Financial Crisis and Capitalism: Solution in Islamic Finance

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Article Info

Abstract

The purpose of this paper is to focus on recent financial crisis and points out the various factors that have contributed to the crisis. It also articulates the need for Islamic banking and financial service industry to be better embedded in the reality of the real sector to achieve the broader economic goals. An in-depth analysis is made based on the information from secondary sources. The paper argues that capitalism is the main factor of the crisis. Some of the causes of the current financial crisis are due to excessive speculation and derivatives, debt finance, greed etc. leading to financial collapse and that then result in an economic recession in the western economies. This study used a qualitative approach and descriptive analysis. In the process, a descriptive analysis is described and analyzed for dissemination and implementation of analyses Islamic economics as a solution to the financial crisis. It then looks Islamic financial system to help solve the current financial crisis. A major factor behind the current financial is

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excessive debt finance and financial economy with a growing disconnect between the monetary and the real sector which are the main characteristics of the capitalistic system. Some proponents of the Islamic finance claim such financial crisis would have been avoided, if asset-backed Islamic finance were adopted. However, while Islamic finance in form and legality is asset backed at the micro-juristic level, it is still largely de-linked from real sector at the macro level.

Introduction

A financial crisis is generally defined to be “a wider range of disturbances such as sharp declines in asset prices, failures of large financial intermediaries, or disruption in foreign exchange markets” (De Bonis et al, 1999). During the financial crisis, the real economy seriously and adversely affects including negative impacts on employment, production, purchasing power. Furthermore, in the situation a large numbers of household, business companies as well governments unable to meet their obligations.

There are a whole host of specific factors such as unethical greed, perverse incentives, inadequate risk controls, lax regulation of financial markets and the increased sophistication of speculation techniques and financial engineering; inherent within Capitalism that caused the current financial crisis. Such factors continue to plague the economies of the developed countries and all those who have imitated them.

The financial crisis that started in August 2008 has reached a climax in the autumn of 2008 with a wave of bank nationalization’s across North America and Europe. Although financial crises are not uncommon, but the current crisis is the largest financial crisis since Great Depression held during the year 1929–33. The current financial crisis has openly moved well beyond the mortgage market and
mortgage-backed securities. It has infiltrated every aspect of the global financial system.

The initial financial liberalization and globalization boom phase of the current crisis was driven in the early 1980s by widespread deregulation of financial markets in the developed world especially the Regan administration reforms in the US and Thatcher administration in the UK. The financial market deregulation and international integration spread not only in Europe and North America but also in Asia, Australia, Africa and Latin America. As a result, newly de-regulated financial products, entities and markets came to play a larger role. Furthermore, dramatic advances in information-processing technology facilitated international arbitrage. These policies were guided by capitalistic ideology and beliefs systems aimed at restoring a more capitalist tradition, eventually prevailed across the global system.

The capitalism assumes naive self-interest, the separation of business and morality, and that valuable resources are limited. These assumptions form the core of four problems that corporate world currently face: the problem of competition, problem of business ethics, problem of dominant groups, and problem of business in a liberal democracy. If financial markets are to overcome these problems they will have to change the way they talk about banking and financial markets as well as the way this sector actually conducts its business.

The unprecedented convergence of global economic crisis threatens the viability of industrial civilization, and proves the urgency of immediate social structural reforms. Furthermore, the financial crisis that has engulf the world with fragile market system, the free market ideologues are finding more and more difficult to defend Capitalism. In this way, the 2008 financial crisis highlights the fragility of Capitalism Therefore, the demands for alternatives are certain to grow.

Some of the advocates of Islamic banking and finance have been claiming that with Islamic banking system the world would have avoided such a crisis or at least it would not have been as severe (Farooq, 2009). They make such claims based on the resilience and performance of the Islamic finance industry in the face
of such crisis, especially pointing to the fact that one of the main principles of financial system is that all transactions must be asset-backed. More Islamic banking and financial system is based on profit and loss sharing (PLS) basis and does not allow excessive leverage. Therefore, the current crisis represents an opportunity for Islamic banking and financial system to present an alternative. Furthermore, core principles of Islamic economics system are justice, equity and welfare (Chapra, 2000). Islamic economics system seeks to establish a broad-based economic well-being with generating employment, equitable distribution of income, wealth and optimum rate of economic growth. Islamic economics ensures the stability in the value of money to enable the medium of exchange to be a reliable unit of account and a stable store of value (Chouhdury, 2008).

Islamic banking system operates based on partnership between the client and the banks, strikes a balance between flexibility and oversight. Furthermore, there is a social commitment within the Islamic banking and finance. It bans the interest (Riba) in its entire activities. The prohibition against riba is how the principles of equity and profit-loss sharing are enforced in Islamic banking by ensuring that excessive gain does not accrue solely to the lender at the expense of the borrower. It also mandates that every transaction in Islamic banking be grounded in something of real economic value and that the financial flows related to the transaction not be excessive relative to its underlying value. Therefore, Islamic transactions generally avoid the excessive leverage and speculation that were so prevalent in the credit default swaps (CDSs), collateralized debt obligations (CDOs) and the rest of the mainstream financial market instruments that came crashing down the market. In a world that mostly consigns itself to the impersonal, ethics-free destiny of financial transactions; Islamic banking system represents an ingenious attempt to return the humanity or God’s divinity to the markets.

