ISLAMIC FINANCE MUST TURN TO THE ROOTS!

THEME TO BE PONDERED IN AFTERMATH OF THE CURRENT GLOBAL CRISIS

By Muhammad Ayub [i]

ABSTRACT

The global economy is facing a deep downturn as a result of the crisis. It was due to excessive ability to create money and credit for earning increasing profits without creating anything of value for use by the mankind. The system needs radical change in the approach, principles and the operation of economic and financial systems. Creation of money, and lending it on interest – interest based debts and financial obligations leading to undue receivables for the lenders, is the biggest and primary problem of the conventional system. Islamic principles of finance provide checks for the factors that have distorted the system. Enhanced supply of risk-related capital, restricted risk taking, balanced return rate structure based on the real sector economic activities, and supply of money commensurate with prospects of growth in an economy, provide a sound basis for sustainable development. Hence, Islamic financial institutions and markets have better ability to sustain in the hard times. Islamic banking industry should not only have escaped unharmed during the crisis, it should also have availed the opportunity of developing into the mainstream system with a new paradigm; but, it failed to take advantage of the opportunity because Islamic banks adopted the same products with some cosmetic amendments. To serve the mankind, Islamic finance must turn to its roots and try to avoid doing the same, before the process becomes irreversible.

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THE GLOBAL CRISIS

The current financial crisis started from the US and spread to other parts of the world due to US Dollar being the reserve currency and the huge size of the American economy. It has taken more than $3 trillion of bailouts and liquidity injections to abate the intensity. Lehman Brothers was the first to collapse due to over-leverage positions and unsound mortgage products, which was followed by failing of a large number of financial institutions and, as a result, the whole system. Alan Greenspan, former Federal Reserve Board Chairman, in his presentation to the American Congress, compared the current financial crisis to a 'great tsunami'.

Hundreds of banks were crashed, many were bought out and a number of merged with other institutions, while some bigger institutions received a government bailout. Many exceptional measures were taken to avoid a system-wide breakdown. The central banks took extraordinary actions to provide liquidity of an unprecedented scale. U.S. and European authorities intervened heavily in the form of capital injection, nationalization, protection of banks deposits, and credit guarantees. But such protective measures and bailouts have not offered any long term solution to the global problem because the idea behind such measures is to give banks / financial institutions the opportunity to lend more money to create activity in the economy. Thus, the action could simultaneously be the cause of prolonged and increasingly severe problems.

As a result of the crisis, the global economy is facing a deep downturn. The more an economy was leveraged, the more it was hit by the crisis irrespective of its past strength and stability; the advanced economies are suffering their worst since the great Depression of 1930s. Similarly, the emerging and the developing economies were hit hard resulting in falling equity markets, reversal of capital flows, pressures on exchange rates - all this leading to increasing poverty and hunger for billions of human beings. According to a recent World Bank report released in January 2010, 64 million more people were living in extreme poverty by the end of 2010 than would have been the case without the crisis[ii].

CAUSES OF THE CRISIS

Basically, the crisis was due to excessive ability to create money and credit for earning increasing profits without creating anything of value for use by the mankind. Financial engineering during the last few decades has lead to generate investment products, even without any underlying real assets in many cases, mainly by way of factoring (selling of accounts receivable) and creation of derivatives. These products include collateralized debt obligations (CDOs), interest rate swaps, interest rate futures, forward rate agreements, Forex trade options, warrants and options on futures contracts. Interest rate futures and options on future contracts are arrangements that allow borrowers and lenders to lock into the interest rates. Interest rate swaps basically consist of the exchange between two counterparties of a fixed interest rate for a floating interest rate. The amount of interest to be paid is calculated by reference to a notionally agreed principal. Principal amounts are not physically exchanged in interest rate swaps. A forward rate agreement (FRA) is an agreement between the two parties on an interest rate for a specified period from a specified future settlement date, based on an agreed notional principal amount. No commitment is made between the parties to the FRAs to lend or borrow the principal amount. The exposure to both parties is only the difference between the agreed interest rate and the settlement rate applicable at the date of settlement.

Hence, over the last two decades, banking and non-banking financial institutions created hundreds of billions of dollars in wealth by simply shuffling the papers and transferring risk to other parties. Many people got rich quickly and wanted more, increasingly adding to their wealth, but everyone passing on the risk to others.

