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**THE GLOBAL FINANCIAL CRISIS: CAN
ISLAMIC FINANCE HELP MINIMIZE THE
SEVERITY AND FREQUENCY OF SUCH A
CRISIS IN THE FUTURE?**

by

M. Umer Chapra*

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* The author is Research Adviser at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB). This paper is a revised and updated version of the keynote Forum lecture delivered by him at the inaugural session of the Eighth Harvard University Forum on Islamic Finance held on 19-20 April 2008 in the Harvard Law School. The views expressed in this paper are his own and do not necessarily reflect those of IRTI or IDB. He is grateful to Shaikh Muhammad Rashid for the excellent secretarial assistance he has provided. He is also grateful to Bashir Khallat, Acting Director of IRTI, for the encouragement and support he has provided and to his colleagues, Drs. Sami alSuwailem, Tariqullah Khan and Salman Syed Ali for their valuable comments on an earlier draft.

ABSTRACT

The paper tries to determine the primary cause or causes of the financial crises that have plagued almost every country around the world over the last three decades. Of particular significance are the 1998 LTCM breakdown and the prevailing subprime mortgage crisis in the United States which is more severe than any in the past and has had devastating spillover effects worldwide. It argues that one of the major causes of these crises is the lack of adequate market discipline in the financial system. This leads to excessive lending, high leverage and ultimately the crisis. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a steep decline in asset prices accompanied by bank failures and economic slowdown. Risk-sharing along with the availability of credit for primarily the purchase of real goods and services and restrictions on the sale of debt, short sales, excessive uncertainty (gharar), and gambling (qimar), which Islamic finance stands for, can help inject greater discipline into the system and, thereby, substantially reduce financial instability.

INTRODUCTION

The financial system has decidedly played an active role in the accelerated development of the world economy, particularly after the Second World War. An unending stream of financial innovations, including the revolution in information and communications technology, has played a crucial role in this development. The system is, however, now plagued by persistent crises. According to one estimate, there have been more than 100 crises over the last four decades (Stiglitz, 2003, p. 54). Not a single geographical area or major country has been spared the effect of these crises. Even some of the countries that have generally followed sound fiscal and monetary policies have become engulfed in these crises. The prevailing financial crisis, which started in the summer of 2007, is more severe than any in the past and shows no sign of abating despite a coordinated bail out of three to four trillion dollars by the US, the UK, Europe and a number of other countries. It has seized-up money markets and led to a precipitous decline in property and stock values, bank failures, and nervous anxiety about the fate of the global economy and the financial system.

This has created an uneasy feeling that there is something basically wrong with the system. There is, hence, a call for a new architecture. The new architecture demands an innovation that could help prevent the outbreak and spread of crises or, at

least, minimize their frequency and severity. Since a number of the crises experienced around the world are generally of a serious nature and have been recurring persistently, cosmetic changes in the existing system may not be sufficient. It is necessary to have an innovation that would be really effective. It may not be possible to figure out such an innovation without first determining the primary cause of the crises.

PRIMARY CAUSE OF THE CRISES

There are undoubtedly a number of causes. The generally recognized most important cause is, however, excessive and imprudent lending by banks.¹ One cannot blame banks for this because, like everyone else, they also wish to maximize their profits in a materialist cultural environment where maximization of income and wealth is the highest measure of human achievement. The more credit they extend, the higher will be their profit. It is high leverage which enables excessive lending. Excessive lending, however, leads to an unsustainable boom in asset prices followed by an artificial rise in consumption and speculative investment. The higher the leverage the more difficult it is to unwind it in a downturn. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a steep decline in asset prices followed by a serious financial crisis, particularly if it is also accompanied by overindulgence in short sales.

It is the combined influence of three forces which can help prevent the recurrence of crises. One of these is moral constraints on the greed to maximize profit, wealth and consumption by any means in keeping with the mores of the prevailing secular and materialist culture. The second is market discipline which is expected to exercise a restraint on leverage, excessive lending and derivatives. The third is reform of the system's structure along with prudential regulation and supervision appropriately designed to prevent crises, achieve sustainable development and safeguard social interest. Since all of these three forces have become blunted by the philosophies of secularism, materialism and liberalism, mankind has been flooded with different man-made problems, including recurring

¹ This is clearly recognized by the BIS in its 78th Annual Report released on 30 June 2008 by stating that the fundamental cause of today's problems in the global economy is excessive and imprudent credit growth over a long period (p.3).

financial crises, family disintegration, flagrant inequalities of income and wealth, and crime and anomie.