The global financial crisis provides an opportunity for Islamic finance to emerge as an alternative in the global financial system. Despite a huge literature on financial crisis and a flurry of the topical essay in recent months, systematic
understanding on Islamic economics and banking has been lacking. The purpose of this paper is to identify and scrutinize various factors that have contributed to the crisis. The Islamic viewpoints of solutions of such factors are presented in Islamic economic and banking perspectives. This paper argues that this alternative system of economic and financial system will bring the much needed stability the world needs.

The paper has 5 sections. The section 1 presents the background of the study. In section 2, we highlight about the fragility of capitalism and discuss various factors of financial crisis. Section 3 focuses on credit crunch and sub-prime market collapse. Section 4 analyses Islamic economics as a solution to the financial crisis. Section 5 draws conclusions.

Research Methodology

This study used a qualitative approach and descriptive analysis. Therefore, this study is a descriptive study that describes the fragility of capitalism and discusses various factors of financial crisis. In the process, a descriptive analysis is described and analyzed for dissemination and implementation of analyses Islamic economics as a solution to the financial crisis.

Forms of implementation are research data obtained through literature review researchers take notes from a source that has been investigated. That can be made as suggested VanWynsberghe and Khan (2007), Case studies aim to give the reader a sense of “being there” by providing a highly detailed, contextualized analysis of an “an instance in action”. The researcher carefully delineates the “instance,” defining it in general terms and teasing out its particularities.

Discussions

Epicenter of Crisis

Starting from the late 1990s, the asset backed securities (ABSs) and collateralized debt obligations (CDOs) issuance showed remarkable growth. There were four main reasons why these asset classes have been successful at a certain level in the structured finance market: regulatory capital relief; funding;
economic risk transfer from the point of view of originators and arrangers; and an interesting risk-return profile to notes investors. But the credit crunch triggered in August 2007 by American sub-prime residential mortgages has probably cut to the heart of the so-called “warehouse and sell” model of business. The problem is that ABS and CDO contracts are often too complicated, and there is a significant level of uncertainty concerning the key parameters that characterize the credit portfolios sold by securitization. Main problems in this type of securitization are high default probabilities, recovery rates low, default correlation, coupled with a strong sensitivity of the CDO prices to the variations of these parameters. No one knows if ABSs and CDOs will ever have a future, but it is sure that, to survive, the securitization business will have to change.

The phenomenon of the 2007–08 credit crunch is complex and it will take several years to explain its causes. Probably at the base of this crisis lies an excessive financial leverage of the private sector in countries such as the US, UK and Spain that, coupled with the economic slowdown of the first part of 2007, sparked an increase of defaults. But one point on which most of the analysts agree is the fact that the crisis was triggered by a specific segment of financial products—United States “sub-prime” residential mortgage-backed securities (RMBSs), ABS, MBS etc. (see table-I).

<table>
<thead>
<tr>
<th>Table 1</th>
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<tbody>
<tr>
<td>US$ Billions</td>
</tr>
<tr>
<td>------------</td>
</tr>
<tr>
<td>ABS</td>
</tr>
<tr>
<td>Agency MBS</td>
</tr>
<tr>
<td>Non-Agency RMBS</td>
</tr>
<tr>
<td>No-Agency CMBS</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Percentage (%) on 2008 United States GDP 70.1%
Source: IMF data.

A keen analysis of the market turmoil of 2008 has been published by the Bank of International Settlements (BIS) in its annual report published in June 2008: “During the period from June 2007 to mid-May 2008, concerns over losses on US sub-prime mortgage loans escalated into widespread financial stress,
raising fears about the stability of banks and other financial institutions. What initially appeared to be a contained problem quickly spread across other credit segments and broader financial markets to the point where sizable parts of the financial system became largely dysfunctional. Surging demand for liquidity, coupled with growing concerns about counterparty risk, led to unprecedented pressures in major inter-bank markets, while bond yields in advanced industrial economies tumbled as investors sought safe havens amid fears that economic growth would weak” (BSI, 2008).