ISLAMIC FINANCIAL INSTITUTIONS CAN SUSTAIN IN THE HARD TIMES

Islamic principles of economics and finance provide checks for all factors that have distorted the system, and therefore, Islamic financial institutions and markets have better ability to sustain in the hard times and pass through all the storms. They focus on clarity and lack of ambiguity along with just and fair treatment with all and care for rights of others more than the self rights. But, these principles are necessarily ethical and, as a ray of hope, some senior policy makers have been witnessed talking about the business ethics. These principles need to be adopted for relief to the mankind.

At the macro levels, efforts of economists, experts, policy makers and the Governments around the world have so far been to strengthen the so called market forces for achieving 'optimal economic growth and sustainable development at national and global levels'. However, market forces have failed to achieve the balanced and equitable growth not only at individual country level but also regionally among both the developed and developing countries. [iii]

CALL FOR A NEW FINANCIAL ARCHITECTURE

Although the governments and the regulators worldwide have been struggling to manage the crisis, but there does not seem to be any longer term solution leading to stable economic and financial system for socio-economic betterment of the mankind. Serious minded people have been talking of 'Ethical Finance' to help minimize the frequency and severity of such crises. A large number of experts have been calling for long the comprehensive reforms of the financial system to help prevent any chaos and spread of financial crises or, at least, minimize their frequency and severity. Even the Pope Benedict XVI urged upon the finance experts to adopt Islamic model of Riba prohibition[iv]. Now the question is: Does Islam, which offers strict moral guidelines for dealing with money and prohibits debt trading and risky speculation, provide a better system, or can it save the Global Economy?

Before answering this question, let's discuss the growth of Islamic finance and its salient principles, products and instruments.

Growth of Islamic Banking and Finance

Over the past three decades, financial activities conducted under the banner of 'Islamic finance' have grown significantly in volume and scope, attracting significant attention worldwide. It is one of the fastest-growing industries, recording double-digit annual growth rates for last thirty years.

Despite the global crisis, Islamic banking continues to see significant growth. According to the Banker magazine's November 2009 Issue, assets held by Islamic banks worldwide rose by 28.6%, over a year, to $822 billion in 2009. The compound annual growth rate for 2006-2009 is estimated at 27.86%. While the prospective market according to *Standard & Poor's* is that of $4 trillion, the global assets are expected to hit $1033 billion by the end of 2010.[v]

Over the recent years, Islamic banking reached Australia, Japan, Canada, Russia, China and France. In Germany, where Sukuk were issued about 5 years ago, the regulators recently issued Islamic banking license to the subsidiary of a Turkish-Kuwaiti bank. All financial capitals like London, Tokyo, Hong Kong, Singapore, Malaysia, Bahrain, Dubai, are going into the active Islamic banking business.

In Pakistan, after the failure of the 'Non-interest based' (NIB) of 1980s (that was based on the prohibited 'Buy-back Stratagem'; a new approach of Islamic banking working in parallel with the conventional system was adopted in 2002. Two types of institutions - full-fledged Islamic banks and Islamic banking branches of conventional banks, are offering Islamic banking products through all 551 branches in all major towns of the country. Islamic banks' total assets, deposits and financing / investments have been estimated at Rs. 323 billion (5.3% of the total banks' assets), 245 billion (5.5%) and 198 billion (4.2%), respectively. [vi]

The roughly $1 trillion Islamic finance, with high annual growth over the past decade, faced difficulties (particularly during 2009), but was relatively insulated from the global financial crisis because of Islam's ban on handling interest-bearing and speculative financial instruments. However, the Dubai debt crisis exposed some of the weaknesses due mainly to a number of objectionable products adopted by Islamic financial institutions (IFIs) in line with the conventional system. It certainly has created a need for reforms in the current Islamic banking practices and turning to the roots.

Unique Principles of Islamic Finance

Islamic banking refers to financial Intermediation under Islamic injunctions with the objective to fulfill financing needs of the society and promote social justice by banning exploitative practices. Loaning on the basis of interest and the sale of debt are not allowed. Islamic banks are expected to involve themselves as financial intermediaries and investment oriented institutions in bringing about wellbeing of the people, society and the economy in the light of the *Sharī'ah* principles. They have to undertake business by observing relevant *Sharī'ah* rules and avoid Riba (interest), Gharar (absolute risk or excessive uncertainty) and gambling:

RIBA

According to the broader definition of Riba, all increases in wealth or benefits accruing to a person without any labour, risk, or expertise are prohibited due to being Riba. One who wishes to earn profit on his / her financial investment must bear the loss or damage accruing to the business where the money capital is to be used. For distinguishing the permissible and the prohibited gains, the nature of a transaction is important: Profit from trading in goods and assets that involves risk taking and value addition is permissible; rental on assets in leasing of assets that entail risk taking, value addition and is, therefore also allowed. While lending is considered a virtuous act, and not a business, exchange transactions are subject to special rules of 'Bai al Sarf'.[vii]

