



# ISLAMIC FINANCIAL SYSTEM: A Tool in Solving Global Financial Crisis

by

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## THE MEANING OF FINANCIAL CRISIS:

**The term financial crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults.**



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# BANKING CRISES

- When a bank suffers a sudden rush of withdrawals by depositors, this is called a *bank run*. Since banks lend out most of the cash they receive in deposits (see **fractional-reserve banking**), it is difficult for them to quickly pay back all deposits if these are suddenly demanded, so a run may leave the bank in bankruptcy, causing many depositors to lose their savings unless they are covered by deposit insurance. A situation in which bank runs are widespread is called a *systemic banking crisis* or just a *banking panic*. A situation without widespread bank runs, but in which banks are reluctant to lend, because they worry that they have insufficient funds available, is often called a credit crunch.
- Examples of bank runs include the **run on the Bank of the United States in 1931** and the run on **Northern Rock** in 2007. The collapse of **Bear Stearns** in 2008 has also sometimes been called a bank run, even though Bear Stearns was an **investment bank** rather than a **commercial bank**. The **U.S. savings and loan crisis** of the 1980s led to a credit crunch which is seen as a major factor in the U.S. recession of 1990-1991.



# Speculative bubbles and crashes

- Economists say that a financial asset (**stock**, for example) exhibits a *bubble* when its price exceeds the present value of the future income (such as **interest** or dividends that would be received by owning it to **maturity**). If most market participants buy the asset primarily in hopes of selling it later at a higher price, instead of buying it for the income it will generate, this could be evidence that a bubble is present. If there is a bubble, there is also a risk of a *crash* in asset prices: market participants will go on buying only as long as they expect others to buy, and when many decide to sell the price will fall. However, it is difficult to tell in practice whether an asset's price actually equals its fundamental value, so it is hard to detect bubbles reliably. Some economists insist that bubbles never or almost never occur.
- Well-known examples of bubbles (or purported bubbles) and crashes in stock prices and other asset prices include the Dutch **tulip mania**, the **Wall Street Crash of 1929**, the **Japanese property bubble of the 1980s**, the crash of the **dot-com bubble** in 2000-2001, and the now-deflating **United States housing bubble**.



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## International financial crises

- When a country is suddenly forced to **devalue** its currency because of a **speculative attack**, this is called a *currency crisis* or *balance of payments crisis*. When a country fails to pay back its **sovereign debt**, this is called a *sovereign default*. While devaluation and default could both be voluntary decisions of the government, they are often perceived to be the involuntary results of a change in investor sentiment that leads to a **sudden stop** in capital inflows or a sudden increase in *capital flight*.
- Several currencies that formed part of the **European Exchange Rate Mechanism** suffered crises in 1992-93 and were forced to devalue or withdraw from the mechanism. Another round of currency crises took place in **Asia in 1997-98**. Many **Latin American countries defaulted** on their debt in the early 1980s. The **1998 Russian financial crisis** resulted in a devaluation of the ruble and default on Russian government



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## Wider economic crises

A downturn in economic growth lasting several quarters or more is usually called a *recession*. An especially prolonged recession may be called a *depression*, while a long period of slow but not necessarily negative growth is sometimes called **economic stagnation**. Since these phenomena affect much more than the financial system, they are not usually considered financial crises *per se*. But some economists have argued that many recessions have been caused in large part by financial crises. One important example is the **Great Depression**, which was preceded in many countries by bank runs and stock market crashes. The **subprime mortgage crisis** and the bursting of other real estate bubbles around the world is widely expected to lead to recession in the U.S. and a number of other countries in 2008



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## SOME EVENTS

A short list of some major financial crises since 20th century

- 1910: **Shanghai rubber stock market crisis**
- 1980s: **Latin American debt crisis**, beginning in Mexico
- 1989-91: **United States Savings & Loan crisis**
- 1990s: **Collapse of the Japanese asset price bubble**
- 1992-3: **Speculative attacks** on currencies in the **European Exchange Rate Mechanism**
- 1994-5: **1994 economic crisis in Mexico**: speculative attack and default on Mexican debt
- 1997-8: **Asian Financial Crisis**: devaluations and banking crises across Asia
- 1998: **1998 Russian financial crisis**: devaluation of the ruble and default on Russian debt
- 2001-2: **Argentine economic crisis (1999-2002)**: breakdown of banking system
- 2008: **Global financial crisis** and **USA, Europe**: spread of the **U.S. subprime mortgage crisis**



