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Research article

Islamic Banking and the Last Financial Crisis

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Abstract
The international financial crisis has started for more than one year now causing the fall of giants groups like Lehman Brothers, this indeed took place in the aftermath of the US sub-prime mortgage crisis. The last few months witnessed the intensification of the crisis. In reaction to the crisis, The International Monetary Fund previewed that this crisis will have serious consequences affecting financial markets all over the world. Different studies argued that within crisis, the Islamic financial institutions were relatively immune, and explained that The global financial crisis was a golden opportunity for the industry as a whole to come to the front and re-establish itself globally as a main stream and a provider for debt and equity, as well as a lawful and genuine choice.

Keywords: Financial crisis, Contagion, Islamic financial institutions.

1. Introduction

The international financial crisis has started for more than one year now causing the fall of giants groups like Lehman Brothers, this indeed took place in the aftermath of the US sub-prime mortgage crisis. The last few months witnessed the intensification of the crisis. In reaction to the crisis, The International Monetary Fund previewed that this crisis will have serious consequences.

The danger of this financial crisis, that it has started in the US and is now engulfing the entire world, since it is affecting financial markets all over the world. The current crisis sprang from three reasons: first an excessive risk taking- credit crisis in the subprime housing market in the US. Second, leverage effect from speculation in the housing market by both households and financial institutions, and third liquidity crisis.

These different crises matters could have been sorted out, but their interplay produced a financial nightmare all over the world. Speculative activities in the housing market and lax regulation created a parallel banking which is about 40 Percent of the regulated banking sector (Morgan, 2008).

In such situation, everyone is to blame for- the regulation: the homebuyers, the mortgage industry, the investment banker and the providers of liquidity and providers of insurance policies. As a reaction to this crisis the policymakers are working hard to infuse capital in the financial market with the hope that it will maintain confidence in the credit market and will let the ailing financial institutions start lending again.

As for regulators, they are also providing different measures to bring confidence in the market such as extending deposit insurance coverage to depositors and short-term debt market. Different studies argued that within crisis, the Islamic financial institutions were relatively immune, and explained that The global financial crisis was a golden opportunity for the industry as a whole to come to the front and re-establish itself globally as a main stream and a provider for debt and equity, as well as a lawful and genuine choice. A legitimate question arises at this level. Indeed with the fall of giants in the world financial sector like Lehman Brothers in the aftermath of the US sub-prime mortgage crisis, why was the impact relatively low on Islamic banks? Many authors tend to answer this question by explaining and describing the nature if the Islamic finance system. This system due to Islamic legislations, forbids lending money for money, usury, speculation, creating debt in an excessive way. In addition, the Islamic law forbids any toxic securities such as credit default swaps (CDS) and collateralized debt obligations (CDOs). These regulations in the world of Islamic finance could serve as good example to follow by the international financial system. As a matter of fact, innovation is beneficial as long as it does not violate the basic principles of good sense. Islam is a natural religion which is very compatible with the modern financial system. A call for an alternative financial structure is on the horizon. Both Muslims and non-Muslim thinkers are seriously thinking of creating a new financial structure which will make the world financial market more stable and less crisis-prone.

The present work will attempt to check the impact of the recent financial crisis on the Islamic banks, then to assess whether the crisis has or not an impact on the Islamic banks. For this purpose, we are first going to present the Islamic banks, then the impact of the crisis on this sector, and finally we will introduce an econometric investigation to prove or reject the hypothesis of Islamic bank immunity following the recent financial crisis.

2. Definition of Islamic Banking, its Practices and main Features

Islamic financial institutions function following rules that prohibit transactions considered immoral (prohibiting loans to fund involving alcohol, gambling, pornography, tobacco, weapons or pork) and promoting greater social justice by sharing risk and reward. Investing in casinos, pornography, arm dealers or anything to do with pork is rejected: long-term investments in projects considered to benefit society are encouraged. Interest payments, short selling and contracts, considered as excessively risky, are also prohibited. That rules prohibit some Western finance product which are the main trouble in the subprime mortgages, collateralized debt obligations or credit default swaps. Moreover, Muslim scholars have approved instruments that parallel many non-Islamic financial products from loans to insurance to bonds. Sukuks are the equivalent of bonds, but instead of selling a debt, the issuer sells a portion of an asset which the buyer is allowed to rent. Islamic finance does demonstrate a good banking behaviour that has been perhaps lost over the last 10 years or so.