The high number of downgrades which, in July 2007, struck Residential Mortgage Backed Securities (RMBSs) and Collateralized Debt Obligations (CDOs) backed by residential mortgage loans substantially “triggered” the credit market turmoil. According to the data published by the BIS Annual Report (2008) in the third quarter of 2007 a “wave” of downgrades in the US hit the sub-prime RMBSs sector (1746 by Fitch, 149811 by Moodys, 858 by S&P) and to a lesser extent that of CDOs (228 by Fitch, 103 by Moodys, 340 by S&P). In the next quarters of 2007 and 2008 the initial “wave” of downgrades became a real “seaquake” which swept away all the segments of the securitization market (an average of more than 8000 downgrades for USD structures and 352 downgrades for EUR structures only in the third quarter of 2008). Drawing again from the June 2008 BIS Annual Report: “Large parts of the investor community essentially withdrew from structured assets altogether loss of confidence in structured finance rating meant that demand for trenched credit products collapsed from the high levels observed in recent years”(BIS, 2008).

Factors behind the Financial Crisis

Recent financial crisis has forced the academics, experts and policy makers to grapple with the challenge of better understanding the nature of the problem and factors behind the financial crisis. The bursting of the bubble in the sub-prime sector in US is recognized as starting points of the current crisis with some other import factors are discussed below:
a. Financial Economy Disconnects Real Economy

One of the main factors that are being commonly identified as a key process behind this crisis is an undesirable level of promotion of the financial economy. Financial economy generally leads to an increasing disconnect between the monetary/financial sector and the real sector. The true measure of an economy’s production and consumption is reflected in the real sector.

The real economy consists of housing, land and property, factories, cars and goods, etc. These are tangible goods which can be traded, leased and sold. In other word, they are physical goods which are produced; people are employed to make them. But the financial economy consists of tradable paper with financial values that rise and fall based upon the value people give them, often with no real asset represented.

The economies in the developed countries over the last 30 years have shifted their focus from industry to services. The service sector now represents over 80 percent of the US and European economies, with the financial sector being the largest service. This development of the financial sector does not in any way manufacture goods or services but provides a new kind of service. Rather than work in the real world, participants gamble on what is going to happen in the real world–by betting on how businesses are performing and by betting on their profits. The financial sector is a parallel economy which exists alongside the real economy and produces nothing real.

The financial economy is now valued more than the real economy. The size of the worldwide bond market is estimated at $45 trillion. The size of the world’s stock markets is estimated at $51 trillion. The world derivatives market has been estimated at $480 trillion, more than 30 times the size of the US economy and 12 times the size of the entire world economy (BIS, 2008).

Soros (1998) claims that the international financial economy is inherently unstable, and that while economists have failed to recognize this because of their commitment to static equilibrium theory, politicians have failed to
stabilize the global economy because of their commitment to an unquestioned faith in the complete efficiency of laissez faire. The financial economy has become divorced from the real economy that investors no longer seek to receive a dividend, but rather, to take advantage of inflated price rises. This has led to speculation of gigantic proportions, including bets on the collapse of economies.

With the financial sector representing the largest segment in the economies of the developed countries, it has also caused prices to become completely detached from the fundamentals of supply and demand (Goodhart, 2008). The UK along with the US is widely viewed as post-industrial economies that have abandoned manufacturing in favor of consumption and ‘hyper-finance’. The financial sector now outstrips the real economy manifolds and this has resulted in this sector influencing government policy across the world.

Characterizing the contemporary global crisis as a financial crisis is also a reflection of the power of financial economy, not just as a process, but also as a notion. While many economists and other relevant experts are trying to bring the economy out of this crisis, there is still much to be desired to better understand it as something much broader than just ‘financial’ (Farooq, 2009).

b. Creation of Money and Use of Excessive Derivatives

Historically, banks used only the money they received from depositors to lend to borrowers. They were not able to obtain money from other sources other than depositors. However, in recent years, banks have been able to rely not only on depositors but also on the wholesale money markets, where they could borrow money from other banks and then resell it to their borrowers at a higher interest rate. This secondary market was in part made possible by the creation of ‘credit default swaps’ (CDSs). These allowed a bank to effectively insure itself against the risk that a borrower might not pay back a loan. This led to an illusion that loans were now much lower risk and allowed such loans to be bought and sold. This then led to the creation of ‘collateralized debt
obligations’ (CDOs), which was bought by banks in the western countries as interest-bearing investments.

In just over a decade the credit default swaps (CDS)-privately traded derivatives contracts ballooned from nothing into a $54.6 trillion market. CDS are the fastest-growing major type of financial derivatives. The derivatives market is estimated at $300 trillion in the year ending 2008, ten times of the size of the U.S. economy. More important, they have played a critical role in the unfolding financial crisis. Furthermore, by ostensibly providing ‘insurance’ on risky mortgage bonds, these derivatives instruments encouraged and enabled reckless behavior during the housing bubble.

c. Debt Finance

The debt culture is at the root of conventional western system and culture. In finance based economy, trading of credit and risk, creed, all these are closely related to debt culture. Therefore, debt has come to play a central role in the mechanism of the western economy. Funding through debt became main sources of capital at new startups as well as expansion plans of many multinational companies (BIS, 2008). In debt finance, the actual money which has been given in debt by the banking industry actually does not exist. This debt causes high level depression in the economy because the actual money does not exist. The banking industry simply assumes the money will exist when it comes for people to repay their debts.

