

# Global Financial Crisis and Islamic Finance

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# Agenda

- Financial Crisis—Background & Build Up
  - Regulatory level
  - Organizational level
  - Product level
- Lessons from Islamic Finance
- Lessons for Islamic Finance
- Conclusion

# Introduction

- The causes of the current crisis can be traced to three levels:
  - Regulatory
  - Organizational
  - Products

# Regulatory Environment

- Financial Institutions operated in a deregulated environment
  - Fed—Emphasis on self-regulation
  - 1999—Gramm-Leach-Bliley Act (repeal of Glass-Steagall Act)
  - 2004—SEC loosened capital requirements for 5 large investment banks (MerL, LehB, GolS, MorS, BeaS)
    - Increased leverage (BeaS had debt/equity ratio of 33:1)
  - Resistance to control OTC derivatives market
  - Basel II—Market based risk assessment and capital requirements

# Organizational Failures

- Lax Risk Management Practices
  - High Leverage (low capitalization)
  - Transferring risk—Excessive risk taking
  - Creating newer risks (not well understood)
  - Under-pricing of risks
  - Ethics and morality
    - Greed
    - Rating Agencies role

# Product Level

- Innovations:
  - Securitization and sale of debt
  - Creation of complex and opaque financial instruments (derivatives)
    - Hedging (risk transfer)
    - Speculation
- Changed financial structure
  - Sources of funds of banks moved from depositors to capital markets (securitization)
  - A complex network of inter-relationships
  - Created systemic risks not well-understood

# Making of the Crisis (1)

1. Driven by excessive profit-motives, banks/financial institutions engaged in sub-prime lending (with adjustable interest rates)
2. Loans packaged as Mortgage Backed Securities (MBS)/Collateralized Debt Obligations (CDO)
  - 55% of the \$10.2 trillion loans securitized (end 2006)
  - 12-15% of securitized loans were sub-prime
3. Rating Agencies gave positive ratings to these securities (to get more business and collect fees)

## Making of the Crisis (2)

4. Investors (banks, hedge and pension funds, municipalities, schools, etc.) acquired these securities
5. Investors/speculators bought Credit Default Swaps (CDS) to hedge credit risks on MBS/CDO
  - Notional amounts of OTC Derivatives in 2007 \$596 trillion, CDS \$58 trillion (US GDP \$13.8 trillion)
6. Issuers of CDS (Investment banks & Insurance companies) took on the risk of default

# From Defaults to Economic Meltdown

- ❑ Interest rates began to rise (1% to 5.25% between 2004-2006)
- ❑ Adjustable rate subprime loans started to default
- ❑ Holders of MBS/CDO incurred losses
  - ❑ Prices of CDOs fell
- ❑ Issuers of CDS had to pay-off the losses caused by default
- ❑ Losses caused depletion of capital of FIs
- ❑ Scramble to get funds
  - ❑ Money market froze (as lenders did not know the risks involved)
- ❑ Lack of financing caused housing market to crumple—further decreasing housing (CDO) prices and increasing market risks
- ❑ Credit risks, market risks, and liquidity risks produced systemic risks
- ❑ Vicious cycle of deleveraging and economic downturn

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# Locating Finance in Islam

- **Ethics** related to financial activities
  - Prohibitions (fraud, hoarding, exploitation of need, gambling, etc.)
  - Obligations & Recommended (charity, honesty, interest-free loans, risk sharing, etc.)
- **Laws** governing economic/financial activities
  - Principle of **permissibility**: All transactions are permitted except what is explicitly prohibited by Islamic law
  - Prohibitions are *riba* and *gharar*

# Islamic Financial Principles and Crisis

- Islamic principles:
  - Using risk-sharing instruments—more monitoring
  - Prohibition of selling of debt (CDOs)
  - Prohibition on derivatives (CDSs)
  - Prohibition on short-selling—limiting betting on downside risks
- If Islamic principles were followed, the crisis would not have taken place the way it did

# Crisis and Islamic Finance:

## Ethical and Legal Dimensions

### Conventional

1. Banks/financial institutions engaged in sub-prime lending
2. Loans packaged as MBS/CDO
3. Rating Agencies gave positive ratings to these securities
4. Investors/speculators bought securities
5. Credit Default Swaps (CDS) to hedge/speculate on credit risks