Islamic banking privileges the principle of being close to the clients and to ensure genuine transactions where we can see the asset, we understand the asset, we can make an assessment of that asset: whether it's financing a ship or an aircraft they will go and have a look at the business. It's giving guidance as to what banking should be. Van Schaik (2001) has defined the Islamic banking system as a form of modern banking in which the financial intermediation process is based on a number of religious legal and economic principles developed in the first centuries of Islam that uses risk-sharing methods instead of interest-based financing. Schoon et al. (2003) have defined the Islamic banking as a form of financial intermediation governed by the concept that both returns and profits can only be earned by the equal acceptance of risk with the overriding goal of serving the interests of the community over that of the personal one. The Islamic banking system was an important facilitator of trade and economic transactions during the golden ages of Islam; it was soon overridden by a different way at banking guided by capitalism with the rise of the Western nations.

Unlike the conventional banking system, Islamic banking embraces the concept that profits can only be earned by the acceptance of risk.. Al Omar and Abdel-Haq (1996) described this banking system as a procedure that functions with a strict compliance to the sharia or the Islamic rules derived from the Koran and sayings of the prophet.

The Islamic banking system follows an important percept, one of the most important precepts in Islam which is the establishment of economic justice through the prohibition of unjustified enrichment by receiving monetary advantages in any business dealing without giving a just counter value.

The “riba” or usury is the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity, represents an unjustified advantage. It is commonly agreed by Islamic scholars that the concept of riba applies on interest-bearing funds for consumption and investment purposes.

It is considered as wrong and inequitable because whilst the earning of profit is uncertain, the payment of interest is predetermined and certain therefore it encourages in a way or another of financial exploitation. The Islamic law also prohibit the act of making profits by financing investment activities that entail uncertainty or speculative risks. Instead, earning profits in Islamic banking is legitimized by engaging in economic venture with a lender-borrower relationship that is based on equitable risk-sharing between the finance or capital provider and the user. Islamic banks earn profits from three principal activities: trading, leasing and direct financing in profit and loss sharing contracts. Banks are allowed to devise instruments to earn profits in any of these three financing methods providing that structure and conditions obey the rules stipulated in the Islamic legislation. The Islamic banking conforms strictly to the “Sharia” principles that set Islamic financing apart from conventional financing. There are three broad Sharia rules that govern Islamic banking:

The first and the most fundamental of these is the strict prohibition of usury, that has been loosely translated by Islamic scholars as the practice of charging and paying interest (Al-Deehani et al., 1999). The second is the ban on financial involvement in all the economic activities considered as sinful in Islam such as gambling and the production of alcoholic and pork. Finally, the third Sharia rule is the injunction to avoid the accumulation of wealth through excessive risk-taking that involves uncertainty (Al-Omar and Abdel-Haq, 1996). Al-Omar and Abdel-Haq (1996) in their study, explained that Islamic banks mainly orchestrate profit and loss by directly engaging in investment projects with finance users where depositors are regarded as shareholders of the bank or a particular deal and they are not guaranteed a nominal value or a pre-determined rate of return on their deposits. In all Islamic banking dealings, economic considerations are equated with moral considerations that serve the common interest as a whole where profitability is not the only matter in evaluating the performance of a bank. Because these concepts are fundamentally foreign to the western banking system, Islamic banking thus represents an adequate financial process that privileges an efficient institution form that deviates from conventional banks. This is because it has a different banker-customer relationship.

In the same vein, Lewis and Algaourd (2001) argued that there exists a partnership between Islamic banks and surplus units (depositors), on the one hand, and the deficit units (investors), on the other, in managing financial resources to finance productive uses. Consequently, the process is akin to a balanced financing arrangement rather than one of debt financing.

3. The State of the Islamic banking sector:

The Institutions following the Islamic financial services represent a growing part of the financial system in a number of countries. El Qorchi (2005) has examined the evolution of the Islamic Banking system in the last three decades, the number and the reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975 to over 300 institutions operating in more than 75 countries.

In Sudan and Iran for example, their entire banking system is currently based on Islamic finance principles. Islamic banks are concentrated in the Middle East and Southeast Asia, but they are also present as niche players in Europe and the United States.

4. The Origins of Modern Islamic Banking

The principle of sharing profit and dealing with intermediation arrangements was existent in the pre-islamic period. However these principles become in institutionalised after the arrival of Islam. Lewis and Algaourd (2001) have argued after their examination of the Islamic banking system through history that it was basically organised around the plain principle of direct profit sharing arrangements without digging deeper into a wider and a more complex financial intermediation system that could resort to gigantic amounts of funds from surplus units to deficit units.

The importance of the Islamic banking system in Muslim countries started to increase as conventional banking become more dominant during colonisation. Moreover, Islamic banking witnessed a revival in the 60s and 70s , du to the regaining of Islamic thoughts in the Muslim world at that time. Despite the experimental nature of its revival, Islamic banking has since then expanded into more than 70 countries, most of which are Muslim ones located in the Middle East and South Asia. Today, the majority of Muslim countries resort in a way or another to the principles of Islamic banking although the degrees of implementation vary between one country to another.

