Islamic Finance: A Therapy for Healing the Global Financial Crisis

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ABSTRACT

Global financial crisis which hit many too-big-too-fail countries and financial institution in the world was mainly made happen by debt securitization. Derivative instruments resulted from this process obviously were not backed by real asset. When any party came up with investment on these instruments, the investment would never support the development of real sector economy, instead, it just worsen the situation by creating bubble economic. This condition becomes more harmful when the securitized debts default. This practice is strictly forbidden according to Islamic finance principles. It has inherent risk management tools to prevent the crisis. This paper attempts to examine the root of the financial crisis and find the solution from Islamic finance principles.

Keywords: Financial crisis, Derivative, MBS, CDO, CDS, Islamic finance

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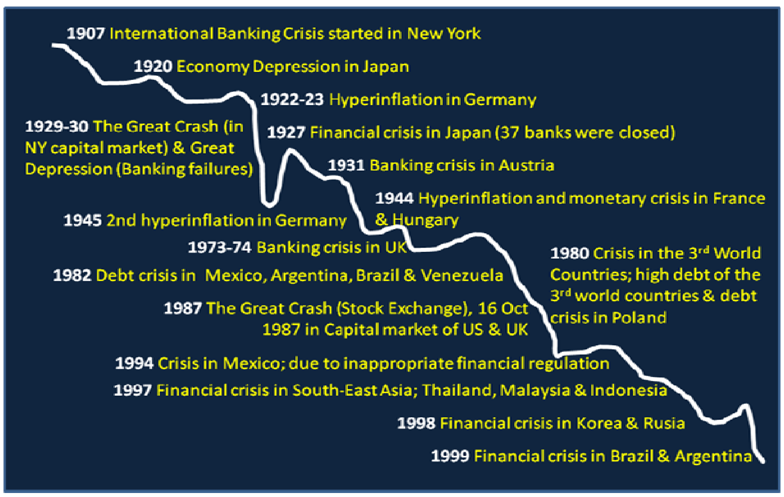
"The credit and capital markets have grown too rapidly, with too little transparency and accountability. ***Prepare for an explosion that will rock the western financial system to its foundations****."* (Barberton and Lane (1999)

INTRODUCTION

As mentioned by Barberto and Lane (1999), the explosion just became a reality. Though the crises in the US and Europe were one of the crises series which regularly hit the world starting from the 20th century, most economists view that the current financial crisis is the greatest one that beat the world economy, even if compared with the Great Depression in 1930s.[2]

Figure 1: Chronologies of the World's Economy Crisis



Source: Sakti (2009), with some adaptations

Since current global financial crisis is frightened can bring prolonged period of economy downturn, it is very important to find ways to cure it. However, as always done by a doctor

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[2] Roy Davies and Glyn Davies (1996) in their book *entitled* "A History of Money from Ancient Times to the Present Day mentioned that until their book was launched, there were more than 20 crises happen in the world, and all of them are financial crises.

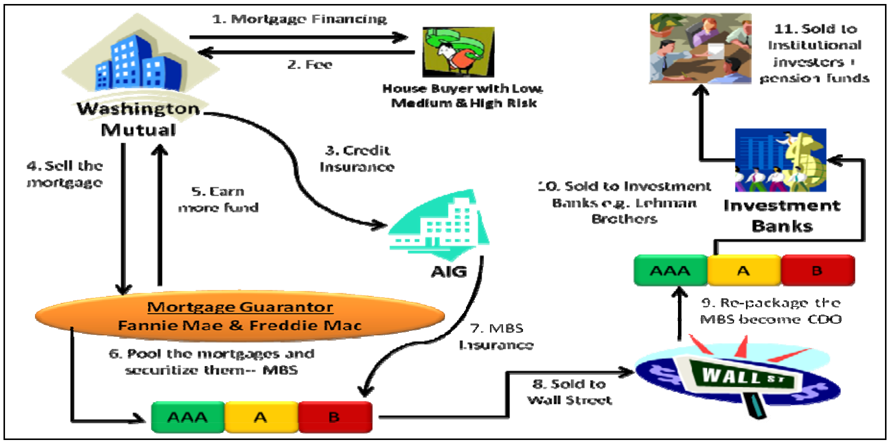
before giving medical treatment to his patients, it is important for us to firstly observe the ground of the problem.