This raises the question of why market discipline has not been able to exercise a restraint on excessive lending. Is it possible that market discipline is not adequate in the financial system? If this is the case, then why is it so? The market can impose a discipline primarily through incentives and deterrents. If incentives and deterrents do not exist or become weak, market discipline will also become weak. The incentives and deterrents come through the prospect of making profit or loss. The major source of profit in the conventional system is the interest that the banks earn through their lending operations. The loss comes through the inability to recover these loans with interest. One would, therefore, expect that banks would carefully analyze their lending operations so as *not* to undertake those that would lead to a loss. There would be a check over excessive lending if the banks were afraid of suffering losses that would reduce their net profit. This does not happen in a system where profit and loss sharing (PLS) does not exist, and the repayment of loans with interest is generally guaranteed.

There are two factors that enable banks to assume that they will not suffer losses. The first of these is the collateral, which is indispensable and unavoidable in any financial system for managing the risk of default. The collateral can, of course, do this only if it is of good quality. Collateral is, however, exposed to a valuation risk. Its value can be impaired by the same factors that diminish the borrowers ability to repay. The collateral, cannot, therefore, be a substitute for a more careful evaluation of the project financed. However, if there is no risk-sharing, the banks may not always undertake a careful evaluation of the collateral and extend financing for any purpose, including speculation. This may be more so if it is possible for banks to transfer the risk of default by selling the debt to someone else. The second factor that provides protection to the banks is the “too big to fail” concept which assures them that the central bank will bail them out. (See Mishkin, 1997, p. 61). Banks which are provided with such a safety net have incentives to take greater risks than what they otherwise would (Mishkin, 1997, p. 62).

Given that banks lend excessively to maximize their profit, why is it that the depositors do not impose a discipline on the banks? They can do so in several different ways: by demanding better management, greater transparency, and more efficient risk management. If this does not work, they can always punish the banks by withdrawing their deposits. They do not, however, do so in the conventional financial system because they are assured of the repayment of their deposits with interest. (Mishkin, 1997, p. 62). This makes them complacent and they do not take as much interest in the affairs of their financial institution as they would if they expected to suffer losses.

The false sense of immunity from losses provided to bankers as well as depositors impairs the ability of the market to impose the required discipline. This leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, to even subprime debt, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favour of debt financing - dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense.

This shows that the absence of risk/reward sharing reduces market discipline and, thereby, introduces a fault line in the financial system. It is this fault line that makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources. (BIS, 1982, p.3). It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. The IMF acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are "likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises" (p.83).

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close

link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have high debt profile and for the private sector to live beyond its means and to have high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period.

While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services by households, firms, and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock, and property markets. Jean Claude Trichet, President of the European Central Bank, has rightly pointed out that "a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds" (Trichet, 2005, p. 4).

If we examine some of the major crises in the international financial system like the one in East Asia, the instability in the foreign exchange markets, collapse of the Long-term Capital Management (LTCM) hedge fund, and the prevailing crisis in the U.S. financial system, we find that the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets due to the absence of risk sharing. (see Chapra, 2007, pp. 166-173). In this paper I will refer only to the collapse of the LTCM, the prevailing imbalances in the US economy, and the subprime mortgage crisis in the US financial system.

The Collapse of LTCM

The collapse of the U.S. hedge fund LTCM in 1998 was due to highly leveraged short-term lending. Even though the name hedge fund brings to mind the idea of risk reduction, "hedge funds typically do just the opposite of what their name

implies: they speculate" (Edwards 1999, p. 189). They are "nothing more than rapacious speculators, borrowing heavily to beef up their bets" (*The Economist* 1998, p. 21). These hedge funds are mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector - positions that might be considered "imprudent" if taken by other institutional fund managers (Edwards, 1999, p. 190; Sulz, 2007, p. 175) They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others. They now account for close to half the trading on the New York and London stock exchanges (Sulz, 2007, p. 175).

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains, and the risks to which they are exposed would also be much greater. They, therefore, normally tend to operate in unison. This becomes possible because their chief executives often go to the same clubs, dine together, and know each other very intimately (Plender, 1998). On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilize the financial market of any country around the world whenever they find it to their advantage. Hence, they are generally blamed for manipulating markets from Hong Kong to London and New York (*The Economist*, 1998, p. 21). Mahathir Muhammad, Malaysia's ex-prime minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian Ringgit in summer 1997, resulting in the collapse of the Malaysian economy (1997, p. C1; Stiglitz, 2007, p.2). It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of Pound Sterling, the Thai Bhat and some other currencies.