Lewis and Algaourd, have demonstrated the presence of two basic forms of expansion in modern Islamic banking. The first consists in changing the whole financial intermediation of a country from a conventional system to an Islamic one. The chose countries that had adopted such an approach are Pakistan, Iran and Sudan. The majority of other countries followed the second approach. In the second form, there are deliberate attempts by both the regulator and the market participants to found Islamic banks to compete with conventional banks. At the same time, they kept a mixed system of banking allowing the existence of both conventional and Islamic banks. Al Omar and Abdel-Haq (1996) carried on historical study about the practice of modern Islamic banking. It has started in 1963 as an experiment in Egypt. This experience latest only for 4 years (until 1967). During that period, a total of nine banks were in operation serving more than 250, 000 depositors and they mobilized some 1.8 million Egyptian pounds Look Inside This Book. However due to a certain number of political factors, the tendency did not last longer since the banks were unable to attract the required substantial numbers of small depositors. As for Hassan and Bashir (2003), they have examined the Islamic Banking in the 80s and 90s. They noticed a large expansion of this sector. Today, Islamic banking is functional in over 70 countries with an asset base of approximately $166 billion. In many Muslim countries especially in the Middle East, Islamic banks rapidly gained market shares in their domestic economies. Schoon et al. (2003) studied the evolution of the Islamic Banking; they argued that this sector witnessed a 10% of growth worldwide and about 15% in the Gulf region which is much higher than the growth rate of conventional banking. Zaher and Hassan (2001) even made the prediction that Islamic banks are poised to control some 40-50% of all Islamic savings by 2009/2010. For this reason, Useem (2002) stated that conventional banks like Citigroup and HSBC have started operating Islamic windows in the Gulf area. As for Van Schaik (2001), he has examined the shift of the banking system functioning in many countries, particularly the ones that have a sizable Muslim population. He noticed that the banking public clients are clearly shifting to Islamic banking as an alternative banking mode to conventional banking. As an alternative, the Islamic banking system takes advantages of surplus funds in order to finance investments with common interest but with the intention of either sharing the profit in case there is a profit and the losses in the opposite case. They as matter of fact, share the gain and the risk with both investors and fun providers. The growing importance of Islamic banking cannot be ignored. Indeed, its growth in recent years has significantly bypassed conventional banks in certain areas. This banking duality and mixture of 2 systems influences deeply the relative competitiveness of both banking systems; It may significantly affect the allocation of scarce financial resources between conventional and Islamic banking.

5. Islamic banks and the recent crisis

With the recent crisis, a number of experts and officials of Islamic banks and financial institutions have confirmed that Islamic banks have not been affected by the global financial crisis, and that any effects would be limited due to the nature of Islamic banking. Experts also believe that Islamic banks are even untouched by the current crisis due to the nature of their banking system especially because they do not deal with debt trading and because they distance themselves from market speculation as it is the case in European and American.

Islamic banks have been somewhat protected from the present financial crisis because, in contrast to their conventional counterparts, they do not borrow from interbank markets; their funds come instead from their own deposits. They also did not hold toxic collateralized debt obligations because they are not allowed to hold interest bearing securities. The Islamic finance industry englobes retail and investment banking, insurance, fund management and the issuance and trading of shariah (the teaching of Islamic law) compliant securities.

The “Shariah” or the Islamic law, prohibit the payment of interest on loans (Riba or usury), as well as investing in any kind of businesse that provide, goods or services considered contrary to its principles such as the trade of pork, alcohol or gambling. Probably, the most important of these factors is the prohibition of debt trading and taking precautions against money laundering, as well as the official and professional restraints upon which banks are based such as the cautions taken against being involved in projects that could cause financial difficulties and risks. Islamic banks instead, propose several alternatives [to conventional banking products] such as “Ijarah Bitamlik” [a renting contract that ends in ownership], Murabaha etc. which demonstrate that Islamic banking is a sound and systematic alternative banking system that others could learn from. Islamic finance is expected to increase on the international level and number of its customers is also expected to rise with the tendency of looking for an alternative banking system.

The Islamic banking system is distinguished by a concrete commitment to distance itself from risky projects. Indeed the crisis has brought about an important global inflation in international banks because they buy debts and enlarge accounts without concrete transactions taking place or without brokers being aware of them. It is worthy to remind here that the Islamic banks do not engage in such risky ventures. If there is one thing that could affect the Islamic banks in this international crisis it is the profits, but not the capital, which is protected by Islamic banking unlike conventional banks. Islamic banking is a part of the global economy and can be affected either negatively or positively by it but Islamic banks are not major investors in conventional banks and this explains why they are not affected by such crises. It is worth noticing that any form of a crisis in the Gulf and the surrounding areas, is rather psychological and is caused by media coverage over the past few months. Allen and Unwin 2008 discuss the principles of the Islamic banking system, which is based on sharia law and is best developed in Malaysia. It’s basically centers around the ban of any kind of ’speculation’ and of interest charges. ‘Immoral’ investments such as in casinos are also forbidden.

