

ISLAMIC BANKING..... A WAY OUT

(Current Global Financial Crisis & Islamic Banking)

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ABSTRACT

1. Banking as a social institution has had its successes and failures in the society. It is performing very useful and essential services to the community. That's why it can be said that the progress of modern society is based on it. However, certain drawbacks in the basic concept of conventional banking have been noticed since its inception mostly by its affected nations or individuals. Global financial crisis which jolted the world, in the year 2007/2008, completely exposed the shortcomings of capitalist economy. Since, in the Secular Capitalism, Profit motive or Private ownership are given unbridled powers to make economic decisions and there are no Divine restrictions in this regard, this unlimited liberty has led to some very harmful practices which cause imbalances in the society. Interest, gambling, speculative transactions tend to concentrate wealth in the hands of few. Unhealthy human instincts are exploited to make money through immoral and injurious products / activities. Unbridled profit making creates monopolies which paralyze the market forces. Some Influential circles control the economy and even legislation in this regard, on the basis of their political strength.

2. The evils emanating from this attitude can only be curbed through Divine Guidance / imposing restrictions. In Islamic Financing and Banking concept which is based on the guidance provided by Almighty Allah in Holy Quran as well as in other Revealed Books like Bible, certain restrictions have been imposed on the economic

activities. Prohibition of Riba (Usuary or Interest), gambling, hoarding, dealing in unlawful goods or services, short sales and speculative transactions are some examples of these divine restrictions. All these prohibitions if followed in true letter and spirit, have a cumulative effect of maintaining balance, distributive justice and equality of opportunities. Islamic Financing covers all spheres of society i.e. trade, industry, agriculture, science, technology, employment, benevolent sector and the environment, with special focus on the “human factor”.

3. In this paper, an effort has been made to highlight certain fundamental weaknesses in the existing banking system which contributed in establishment and spread of global financial slump. In addition, the impact of this financial crunch on developing as well as developed countries has also been touched upon. Later on, a brief account of the concept of Islamic Financing vis a vis its comparison with current system of banking has been discussed. Aim of the paper is to present peculiarities of Islamic Banking due to which it remained unaffected from the current global financial turmoil and suggest it as an alternate to the existing system.

INTRODUCTION (COLLAPSE OF CONVENTIONAL BANKING / FINANCIAL SYSTEM)

4. Mid 2008 was a turning point of the contemporary financial world which is based on so called capitalist system. It proved that even the biggest powers in the world can go down due to their own mistakes. Starting from United States of America through Europe, Africa and then Asia, the financial crisis and its waves struck hard enough to collapse these super powers’ financial system within a very short span of time.

5. Around the world stock markets had fallen, large financial institutions had collapsed or been bought out, and governments in even the wealthiest nations were shaken badly. On the one hand, many people were seriously concerned that those responsible for the financial crisis were being bailed out, while on the other hand, there was a fear that a global financial meltdown would affect the livelihoods of almost everyone in an increasingly interconnected world. Governments came up with rescue packages to bail out their financial systems. A collapse of the US sub-prime mortgage market and the reversal of the housing boom in other industrialized economies had a ripple effect around the world. It was known to be the worst of crisis since the great depression of 1930.

FROM WHERE IT STARTED (ROOT CAUSES)

6. Most of the people around globe blamed the greed of Wall Street responsible for this financial crunch since most of the influential banks, institutions and ideologues that pushed for the policies that caused the problems are located in the US. United Nation's Conference on Trade and Development, in its Report for the Year 2008 summarized that the downturn after four years of relatively fast growth was due to a number of factors: the global **fallout** from the financial crisis in United States, the **bursting of the housing bubbles** in the US and in other large economies, soaring commodity prices, increasingly **restrictive monetary policies** in number of countries, and **stock market volatility**.

