

Risky business

The financial difficulties in which many Islamic banks now find themselves are symptomatic of the same exuberance and risk-taking practised by conventional institutions. **Fehmy Saddy PhD** stresses the importance of Islamic finance returning to the foundations on which it was based

THE FINANCIAL CRISIS has created an atmosphere of euphoria in Islamic financial circles and new players have arrived on the scene to capture the moment. France, for example, has emerged as the new kid on the block to challenge London, the self-proclaimed global centre of Islamic finance.

With international markets under stress, France plans to raise €155bn in long-term securities and hopes to find Islamic takers (Bloomberg, 2009). With the rebounding of oil prices and the expected new wave of wealth accumulation by GCC countries, there is reason for France to be optimistic about the future of Islamic finance.

But has the financial crisis affected the Islamic investment banking industry? This article contends that Islamic banking—particularly in the GCC—has been integrated into the conventional banking system as a surrogate and has been affected by the same exuberance and losses suffered by conventional banks.

This article will address the conditions for sustainability of the Islamic financial system and examine whether this system has evolved as an independent and parallel system of finance, or simply as a subsystem to conventional finance.

Looking to the future, the question for Islamic banks is whether they will be used as an instrument to shore up sagging western economies and support the conventional banking system, or to chart a new path as an instrument of social and economic development.

Resilience

At a May conference in Bahrain, some hailed the resilience of Islamic finance. One participant said the “Islamic economy has truly proved to be the way to ben-

efit mankind as it could withstand the turmoil that the conventional economy could not cope with.”

Another declared: “The key fact that the Islamic finance industry is asset-based and not debt-financed has protected and prevented this sector from the crisis that has brought the downfall of conventional financial giants worldwide.” Yet, a third and more restrained participant cautioned that “recovering from the current financial crisis will require thought leadership and innovation by Islamic investors and fund managers”.

The implied uncertainty in the use of “could” in the first statement makes it more realistic, as the Islamic financial system may not live up to its claims. As for the second statement heralding the downfall of the conventional banking giants, it is appropriate to recall Mark Twain’s famous comment: “Reports of my death have been greatly exaggerated.”

But the statement of the third participant is both wise and opportune. Islamic finance needs thought provoking ideas, leadership and innovation if the industry is to be sustained.

The Islamic financial system rests on the premise that it serves the community and is therefore an instrument for social and economic development. It claims the higher moral ground by shedding away “interest” as unjustifiable since money is not a commodity, but an instrument for wealth creation and growth. Borrowing is not allowed, but trade is. Its ethical parameters are defined by its abstention from engaging in certain activities.

The system claims integrity and transparency in its transactions. While calculated risk is allowed in commercial transactions, excessive risk-taking is not allowed by those in charge of managing Islamic funds—they may be found liable for breach of fiduciary duty and bad faith. Theoretically, these premises should lead to a more resilient financial system.

The growth of the Islamic financial industry points in this direction. With around 300 Islamic banks serving a community of 1.5 billion Muslims, the need for more institutions is obvious.

The missionary vision implied in the growth of this system has stimulated a sense of pride by those involved, and prejudice against the conventional banking system as a whole. Some have even argued that the Islamic financial system is the answer and salvation of the global financial system—so it is destined to sail into the sun.

While some of the above claims are true and can be evidenced by facts, Islamic finance as practised by some institutions, particularly in GCC countries, is

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far from the utopian moral, ethical, integral, transparent, risk averse and resilient industry it claims to be. The panel overleaf shows a laundry list of some of the practices of Islamic financial institutions.

This analysis demonstrates, to varying degrees, that the Islamic financial industry has suffered the same fate as conventional finance during the current crisis, as both are involved in the same markets and product lines.

Both have relied on leverage and have undertaken significant risks. In most cases, an Islamic financial product is a mir-

Common practices of Islamic financial institutions

The players: The main players of Islamic banking are western conventional banks that have found a new source of funds for their investment banking products.

To convert a conventional product into an Islamic product, institutions need a conventional lawyer to create a scheme that separates ownership from management. This is done via a labyrinth of corporate entities in such a way that the holders of Islamic funds do not participate in the unethical work of leverage. As long as there is distance between the holders of funds and the corporate entities undertaking borrowing, the transaction is deemed Shariah-compliant.

Western banking institutions have designed financial products where even borrowing, earning interest and tainted transactions are considered acceptable as long as they are limited in scope. This has opened the door to the lucrative market of Islamic investments in quoted shares and equity funds, largely in western markets.

Shariah boards: The above “Islamic” products must pass the test of legitimacy to be accepted by Muslim investors and Islamic institutions. Shariah boards approve these on face value without going into the details of transactions further down the line.

The financial incentives and rewards make objection to these transactions a rarity. This problem is compounded by the fact that the opinion of any constituted Shariah board has the same power and privilege, from an Islamic jurisprudential point of view, as any other Shariah board. There is no need for unanimity of opinion among Shariah boards as they are all permitted to engage in *ijtihad*—the Islamic concept of interpretation of Shariah law.

There has been an effort to develop a set of rules and opinions unanimously agreed upon by reputable Islamic scholars, but resistance to this effort is strong since it will likely intervene with the free-style jurisprudence and pecuniary interest of some Shariah boards.