The LTCM had a leverage of 25:1 in mid-1998 (BIS, 1999, p. 108; Sulz, 2007, p. 179), but the losses that it suffered reduced its equity (net asset value) from the initial \$4.8 billion to \$2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance-sheet positions alone. However, its equity continued to be eroded further by losses, reaching just \$600 million, or one-eighth its original value, on

September 23, 1998. Since its balance-sheet positions were in excess of \$100 billion on that date, its leverage rose to 167 times capital (IMF, December 1998, p. 55). There was, thus, tier upon tier of debt, which became difficult to manage. The Federal Reserve had to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the U.S. financial system, with spillover and contagion effects around the world.² If the misadventure of a single hedge fund with an initial equity of only \$4.8 billion could take the U.S. and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of the 9,000 hedge funds managing more than \$2.8 trillion of assets got into trouble.³

A hedge fund is able to pursue its operations in secrecy because, as explained by the former Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is "structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals" (1998, p. 1046). He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such "highly sophisticated, very wealthy individuals" for risky speculation when it is well known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects (IMF, December 1998, pp. 51 -53).

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the United States. Even though the hedge funds were not

2. This was clearly acknowledged by Greenspan in the following words: "Had the failure of the LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own" (1998, p. 1046).

3. The number of hedge funds is from Financial Stability Forum (www.fsforum.org) The amount of assets they manage is for the third quarter of 2007 from Institutional Investor News and Hedge Asset Flows and Trends Report, 2008.

regulated, the banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing, and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk sharing by banks, stop excessive flow of funds to other speculators?

The Prevailing Imbalances in the U.S. Economy⁴

The lack of discipline in the financial system has also created two serious problems for the United States. Both of these, the public-sector budgetary deficits and the private-sector saving deficiency, ring a worrisome note not only for the United States but also for the world economy. The federal government has been running budgetary deficits ever since 1970, except for a brief respite between 1998 and 2001. The budget moved from a surplus of \$255 billion in fiscal year 2000 to a deficit of \$412 billion in 2004 (Kohn, 2005, pp. 1–2; and IMF, August 2008, p. 602). The deficit declined thereafter to \$317, \$248 billion and \$163 billion in 2005, 2006 and 2007. (IMF, August 2008, p. 1188), but is estimated to have risen to a record \$438 billion in fiscal 2008. Instead of declining, the deficits are expected to rise further in the near future as the government tries to stabilize the financial system by buying illiquid assets from financial institutions, fulfils campaign pledges, and the baby boomers reach retirement age.

The continuing deficits have already raised the gross public debt of U.S. Treasury to more than \$9.4 trillion in March 2008 (Federal Reserve, *Statistical Supplement*, August. 2008, Table 1.41), approximately \$79,000 on average for every taxpayer.⁵ Of this, the external debt is around 25 percent, virtually double the 1988 figure of 13 percent (Wikipedia, 2008, pp.1 and 5). The rise in external debt resulting from continuous current account deficits has had an adverse impact on the strength of the US Dollar in the international foreign exchange markets.

⁴ See the address entitled "Imbalances in the US Economy" by Donald Kohn, member of the Board of Governors of the US Federal Reserve System, at the 15th Annual Hyman Minsky Conference, the Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, 22 April 2005 (BIS Review, 28/2005).

⁵ According to the U.S. National Debt Clock, the outstanding public debt was \$10.2 trillion on 5 October 2008. The statutory ceiling on the national debt has already been raised to \$ 11.315 trillion to accommodate the expected rise in debt.

These deficits may not have created a serious problem if the US private sector saving had not declined precipitously. Net private saving (saving by households and businesses minus investment) has been declining as a result of the borrowing and spending spree by both households and firms. This may not have been possible without excessive and imprudent lending by the financial system. Over the last three years (2005-2007), the net saving by households has been less than 1% of the after-tax income, compared with an average of 8 percent from 1950 to 2000 (Kohn, 2005, p. 1; and OECD Economic Outlook 82, Annex Table 23). Government deficits combined with the gross debt of households and corporations have raised the total American debt to around 350 percent of GDP. This should have pushed up interest rates but did not because of the inflow of funds from abroad. This inflow has, however, been only a mixed blessing because it did not only raise the U.S. net foreign indebtedness to a record high in both absolute terms as well as a percentage of GDP but also lowered interest rates which has promoted a steep rise in consumer spending along with a boom in residential real estate prices.