Although the economy has grown enormously. This was largely through borrowing, hence debt has driven such economic growth. Such debt continued to grow funding growth in the different strata of economy. This has now reached in a point where it has been realized that the debt may most likely not be repaid. This practice is extremely fragile and it has been at the heart of the 2008 financial crisis.
d. Sub-Prime Market

The Sub-prime mortgage market differs from the prime market as it comprises all those people who do not meet the criteria for a mortgage in the mainstream market. The adoption of the Depository Institutions Deregulatory and Monetary Control Act in 1980 was part of the deregulation drive that eliminated many restrictions to lending (Sengupta, and William, 2007). This resulted in loans reaching unprecedented levels which led to the mainstream mortgage market becoming saturated and reaching its peak of profitability. Those people with patchy credit histories and of low income were turned away from mainstream mortgages at a time when the market was buoyant due to consumer spending and borrowing. The Sub-prime market was carved out after this point as 25 per cent of the United States population fell into this category and represented a market opportunity.

Hence United States lenders gave mortgages to people who had little means to pay for a mortgage and charged them a rate of interest much higher than the commercial rate due to the increased default risk. Therefore, the present credit crunch is widely blamed upon the ‘subprime’ crisis which originated in the US, where banks offered mortgagee to those known in the industry who are unemployed and do not have any income. Such people often had poor financial track records. These mortgages were issued with the intention that if the buyer defaults, then they would be able to repossess the property, and sell in a buoyant property market. By the start of 2007, the sub-prime market was valued at more than $1.3 trillion.

Due to the appetite for housing by speculators, the housing sector continued to inflate. Therefore, the sub-prime sector in the US continued to grow. Several mainstream commercial banks entered what they considered a buoyant market. Many Americans refinanced their homes by taking out second mortgages against the added value to use the funds for consumer spending. On 2 April, 2007, it was observed that the United States housing bubble was in trouble when New Century Inc. the largest sub-prime mortgage lender in the United
States declared bankruptcy due to the increasing number of defaults from borrowers. Earlier, 25 subprime lenders were declared bankruptcy, announcing significant losses, with some putting themselves up for sale. This was in hindsight the beginning of the end.

Gradually, the crisis spread to the owners of collateralized debt. They were in the position where the payments they were promised from the debt they had purchased were being defaulted upon. By being owners of various complex products, the constituent elements of such products resulted in many holders of such debt to sell other investments because balance losses incurred from exposure to the sub-prime sector (Adrian, and Song, 2008). Due to drastic fall in share prices across the world in August 2007. The matters became worse when many investors caught in this vicious spiral of declining prices. In this situation, the investors not only sold sub-prime and related products; but also sold anything that could be sold (FSA, 2007). This is why share prices plummeted across the world and not just in those directly related to sub-prime mortgages. International institutional investors who poured their money into the United States housing sector realized that they would not be able to recover the monies what they loaned out. Because the individual subprime mortgage holders were defaulting on mass on such loans due to lack of repaying capacity.

It was for this reason central banks across the world intervened in the global economy in an unprecedented manner providing large amounts of cash to ensure such banks should not go bankrupt. The Australian Central Bank, Bank of England, European Central Bank, Federal Reserve of United States and the Japanese central bank- the Bank of Japan injected over $300 billion into the banking system within 48 hours in a bid to avert a financial crisis. They stepped in when banks, such as Sentinel, a large American investment house stopped investors from withdrawing their money, spooked by sudden and unexpected losses from bad loans in the American mortgage market (European Central Bank, 2008).
### Table 2
**Major Sub-Prime losses**
(As on 30th June, 2008)

<table>
<thead>
<tr>
<th>Name of Financial Institutions</th>
<th>Amount (US$bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citi Bank Group</td>
<td>$46.40</td>
</tr>
<tr>
<td>UBS</td>
<td>$38</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>$36.80</td>
</tr>
<tr>
<td>HSBC</td>
<td>$18.70</td>
</tr>
<tr>
<td>Bank of America</td>
<td>$14.9bn</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$12.6bn</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>$16.50</td>
</tr>
<tr>
<td>JP Morgan Chase</td>
<td>$9.7bn</td>
</tr>
<tr>
<td>Washington Mutual</td>
<td>$8.3bn</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>$7.5bn</td>
</tr>
<tr>
<td>Wachovia</td>
<td>$7.3bn</td>
</tr>
<tr>
<td>Credit Agricole</td>
<td>$6.6bn</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>$8.13</td>
</tr>
<tr>
<td>Mizuho Financial</td>
<td>$5.5bn</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>$3.2bn</td>
</tr>
<tr>
<td>Barclays</td>
<td>$9.2</td>
</tr>
<tr>
<td>AIG</td>
<td>$20.23</td>
</tr>
<tr>
<td>HBOS</td>
<td>$7.5</td>
</tr>
<tr>
<td>MBIA</td>
<td>$8.14</td>
</tr>
<tr>
<td>Ambac</td>
<td>$9.22</td>
</tr>
</tbody>
</table>

Source: Reuters.