7. **US Housing Bubbles.** All the Americans have a dream of having a two kids family with a yard home, a car or two, multimedia room with flat screen etc. To achieve this vision, Bush administration pushed a new policy of encouraging home

ownership with “Zero down payment”. Some companies had government backed programs allowing getting mortgages with no down payment and some with no maturity payment. Most of these were without proper documentation. At the end, these turned into derivatives built on some other derivatives packed and repackaged in a manner where it could not be identified what it contained and how much is it worth of. Experts termed these derivatives as “Financial weapons of mass destruction”. This is because these are negotiated between two private parties. These are neither regulated by governments nor have any central reporting mechanism to determine their value.

8. This bubble busted after the housing prices went down due to supply overwhelming the demand. Money sub prime borrowers found that their homes were worth less than their mortgages. Defaults rose and the downward spiral started. Now investors piled on Collateralized debt obligations (**CDO's**) which are complicated securities based on pools of mortgages. Consumers who got big mortgages with little documentations began to default. Due to rising neglect of obligations, CDOs lost their value. As a result, big names like Bear sterns, Lehman brothers went down.

9. **Paper Based Financing (Issuance of Derivatives)**. As discussed above the derivatives (conventional) were changed from forward to future contracts. In these contracts, delivery (receiving) was not necessary but the contract started moving hand to hand. In this way, the transactions had been done many times although the real assts were very little; *It's just similar to an inverted pyramid where the real asset lies on the bottom and the debt layers on top of it.*

10. **Gambling and Speculative Business.** As 95% of the money loaned through derivatives was used for **gambling** and **speculative** purpose, it started growing rapidly. And when the people were not in a position to repay the bank loans, the banks were also unable to face the depositors and collapsed. It's very clear that the sudden growth of the Credit Default Swap (CDS) were due to the gamblers interest which brought them multiple profits with no effort at all. The best example is Barings Bank (1762 - 1995) which was the oldest merchant bank in London until its collapse in 1995 after one of the bank's employees, Nick Leeson, lost 827 million pound (\$1.4) billion) speculating primarily on future contracts

11. **Debt to Debt Financing.** Debit to debt financing was another problem in this system. Where an already existing debt was dealt with another new debt based transaction. Thus the debtor had an upper hand on the creditor while entering into the contract. Such contracts were mostly based on lot of conditions which subsequently created problems for the system.

12. **Compound Interest.** Interest factor, which is the basis of conventional banking, emerged as a root cause for this crisis. It brings multiple effects on the debtor's burden. It also makes the rich richer and the poor poorer. Following the **August 2000 G8 Summit in Okinawa, Nigerian President Obasanjo** told reporters: **“All that we had borrowed upto 1985 or 1986 was around \$5 billion and we have paid about \$16 billion, yet we are still being told that we owe about \$28 billion. That \$28 billion came about because of the injustice in the foreign creditor's rates, If you ask me what the worst thing in the world is, I will say it is compound interest.”**

INGREDIENTS OF ISLAMIC FINANCING

13. Islam gave an all-embracing system of finance to the mankind, which takes care of not only the individual but also the societal interests and concerns. The constituents of the Islamic Financial System (IFS) are not only logically comprehensible but also appealing in that they are natural, compassionate and contemporary in all respects. The IFS is different from other prevalent financial systems because it is based on certain social objectives. Islam guides human life and ensures free enterprise. While the conventional banker may not be concerned with moral implications of the business, Islamic bank keeps a close eye on utilization of loaned capital..¹ Describing the IFS simply as "interest-free" does not provide a true and complete picture of the system. Certainly, prohibition of interest is the nucleus² of the system but it is supported by various other codes of finance. Similarly, the IFS is not limited to banking but covers capital formation, capital markets and all types of financial intermediation.³

14. **Principles of Islamic Financial System**⁴

- a. **Prohibition of Interest (*Riba*)**. Prohibition of *riba*, whether in loans or sales, is the key tenet of the system. Any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited.