This brings into focus the crucial issue of how long will the foreigners be willing to continue lending. Confidence in the strength and stability of the dollar is necessary to enable it to serve as a reserve currency. This is, in turn, not possible without the willingness of foreigners to hold dollars. What will happen if the deficits continue, create loss of confidence in the dollar, and lead to an outflow of funds from the United States? This is not just a theoretical question. In the last 40 years, the dollar has experienced four bouts of marked depreciation. Since nearly two-thirds of the world's foreign exchange holdings are still in dollars,⁶ a movement out of the dollar into other currencies and commodities, as happened in the late 1960s, could lead to a sharp fall in the exchange rate of the dollar, a rise in interest rates and commodity prices, and a recession in the U.S. economy. This might lead the whole world into a prolonged recession. The correction would then come with a vengeance when market discipline could have led to it much earlier with significantly less suffering. Accordingly, the President's Working Group on Financial Markets (PWG) has rightly concluded in its report on "Principles and Guidelines Regarding Private Pool of

⁶ At the end of the third quarter of 2007, 63.8 of the identified official foreign exchange reserves in the world were held in United States dollars (www.imf.org/external/np/sta/cofer/eng/cofer.pdf).

Capital” issued in February 2007 that the most effective means of limiting systemic risk is to reinvigorate market discipline.

The Subprime Mortgage Crisis

The subprime mortgage crisis in the grip of which the US finds itself at present is also a reflection of excessive lending. Securitization or the “originate-to-distribute” model of financing has played a crucial role in this. There is no doubt that securitization was a useful innovation. It provided lenders greater access to capital markets, lowered transactions costs, and allowed risks to be shared more widely. The resulting increase in the supply of mortgage credit contributed to a rise in the homeownership rate from 64 percent in 1994 to 68 percent in 2007 (Bernanke, 20 September 2007, p.1).

However, even a useful innovation can have a negative impact if it is used in a way that reduces market discipline. Mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security. They had, therefore, less incentive to undertake careful underwriting. (Mian and Sufi, January 2008, p. 4; and Keys, et al, January 2008). Consequently loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers increased. According to Mr. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, “far too much of the lending in recent years was neither responsible nor prudent. ... In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly (Bernanke, 14 March 2008, p.1).

The check that market discipline could have exercised on the serving of self-interest did not, thus, come into play. This sowed the seeds of the subprime debt crisis and led to not only the financial distress of subprime borrowers but also a crisis in the U.S. financial system which has had spillover effects on other countries.⁷ Consequently, a number of banks and other financial institutions have either failed or have had to be bailed out or nationalized at the expense of the taxpayer not only in the

⁷ Roughly 4.2 million mortgages were overdue or in foreclosure at the end of 2007, according to the Mortgage Bankers Association. An additional three million borrowers may default in the near future. (Herszenhorn and Bajaj, 2008, p. 2).

US, but also in the UK, Europe and other countries. The general feeling seems to be that more may come if credit card institutions, corporations and derivatives dealers default as a result of the prevailing crisis as well as the expected recession.

When there is excessive and imprudent lending and the lenders are not confident of repayment, there is an excessive resort to derivatives like credit default swaps (CDS) to seek protection against debt default. The buyer of the swap pays a premium to the seller (a hedge fund) for the compensation he will receive in case of debtor default. This may not have created any problem if the protection was provided to the actual creditor. However, in a typical swap deal, a hedge fund will sell the swap not to just one bank but also to several other wagers who are willing to bet on the default of that specific debtor, even though they may not have themselves lent to that debtor. These wagers may again resell the swaps to others, thereby unduly accentuating the risk. Accordingly the notional amount of outstanding derivatives rose to the high of \$692 trillion (including CDRs of \$62.2 trillion) in the first quarter of 2008, but declined thereafter to \$600 trillion (including CDRs of \$54.6 trillion) in the second quarter (BIS, September 2008, p.20). However, even after the decline, it is more than ten times the size of the total world output of \$57 trillion.

Since the derivatives market is not regulated and supervised like insurance companies, the dealers are not subject to statutory limits, minimum capital and reserve requirements, and other prudential regulatory measures. This has created a great deal of uncertainty about whether the excessively leveraged 6 to 10 dealers, who are the ultimate settlers of derivatives will be able to fulfill their obligations in case there is a large number of defaults. The default of any one of them may set in a global chain reaction that might leave buyers of derivatives with billions of dollars of worthless contracts and bring down the international financial system. No wonder George Soros described derivatives as ‘hydrogen booms’, and Warren Buffett called them ‘financial weapons of mass destruction’.