By sudden and unexpected losses from bad loans in the American mortgage market (European Central Bank, 2008). Other financial institutions followed suit and suspended normal lending. Intervention by the world’s central banks in order to avert crisis already cost them over $800 billion. The table-1 shows the major sub-prime losses in the 2008 financial crisis.

The initial problem with ‘subprime’ debts triggered a secondary problem whereby banks which relied for cash flow principally on accessing funds from other banks via the wholesale market. But banks suddenly found that they could no longer borrow enough money to meet their cash flow requirements. The paralysis in inter-bank lending led in turn to banks drastically reducing the money they lent to customers, as well as dramatically raising the cost of existing loans. This in turn substantially reduced demand for property and led to the ongoing crash in the property market. This is now feeding back to create...
a yet bigger problem for the banks because property is what they mostly hold as collateral for all the debts people owe them.

e. Greed

In the capitalistic economy, the consumers not only should buy, but also they should buy more and more every year. In this way the consumption plays such a key role in the functioning of Capitalism that people have come to be symbolized by what they wear, eat and drive. Hence, sensual gratification becomes aim of life. It is dwindling world resources and ever increasing numbers competing for sensual gratification greed has come to characterize the capitalist societies. Capitalism believes, if individuals in society pursue their self-interests then the right resources are produced for those who want them and this is the best way to allocate resources.

Furthermore, the self-interest is considered a necessary trait for the twenty first century individual. Therefore, the corruption can now be seen across society. Greed is the motivation that led to predatory mortgage brokers selling mortgages to people that have no way in paying it back. Then they are increasing the rates of interest until the buyer defaults. Greed is also the motivation that led the credit ratings agencies to rate the investments less risky than they really were.

The most pathetic side of the fact that the motivation of all these acts is seen as a virtue. Many people think that greed is good and necessary for modern life. Hence greed is a systematic problem for the general public. It is enshrined in the modern capitalistic economy. No amount of regulation or legislation can deal with this as it is part of the mentality comes directly from the capitalist belief.

f. Weak Credit Rating

The credit turmoil of 2007–08 is a complex phenomenon and the initial sub-prime crisis and the subsequent spillover into the other credit markets of RMBS and CDOs were just the first two stages of a wider systemic crisis.
However, a question that almost naturally arises is ‘what went wrong with the rating system associated with structured finance transactions?’ A recent paper by the Committee on the Global Financial System (CGFS, 2008) came to the conclusion that credit rating agencies underestimated the severity of the housing market downturn, both in terms of level and correlation of defaults.

The use of limited historical data added a significant model risk to rating risk. Historical data on US sub-prime loans were largely confined to a relatively benign economic environment, with very little data on periods of significant decline in house prices. Credit rating agencies also underestimated the original risk factor. In fact, loan service quality has a dramatic impact on the loss distribution and credit rating agencies did not deal with differences in originator quality with a sufficient level of rigor.

**Islamic Banking and Financial System-An Alternative**

Islam has a completely different philosophy for the economy which results in a very different society to a capitalist one. To focus on the entire Islamic economic system in this paper is out of the scope, but some aspects of Islamic economics will be discussed and show how it will help to solve the current global financial crisis.

Islamic economic thought differs significantly from conventional economic thought. The absence of interest constitutes the moral dimension of Islamic economics (Chapra 2006). Morality is inherent to the *homo Islamicus* whose values do not tolerate the injustice of charging interest. Injustice in the case of interest on consumption credit results from the exploitation of the needy and on production credit from the absence of sharing the uncertainty embodied in every enterprise. Islamic economic teaching adheres to the idea of ‘natural law’ providing a society that is just and un-exploitative. ‘Natural law’, however, implies the universal nature of humanity, society, and economy based on Islamic principles. The efforts put up in interlinking among people and community through Shura (consultation) which highlights the mutually dependent and interactive ways where social engineering occurs (Choudhury, 2003).
In the conventional economic theory, Keynes’s concept of the marginal efficiency of capital explains why interest rates destabilize the economy and cause cycles of booms and busts (Keynes, 1936). He recognized that the rate of interest in the monetary system impedes investment, production, and full employment. Commenting on his theory, Ahmad (1952) states that Keynes’s theory failed to draw the decisive conclusion that could eliminate economic crisis: the abolition of interest. This is because Keynes understood interest as inherent to every commodity not only money. But Ahmad (1952), Khan (1968), Mawdudi (1968) argue that depression and stagnation occur because interest rate payments introduce an imbalance between production and consumption. The wealth and purchasing power are transferred from the debtor to the creditor.

Islamic economics does not merely centre on high or optimum growth rates but explicitly refers to social welfare including need fulfilment and full employment (Chapra, 2006). This dimension also possesses an aspect of justice because the notion of development embraces an equitable wealth distribution. The enterprise and social welfare occupy a central role in Islamic economic system (Chapra 2000; Siddiqi 1981; Iqbal and Khan 1981).

