

Institute of Islamic Banking and Insurance

Would Islamic Finance have  
prevented the global financial crisis?

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# Overview

Preamble

Global financial crisis - effects

Global financial crisis – causes?

Introduction to Islamic Finance

Would Islamic Finance have prevented the global financial crisis?

Preamble

Disclaimers

About Mohammed Amin

# Disclaimers

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Mohammed Amin is a tax partner at PricewaterhouseCoopers LLP and leads their Islamic Finance practice in the UK.

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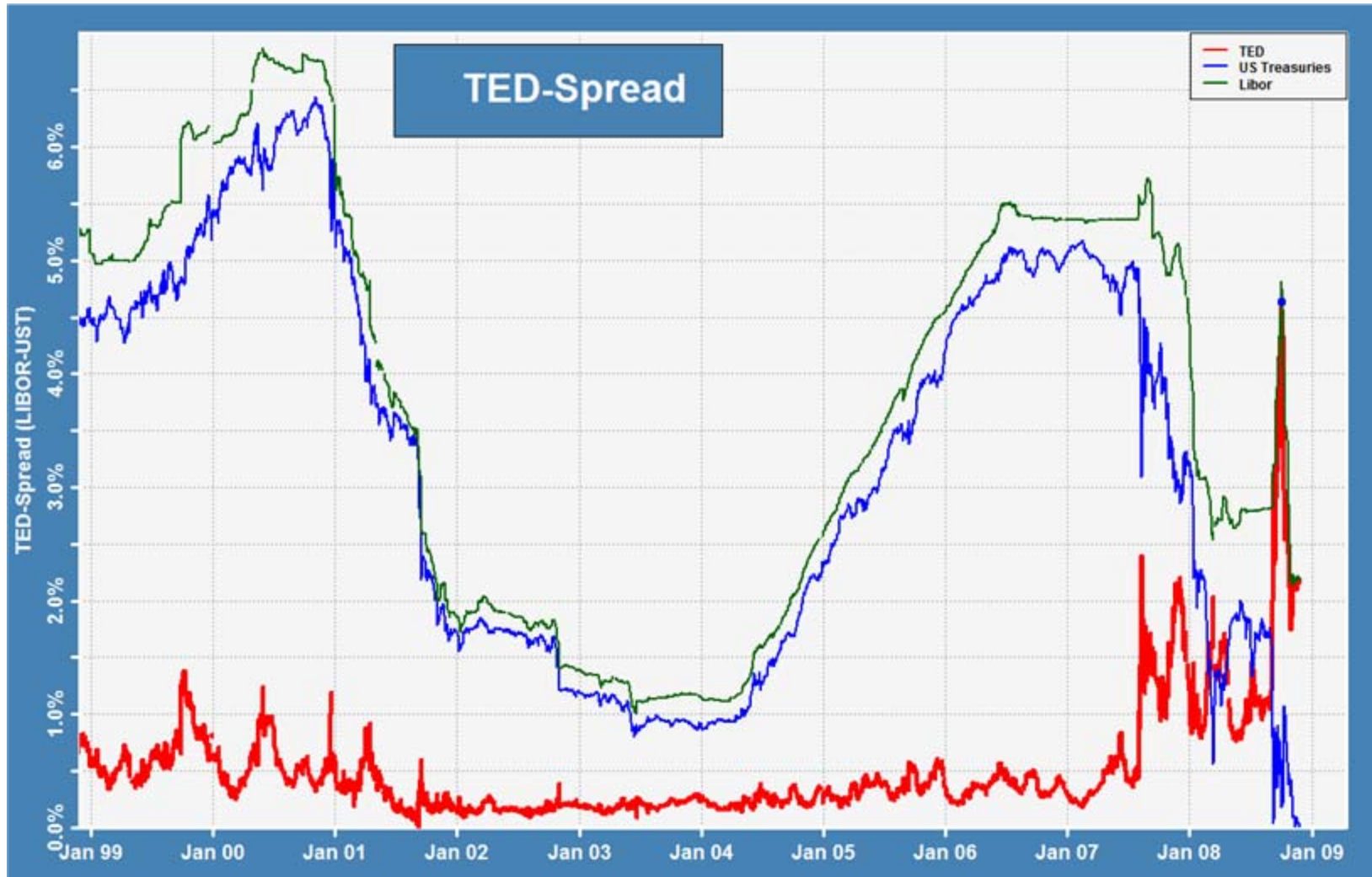
- a member of HM Treasury's Islamic Finance Experts Group, set up to advise the Government on Islamic finance strategy
- chairman of the Business & Economics Committee of the Muslim Council of Britain
- a Council member of the Chartered Institute of Taxation
- a member of the Policy & Technical Committee of the Association of Corporate Treasurers

Many of Amin's previous articles and presentations on Islamic Finance can be found on his Islamic Finance blog at:

[pwc.blogs.com/islamicfinance](http://pwc.blogs.com/islamicfinance)

# Global financial crisis - effects

# The US Treasuries / Eurodollar Libor (TED) spread



# IMF Global Financial Stability Report April 2009 estimated bank writedowns 2007-2010

<b>Writedowns on assets</b>	<b>\$US billion</b>	<b>% of total assets</b>
US banks	1,049	8.8
UK banks	316	5.0
European banks ex UK	1,109	4.6
Asian banks	337	3.5
<b>Total</b>	<b>2,810</b>	<b>5.4</b>

# Falls in bank share prices

	<b>1 or 2 Jan 2007</b>	<b>Lowest price</b>	<b>Date</b>
Citigroup	\$56.28	\$0.97	2/3/2009
Bank of America	\$54.18	\$2.53	16/2/2009
Royal Bank of Scotland	582.51p	10.3p	20/1/2009
Lloyds TSB	577.35	42p	6/3/2009