GHARAR

Literally, Gharar means uncertainty, hazard or risk relating to major elements of a contract; Technically, Gharar is the sale of a thing which is not present at hand – short selling in the conventional sense; or the sale of a thing whose consequence or outcome is not known; or a sale in which one does not know whether it will come to be or not, such as fish in water or a bird in the air. It refers to an element of absolute or excessive uncertainty in any business about the subject of contract or its price, or mere speculative risk.

GAMBLING – MAYSIR AND QIMAR

Maysir refers to all types of hazard and gambling - acquisition of wealth by chance / easily (without paying an equivalent compensation ('Iwad) for it or without working for it, or without undertaking any liability against it). Qimar refers to all games of chance. Technically, it is an arrangement in which possession of a property is contingent upon the happening of an uncertain event. By implication, it applies to a situation in which there is a loss for one party and a gain for the other without specifying which party will lose and which will gain.

REWARD COINCIDES WITH THE RISK

In Islamic finance, the business risk can be managed, but not eliminated from economic activities. The classical maxim, "gain is justified by taking liability of loss" serves as a basis and implies that risk cannot be separated from the ownership – the owner of an asset has both the risk and reward of that asset. Similarly, Islamic finance has the provision of forward trading (in the form of Salam) with strict conditions of delivery and settlement to ensure that risks and liabilities pertaining to an asset are properly taken by the owner. It is particularly relevant in case of Forex business where the requirements of *Bai´ al sarf* (trading in monetary units and currencies) have to be observed. Delivery of the Salam goods has to be made irrespective of the upward or downward movement of the price. It implies that forward trading can be used only for promoting real productive and exchange purposes.

The modern derivatives like options, futures and swaps, on the other hand, have no valid subject matter even in the most of cases. The conventional investment products and particularly the 'derivatives', separate risk from real economic activities and make it traded separately. Risk is treated as a commodity that becomes a basis for financial engineering without any valid assets, and compounded derivatives are derived based on market indices and volatilities, where no ownership of any sort exists. It ultimately multiplies the risk in the economy and only the speculators are better off while real economic agents like producers and consumers, individuals as well as economies, are worse off – they are better off if risk is minimized. Hence, the artificial risks distort real economic activities with negative impact on real investment opportunities. [viii]

ISSUES IN DEVELOPMENT OF ISLAMIC FINANCE

Although Islamic finance has gained rapid popularity thanks to abundant Sukuk issuance, but it is facing the challenge of distinguishing the Islamic from the non-Islamic transactions. Bahrain based AAOIFI has played a significant role in providing *Sharī'ah* standards for a large number of contracts based on the principles of the *Sharī'ah*. But most of the IFIs have not adopted the AAOIFI's *Sharī'ah* standards. The practices like Ba'i al 'Inah (sale and buy-back transaction of an asset), organized Tawarruq (getting liquidity by way of purchasing a commodity and selling it forthwith to any third party as a pre-agreed arrangement) and Sukuk with repurchase agreements have made Islamic finance almost similar to the conventional finance. Even in Mudarabah and Musharakah based Sukuk, the issuers make an upfront promise to pay back Sukuks' face value at maturity. Similarly, the Islamic Fiqh Academy issued in April 2009 a decree outlawing organized Tawarruq as a "deception"; even then, IFIs continue to use Tawarruq based products causing more doubts to the emerging system.

Same is the case of Takaful institutions who have failed to transform their products in real sense to non-commutative basis from the commutative and commercial nature. A part of the underwriting surplus is given to the insurers in many cases. The issue of the best model of Takaful consistent with the principles of the *Sharī'ah* is yet to be resolved.

ISLAMIC BANKS SHOULD HAVE AVAILED OF THE OPPORTUNITY!

When the conventional banking collapsed, Islamic banking industry should not only have escaped unharmed, it should rather have availed the opportunity of developing into the mainstream system with a new paradigm; but, it failed to take advantage of the opportunity because Islamic banks also adopted the same products with some minor amendments – its instruments and the products are not really distinguishable from those of interest-based institutions. Re-purchase promises in the most of the Sukuk and Tawarruq based $100 billion commodity Murabaha market have almost diluted any difference between the two systems, as in operations. So much so that, while some Islamic investment managers attempt to develop '*Sharī'ah* -compliant', short-selling techniques, several Western authorities are banning the practice, on account of the instability that it causes.