The financial and economic stability is perceived to be an original feature of the Islamic economic system conceptually ensured by morality, development and a relatively equitable wealth distribution and practically by the abolition of interest and promotion of wealth redistribution in accordance with divine law. The economic policy in Islam or the overall direction of the Islamic economic system is to secure the satisfaction of all basic needs for every individual completely, and to enable them to satisfy their needs as much as possible. So from this perspective, Islam looks at people individually rather than the whole of society. This means economic policies will look to cater for all rather than just leaving satisfaction to the market. This may be achieved by a host of rules Islam has in ensuring prohibition of interest (Riba) in the financial system, wealth distribution and government involvement in the economy which ensures the economy moves in the direction Islam has designated for it.
a. Riba is Unlawful But Trade is Lawful

Islam made a clear distinction between trade and Riba (interest) where trading is welcomed and Riba is prohibited. Islam does not consider money as a commodity as such that there should be a price for its use. Money is recognized in Islam as a means of exchange it may not lawfully be regarded as a commodity for exchange. The important difference between trade and Riba is that the business risk in trading is allocated more evenly among all the parties involved, whereas in Riba operations the business risk lies heavily, if not solely, on the borrower. In its widest general implication Riba signifies any increase of capital not justified by a risk taken.

Al-Qur'an clearly stated that trade and Riba (interest) are not alike. “As for those who devour interest (riba), they behave as the one whom Satan has confounded with his touch. Seized in this state they say: ‘Buying and selling (trade) is but a kind of interest’, even though God has made buying and selling (trade) lawful, and interest (riba) unlawful. Hence, he who receives this admonition from his Lord, and then gives up (dealing interest), may keep his previous gains, and it will be for God to judge him. As for those who revert to it, they are the people of Fire, and in it shall they abide” (al-Baqarah, verses 275). Understanding this verse from the Al-Quran, one can see the link between forbidding interest and allowing trade as a clear and obvious reference to commercial loans. It may be mentioned here that trade provides risk where entrepreneurs incur the risk of either making profit or losing. In contrast to this, interest offers no risk to the lender. Financiers who do not wish to take the risk are entitled to only the principal and nothing more. Apparently, Riba is essentially in conflict with the clear and unequivocal Islamic, Marxian, and Keynesian socio-economic justice.

The principle reason for why Al-Qur'an has delivered such a harsh verdict against interest or riba is that Islam wishes to establish an economic system where all forms of exploitation eliminated, particularly the injustice perpetuated in the form of the financier being assured of a positive return
without doing any work sharing the in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return. Islam wishes to establish justice between the financier and the entrepreneur.

The sheer existence of the concept of interest is an important factor of destabilizing economy (Ahmad, 1952). It encourages unproductive and speculative activity making capital for productive undertakings consequently scarce. Interest is seen to play a role in bringing about economic crisis. During a boom period credit expansion takes place and due to interest payments the marginal cost of production increases. Profit rises and, while wages stagnate, productive and speculative investment increases raising capital demand for both kinds of investment. Increased capital demand in turn pushes interest rates upwards, squeezing profit margins (Choudhury and Hussain, 2005).

b. Real Economy

The pursuit of economic growth and development is tied primarily with the real sector. Islamic economists recognize that realization of the potential of Islamic banking will require structural adjustments enabling Islamic financial institutions to deal with real sector business in such a way that financial assets can only grow in proportion to the growth in real economic activities or that sustainable expansion of financial services in proportion with the real sector is critically needed (Brodjonegoro, 2008).

The Islamic economy in essence is a collection of rules which cater for society as a whole by removing all obstacles to invest in the real sector of the economy. Islamic financial systems mobilize resources for the real economic development to attain the wellbeing of the community (Choudhury and Hussain, 2005). The Islamic economy does not encourage the financial economy in their current form due to the following reasons:

Firstly, rules and regulation by which the financial economy runs are not neutral. In fact, the rules favor some actors over others. The capitalistic system favors capital over labor, corporations over peoples, and the first world over
the third world. But even at a more superficial level, the rules can be set to favor speculators and their activities rather than the businesses the speculators are supposed to serve by managing risk. By changing the rules of the game, speculators undermine the value of real economy business and subordinate that activity to their own.

Secondly, the ultimate absorber of any risk of crisis of the financial market is always society at large. That is what happened with every bailout in the past, despite the pretense of a private enterprise system. Governing financial market based economic life is organized by the market players to provide support for corporations and elites to accumulate massive shares of wealth and power, guaranteed. Furthermore, banking and financial markets have been de-regulated to facilitate gambling in the name of financial economy.

In contrast to conventional financial system which has periodically experienced crises, Islamic financial system is considered as a stable financial system capable of promoting sustained growth of income and employment. Prohibiting interest, speculation, and debt trading, Islamic finance establishes one-to-one mapping of financial and real sectors of the economy.