When the system has reached a crisis point, then it becomes difficult to apply the brakes. Central banks have no choice other than to bail out banks, lower interest rates, and provide liquidity to avoid a recession. The liquidity made available now at extremely low interest rates will not only raise public and private sector debt but also enable the imprudent funding to continue. This will be followed by a financial crisis,

which will again necessitate the pumping of further liquidity into the system to overcome the crisis. Therefore, while measures are being adopted to contain the prevailing crisis, it is also necessary to simultaneously think of some effective way of avoiding crises in the future by checking excessive and imprudent lending through the introduction of greater discipline in the financial system.

Introduction of greater discipline in the financial system will, however, tend to deprive the subprime borrowers of the financing they need for purchasing a house, other indispensable goods and services, and establishing their own businesses. Some kind of an arrangement needs, therefore, to be made to enable such borrowers to have access to financing. Instead of spending billions to save the financial system from the default of such borrowers after the crisis has taken place, it is desirable to create some mechanism before the crisis to provide low-cost financing at affordable terms to such borrowers. Not doing so is likely to increase the gulf between the rich and the poor and give rise to social and political tensions.

Hence there is dire need for a new architecture of the financial system. Bookstaber (2007) has rightly asserted that today's financial crises do not arise from economic instability or acts of nature, but from the very design of the financial markets themselves. *The Economist* has also observed that "the world needs new ways of thinking about finance and the risks it involves" (2008, p. 25). It is here where Islamic finance can make a valuable contribution to the international financial system.

THE ISLAMIC FINANCIAL SYSTEM

One of the most important objectives of Islam is to realize greater justice in human society. This is not possible unless all human institutions, including the financial system, contribute positively towards this end. One of the principle needs for this is to subject all aspects of human life, social, economic, political and international, to moral values. This will help curb greed and avarice which have made maximization of wealth and want satisfaction as the highest measure of human achievement (See Galbraith, 1972, p. 153).

The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions. One of these is that the financier must also share in the risk so as *not* to shift the entire burden of losses to the entrepreneur, and the other is that an equitable share of financial resources should become available to the poor to help eliminate poverty, and reduce inequalities of income and wealth. Within the framework of Islamic values, it is not possible to achieve sustainable development without justice. Injustice ultimately leads to destruction (Al-Qur'an, 57:25). A number of classical Muslim scholars, including Abu Yusuf (d. 798), al-Mawardi (d. 1058), Ibn Taymiyyah (d. 1328) and Ibn Khaldun (d. 1406) have emphasized the close relationship between justice and development. This is also now being emphasized more and more in economic literature.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. For this purpose, one of the basic principles of Islamic finance is: "No risk, no gain". If we wish to have a gain we must also be prepared to share the risk. Introduction of risk/reward sharing in the financial system should help induce the financial institutions to assess the risks more carefully and to monitor more effectively the use of funds by the borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the financial system, and go a long way in reducing excessive lending and making the financial system healthier. However, making just the banks share in the risk may not be enough because the desire to maximize profits may still induce the banks to indulge in excessive lending. It is, therefore, necessary to also motivate the depositors to play a more active role in the enforcement of this discipline. This will be possible if the depositors also share in the profit or loss.

However, since demand depositors do not get any return, it would not be fair to make them participate in the risks of financing. Their deposits must, therefore, be guaranteed. In contrast with this, investment depositors share in the profit and should, therefore, participate in the risks. What this will do is to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares, and withdrawing them will be like redeeming them. This will motivate investment depositors to monitor their banks, and demand greater

transparency, better governance, and more effective risk management, auditing, regulation and supervision. Making the depositors participate in the risk would also help motivate them to take greater care in choosing their banks.

Instead of introducing greater discipline in this manner, the primary focus of the international financial system is at present on regulation and supervision. There is no doubt that prudent regulation and supervision are both necessary and unavoidable, and it is a matter of great relief to know that there has been substantial progress in this direction under the aegis of the Basel Committee on Banking Supervision (BCBS). Regulation and supervision cannot, however, be relied upon totally for two main reasons. Firstly, it is not possible to curb greed and avarice by means of just regulation. It is also necessary to create a moral commitment to the faithful observance of regulations, because unscrupulous persons may circumvent these in a surreptitious manner without being detected. Secondly, regulation may not be applied uniformly in all countries and to all institutional money managers as a result of off-balance-sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. The LTCM collapse as well as the prevailing financial crisis in the United States clearly show how banks can get into difficulties as a result of overlending even in an apparently well-regulated system.