ROOT OF THE CURRENT GLOBAL FINANCIAL CRISIS

The Bank for International Settlement (BIS) has mentioned on its 2008 annual report that the root of almost all crises has been excessive and imprudent lending by banks. Furthermore, this factor also becomes important cause that makes this current crisis happen, which was boomed with defaults of subprime mortgages in the United States on 7th February 2007 (Sakti, 2009).

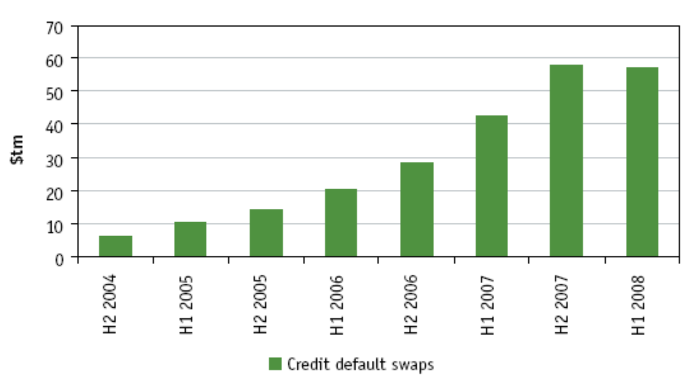
The default was made happen by excessive and imprudent mortgage lending given by Washington Mutual to many high-risk home purchasers in the US. In return, the purchasers should pay certain amount of service fees to Mutual. This mortgage lending was then securitized by the Mutual and sold to mortgage guarantee institutions (Fannie Mae and Freddie Mac) to earn more funds. Furthermore, the guarantors pooled and packaged the mortgages into instrument called Mortgage backed Securities (MBS). This type of instrument later sold to the Wall Street. After that, the Wall Street re-packaged the MBS into another derivative instrument called as Collateralized Debt Obligations (CDOs) and sold them to some investment banks, e.g. Lehman Brothers (Karim, 2009). From this stage, the investment banks sold the instruments by mixing prime and subprime debt to pass the entire risk of default of even subprime debt from mortgage originators to the ultimate purchasers who would have normally been reluctant to bear such a risk. But do to this camouflage packaging; the buyers could not clearly see the inherent risk of the financial instrument they bought. As a result, the lending to subprime borrowers and speculators increased steeply (Chapra, 2008). Illustration of the root of the financial crises can be seen in the following figure.

Figure 6: Root of the Recent Global Financial Crises



Those unhealthy practices lead to nationalizations of a number of banks by the governments in the US, the UK, Europe and a number of other countries. In consequence, the creditors became uncertain with the situations and sought for protection against default by buying derivatives like Credit Default Swaps (CDSs). By owning these instruments, they pay a premium to hedge funds for the compensation they will receive in case the debtor defaults. Another problem here is that the hedge funds did not only sell the CDSs to creditors, instead, they also sell the derivatives to a large number of others who were willing to bet on the default of the debtor. They even resold the swaps to others.

Figure 4: Growth in Outstanding CDSs



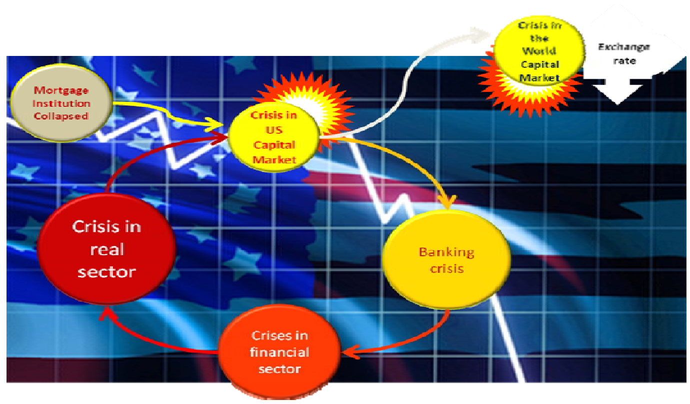
Source: BIS Quarterly Review, 2008 on FSA (2009)

Consequently, the hedge funds as well as the investment banks could not afford to pay such incentives to the instrument buyers. Such default, therefore, brought those institutions to unavoidable bankruptcy and those buyers to extremely high investment losses.