As a result, even the pious Muslims who had been the supporters of any move for *Sharī'ah* based system of finance have been talking against the Islamic banks' products. Following are some of their concerns:

a) "Islamic banking" as in vogue, does not reflect the ethos of Islamic teachings;

b) Particularly, the 'Structured products' do not reflect *Sharī'ah* 's spirit;

c) Strayed from the theoretical foundation: joint-risk and reward sharing;

d) Seeking to strike a deal with the conventional institutions, particularly to enter the derivatives market - separating risk from real economic activities and making it traded separately;

e) Tawarruq - originally a solution to provide monetary funding in crunch has become the predominant instrument for investment and liquidity management;

f) " *Sharī'ah* Conversion Technology" coined to allow the total return swaps (TRS)

g) LIBOR and other such benchmarks are used as a determinant of interest on non-*Sharī'ah* compliant assets, not only as a pricing tool.

There are concerns about the nature and extent of supervision by the *Sharī'ah* experts / advisors. *Sharī'ah* committees of institutions provide relaxations, but when the practitioners make exploitative use of such relaxations, Fatawa are followed by retraction / criticism. The most prominent example of such criticism is that of Sukuk, each of which was allowed by the *Sharī'ah* scholars, but afterwards it was said that the most of Sukuk did not comply with Islamic principles.[ix]

There have been some general and macro-economic problems as well, some of which were not in the control of any individual Islamic financial institutions. The problems include:

a) Excessive money and credit creation by banks (lending) and the States (borrowing);

b) Banking and finance only a part of economics and socio-political economy;

c) Lack of coordinated work by the economists for finding the real benchmarks / reference rates;

d) Lack of *Sharī'ah* scholars – the opinion makers - familiar with the tools and instruments of modern finance;

e) Lack of human resources with *Sharī'ah* inspiration and professional expertise;

During the recent years, there has been a significant increase in the use of Commodity Murabaha as a financing device - Tawarruq by way of Murabaha in metals that is reluctantly accepted by some *Sharī'ah* scholars. May be that the transaction in such Murabaha is *Sharī'ah* -compliant in form, but actually it is unrelated to the substance of the commodity: the commodity is used as a vehicle to facilitate the transaction, not its object.

The IFIs are not allowed exposure to the CDOs, derivative products and the kind of intra-financial counterparty risk that crippled the conventional system. However, many IFIs mimicked the conventional product of 'total return swaps' to deliver '*Sharī'ah* compliant' returns from non-compliant investments. Hence, the Islamic finance system, as in vogue at present, is not fully prepared to play a significant role in ensuring the health and stability of the national and global financial systems.

However, the world is looking for fairer values that it cannot find in the current so-called market based capitalistic system. The economists and the policy makers have to draw up the system based on ethical principles of risk and profit sharing. Only that is the way to salvation by dint of which we can lead the humankind to happiness, security, justice and prosperity. The system needs radical change in the approach, principles and the operation of economic and financial systems. Creation of money and lending it on interest is the primary problem of the conventional system. Islamic finance must try to avoid doing the same before the process becomes irreversible.

ISLAMIC FINANCE MUST RETURN TO ITS ROOTS

Islamic theory of finance has potential in terms of its principles and instruments that allow the minimum possible loop-holes. Enhanced supply of risk-related permanent and redeemable capital, restricted risk taking, balanced return rate structure based on the real assets backed economic activities, and supply of money commensurate with prospects of growth in an economy, provide a sound basis for sustainable development and evenly shared incomes for socio-economic benefit of the mankind as a whole.

The solution lies in disciplining the creation of money, limiting the self-interest with social aspects and the business ethics, transforming the corrupt financial system to make it free of exploitation and games of chance and thus enabling the mankind to optimally use the resources for benefits at the larger scale.

The global crisis and the recent Sukuk related defaults in many parts of the world, particularly the Sukuk problem of Dubai, have made it sufficiently clear that Islamic finance must return to its roots and avoid imitating the practices of conventional banking if it is to avoid the same fate as faced by the capitalistic system. IFIs must move from Tawarruq to Mudaraba and from Ba'i al Dayn-based to equity and Ijarah-based Sukuk ensuring the adherence to the *Sharī'ah* essentials of all underlying contracts.