Regulation and supervision would, therefore, be more effective if they were complemented by a paradigm shift in favour of greater discipline in the financial system by making the banks as well as investment depositors share in the risks of financial intermediation. Just the bailing-in of banks, as is being suggested by some analysts (Calomiris 1998, Meltzer; 1998; Yeager, 1998) may not be able to take us far enough because the capital of banks may be only around 8 percent of their risk-weighted assets. What is also necessary is to strongly motivate not only the banks to undertake careful underwriting of all loan proposals but also the depositors to be cautious in choosing their bank and to monitor their bank's affairs more carefully. The establishment of depositors' associations may make it easier for them to do so.

Islamic finance should, in its ideal form, help raise substantially the share of equity in businesses and of profit-and-loss sharing (PLS) in projects and ventures

through the *mudarabah* and *musharakah* modes of financing. Greater reliance on equity financing has supporters even in mainstream economics. Prof. Rogoff of Harvard University states, "In an ideal world equity lending and direct investment would play a much bigger role". He further asserts that, "with a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted" (Rogoff, 1999, p.40). The IMF has also thrown its weight in favour of equity financing by arguing that "foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily" (IMF, May 1998, p.82).

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable, but should not be promoted for inessential and wasteful consumption and unproductive speculation. For this purpose, the Islamic financial system does not allow the creation of debt through direct lending and borrowing. It rather requires the creation of debt through the sale or lease of real assets through its sales- and lease-based modes of financing (*murabahah, ijarah, salam, istisna* and *sukuk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his ability to make the payment later. Islam has, however, laid down certain conditions that would help prevent excessive expansion of debt. Some of these are:

1. The asset which is being sold or leased must be *real*, and not imaginary or notional;
2. The seller must own and possess the goods being sold or leased;
3. The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and

4. The debt cannot be sold and thus the risk associate with it cannot be transferred to someone else. It must be borne by the creditor himself.

The first condition will help eliminate most of the speculative transactions which involve *gharar* (excessive uncertainty) and *qimar* (gambling). The second condition will help ensure that the seller (or lessor) also shares a part of the risk to be able to get a share in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. The *Shari'ah* has made an exception to this rule in the case of *salam* and *istisna* where the goods are not already available in the market and need to be produced before delivery. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion.

The third and fourth conditions, that the transaction must be a genuine trade transaction and that the creditor cannot transfer the risk to someone else by selling the debt, will also help eliminate speculative and derivative transactions and also prevent the debt from rising far above the size of the real economy. It will also release a greater volume of financial resources for the real rector and, thereby, help expand employment and self-employment opportunities and the production of need-fulfilling goods and services. The discipline that Islam wishes to introduce in the financial system may not materialize unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability.

Reducing Government Budgetary Deficits

The discipline that Islam wishes to introduce in the financial system may not materialize unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability. If the governments borrow heavily from the central banks, they will provide more high-powered money to banks than is necessary and, thereby, promote excessive monetary expansion. It is essentially excessive liquidity which, along with high leverage, enables banks to resort to lax lending. It is, therefore, necessary to have independent central banks along with legal curbs on the government's ability to borrow so that

they do not run deficits in their budgets in excess of what is permissible within the framework of growth with stability.

Islamic Finance in Practice

The way the Islamic financial system has progressed so far is only partly, but not fully, in harmony with the Islamic vision. It has not been able to fully come out of the straitjacket of conventional finance. The use of equity and PLS modes has been insignificant, while that of the debt-creating sales- and lease-based modes has been predominant. Moreover, even in the case of debt-creating modes, all Islamic banks and branches or windows of conventional banks do not necessarily fulfill the conditions laid down by the *Shari'ah*. They try to adopt different legal stratagems (*hiyal*) to transfer the entire risk to the purchasers (debtors) or the lessees. The result is that the Islamic financial system, as it is being practiced, does not appear to be a genuine reflection of what it is expected to be.