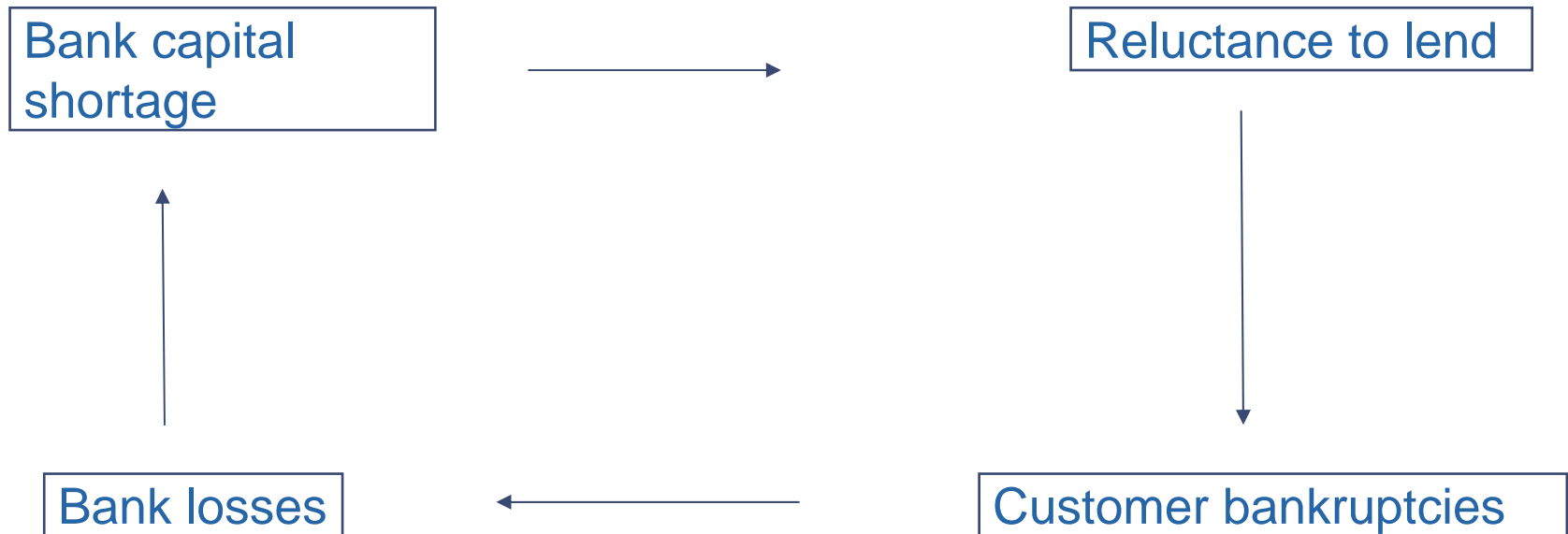
# Why bank share prices matter

Ability to remain in business

Lehman Brothers

Temporary restrictions on short selling financial shares

# The downward spiral



# Global financial crisis – causes?

Sub-prime mortgages

Incentive effects of securitisation

Co-mingling in CDOs

Monoline insurers

Insurers selling credit default swaps

US government sponsored enterprises

Over leveraging generally

# Sub-prime mortgages

Homebuyer

Lender

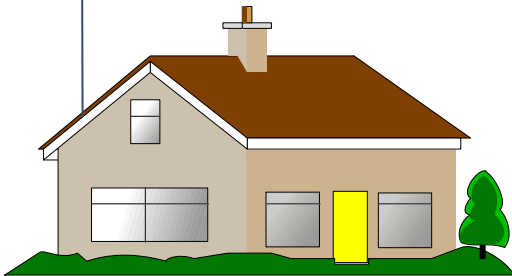
## Mortgage

Very low rate first 2 years  
Higher rate next 28 years

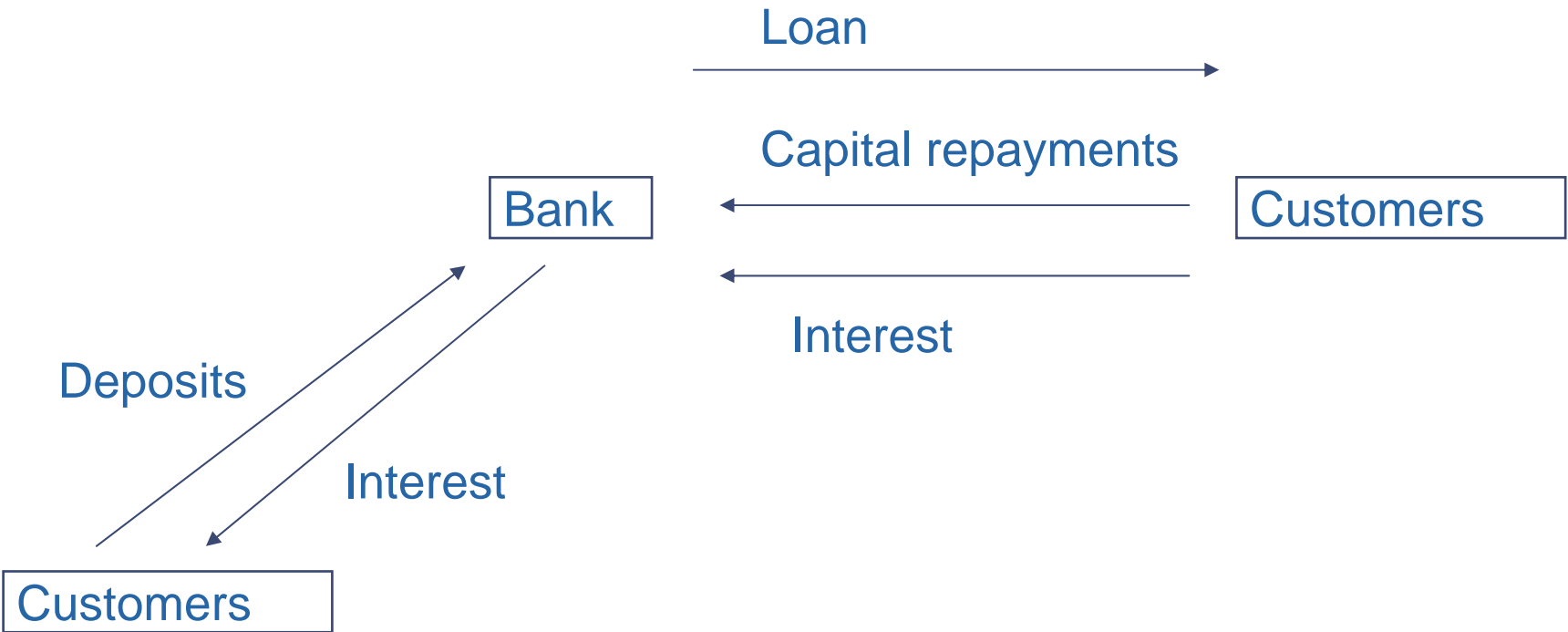
## Homebuyer

Cannot pay after 2 years  
Relying on price increase to refinance or sell  
Mortgages non-recourse in many states

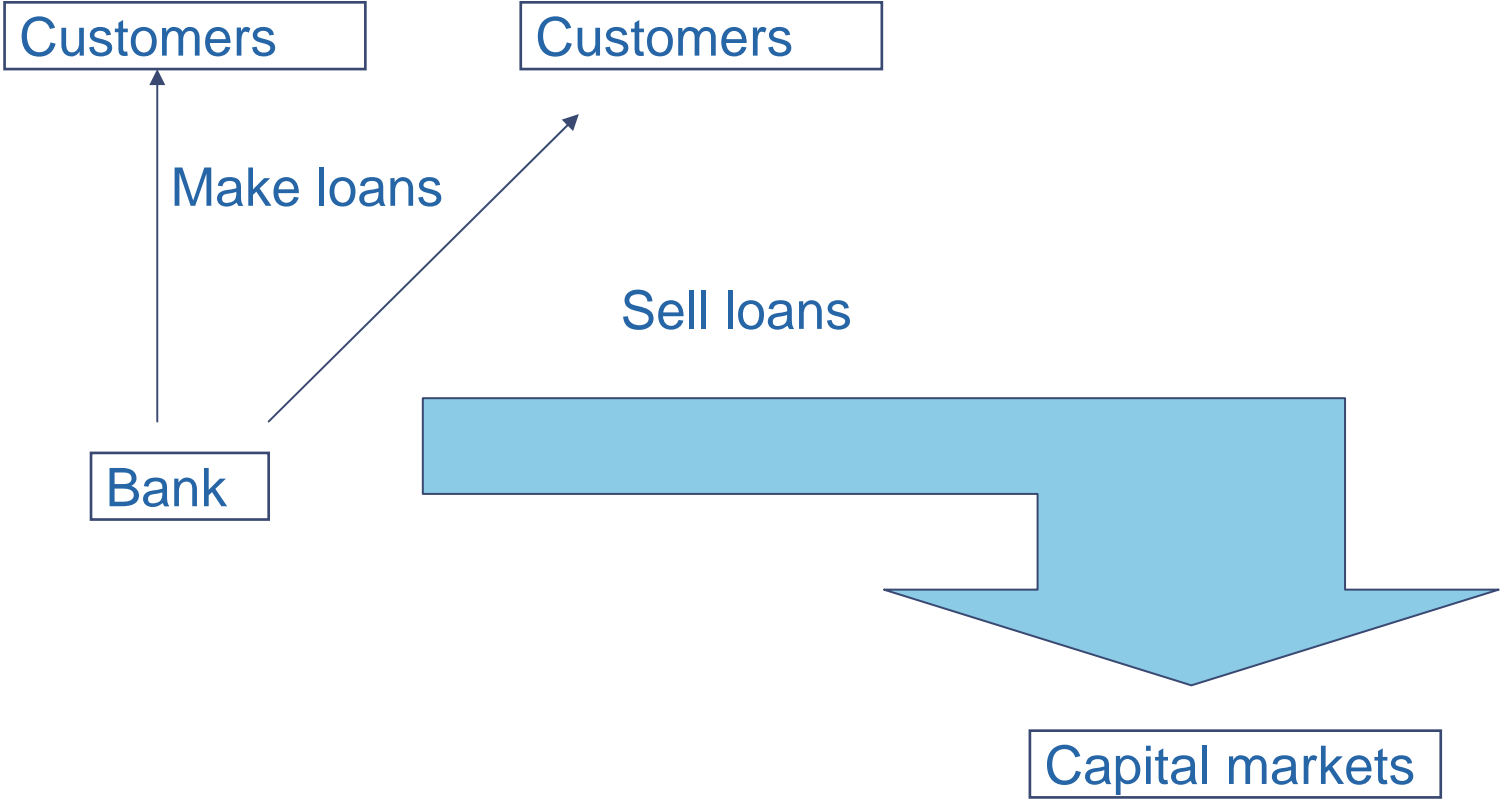
Would you lend?