They do this by buying assets on behalf of the customer, who has to repay the ‘loan’ and a fee for using the asset. When the ‘loan’ is paid off, the asset’s ownership is transferred to the borrower. The advantage of this arrangement is that the bank shares not only the profit but the risk as well. For that reason, it will also have a very close look at the potential borrowers. The partnership (sharing risk and profit) and avoidance of excessively risky investments are characteristic of Islamic banking. Loretta Napoleoni (2008) discusses the Asian financial crisis of the nineties. Several countries (Thailand, South Korea, Indonesia, Philippines) decided to accept financial support from the IMF and its restrictive conditions, which resulted in a worsening of the crisis. Malaysia, blaming international speculators for the crisis, refused to take the offer and relied on Islamic banking instead. It was the only country which survived the crisis without much damage. Clancy Yeates (2008) shows that the story is being repeated, “Whereas we in the West are in a severe global crash, the Dow Jones’s Islamic financial index rose 4.75 per cent in the most recent September quarter and lost a modest 7 per cent in the previous years. Taking into consideration the previous arguments, one need to wonder about the things one can learn from them beyond the immense debts accumulated particularly in the US, the almost unrestricted speculation (which is often connected with accumulation of debt) is at least to a large degree responsible for the present meltdown. As for as speculation is concerned, the US-magazin Fortune reports that Credit Default Swaps (CDS's) have doubled annually over the last decade. Trading in CDS's is completely non-transparent, therefore the CDS volume can only be estimated. Such estimates arrive at US$ 54.5 trillion (compared with the global GNP of US$ 54.3 trillion). What would be the result if sellers default on their payments

6. The criticisms of the Islamic banks

Ariff, (2002), despite the noticeable growth rates, Islamic banking, like any other financial intermediation system has its own critical and negative issues. One interesting development in Islamic banking for instance, has been the dominance of international conventional banks, rather than Islamic banks. Al Omar and Abdel-Haq (1996) argued that the Islamic banking is still in its infancy, domestic Islamic banks continue to experience lack of risk analysis and management capability, lack of qualified professionals, lack of product diversification and service quality, cost ineffectiveness and non-maturity of secondary markets vis a vis their foreign conventional counterparts. This means that these banks, due to their recent experience in the financial world, lack expertise and competitivity. In addition, Islamic banking is particularly vulnerable to the heightened risk of equity funding, moral hazard and adverse selection, political pressures, reduced avenues for risk hedging and potential friction with the interests of central banks and regulators that oversee operations of authorized depository institutions. Arayssi (2003), for example, found that inefficient decisions are often made when it comes to financing investments while Aggarwal and Yousef (2000) found a general lack of commitment from Muslim governments to fully develop Islamic financing options. The authors also revealed the presence of high levels of information asymmetries in Islamic banking operations in developing countries. These factors would undoubtedly have significant impacts on the ability of Islamic banks to generate attractive returns. At the same time, although Islamic banking is considered as a form of ethical and moralized banking with a particular priority assigned to moral considerations over those of profit. The growth of Islamic banking in international conventional banks has been mostly driven by the profit motive. There is something paradoxical and a certain disparity from the principle which is moral and the practice which is pragmatic. Despite the fact that many of the fully-fledged Islamic banks have been trying to fulfil the religious expectations of socio-economic growth, they usually end up losing market shares to conventional banks that partake in Islamic banking with the sole objective of earning economic profits. In this regard, Islamic banks are often represent certain disadvantages compared to conventional banks because those banks do not prevent themselves from adopting Islamic banking practices if they prove to be viably profitable (Al Omar and Abdel-Haq, 1996). Ariff (2002) however demonstrated that Islamic banks cannot issue all the financial instruments available to conventional banks.

7. Conclusion

With globalization, the biggest threats to Islamic banking would come mainly from foreign competition and takeovers because Islamic bank units are generally small with 2/3 of them having less than the critical banking minimum of $500 million worth of assets. But we must mention that given the extent of the global crisis, Islamic banks may suffer damage despite their strong position. Islamic banks, especially in the Middle East, got heavily into private equity and real estate investments, and a lot of loans may be backed by properties. So if the property market goes down, there will be an impact:

If a borrower is not able to pay then the bank will foreclose and the question is - can you sell the property in the market and at what value? These are issues which all banks could face in case of problems. There have been calls for the conventional banking industry to take a leaf out of the book of Islamic finance, which also shuns investments in gaming, alcohol and pornography in favour of ethical investments.

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