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## Causes and consequences of financial crises

- **Strategic complementarities**
- **Leverage**
- **Asset-liability mismatch**
- **Regulatory failures**
- **Fraud**
- **Ecopathy**
- **Contagion**
- **Recessionary effects**





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## Other factors contributing to the financial crisis

- computerisation
- off-balance sheet creations and the unregulated, largely unseen, derivatives market
- the elimination of legislative constraints (e.g. repeal of the 1933 Glass-Steagall Act which ensured that banking, stockbroking, mortgage provision and insurance had to be separate activities)
- the ending of proper banking reserves
- the reliance only on interest rates as the basic controlling mechanism
- corrupt lending practices and valuations
- the vacuous belief that the 'free market' is Perfection Manifested (and soon everything returns to the most perfect equilibrium).



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## RESCUE PACKAGES

**USA : USD700 billion**  
**UK : USD850 billion**  
**Germany : Euro540 billion**

**Total loss in the banking system is expected more than 4 trillion**



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## Key elements in the conventional financial system

### **INTEREST (riba):**

- Interest given to deposit facilities
- Interest charge on loans and credits
- Interest given to bond holders

### **SPECULATION (misir)**

- Short selling
- Manipulation
- Profiteering

### **UNCERTAINTY (gharar)**

- No transparency
- Unreal sector
- Not in permissible trades



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## WHY RIBA IS UNLAWFUL FOR MUSLIMS

*There should not be two opinions on the categorical prohibition of riba in Islam. The difference lies in the interpretation of its scope and coverage. The prohibition of riba is not only revealed in various Verses of the Qur'an but is also reinforced by the Prophet(pbuh) who uses unambiguous words in condemning the receiver and the provider of riba.*



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## One of the Revelations in Quran:

- ***“Those who devour usury Will not stand except As stands one whom The Evil One by his touch Hath driven to madness. That is because they say: “Trade is like usury,” But Allah hath permitted trade and forbidden usury. Those who after receiving from their Lord, Desist, shall be pardoned For the past; their case Is for Allah (to judge): But those who repeat (The offence) are Companions of the Fire; they will Abide therein (forever).”***
- ***“Allah will deprive Usury all the blessing, But will give increase For deeds of Charity; For He loveth not Creatures ungrateful And wicked.”***
- ***“Those who believe, And do deeds of righteousness, And established regular prayers And regular charity, Will have their reward With their Lord: On them shall be no fear, Nor shall they grieve.”***
- ***“O ye who believe! Fear Allah, and give up What remains of your demand For Usury, if ye Indeed believers.”***
- ***“If ye do it not, Take notice of war from Allah and His Messenger: But if ye turn back, Ye shall have Your capital sum; Deal not unjustly, And ye shall not Be dealt with unjustly.”***
- ***“If the debtor is in difficulty, Grant his time Till it is easy For him to repay. But if ye remit it By way of charity, That is best for you If ye only knew.”***
- ***“And fear the day When ye shall be Brought back to Allah. Then shall every soul Be paid what it earned, And none shall be Dealt with unjustly.”(Al-Baqarah 2:275-281)***



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# The five pillars of Islamic finance

## **The ban on interest:**

Interest must not be charged or paid on any financial transaction, as interest is prohibited by Islam

## **The ban on uncertainty and speculation:**

Uncertainty in contractual terms and conditions is unlawful. On the contrary, risk taking is allowed when all terms are clear and accepted by all parties

## **The ban on financing in certain economic sectors:**

Financing of industries deemed prohibited by Islam-such as pork, gambling, pornography-is forbidden

## **The profit-and loss-sharing principle:**

Parties to a financial transaction must share in the risks and rewards attached to it.

## **The asset-backing principle:**

Each financial transaction must refer to a tangible, identifiable underlying asset.