This raises the question of why the system has been unable to make significant headway in the direction of attaining greater authenticity. One of the primary reasons for this is that the institutions that are necessary to minimize the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations have not yet been established. Such institutions are needed to enable the banks to obtain reliable information about their clients and to ensure that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared by them reflects the true picture of the business. They are also needed to help receive repayments on schedule, and to get justice promptly in case of dispute with, or willful procrastination of payment by, the banks' clients. They are also needed to help banks gain liquidity when it is needed by them in situations of liquidity crunch resulting from unforeseen circumstances. The establishment of such institutions would go a long way in providing an enabling environment for Islamic finance. The

longer it takes to establish such institutions, the longer it will take to realize the vision.⁸

MAKING SOME ARRANGEMENT FOR SUBPRIME BORROWERS

While the introduction of greater discipline into the financial system through risk/reward sharing will help promote justice between the financier and the entrepreneur, it will not help spread equitably the benefit of the nation's savings mobilized by the financial institutions to all sectors of the economy. Subprime borrowers will most probably be weeded out. The financial system has generally tended to do so in almost all countries around the world and, thereby, accentuated the inequalities of income and wealth. Arne Bigsten has rightly observed, that "the distribution of capital is even more unequal than that of land" and that "the banking system tends to reinforce the unequal distribution of capital" (1987, p. 156). Khawaja and Mian have shown in a recent paper that banks tend to favour politically connected firms (2005).

This bodes ominously for society because it leads to the recruitment of entrepreneurs from only one social class and to the failure to utilize the society's entire resource of entrepreneurial talent (Leadbearer, 1986, p. 5). Since the financial system plays a dominant role in the determination of the power base, social status and economic condition of individuals in the economy (See Claessens and Perotti, 2007), it may be difficult to realize the socio-economic goals of Islam without restructuring the system in a way that would facilitate the realization of these goals.

This becomes even more important because, as already indicated, the effort to introduce greater discipline into the financial system may worsen the inequalities further by depriving primarily the subprime borrowers from getting credit. Therefore, what needs to be done is to introduce some suitable innovation in the financial system to ensure that even such borrowers are able to get adequate credit to enable them to realize their dream of owning their own homes and micro-enterprises. Any society where the poor are not able to get out of wage slavery by establishing their

⁸ For a brief discussion of some of these institutions, see Chapra, 2008.

own enterprises and satisfying their basic needs satisfactorily from the higher income earned thereby, cannot be considered a just society. Dr Muhammad Yunus, founder of the Grameen Bank, has aptly emphasized that financing for self-employment should be recognized as a right that plays a critical role in attaining all other rights (1987, p. 31). The Select Committee on Hunger established by the US House of Representatives concluded in its Report that “the provision of small amounts of credit to micro-enterprises in the informal sector of developing countries can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies” (1986, p.v).

Experience has shown that micro-enterprises have generally proved to be viable institutions with respectable rates of return and low default rates. They have also proved to be a successful tool in the fight against poverty and unemployment. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings (*The Economist*, 16 February 1985, p. 15). Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 per cent since the Bank's inception (Yunus, 1984, p. 12; Wikipedia, 2008, p.3).

A number of countries have, accordingly, established special institutions to grant credit to the poor and lower middle class entrepreneurs.⁹ Even though these have been extremely useful, there are two major problems that need to be resolved. One of these is the high cost of finance in the interest-oriented microfinance system. A timely study by Dr. Qazi Kholiquzzaman Ahmed, President of the Bangladesh Economic Association, has revealed that the effective rate of interest charged by microfinance institutions, including the Grameen Bank, turns out to be as high as 30 to 45 percent.¹⁰ This causes serious hardship to the borrowers in servicing their debt. They are often constrained to not only sacrifice essential consumption but also borrow from money-lenders. This engulfs them unwittingly into an unending debt cycle which will not only perpetuate poverty

⁹ For the experience of microfinance institutions in some Muslim countries, see Obaidullah (2008).

¹⁰ This is highly plausible because some other studies indicate even higher effective rates of interest. According to Nimal Fernando (2006), Principal Microfinance Specialist in the East Asia Department of the Asian Development Bank, the nominal interest rates charged by most microfinance institutions in the region range from 30 to 70 percent a year. The effective interest rates are even higher because of commissions and fees charged by them (p.1). According to Mannan (2007), the effective rates range from 54 to 84 percent (pp. 2 and 12).

but also ultimately lead to a rise in unrest and social tensions (Ahmed, 2007, pp. xvii-xix; see also Sharma, 2002).¹¹ No wonder, the Minister of Finance for Bangladesh described microcredit interest rates in that country as extortionate in an address he delivered at a micro-credit summit in Dhaka in 2004.¹²