# Banking the old fashioned way



# New banking - "originate and sell"



# The role of securitisation

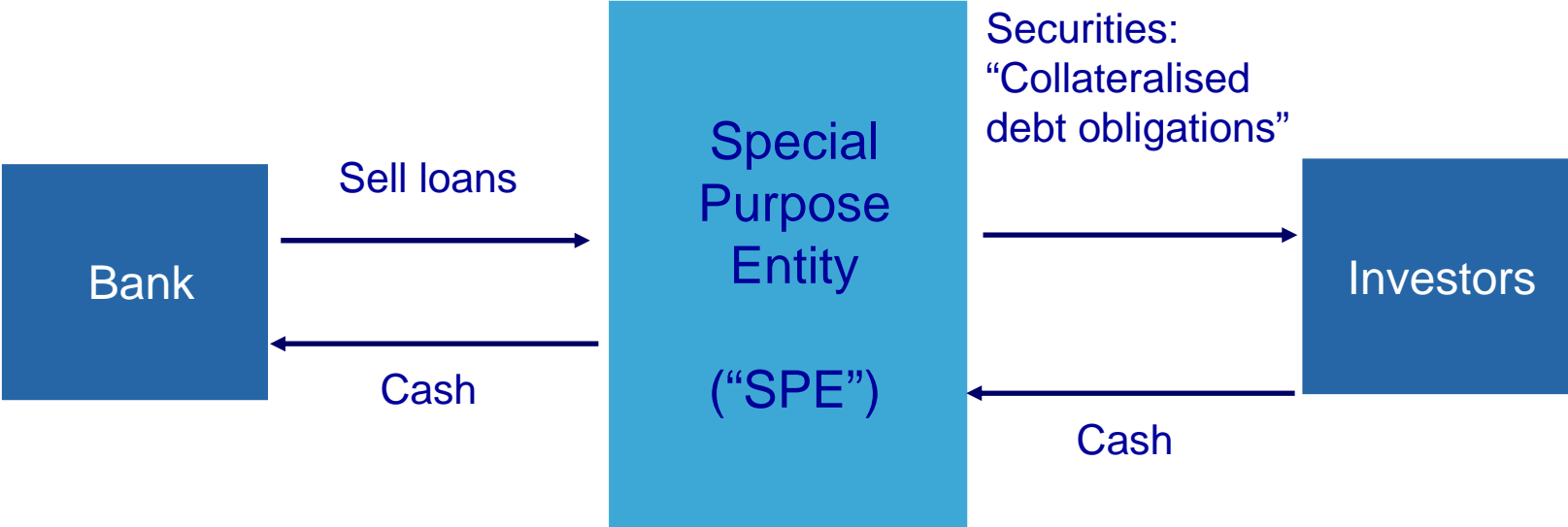
Basic securitisation

Collateralised debt obligations

CDO squared

Government sponsored enterprises

# Collateralised debt obligations

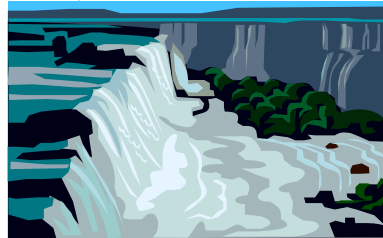


# Tranching and “waterfall”

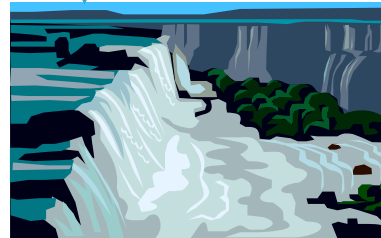
Cash in



Senior Debt 20%  
AAA (3% return)



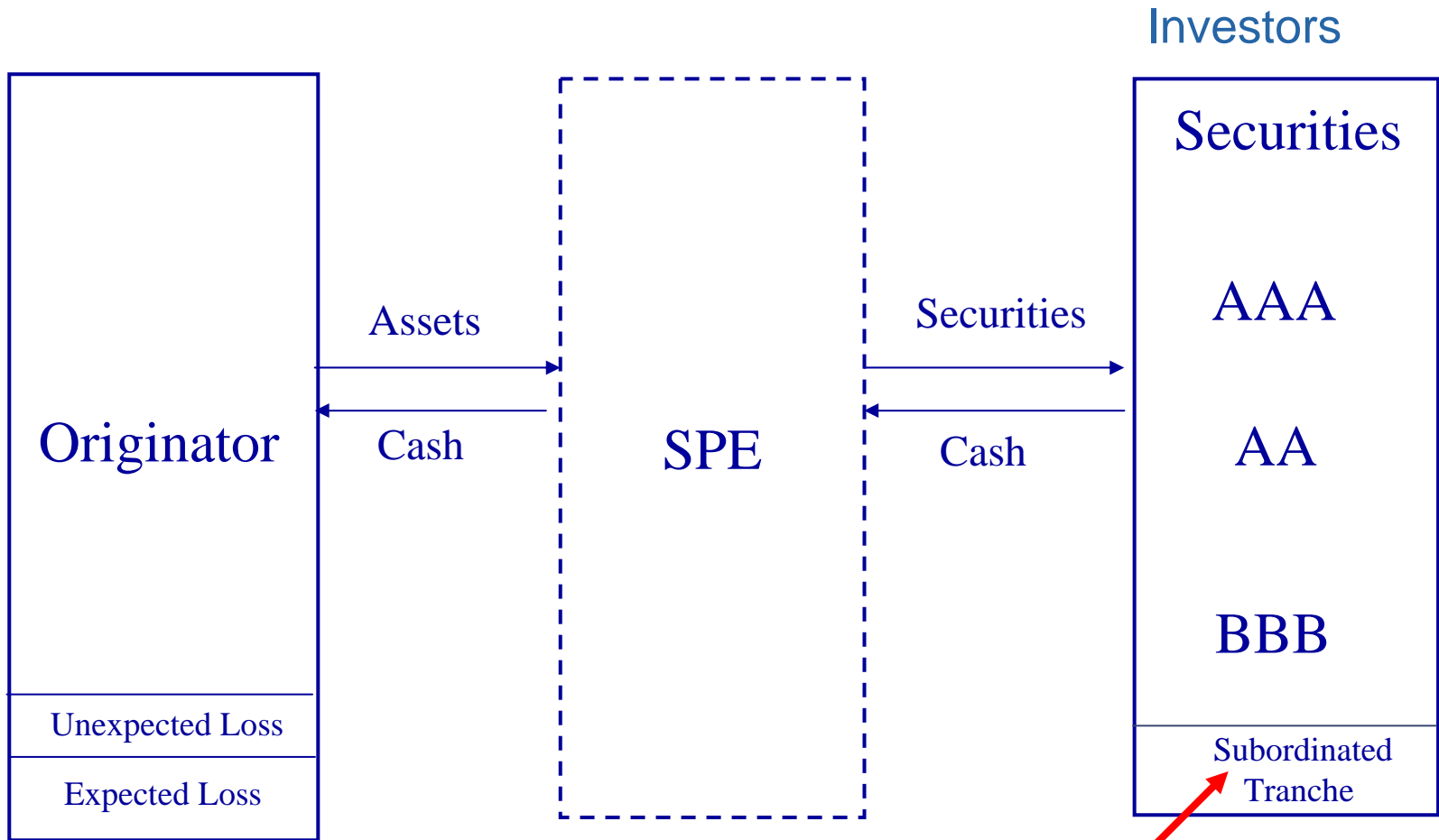
Investment Grade 60%  
(4% return)



Subordinated 20%  
(8% return)

# Asset sale securitisation

## Basic structure



May be held  
by originator

# Why regulated entities securitise

## Capital requirement for pool of bank loans:

Pool of bank loans            £100

Bank capital required        £ 8

## Capital requirement for credit underpinning to SPE:

Pool of bank loans            £100

Financed by:

Securities                      £ 98

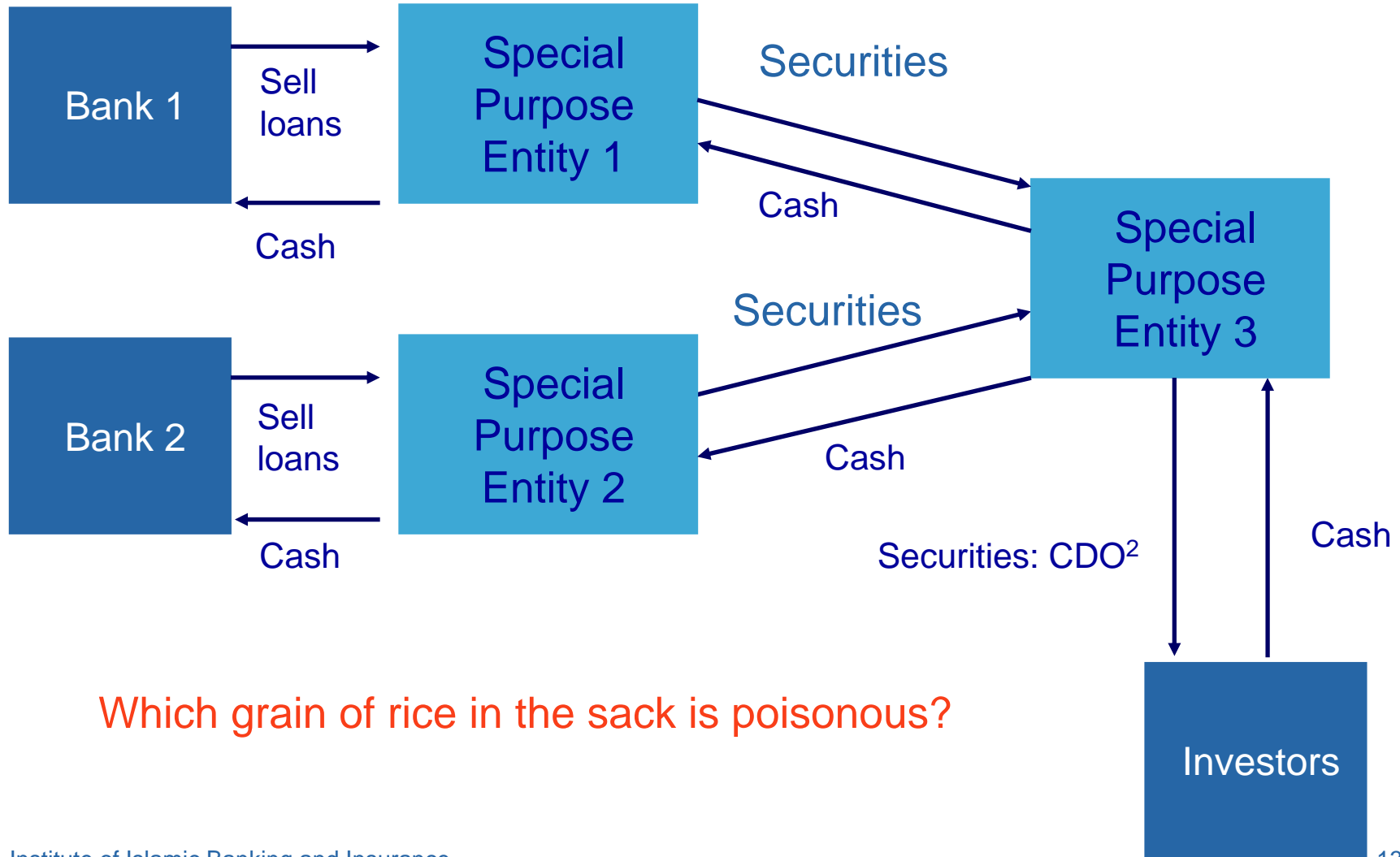
Subordinated debt            £ 2

£100

# Can a bank let its SPE's fail?

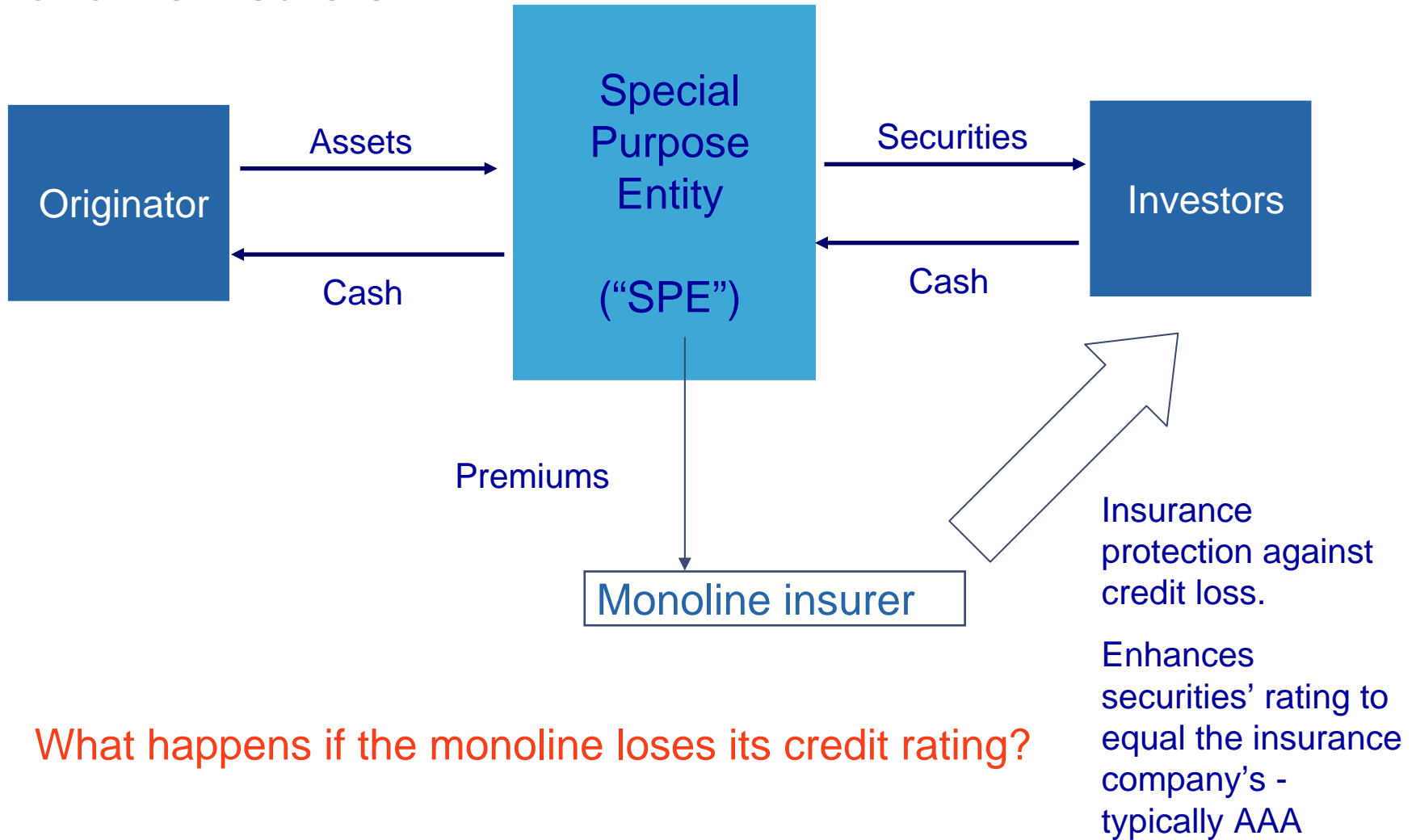
Banks bringing structured investment vehicles (SIVs) back onto balance sheet  
Impact on capital ratios