Islamic finance is merely one ethical dimension of the unfolding process of programming of market effects. Globally there is a resurgence of activism for real economic reform. Islamic financial system will give much hope to those who work on the premise that operating system of the global markets can be altered. The new operating system would ensure that externalities are more clearly accounted for and paid for, by both producers and consumers. This would encourage more realistic pricing of both financial and commodity products- only then will economy will recover from current artificial price anomalies. Proponents of Islamic financial service industry have already predicted that the industry may have a remedy and this fast-growing industry can come forward to solve the financial crisis. While the relatively small size of the Islamic finance industry may make this unrealistic at the moment, there exists an unprecedented opportunity to present the details of the Islamic
Lessons of the Financial Crisis

Some proponents’ Islamic finance have already predicted that the Islamic banking and finance industry may have a remedy and this fast-growing industry can come forward to solve the financial crisis. This claim is based on the resilience and performance of the industry in the face of such crisis, especially pointing to the fact that one of the main principles of Islamic finance is that all transactions must be asset-backed. According to Usmani (2002) explains the importance of asset backed: “The conventional/capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; each unit of money is 100 per cent equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units inter se. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanges, one for another. The profit earned through dealing in money (of the same currency) or the paper representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on non-liquid assets which create real assets and inventories.”(p.xiv) Therefore, the relevant and valuable, transactions being asset-backed are not enough for economic growth and development, or poverty alleviation, which is tied with the real sector.

Being asset-backed is one of the primary reasons on the basis of which its proponents attempt to make the case that Islamic finance is more resilient to loss of value during this financial crisis and thus less vulnerable as a system. Mirakhor (2009) explains: “In Islamic finance there are no risk-free assets and all financial arrangements are based on risk and profit-and-loss sharing (PLS). Hence, all
financial assets are contingent claims and there are no debt instruments with fixed or floating interest rates. Investment accounts could be conceived as non-speculative equity shares. The rate of return on financial assets is primarily determined by the return to the real sector, and therefore in a growing economy, Islamic banks will always experience net positive returns.”

Mirakhor (2009) is clear about the importance and relevance of the real sector and how Islamic finance is resilient because it is intimately linked with the real sector. Mirakhor (2009) further argues that “In contrast to conventional finance which has periodically experienced crises, Islamic finance is considered as a stable financial system capable of promoting sustained growth of income and employment. Prohibiting interest, speculation, and debt trading, Islamic finance establishes one-to-one mapping of financial and real sectors of the economy. That is, it is based on real trade and production activities. The financial sector cannot expand beyond the real economy, and is immune to unbacked credit expansion and speculation that are characteristics of conventional finance and that have destabilized even the most sophisticated and complex financial systems.”

Mirakhor (2009) claims that Islamic finance establishes one-to-one mapping of financial and real sector of the economy. In reality this mapping is possible at the micro and transactional level in terms of trade, but such one-to-one mapping does not translate into value-creation in the real sector, because due to uncertainty and risk factor the value-to-be created is not known a priori. Moreover, the claim that all transactions in Islamic banking are based on risk and profit-loss sharing (PLS) is patently incorrect, especially if it is staked not in a normative, but in a positive sense. It is well known that the mainstay of the Islamic financial industry is not PLS modes, such as mudarabah or musharakah, but instead, the non-PLS modes, such as murabaha, salam, ijarah, that are fixed return based and generally risk-free.

Although it is appeared that Islamic banks are immune to the crisis, they are also affected by the general downturn and the fall in the value of assets, since they operate within the same financial system and are asset based or backed as
Islamic investments are required to be. However, due to the prohibition on
derivatives, the exposure has been restricted and therefore so is the direct impact.
What still remains to be seen is whether these institutions are capable of absorbing
the stresses and shocks in the future, particularly those which are more specific to
the Islamic financial market.

However, major lesson of the recent crisis for Islamic financial system,
especially at this juncture in its evolution, is the need for the design and
development of a comprehensive and dynamic regulatory-prudential-supervisory
framework, uniquely and properly designed for an Islamic financial system. Such
a framework will satisfy the requirements of any existing regulatory framework
anywhere in the world, and go beyond them to ensure the stability of the system.

As per theory, the Islamic financial system demonstrates the stability of an
equity-based, risk-sharing financial system. Moreover, theory can also
demonstrate, easily and comfortably, that the institutional framework of Islam,
within which its financial system must operate, reinforces to a high degree the
stability and efficiency of the financial system. In practice, however, and as long
as the institutional framework is not fully in place, an Islamic financial system can
fall victim to the same adversely designed incentive structure as the conventional
system, particularly because Islamic finance is presently operating in an
institutional framework which is basically that of the conventional system.

