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The Agenda

- Part 1 – Genesis of the crisis
- Part 2 – Understanding human nature – the Quranic view
- Part 3 – Islamic Finance – seeking clues

The Crisis

- Former Chairman of the U.S. Federal Reserve, Alan Greenspan, on October 23, 2008 testifying before the House Committee on Government Oversight and Reform called this crisis a, “once-in-a-century credit tsunami.”
- U.S. unemployment rate is expected to reach 10 percent

The Crisis

- Projected GDP growth for 2009 is at an anemic 0.1 to 0.2 percent.
- National debt is over \$10.6 trillion and climbing
- Budget deficit stands at nearly \$455 billion and is expected to be over one trillion dollars.

Global Nature of the Crisis

- World economic growth rates will be around 1 percent (largely fueled by China).
- Growth in the Euro area and Japan will decline sharply, with the IMF predicting 2009 GDP growth of just 0.2 and 0.5 percent.
- Stock markets around the world have lost value, some losing as much as 70 percent of their value in one year!
- The number of people chronically hungry may increase by 130 million, reaching three-quarter of a billion people.
- Growth in trading volume will drop by half its 2006 levels.

What caused such a deep crisis?

- Greedy traders
- Lax bankers
- Clueless regulators
- All failed to perform their fiduciary duties!

- But this alone does not explain the depth of this crisis.

- At the core lies a dogmatic beliefs:
 - In the “invisible hand” of the market.
 - In assuming human beings are “rational”

Are people “rational” or “human”?

- A rational being:
 - Prefers more wealth to less.
 - Pursues this goal in an optimal manner.
 - Is a “*Homo economicus*” or Economic human
 - Seeks to maximize wealth with the least possible cost.
 - Seeks to maximize well being as defined by a utility function.
 - Makes decision using logic not emotion.
- A human being:
 - Is not always *Homo economicus*.
 - Does not perceive gains and losses in the same way (Prospect Theory).

Animal Spirits

- Five "animal forces" (emotion) that drive economic choices:
 - **Confidence**: Rather than make investment decisions based on objective facts, investors are more likely to use “gut feelings.”
 - **Fairness**: People in general want to be fair and they want others to live with fairness (may contradict pursuit of efficiency).
 - **Corruption**: Each major financial crisis of the past century has been preceded by anti-social behavior.
 - **Money illusion**: People often take the numerical or face value of an asset as its true value ignoring the impact of inflation.
 - **Stories**: Stories propagate myths, which in turn leads to bubbles.

Human beings in the Quran

- *"We have indeed created man in the best shape, then We reduced him (to be) the lowest of the low, except those who believe and do righteous deeds: for they shall have a reward unfailing."* (95:4-6).
 - The presence of “animal spirits is well illustrated in the many stories of human failings in the Quran.
 - However, the same human being is also capable of extraordinary compassion and understanding.
 - Prophet Muhammad said, “God created Adam in His form.”

Human beings in the Quran

- This suggests that human beings have unlimited capacity for development and the pursuit of perfection.
- With proper nurturing, appropriate environment and enforceable reward-punishment structure human beings can gain reasonable control over their “animal spirits.”
 - Allowing emotions to be held in check promoting better decision making.

Shades of Human Nature - *Nafs*

- *Nafs* - linguistically can be translated as soul or self.
 - The term *Nafs* has different uses in the Holy Qur'an. In most cases, it means the human self and his person (3: 61; 12:54). It also means the human soul (6:93; 50:16).
 - The Quran describes 3 types of *Nafs*:
 - *Nafs al-ammarah bi al-su'*, (the self urging evil) - Al-Ghazali asserts that this *nafs* can direct its owners to hypocrisy, arrogance, greediness, negligence and restlessness.
 - *Nafs al-lawwama*, (the blaming self) - This *nafs* is our self-conscience and if properly nurtured can spur us towards growth and perfection.
 - *Nafs al-mutma'inna*, (the self at peace) - A person if advanced to this stage achieves satisfaction while his personality manifests mildness, tolerance, forgiveness, and understanding of all beings.

Shades of Human Nature - *Ruh*

- Are *nafs* and *ruh* the same?
 - *Ruh* spans the entire spectrum of existence - the seen as well as the unseen.
 - *Nafs* is restricted to only that which may be experienced in the creational world.
- Holy Qur'an declares that God blew His spirit into human body: "*When I have made him and have breathed into him of My spirit, (I ordered the angles to) bow down, prostrating yourself before him.*
(15:29)
- Also see 38:72 and 32:8

Shades of Human Nature - *Qalb*

- The Qur'an considers *al-Qalb* as the seat of wisdom and intellect.
 - *“Do they not travel through the land, so that their hearts may learn wisdom and their ears may learn to hear? Truly it is not their eyes, rather it is their hearts which are in their chests are blind.”* (22:46).
- God has declared that on the Day of Resurrection, only those would be saved who come with a healthy heart: (26:88-89)
- The heart will remain restless until it rests in God: *“For sure it is in the remembrance of God that the heart finds rest,”* (13:28)

What do all this mean?