# CDO squared



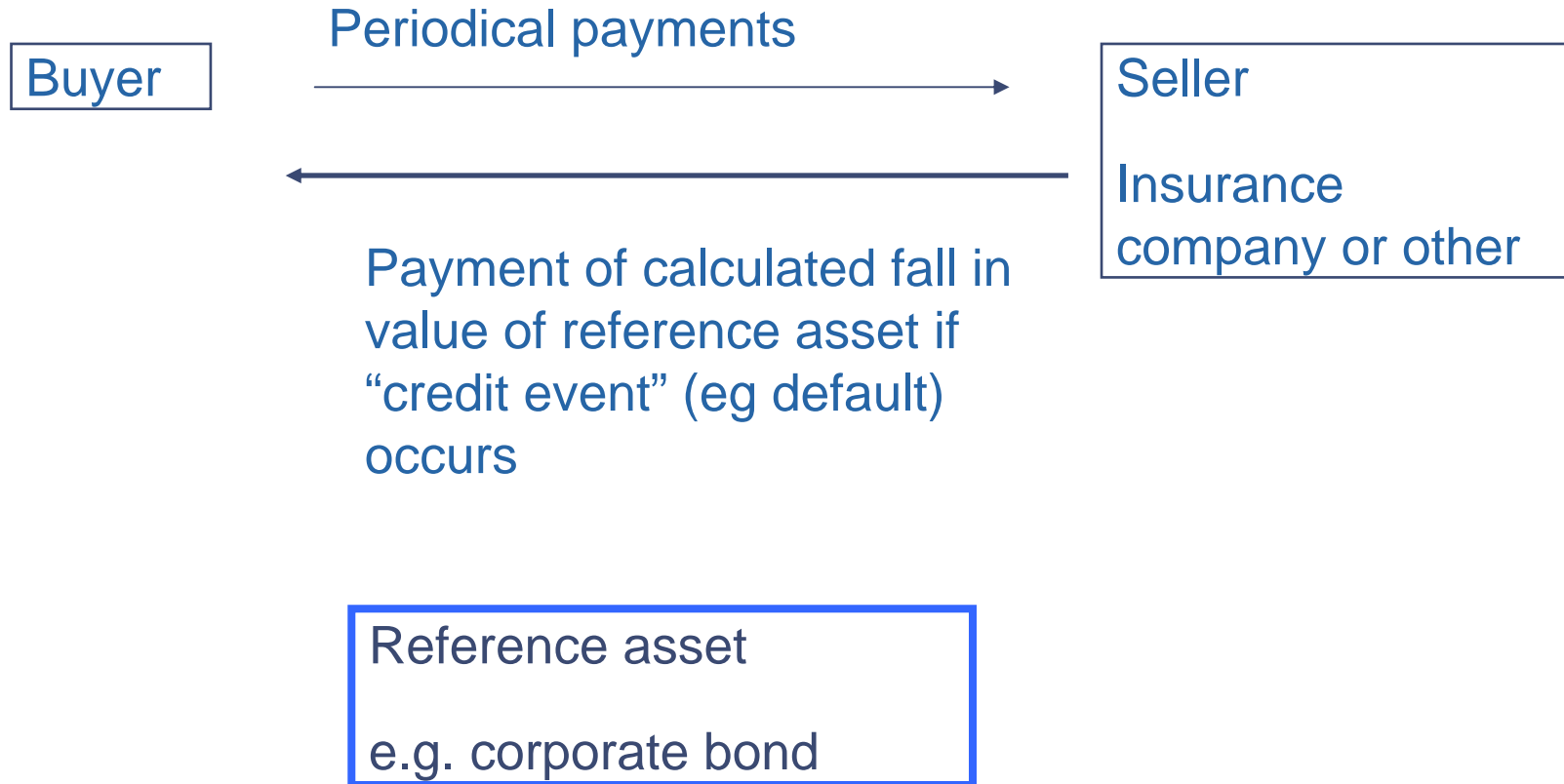
Which grain of rice in the sack is poisonous?

# Monoline insurers



What happens if the monoline loses its credit rating?

# Insurance companies selling credit default swaps - “CDS”



**NB: Buyer need not own the reference asset**

# Government sponsored enterprises



Federal National Mortgage Association (Fannie Mae) total assets \$919 bn at 31 March 2009

Federal Home Loan Mortgage Corporation (Freddie Mac) \$947 bn at 31 March 2009

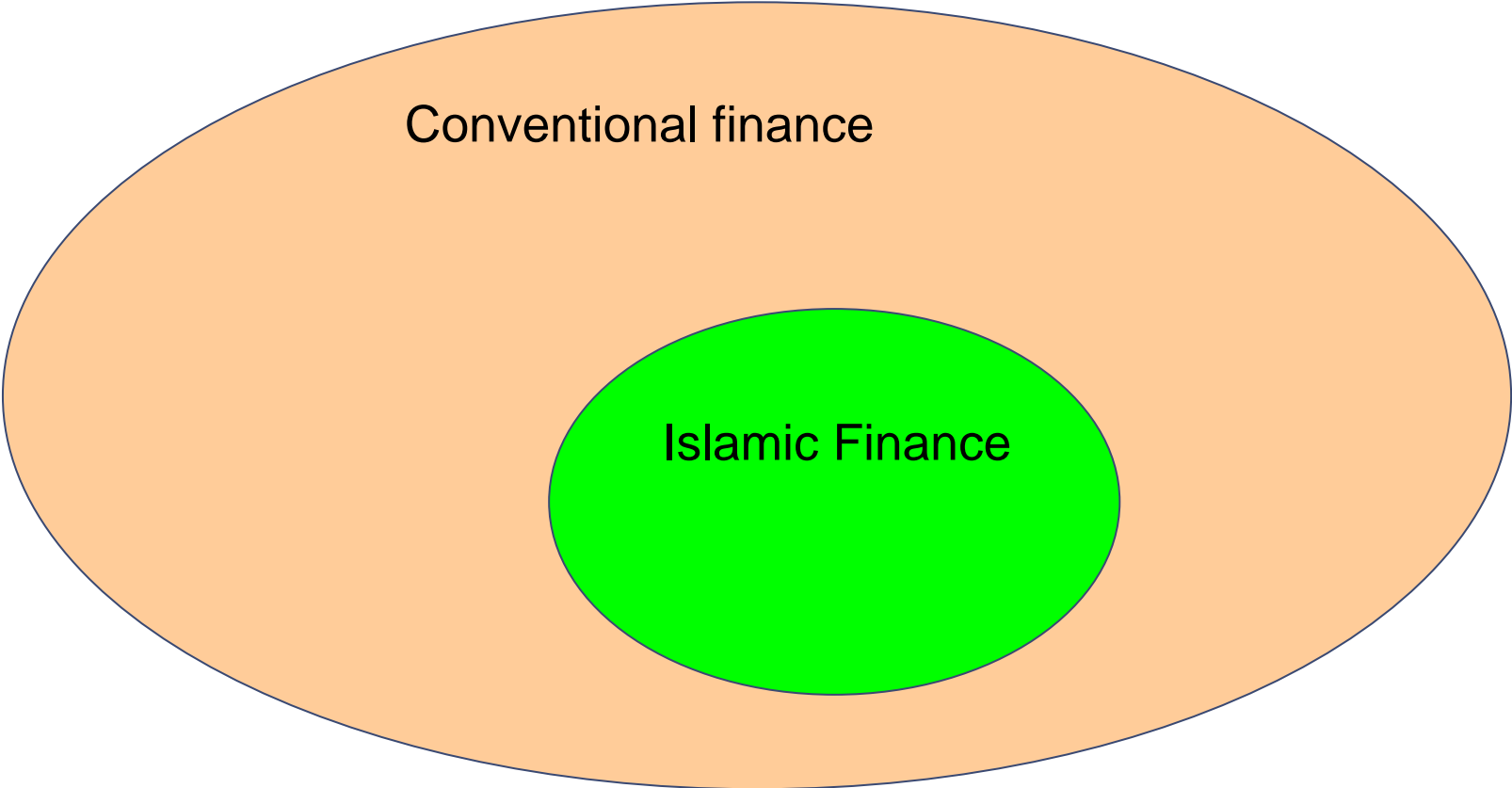
IMF forecasts \$250 billion of losses in US GSEs

# Over leveraging generally

## Interest tax deductible

- Private equity
- Commercial companies generally: “efficient balance sheets”

# Introduction to Islamic Finance



# What Shariah prohibits




RIBA

Prohibits paying  
or receiving interest



GHARAR  
and  
MAYSIR

Prohibits gambling and  
uncertainty



Selling what  
you don't own

Prohibits conventional  
derivatives,  
especially combined with  
gharar prohibition