- b. **Risk Sharing.** Because interest is prohibited, supplier of funds becomes investor instead of creditor. The provider of financial capital and the entrepreneur share business risks and profits.
- c. **Money as Potential Capital.** Money is treated as potential capital i.e. it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money but only when it acts as capital and not when it is potential capital.
- d. **Prohibition of Speculative Behaviour.** IFS discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling and risks etcetera.
- e. **Sanctity of Contracts.** Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.
- f. **Shariah-Approved Activities.** Only those business activities that do not violate the rules of *shariah* qualify for investment. For example, any investment in businesses dealing with alcohol, gambling and casinos etcetera is prohibited.

15. **Islamic Financial Instruments**¹. A few quite popular instruments in Islamic financial markets are discussed in ensuing paragraphs.

- a. **Trade with Mark-up or Cost-plus Sale (*Murabaha*).** This is the traditional notion of purchase finance. The investor undertakes to supply specific commodities, incorporating a mutually agreed contract

for resale to the client at a mutually negotiated margin. Around 75% of Islamic financial transactions are cost-plus sales.

- b. **Leasing (Ijara)**. Leasing is designed for financing vehicles, machinery, equipment and aircraft etcetera. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee).
- c. **Profit-Sharing Agreement (Mudaraba)**. This is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities.
- d. **Equity Participation (Musharaka)**. This is analogous to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise and working capital etcetera) of the operation in varying degrees and agree to share risks and returns in proportions agreed to in advance.
- e. **Sales Contracts**. Deferred-payment sale (*bay' mu'ajjal*) and deferred-delivery sale (*bay' salam*) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery

sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.

- f. **Binding for Islamic Financial Institutions.** Two things are very important for the Islamic financial institution. Firstly the Islamic banks are bound to follow the Islamic Shariah principles. Since shariah is the divine will of Allah (s.w.t) NO LAPSES Can be found in any situation Secondly the Shariah supervisory board/ advisors will make sure that all the bank transactions as well as fields of investment remain Islamic and according to Shariah.

COMPARISON OF BOTH THE BANKING SYSTEMS

16. Even though there is some commonness as well, yet there are clear differentiation between two banking systems and glaring values in Islamic Finance , which make Islamic banking system more fruitful to the society.

a. CONVENTIONAL

- (1) It is based on interest.
- (2) It deals in money or papers.
- (3) It is based on fixed return on both sides of the balance sheet.
- (4) It does not involve itself in trade and business.
- (5) Conventional banking prices money
- (6) Depositors get a fixed rate regardless of the bank's profitability, thus insulating them from the bank's true performance.

b. ISLAMIC BANKING

- (1) It is based on profit or rent and loss sharing.
- (2) It deals in assets.
- (3) It Is based on profit sharing on deposits side, and on profit on assets side.
- (4) Islamic Bank actively participates in trade and production.
- (5) Islamic banking prices goods and services
- (6) Profit is shared with the depositor, higher the bank's profit, higher the depositors income

CONCLUSION

17. From the current financial crisis a significant conclusion can be drawn. That is the centuries old capital based financial system collapsed while the forty year old Islamic financial industry remained steady and unaffected. The reasons for stability of Islamic Banks are following of Divine principles which never allow exploiting, or gambling. Secondly the Shahrīah supervisory board / advisors ensure that all the transactions including depositors' money usage remain Islamic and according to Shari'ah. Major flaws in the Conventional Banking like Paper based financing including forward contracts (credit default swaps) , Paper based derivatives used in Deceiving, Speculative business and gambling, Debt transaction, Compound interest etc which became cause of crisis, are strictly forbidden in Islamic Financing.

18. Islamic banking has been defined as banking in consonance with the ethos and value system of Islam; it is governed, in addition to the conventional good governance and risk management rules,

by the principles laid down by Islamic Shariah Law. Islamic banking system is based on risk-sharing, owing and handling of physical goods, involvement in the process of trading, leasing and construction contracts using various Islamic modes of business and finance. It is an alternate to the interest-based banking, not in the traditional sense of the world. The real aims and objectives of establishing Islamic banks are put the Islamic economic system into practice through banking and financial institutions.

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