- Muslim philosophers like al-Farabi and Ibn-Rushd assert that even though the human soul is made of different parts, all the parts are working towards one final end - **happiness**.
- Happiness cannot be measured.
- Happiness cannot be reduced to *Homo economicus*.
- Thus the goal of all institutions and systems will be to promote human happiness.
 - This requires mutuality.

What is the Muslim obligation?

- Islam does not prohibit the pursuit of finance's fundamental goal - wealth maximization.
 - However it conditions this endeavor, as it does all human endeavors, on upholding such basic keeping promises, fulfilling contracts, avoiding usury, etc.
 - Islam's intense commitment to justice and kinship demands that society take care of the basic needs of all people, regardless of color, religion, ethnicity or social status.
 - While encouraging such help, Islam also obliges individuals to work hard to earn a living, stressing that the hand that gives is superior to the hand that receives.

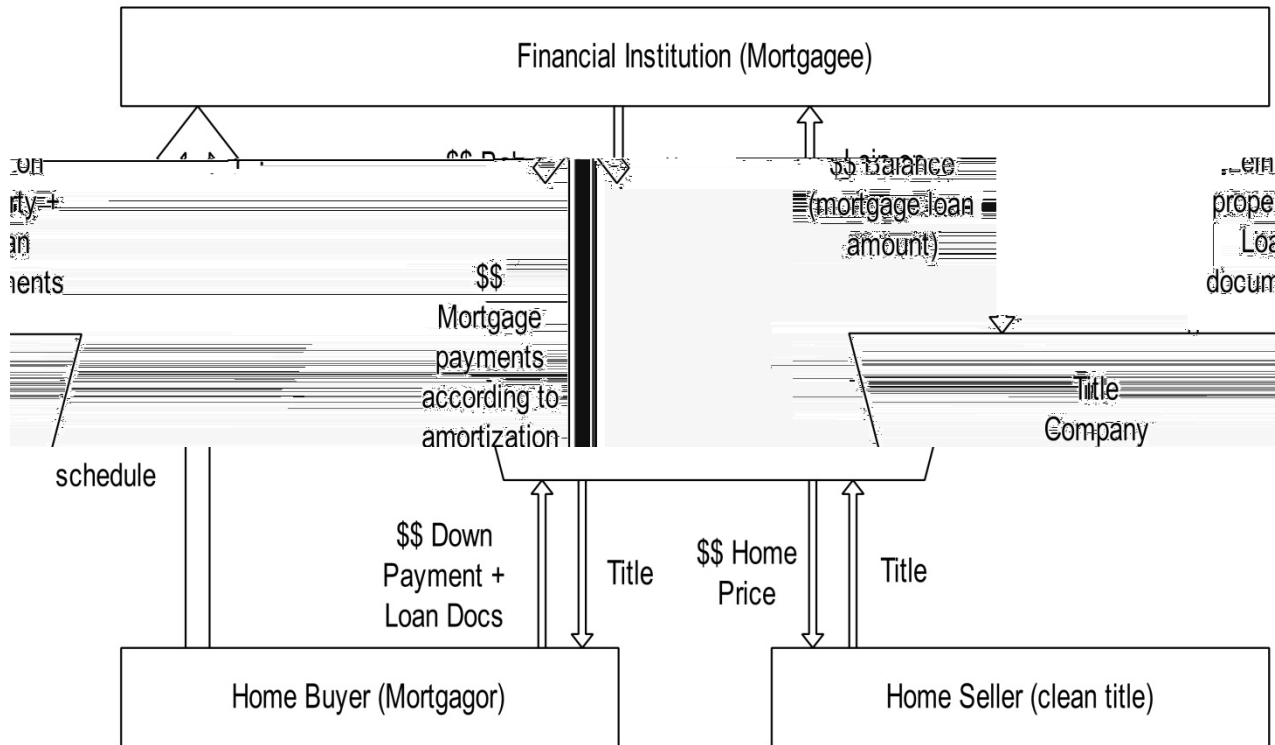
What is the Muslim obligation?

- Prophet Muhammad described Islam as the “middle way” and advised Muslims to be moderate in whatever they do.
- A balance in human endeavors is necessary to ensure social well-being and the continued development of human potential.
- Islam does not neglect that issue of rights but places a greater emphasis on duties.
- The wisdom behind this is that if all people fulfill their duties (relating to justice and trusteeship, for example) then self-interest will not run amuck ensuring that everybody’s rights are safeguarded.

What can Islamic Finance do?