If projected properly, Islamic finance would have appeal for followers of all the religions. By introducing it as ethical banking in all societies of the world, Islamic finance can become an engine of economic growth by mobilizing savings from so far untapped groups of people and channeling them to healthy and real assets based investments. Prohibition of Riba in all revealed religions could be instrumental in enhancing this appeal.

Also, Islamic modes of business and investment have the possibility of being used as an efficient alternative to interest based deficit financing along with added benefit of disciplining the fiscal behavior of the sovereigns. In that case, each economy would be able to get real benchmarks for pricing of goods, their usufruct and the services, both in cash and credit markets, representing the real demand/supply scenario and the strength of the economy. Obtaining a benchmark for Sharī´ah compliant securities in present situation is almost impossible. The economists and the policy makers are, therefore, required to come out of the syndrome of allowing creation of monetary assets without any meaningful limit on the one hand and allowing a fixed rent on such assets on the other; and be encouraged to adopt the real economic activity based regimes that allow ex-post profit or loss sharing as also fixed or quasi-fixed return through pricing of real goods/assets or their usufruct. Putting the conventional financial system on the right track would require a lot of work and sacrifice by the present generations for bright and safe future of the mankind.

CHALLENGES IN ACHIEVING THE OBJECTIVE

Changing the approach of the practitioners that all banking products should have *Sharī'ah* based alternatives is a big challenge; they have to understand that ensuring the real difference between the two systems is the main key to the stable and long-term growth of the new system. The economists have to make joint efforts for developing benchmarks based on real performance of the economic sectors and that would be possible by linking the money and credit expansion to growth of the real economy. There is a need for a global move in this direction. Efforts also need to be strengthened to enhance supply of well educated and trained human resources having *Sharī'ah* inspiration and confidence to operate the system as per its requirement.

The standards setting, including *Sharī'ah*, risk management, regulatory, accounting and market standards, constitutes a big challenge for the emerging industry. This standardization must base on the cardinal principles of the *Sharī'ah* that have been better taken care of by the AAOIFI Standards. But unfortunately, the practitioners who are using the dubious structures like that of Ba'i al Inah and Tawarruq and are operating 'Islamic' hedge funds based on options and derivatives do not really feel any need for standardization.

THE CONCLUSION

Islamic banking conducted in accordance with the Sharī'ah precepts is in a position to play crucial role interrelating finance, economy, community and society, enabling the world to avoid crises in future. For this, Islamic banks and financial institutions must turn to the roots, to carry out their operations according to the principles of Islamic economics and finance and also play role in socioeconomic development by combining the goals of efficiency and social justice. They must be ready to take the business risks and expand their role in the real sector rather than just provide credit. The current trend may not help in achieving the objective. But, it is not due to any weakness in the philosophy and theory of Islamic finance. For such a model of socioeconomic development IFIs will have to design different financial structures than what they are presently following in effort to compete with conventional system for 'profit maximization'. The universities and business schools may come forward to educate Sharī'ah scholars enabling them to understand the principles properly and guide the banking industry and the public. AAOIFI's Standards must be applied to all banks and areas.

[i] The writer is Director Research and Training, Riphah Center of Islamic Business, Riphah International University, Islamabad. Formerly, he was Head of Islamic Banking, National Institute of Banking and Finance (NIBAF), Senior Joint Director, Islamic Banking Deptt; State Bank of Pakistan; He is the author of the textbook *"Understanding Islamic Finance"* John Wiley & Sons, London, 2007.

[ii] http://www.punchng.com/Articl.aspx?theartic=Art20100121234292

[iii] Ayub, Muhammad; "Understanding Islamic Finance", John Wiley & Sons, London; October, 2007, Chapters: 1 and 18.

[iv] http://www.bloomberg.com/apps/news?pid=20601092&sid=aOsOLE8uiNOg&refer=italy; http://www.brusselsjournal.com/node/3819; http://www.vatican.va/news_services/or/or_quo/text.html

[v] http://top500islamic.thebanker.com/index.cfm?fuseaction=top500.home&CFID=1063027&CFTOKEN=40815224

[vi] State Bank of Pakistan; Quarterly Performance Review of the Banking System (quarter ended September 30, 2009) http://www.sbp.org.pk/publications/q_reviews/q_review_September_09.pdf

[vii] For details, see: Ayub, op.cit. Chapter: 3.

[viii] Steinherr, A; Derivatives: The Wild Beast of Finance; John Wiley & Sons, 2000.

[ix] http://www.aabaig.com/resource/viewtopic.php?p=1692&sid=20a19097a9a781c27a5c8533b97bee1e