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## CURRENT INFORMATION

- **To date there are more than 400 Islamic financial institutions worldwide and mobilized funds worth more than USD600 billion.**
- **Islamic financial institutions operate in both Muslim and non-Muslim countries.**
- **Western based banks such as Citibank, HSBC, Standard Chartered are providing Islamic products to their customers.**
- **Islamic banking system is already supported by Islamic capital and financial market. Islamic takaful is also available in many countries**



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## WHAT MAKES IFS DIFFERENT FROM THE CONVENTIONAL SYSTEM?

- Philosophies and objectives?
- Target customers?
- Delivery methods and channels?
- Rules and regulations?
- Reporting process?
- Operational aspects and processes?





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## PROFIT MAXIMIZATION VS MORAL OBLIGATION

“The ‘Islamic economic order’ is based upon a set of principles found in the Qur’an. No matter what aspect of the Islamic economic order is introduced, for practical operations it has to base itself on the Qur’anic concept of social justice. The Islamic financial system, therefore, cannot be introduced merely by eliminating *riba* but also by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance and dispensation of justice, equity and fairness.”



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# Goals of Islamic Economics

- a. Economic well-being within the framework of Islamic moral values.**
- b. Universal brotherhood and justice.**
- c. Fair and just distribution of income or wealth.**
- d. Freedom of the individual in the context of social welfare.**



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# SHARIA PRINCIPLES USED IN ISLAMIC FINANCIAL SYSTEM

## Profit and loss sharing principles

*Mudaraba, Musharaka, Mozaraah, Mosaqat.*

## Trade principles

*Murabaha, Bai mu'azzal, Bai salam, Musawamah, Bai al-Inah, Istisna, Bai ad-dayn, Da'wa ta'ajjal.*

## Fees or charges based principles

*Ijarah, Ijarah wa-iktina, Wakalah, Kafalah, Joalah, Hawalah, Ujr.*

## Free service principle

*Qard hassan*

## Ancillary principles

*Rahn, Wadiah*



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## DEPOSIT FACILITIES

- Demand deposits (qard hassan, wadiah, wadiah yad dhamanah)
- Savings account (qard hassan, wadiah, wadiah yad dhamanah, mudarabah, qard hassan + mudarabah)
- Investment deposits (mudarabah)
  - Deposits based on duration
  - Deposits based on notice
  - Deposit for a specific project or purpose
- Negotiable certificate of deposits (mudarabah)