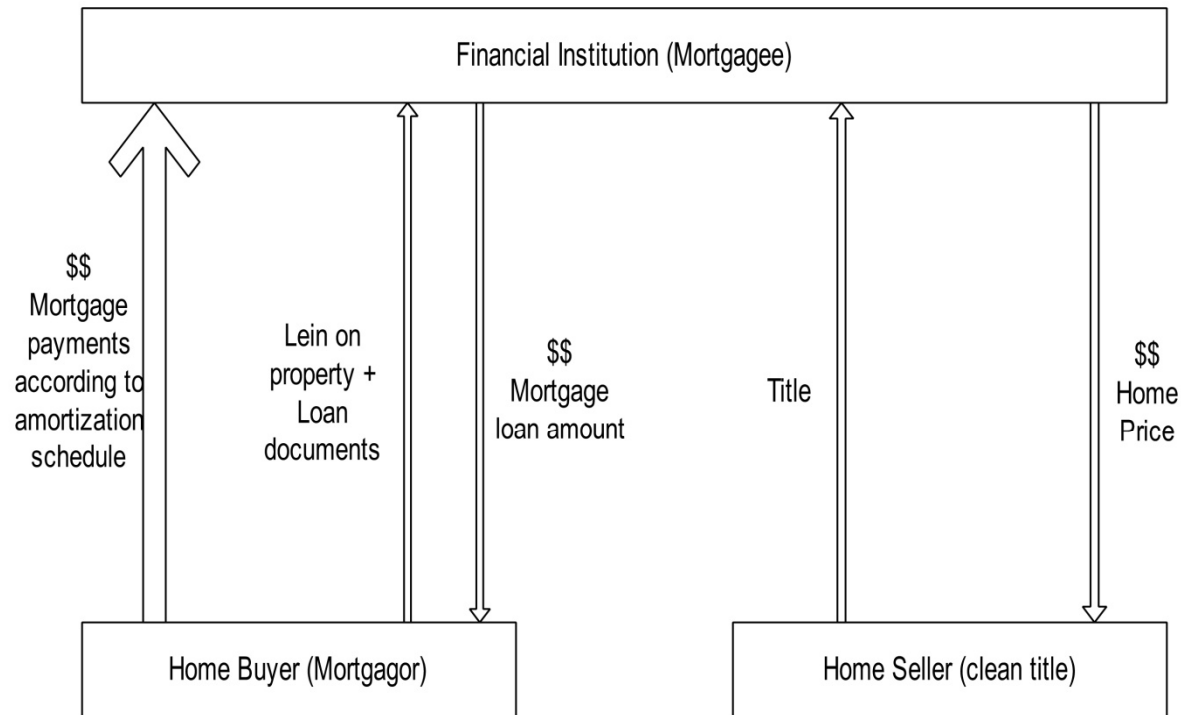
- Islamic finance needs to find broader resonance.
 - If Islamic finance is only Muslim-centric then pervert the grand purpose of Islam and the mission of Prophet Muhammad, which came to benefit all of humanity and not remain restricted to a handful of Muslims.
- If we agree on this goal then it requires soul-searching and going back to the basics to re-examine and perhaps redefine Islamic finance.
 - Trying to straddle between being similar to traditional finance and yet stand out be different has created a situation where Islamic Finance today more form than function.

Conventional Financing Scheme



Conventional home mortgage transaction

Islamic Financing



Murabaha Home Financing

The State of Islamic Finance

- Shariah-based investment industry currently has assets globally worth U.S. \$700 billion and is expected to double to \$1.4 trillion by 2010.
- In the U.S. Shariah-compliant funds have outperformed the broad market.
- The Islamic finance market was about 1% of the global finance market!
 - In 2006 the world GDP was \$48 trillion and the stock market capitalization was \$50 trillion, debt market was \$69 trillion and bank assets \$74 trillion.