It is, therefore, important that, while the group lending method adopted by the Grameen bank and other microfinance institutions for ensuring repayment is retained, microcredit is provided to the very poor on a humane interest-free basis. This may be possible if the microfinance system is integrated with *zakah* and *awaqf* institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit-and-loss sharing and sales- and lease-based modes of finance in Muslim countries not only to avoid interest but also to prevent the misuse of credit for personal consumption.¹³

Another problem faced by microfinance is that the resources at the disposal of microfinance institutions are inadequate. This problem may be difficult to solve unless the microfinance sector is scaled up by integrating it with the commercial banks to enable the use of a significant proportion of their vast financial resources for actualizing a crucial socio-economic goal. Commercial banks do not at present fulfill this need and the Select Committee on Hunger is right in observing that “formal financial institutions in these countries do not recognize the viability of income generating enterprises owned by the poor” (1986. p. v). This may be because it is too cumbersome for commercial banks to get directly involved in the business of financing micro-enterprises. They do not, however, have to do this. They can operate through their own subsidiaries or through the institutions that already exist for this purpose, like the agricultural banks, cooperative banks, development banks and leasing and finance companies. Nevertheless, it is important to reduce the risk and expense of such financing for not only commercial banks but also the microfinance institutions.

¹¹ According to Sharma (2002), “while the Grameen Bank model of micro-credit has landed poor communities in a perpetual debt trap, the rising number of loan defaulters has given a serious setback to the Bolivian experiment (p.2).

¹² Cited by Fernando, 2006, p.1.

¹³ For some details see IRTI/IDB (2007), p. 30; and Feroz (2007), p. 42.

The risk arises from the inability of micro-enterprises to provide acceptable collateral. One way of reducing the risk is to use the group lending method which has already proved its effectiveness. Another way is to establish the now-familiar loan guarantee scheme which has been introduced in a number of countries. To reduce the burden on the loan guarantee scheme it may be possible to cover the losses arising from the default of very small micro-enterprises from the *zakah* fund provided that the loan has been granted on the basis of Islamic modes of finance and does not involve interest. A third way is to minimize the use of credit for personal consumption by providing credit in the form of tools and equipment through the *ijara* (lease) mode of Islamic finance rather than in the form of cash. The raw materials and merchandise needed by them may be provided on the basis of *murabahah*, *salam* and *istisna'* modes. If they also need some working capital, it may be provided as *qard hasan* (interest-free loan) from the *zakah* fund.¹⁴

The additional expense incurred by commercial banks in evaluating and financing microenterprises also needs to be reduced. In the case of financing provided to the very poor on the basis of Islamic modes of finance, a part of the expense may also be covered from the *zakah* fund, one of the primary purposes of which is to enable the poor to stand on their own feet. For those who are not eligible for *zakah* but still deserve some help, it would be worthwhile for the governments to consider subsidizing a part of the cost, at least in the initial phase, in the interest of helping realize the cherished goals of increasing self-employment opportunities and reducing inequalities of income and wealth. As the system matures, the dependence on *zakah* as well as the government subsidy may tend to decline. This would be better than spending billions to stabilize the financial system after the crisis has occurred as a result of subprime loans.

Microenterprises may not, however, be able to make a significant headway unless a substantial improvement is made in the environment for microenterprises through better access to markets and provision of the needed physical and social infrastructure. Such an infrastructure, including vocational training institutions, roads, electricity and water supply, will help increase the efficiency of

¹⁴ For some details on the risks associated with these forms of financing, see IRTI/IDB, 2007, p. 30.

microenterprises and reduce their costs, thereby enabling them to compete successfully in the market.

LESSON FOR THE FUTURE

The Islamic financial system has so far been able to gain a very small share of the global financial market and, even if it operates perfectly as desired by the *Shari'ah*, it may not be able to create a significant impact on the international financial system in the near future. The likelihood is that a substantive reform of the structure of the conventional financial system is not likely to take place. The stopgap measures that have been adopted in the West so far to overcome the present crisis, even though necessary and unavoidable, will steeply increase the public and private sector debt which is already very high. This may have the effect of intensifying the crises in the future. So what should Muslim countries do? The only option they have is to explain the Islamic system rationally to create a conviction about its superiority. This will be more effective if they themselves implement the system seriously and sincerely in their own countries to practically establish its effectiveness in promoting financial health and stability.

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