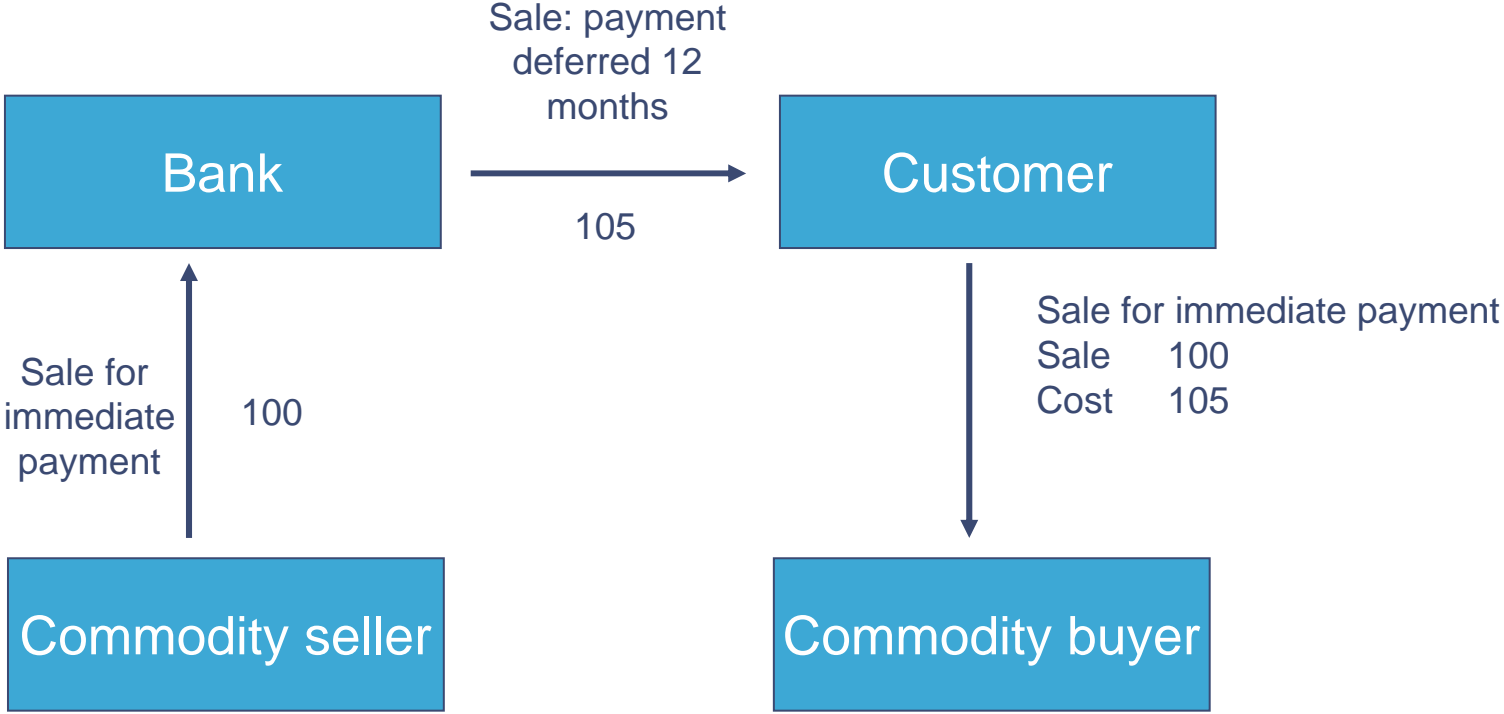
# Islamic contracts with “conventional” economics