Reasons for success

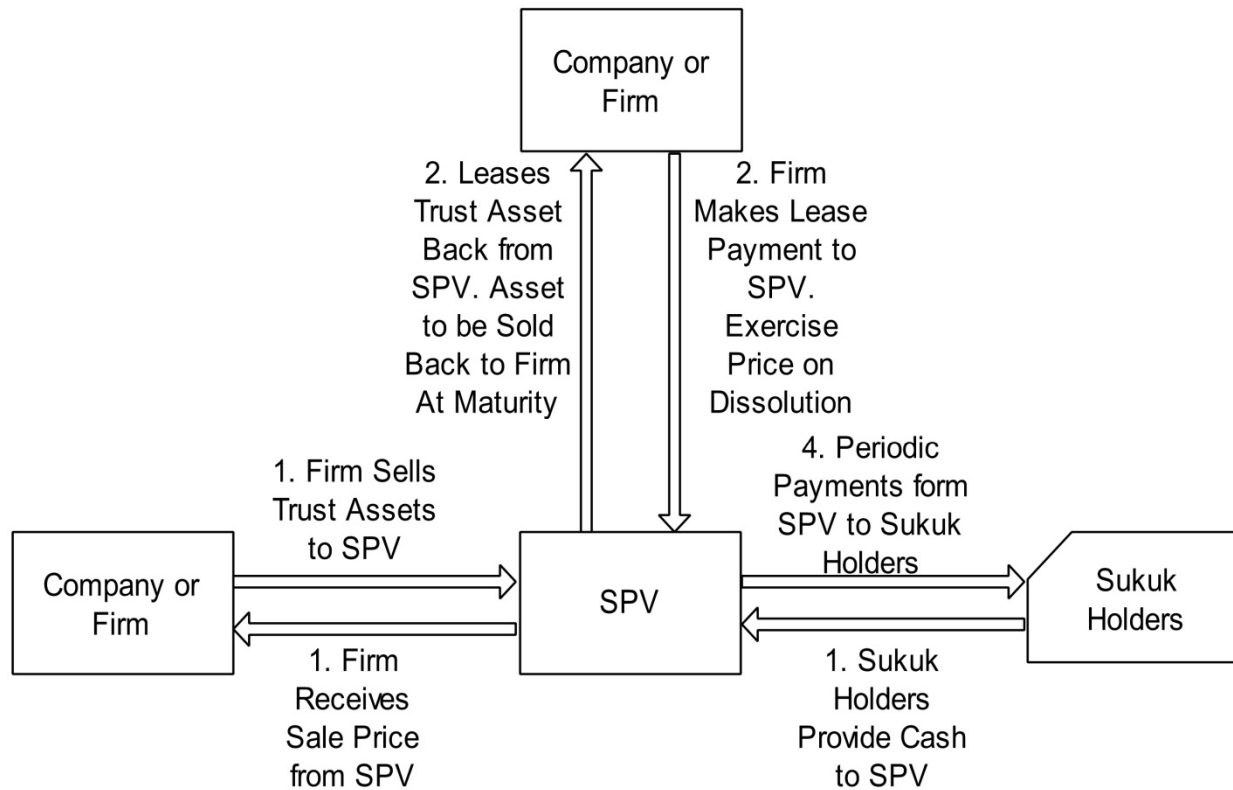
- Catering to the “pious”
- Branded as “Islamic”
- Supported by most major religious personalities and institutions.

- What is not being questioned?
 - Is it fair?
 - Is it efficient?
 - Is it a true alternative?

What are the challenges?

- Re-examine the branding
 - “Islamic” attracts pious Muslims but alienates others
- Excessive use of Arabic terms and pre-modern contracts
 - Makes the system form driven not function sensitive.
- Islamic Finance is primarily viewed as “interest-free” and yet interest is very much part and parcel of the products.

Islamic Bonds - *Sukuk*



Sukuk Structure

The Pillars of Islamic Finance

- Traditionally thought of as only the following:
 - Prohibitions against *riba* (usury), *gharrar* (speculation) and *maysir* (gambling) in financial transactions.
- Islamic Finance needs to expand to encompass:
 - The grand purpose of Shariah whose basic objectives are not prohibition based but they are inclusive and egalitarian i.e. the sustainability of Life, Mind, Religion, Ownership and Offspring.
 - Require the development of a positive and inclusive vision that can address the many shortcomings plaguing the world of finance:
 - Bad regulation.
 - Un-transparent or opaque contracts.
 - Lack of ethics.

The Fusion of Islamic and Traditional Finance

- Acceptance of "internal good."
 - Classical philosophers and religious doctrines describe this as "virtue" an internal good toward which all human endeavor should strive.
 - If the attainment of "internal good" were to become generally accepted, then financial markets will become more sustainable.
- Islamic philosophy points out that human beings indeed have the propensity to be self-centered and self-interested.
- Islamic philosophy also contends that human beings have the innate ability to rise into an angelic realm.

The Fusion of Islamic and Traditional Finance

- The new finance theory borrowing from experiments in psychology suggests a new way to move forward.
 - Thaler and Sunstien label this “libertarian paternalism”
 - Arguing that markets need to be free
 - But government can be paternalistic by “nudging” people to make decisions that allow people to personally and professionally attain “internal good.”
- Public policy can be improved not by government interventions but by the government educating people about the choices they have the real consequences of those choices.

Conclusions

- Rethink the basic framework of finance.
- To do this we need better understanding of human nature as it relates to making financial decisions.
- Human beings are persuaded by “animal spirits”.
- Human beings also have the ability to pursue “internal good.”
- This is possible within the framework of free markets.
- However, it requires paternalistic government policies that can nudge people to make decisions that can be good for their pocket book, the environment and the global society.

