otherwise be keen to embrace. The Islamic banking sector is in a pivotal phase of its development and is growing rapidly on an international basis; however, the main challenges it now faces is to negotiate this period of economic crisis in such a way that it gains from the failings within the conventional banking sector.

2. CONCLUSION

The Islamic banking sector has undergone radical changes, in recent years, and the financial crisis, which began in 2007, has once again brought the questions to the forefront about whether or not the Islamic banking sector could, potentially, have much greater appeal than simply dealing with Muslim customers. In particular, the essence of Islamic banking is so different from conventional banking, as it uses a risk-sharing strategy that offers a real opportunity to consider whether or not the way in which conventional banking is undertaken still remains the best option, in all cases. Couple this with the fact that there has been increased globalisation of financial services, in recent years, and the opportunity to use Islamic financing principles in a wide range of countries is now much more relevant.

Concerns have been raised about the activities of the conventional banking sector, particularly following the recent financial crisis. As such, looking at alternatives, such as the Islamic banking sector is a real opportunity to make suitable changes. Despite this, there are difficulties facing the Islamic banks in trying to gain general appeal. One of the major issues is the fact that many Islamic banking establishments are dealing with developing countries which have their own set of challenges, especially in times of economic difficulties. Furthermore, the legal structures surrounding Islamic banking have not kept pace; as a result, many of the rules and regulations associated with Islamic banking are no longer current and will not support the essence of how Islamic banks work. With this in mind, it is suggested that a much stronger legal framework is necessary to facilitate Islamic banking and, in the fullness of time, it is unlikely that Islamic banks will win general worldwide appeal. Encouraging a change in behaviour from investors across the world takes time, and confidence needs to be attained. However, without having a legal structure in place, it is difficult to gain this level of confidence; therefore, getting the frameworks in place will be a crucial part of ensuring that the Islamic banking sector is in the appropriate place to benefit from a period of growth which is likely to take place as part of the recovery from the current economic position.

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