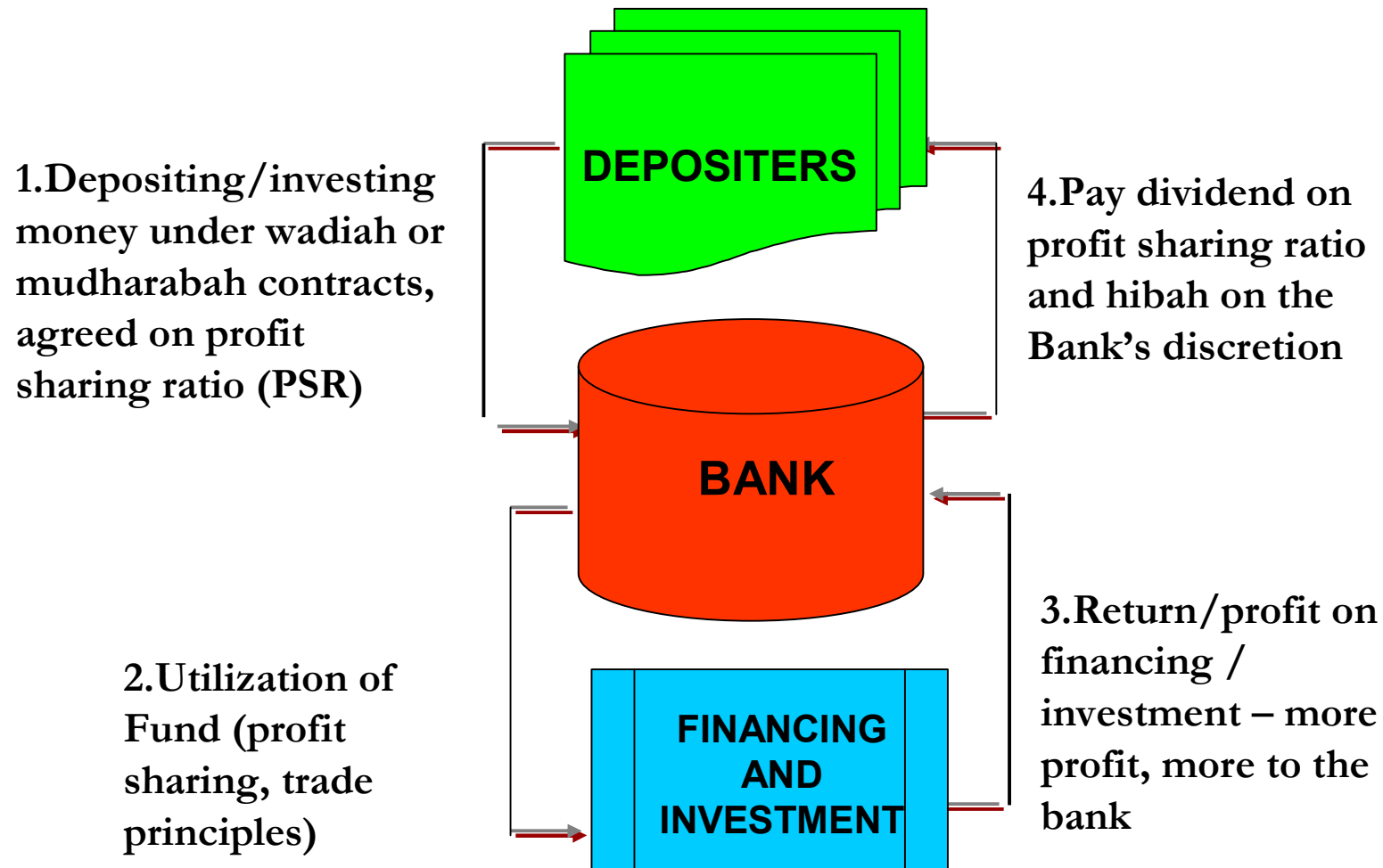


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# APPLICATION OF SHARIA PRINCIPLES

- **Retail customers**
  - Qard hassan
  - Bai inah
  - Murabaha
  - Bai murabaha
  - Bai muazzal (bai bithaman ajil)
  - ijarah
- **Business customers**
  - Qard hassan
  - Bai inah
  - Bai salam
  - Istisna
  - Ijara (ijarah waiktina)
  - Mudaraba
  - Musyarakah (musyarakah muthanaqissah)
  - Musawamah
  - Murabaha
  - Tawarruk