Murabaha

Ijara

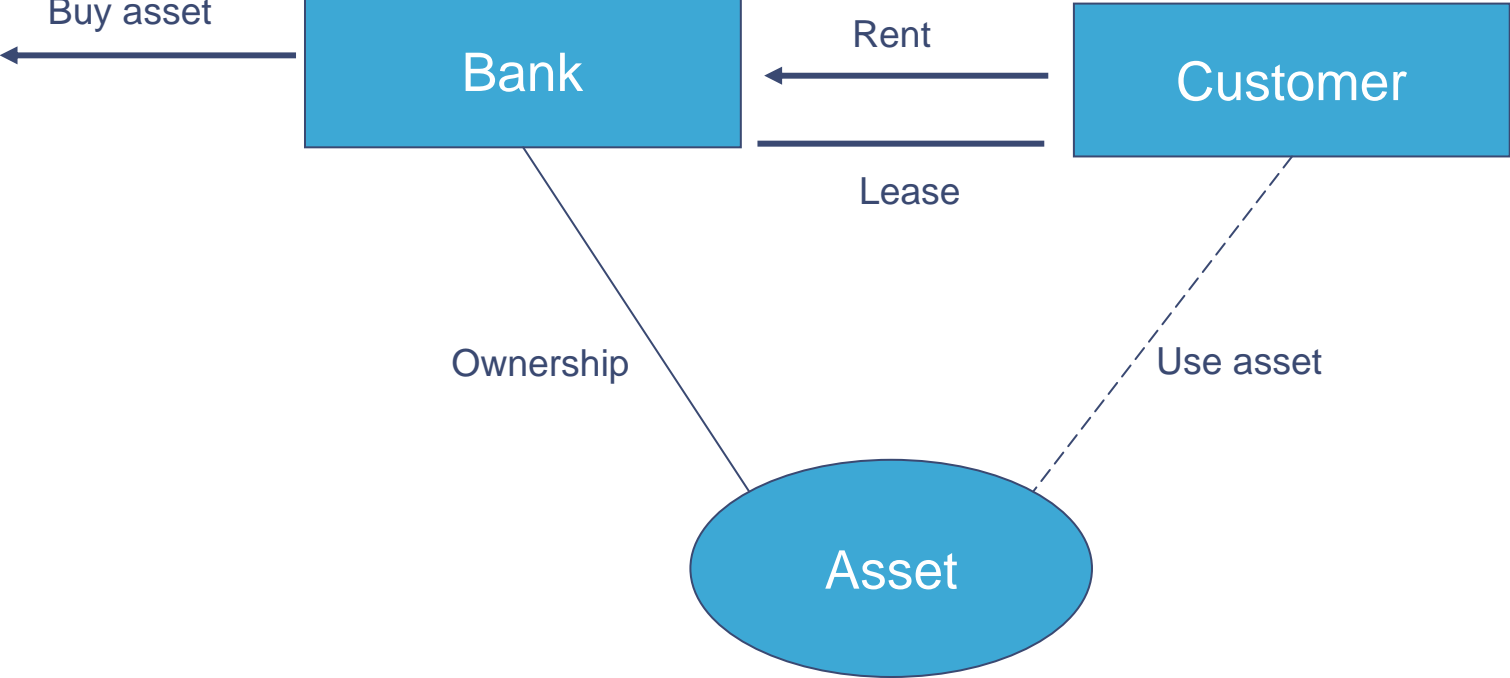
# Synthesising debt

## Commodity murabaha or tawarruq



Equivalent to 5% interest bearing loan by Bank to Customer

# Ijara

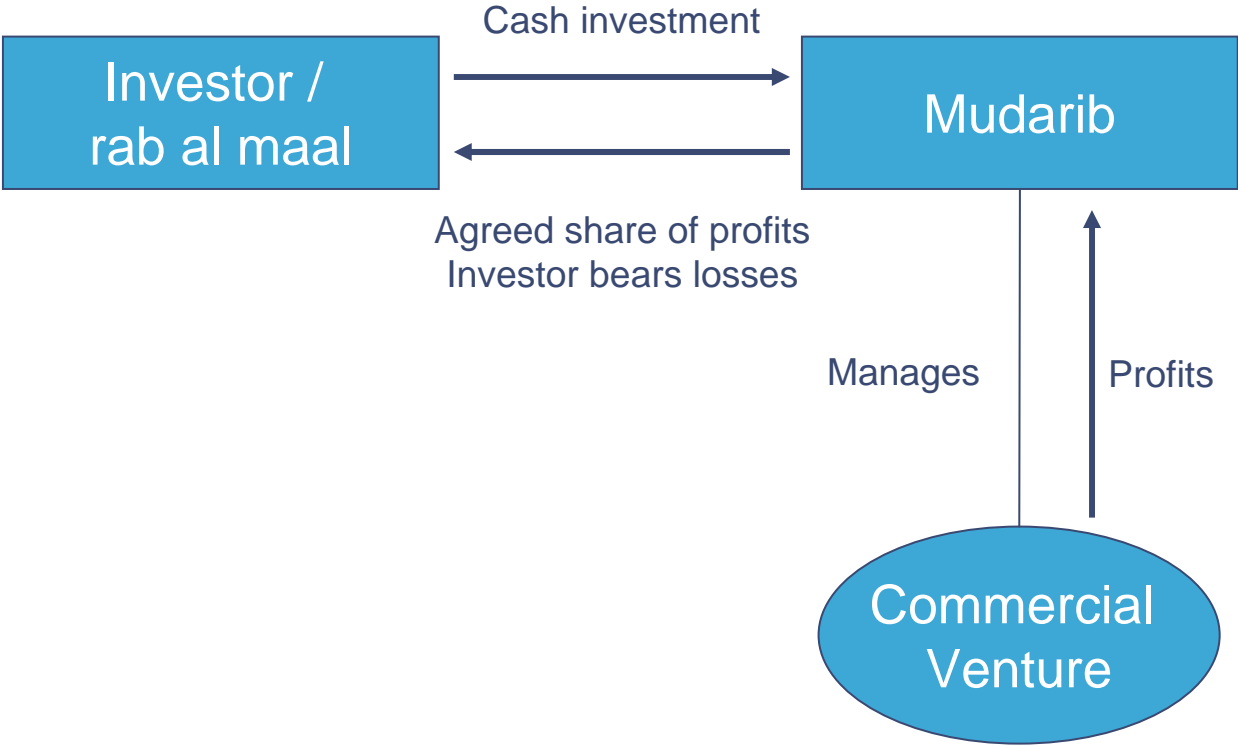


# Islamic contracts with financier risk sharing

Mudaraba

Some sukuk

# Mudaraba – partnership with one capital provider



# Islamic bank's liabilities

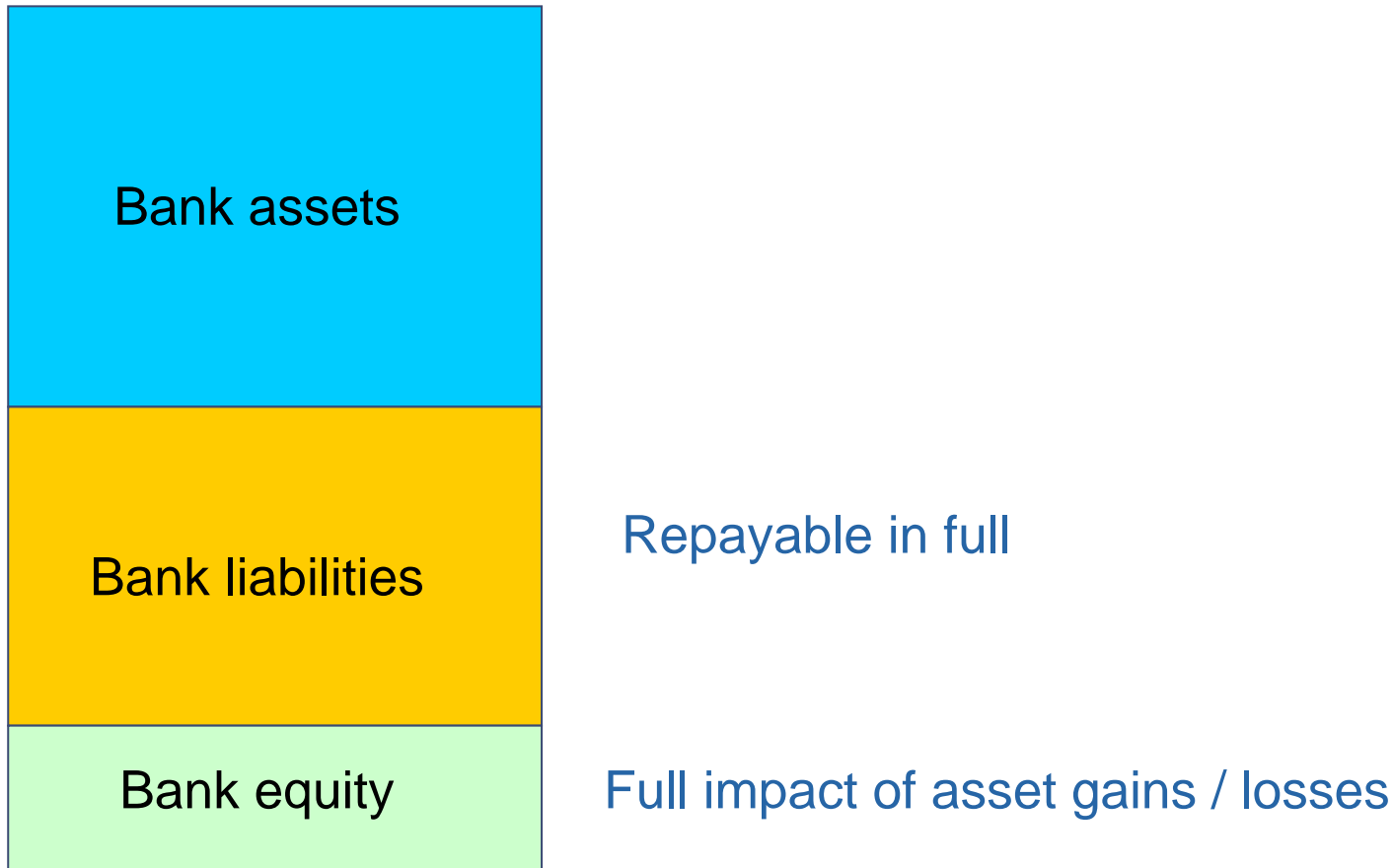
Current account

- Interest free deposit
- No return

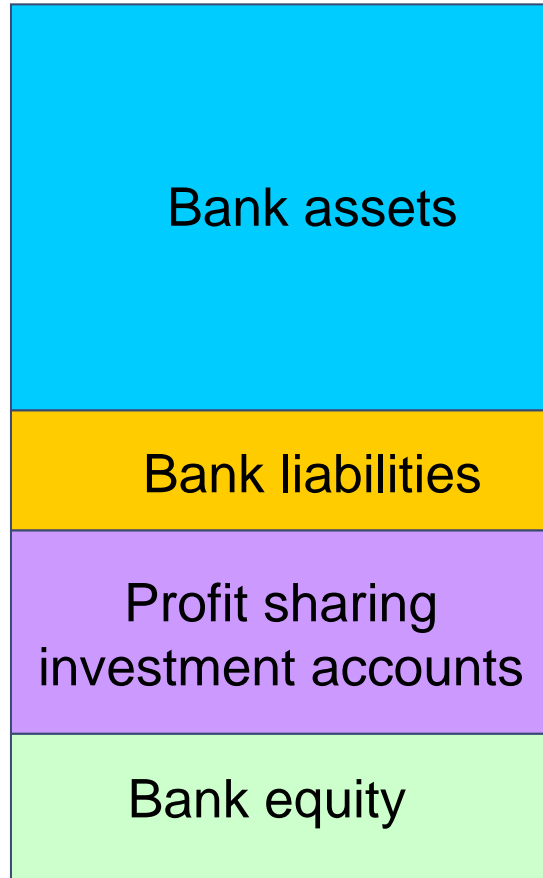
Deposit account

- Profit and loss sharing investment account (mudaraba)