### Islamic

1. [Risk-sharing modes preferred]  
[Excessive greed discouraged]
2. **Selling of debt prohibited**
3. [Dishonesty discouraged]
4. -
5. **Derivatives prohibited**  
[Speculation discouraged]

# Ethics and Governance

- The crisis was as much financial as ethical—there has to be some mechanism for to ensure ethics prevail
- Board of Directors (BOD) serve the interests of the shareholders only
- Islamic financial institutions also have *Shari'ah* Supervisory Boards (SSB)
- SSB should ensure ethical operations and *Shari'ah* compliance

# Islamic Financial Sector and Crisis

- Islamic financial sector has performed relatively better under the crisis
  - 'While conventional banks worldwide are nursing losses of more than \$400 billion from the credit crisis, Islamic banks are virtually unscathed' (IHT, August 19, 2008)
  - 'In a dire year for mutual funds, the Amana Trust Income Fund, the main Muslim investment fund, has trumped those from all other faiths in the US by losing only 25.8% of its value for the year – half the average 44% loss for the US stock funds' (FT, Dec. 26, 2008)
  - 'Non-Muslims turn to Islamic Bank as a safe option' (Birmingham Post, Oct. 3, 2008)
  - 'Shares of most Islamic Banks in GCC markets record spectacular rise' (Arab News May 14, 2009)

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# Financial Crisis: Lessons for Islamic Finance

- Key elements of the crisis from risk perspectives are
  - De-regulated environment
  - FIs seeking higher rates of profit (excessive risk taking and leverage)
  - Using innovative complex instruments
- If Islamic finance follows the same path, can it end up in the same situation?

# Status and Practice of Islamic Finance

- **Regulatory:** IF regulatory environment in elementary stages and still evolving
- **Organizational:** Excessive profit/risk-taking—difficult to impose moral order
  - Episodes of speculation observed in the Gulf states
- **Products:** Innovations mimicking conventional products
  - Fixed income assets—No risk-sharing
  - *Sukuk*
    - Risk transfer through securitization
    - Do investors have control over assets?
  - Return-swap
    - Returns on assets can be swapped with return on any class of assets (including sub-prime CDOs)
    - Capital efficient solutions?

# Crisis: Lessons for Islamic Finance (1)

- Markets/banks cannot be left to regulate themselves
- *Shari'ah* principles do not have anything specific to say about systemic and organizational aspects of the crisis
- IF has principles at product level that could have prevented the crisis
  - Products developed are diluting the principles
- Regulators have to address risks arising at systemic, organizational and product levels
  - Minimizing Systemic Risks
  - Strengthening Organizational RM Regimes
  - Products Regulation

# Regulations and Support Systems to Minimize Systemic Risks

- Until now, the focus has been on regulating individual institutions
- Need to minimize systemic risks—oversee the system as a whole
  - Regulate all FIs—understand the inter-linkages
  - Separation of commercial and investment banking
  - Reformation and accountability of Rating Agencies
  - Liquidity Risks—*Takaful* Fund to be used in case of crisis

# Regulations: Strengthening Organizational RM Regimes

- Capital Requirements—understand the risks of Islamic financial products
- Introduce prudent risk management culture and practices in IFIs
  - Prevent excessive risk-taking by setting investment criteria
  - Impose restrictions on excessive leveraging
  - Require more transparency and accountability
  - Enhance transparency and information disclosure
  - Ensure maintenance of credit standards at all times

# Product Regulation

- Products determine the nature and direction of industry
- *Shari'ah* Boards play a key role in approving the appropriate products
  - Products approved at organizational level taking the industry closer to conventional
- *Shari'ah* Board at the national level
  - Approve and monitor Islamic products
  - Provide *Shari'ah* governance guidelines
  - Reduce *Shari'ah* compliance and reputational risks

# Conclusion

- After the crisis, economies are looking for ideas to restore the system
- Principles of Islamic finance has much to offer
- It is good time to strengthen the regulatory architecture of Islamic finance
- This would require understanding the risks at systemic, organizational and product levels



Thank you!

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