Innovation or adaptation: Transactions undertaken by Islamic banks are often adaptations of conventional transac-

tions. These are mirror images of conventional products structured in accordance with Shariah rules and approved by Shariah boards. Innovation is an adaptation of a product developed by the conventional banking industry—not a process by which the Islamic financial industry renovates itself by developing a home-grown product representing its inherent values.

It is a process of generating Islamic products *la carte*, in which a “structured product” remains faithful to convention. For an Islamic product to qualify, it must be based on the Islamic model. Changing this produces different values reflecting an entirely different world view and outlook on financial products and transactions.

Form over substance: The great debate of form and substance among Islamic scholars has been going on for centuries, but at no time has the use of form become such a travesty as today. The prevalence of form over substance has reached an epidemic level by using legal fictions, known in Islamic jurisprudence as *hyals* (“tricks”).

The *murabaha* structure (buying a product and selling it for profit) has turned into a synthetic activity that has nothing to do with real trading. It is a monetisation process by which banks—Islamic and conventional—borrow money at rates pegged to Libor with certain maturity periods.

Islamic corporate bonds (sukuk): In the conventional financial world, corporate bonds are normally issued by established corporate entities to finance their activities. Bond holders look at the track records of such entities for comfort. In Islamic finance, sukuk are often used to raise funds for new and speculative real estate investments by developers—some with no prior experience. In the conventional business world these investments are usually structured as partnerships where partners assume the risk equally.

In addition, sukuk holders are rarely made aware of the risks involved, as is the case of disclosure requirements in conventional finance. The lack of transparency and concentration of risk, particularly during the downturn of real estate markets, has caused losses to sukuk holders.

ror image of a conventional product painted “Islamic” with a coarse brush, but with less security than a conventional product.

Some Islamic transactions are riskier than their conventional cousins. Some Islamic funding of western corporate entities has taken place with less stringent investigation, even with eagerness. Some of these western companies with risky profiles and low credit ratings would not have been considered bankable by conventional banks.

But Islamic financial institutions had excess liquidity before the flare-up of the international crisis and fall of oil prices and were under pressure to place the funds quickly and pocket hefty fees. So some of the sukuk issued by these corporate entities with low ratings are effectively “junk sukuk”.

The securitisation of these bonds is a process of bundling up portfolios of toxic assets for sale to Islamic investors in the wholesale market with little or no disclosure. The financial difficulties in which most Islamic financial institutions find themselves today are symptomatic of the same exuberance and risk-taking of conventional institutions. The impact of the crisis demonstrates that Islamic finance is a sub-system rather than an independent or parallel system distinct from conventional finance.

Islamic financial institutions under stress have reverted to the same measures as conventional banks to stave off failure. Playing what might be called “Islamic Russian roulette” they have pressured their central banks to extend funding to them in order to survive.

UAE and Qatar central banks injected substantial amount of funds into their banking systems to provide liquidity and prevent failures.

Banks have reverted to “creative accounting” to hide their losses. Some have even been able to play up their losses as gains and raise additional capital from gullible investors.

A GCC-based bank which reported a net profit of up to 97% for nine months ending in September 2006 has since raised its capital to cover losses by 10% through a rights issue. In calculating the new capi-

tal, the bank included the reserves against losses and profits.

Meanwhile, the consolidation of Islamic financial institutions remains one way to rein in speculation.

Sustainability

Sustainability of the Islamic financial industry requires new directions based on lessons learned. First, the Islamic financial industry must return to the foundations upon which it was based. This means it must serve as an instrument of social and economic development. Muslims will benefit from Muslim wealth that is generated through trade and business once resources are placed in the service of the community.

Secondly, Islamic banks and Middle East investment banks must look outside the box. Dependency theorists have long recognised that for much of the 20th century and earlier, Latin America was dependent economically—and psychologically—on the United States. Only after Latin American countries began dealing directly with Europe, Africa and the Far East were they able to develop self-confidence and liberate themselves.

Islamic investment bankers need to spend more time looking at investment opportunities in non-western markets. Some have started to do so, albeit timidly.

Thirdly, the security of a transaction rests on the underlying asset—not on its designation. Islamic banks and Middle Eastern banks must focus on asset-based investments as the backbone of the Islamic financial industry. They must invest in the real economy: agriculture; natural resources; infrastructure projects; and other sustainable development undertakings, instead of “structured products” manufactured by western financial institutions. Islamic financial institutions may undertake financing joint projects with governments under the form of public private partnerships (PPPs).

Lastly, investment banking is all about research. Sustainability of the Islamic

INDUSTRY DEVELOPMENT Islamic finance must follow new directions based on lessons learned

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finance industry rests on risk analysis and the objectives to be attained. Any product is as good as the research behind it. It is not necessarily more secure just because it is Shariah-compliant.

Islamic financial institutions rely on research provided by Western financial institutions interested in selling transactions that are often unbankable in their own territories. So Islamic investment banks are consumers—not originators—of research. Going down the list of major investment banks in the GCC region today, there are hardly any research depart-

ments. When an Islamic investment bank invests huge sums in agribusiness, for example, the first order of business is to invest in the best experts money can buy.

In conclusion, Islamic finance is no guarantee against failure. Sound investment banking principles, with clearly defined objectives, is the answer to the question of sustainability.

By adhering to the same failed investment strategy of past years, most Islamic investment banks, including conventional Middle Eastern banks, have suffered from the international financial crisis. This is the third time in one generation that the receipts of a single and finite resource—oil—have been squandered. Hopefully it will be the last. ■

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