# BANK AND CUSTOMER RELATIONSHIP IN ISLAMIC BANK

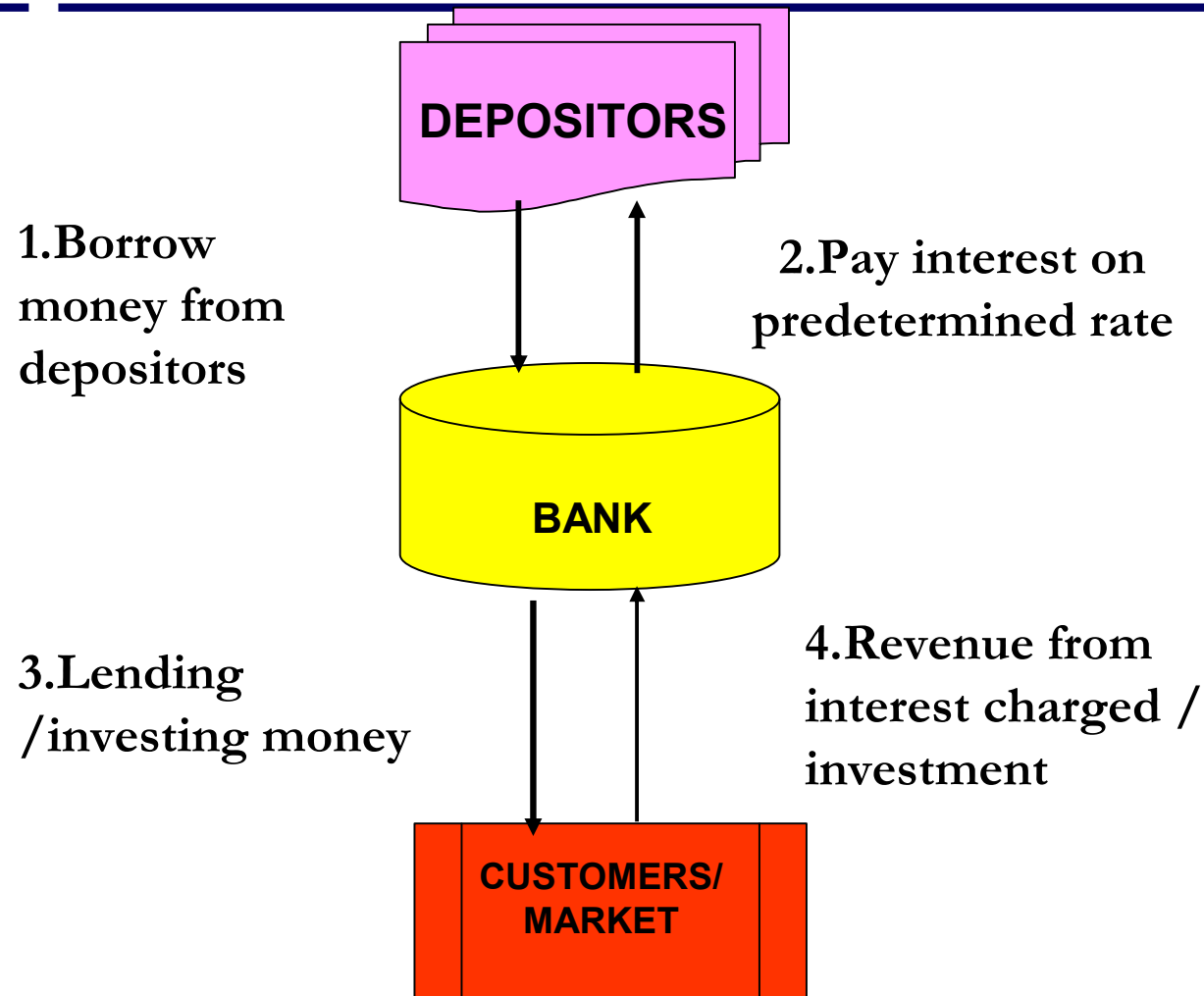


**Bank and Customer relationship is based on Profit Sharing concept**



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## BANK AND CUSTOMER RELATIONSHIP IN CONVENTIONAL BANKING



**Bank and Customer Relationship is based on Lender and Borrower concept**



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# KEY PRINCIPLES IN ISLAMIC FINANCE AND BANKING

- **No interest (riba), manipulation, and speculation elements in the system.**
- **System is based on profit sharing and fixed trade principles (win-win principles for profit sharing, and no burden to customer in the case of increased in conventional interest rate)**
- **Involve in real economic sectors, and Islamic banks will not involve in sectors which are illegal from Shariah view point)**
- **Maintain the justice and equity philosophy in doing business and uphold Islamic business philosophies.**
- **Banking for today and world hereafter.**





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## TESTMONY

France is becoming the latest country to woo Islamic banks, which avoided much of the damage from the subprime mortgage crisis by following strict principles laid out in the Quran — as the global financial crisis broadens the appeal of Islamic finance. French Finance Minister Christine Lagarde has promised to make adjustments to the regulatory and legal arsenal to enable Paris to become a major marketplace in Islamic finance. At a recent forum in Paris, she said Western financiers could learn a thing or two from the Islamic world as global leaders try to establish "new principles for the international financial system, based on transparency, responsibility and, I would like to add, moderation." "In this sense, Islamic finance is calling out to us," she said.

(December 24, 2008-James Joyner [www.acus.org](http://www.acus.org))



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