Mere declaration of prohibition of ex-ante, fixed interest-based debt
contracts by fiat, but without any effort at implementation of the supporting
institutional framework, will not accrue the benefits of properly structured Islamic
finance to the population; indeed, it may do harm by creating a sense of
complacency in the society. Creating a non-interest-based system side by side
with a conventional system within an institutional framework that is basically
designed to support the latter system has benefits and costs. Which of the two
dominates is an empirical question.

However, from pure intuition, the benefits would seem to overwhelm the
costs in the long run when all possible benefits are considered, as it allows an
orderly evolution of Islamic finance. In either case, a properly designed regulatory-prudential-supervisory framework seems essential to the orderly development and evolution of Islamic finance. Such a framework will have to be uniquely designed to distinguish it from that of a conventional system, in that it has to structure its incentive system to include both negative elements that specify prohibited behavior and positive elements that encourage and enforce recommended behavior.

Such a framework will have to be comprehensive, covering all transactions, financial instruments and institutions operating in the system, without exception. One of the most damaging elements of the US regulatory system was that a larger segment of the financial markets and institutions had little or no regulatory-prudential supervisory oversight. Moreover, the regulatory framework was fragmented. In an Islamic financial system, there are no interest based debt contracts; financial innovation can proceed only as it relates to equity and trade-based transactions.

Furthermore given the rapidly paced financial innovation, the line of demarcation between money markets, capital markets and all sorts of financial asset markets is blurred. In an Islamic financial system, the segmentation of regulatory authority is even less logical because of the nature of a system that promotes nearly a one to-one interaction between real sector and finance activities.

Moreover, the properly designed regulatory oversight for Islamic finance will have to be uniform that is, its standards must apply uniformly to all Islamic financial institutions, transactions and instruments everywhere, globally across all jurisdictions; the reason being that the systemic risk of a failure of one Islamic financial institution or instrument is far greater for Islamic finance than for its conventional counterpart because of the potentially magnified reputational damage for the entire system, particularly at this juncture of the evolution of Islamic finance.
Because profit-seeking motivation currently drives financial-sector innovations, there are strong incentives to create instruments and ways and means of regulatory arbitrage. An appropriately designed regulatory framework for Islamic finance will have to have sufficient built-in flexibility and dynamism to allow it to stay ahead of the innovation curve in order to minimize the risk of regulatory arbitrage. An appropriately designed, unified, uniform-comprehensive framework, administered globally, requires a universal mandate to enforce its rules and standards everywhere.

Consequently, the most important lesson of the recent crisis for Islamic finance is an urgent need for the design, development and implementation of a comprehensive, unified, uniform, global and dynamic regulatory-prudential supervisory framework. Such a framework of standards needs a unified administrative agency to uniformly and globally enforce the rules of the framework across jurisdictional boundaries. This requires the agency to have a legislatively based mandate to enforce implementation of its standards and oversight rules.

Clearly, this is a most serious challenge, but one that must be met because, at the present stage of development, Islamic financial system is embedded in an institutional framework designed to support a conventional financial system in which innovations replicate instruments designed for a conventional system through-reverse engineering. In such a system, there is no assurance that financial bubbles and their boom and bust cycles can be avoided. Because the materialization of such events has significant reputational risk for Islamic finance, to a degree that may abort its further development, the design and implementation of an appropriate regulatory framework is urgently needed.

Conclusion

The bursting of the bubble in the real estate sector in United States is usually recognized as the starting point of the current financial crisis. However, some of the other factors that are being commonly identified as a key process behind this crisis are; de-linking financial economy with real economy, creation of
money and excessive use of derivatives, debt finance, greed and weak credit rating etc. These factors generally leads to an increasing disconnect between the monetary/financial sector and the real sector. The true measure of an economy’s production and consumption is reflected in the real sector. Characterizing the contemporary global crisis as a ‘financial’ crisis is also a reflection of the power of financial economy, not just as a process, but also as a notion. While many economists and other relevant experts are trying to bring the economy out of this crisis, there is still much to be desired to better understand it as something much broader than just ‘financial.’ Some proponents of the Islamic banking and finance claim such financial crisis would have been avoided, if asset-backed Islamic finance were adopted. However, while Islamic banking and financial system in form and legality is asset backed at the micro-juristic level, it is still largely de-linked from real sector at the macro level. In fact Islamic banking and financial service industry is mostly involved in debt creating modes, without appreciating the fact that debt culture is at the root of conventional western system and culture. Debt finance, trading of credit and risk, greed, all these are closely related to debt culture. While emphasizing the prohibition of interest, Prophet Muhammad (PBUH) used to seek refuge from debt, regularly in his prayer saying, “O God, I seek refuge with you from all sins, and from being in debt”. (Sahih al-Bukhari).

It is true that Islamic banking and finance industry certainly did not suffer as badly as conventional financial industry over the past few years, it was not unaffected. With the sign of the better times on the horizon, it is appropriate to reflect on the consequences of the global financial crisis for Islamic banking and finance industry and to see what lessons can be learned going forward.

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