# Conventional bank balance sheet



# Islamic bank balance sheet



Repayable in full, invested in “safe” assets

Share in asset profits but also bear losses on assets

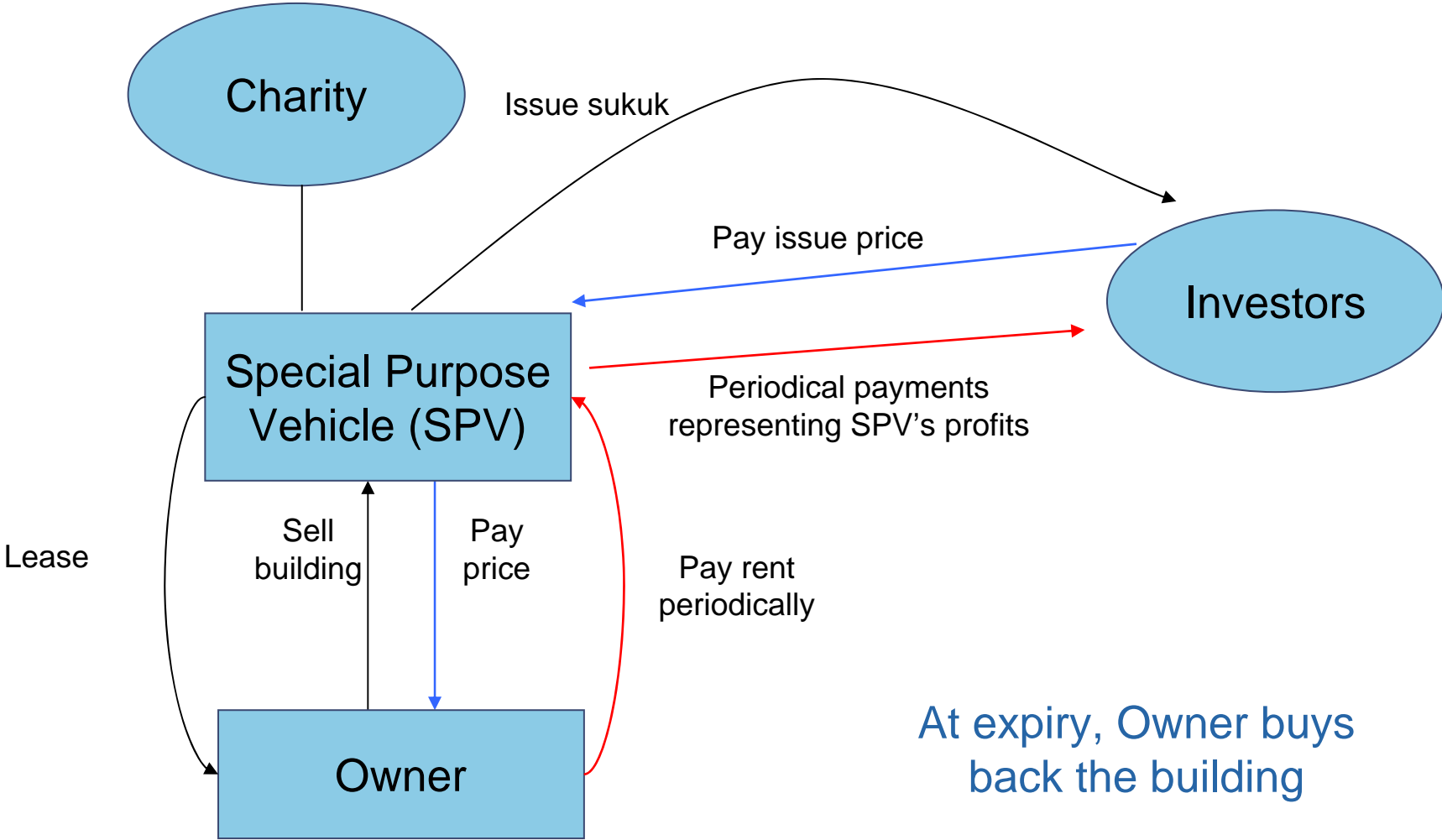
Reduced impact of asset gains / losses

# Sukuk

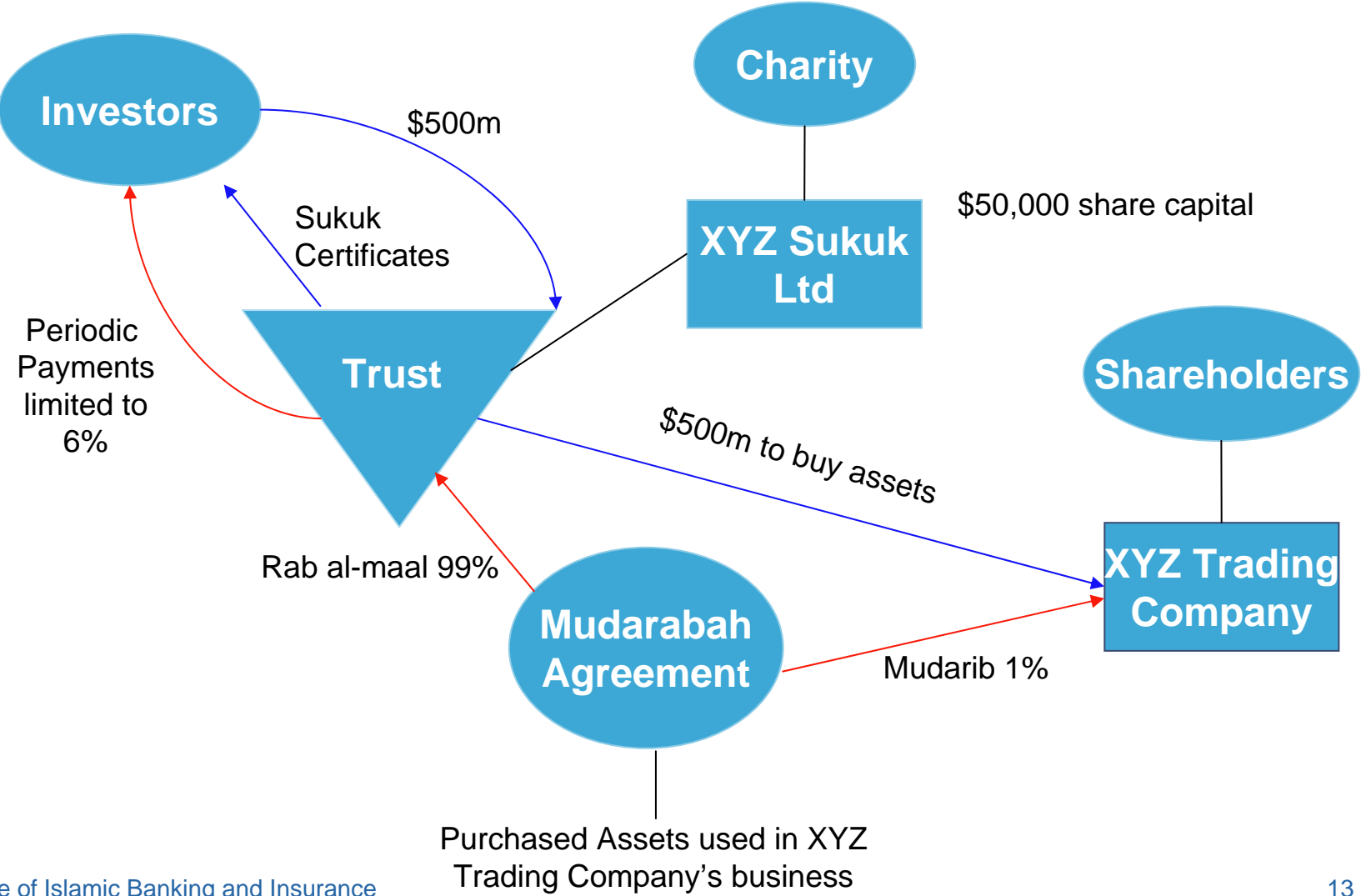
The Islamic equivalent of bonds

- Goal – replicate characteristics of conventional bonds without infringing the rules of Shariah
- No legal debt involved
- Can be bought and sold between holders of the instrument without affecting the company
- Provides finance for a fixed period of time (typically 3–5 years)
- Provides investors with a flow of regular payments without involving interest

# Ijara sukuk – conventional economics



# Mudaraba sukuk – risk sharing economics



# What's different about Islamic finance?

Caveat emptor v requirement for ethical dealing

- Don't lend if customer should not borrow

Prohibition of debt trading

Prohibition of gharar (CDO<sup>2</sup>, derivatives)

Risk sharing by PSIA holders

Risk sharing by some sukuk holders

## Concluding comment

Islamic Finance distributes risk differently from conventional finance.

Many of its features would have made the global financial crisis much less likely.

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