EFFECT OF THE GLOBAL FINANCIAL CRISIS

While globalization has made fewer borders between countries, this panic situation also spread to other part of the world. Both institutional and individual investors of the US, UK, and European countries hastily withdrew their investments in capital markets of developing countries, such Indonesia, and make their domestic investors become even more panic. This condition somewhat brought destabilization of the country economy, and brought problem on the country exchange rate. To calm down the domestic investors, the government took an initiative to close the capital market for some days and made public explanations that the country real sector economy was still on control and people were expected not to panic for that situation. This is because crisis on financial sector will bring very harmful impacts on the real sector if not immediately settle down.

Figure 5: Real vs Financial Activity in the Economy



Source: Sakti (2009), with some adaptations

Additionally, Sakti (2009) noted that the volume of transactions in the world money markets (which consist of currency speculation and derivative market transaction) amounted US$ 1.5 trillion in a day, while in very contrast, the transaction volume in the world real sectors amounted only US$ 6 trillion in a year. This non-productive activity is frightened to bring real economy situation in a long time of crisis – a crisis which the impacts may really and directly harm the people of the world.

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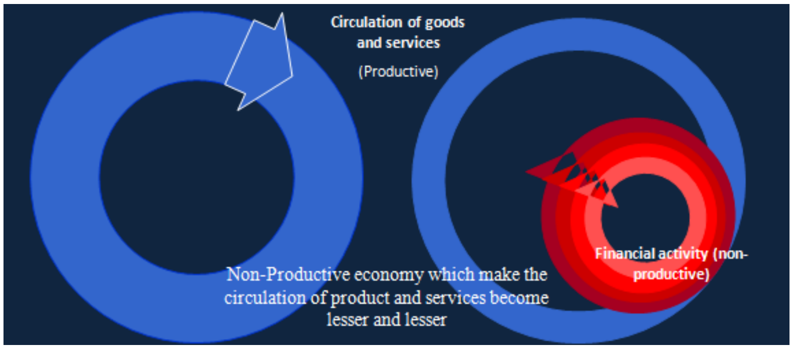

Source: Sakti (2009), with some adaptations

CAN ISLAMIC FINANCE BECOME SOLUTION?

We sent aforetime our messengers with Clear Signs and sent down with them the Book and the Balance (of Right and Wrong), that man may stand forth in justice… (HQ Al Hadid (57): 23)

By deeply think about the above Qur'an verse, that Islam will bring justice in the world, the answer on question whether Islamic finance can become solution on the current global economic crisis is very firm. However, how to explain this?

Some thoughts expressed by Miskhin (1997) are quite suitable to summarize the crisis problems. According to him, there are three factors that may lead to crisis: 1) inadequate market discipline in the financial system resulting from the absence of profit and loss sharing (PLS); 2) expansion in the size of derivatives, particularly CDSs; and 3) the "too big to fail" concept.

Those three above problems are actually can be anticipated by ways of implementing the Islamic finance principles, which aimed to realize greater justice in human society. Firstly, by implementing PLS-based transactions, the risk of transaction is not entirely shifted from financier to financed party; instead they are required to share in the risk. In return, the financier is also entitled for profit generated by the business of the financed party. This is because Islam regulates that *al-ghurm bil ghunm* – there is no reward can be generated without taking any risk. This principle, basically, act as a control toward higher market discipline. This is because the financiers are really encouraged to be more careful in assessing the risk of the financed parties before giving any funding to them. Furthermore, to ensure the financiers that they will get appropriate profit sharing, they are needed to monitor the use of funds by the financed parties. These mechanisms will later establish higher market discipline and even more stable economy.

Moreover, for any transaction that cannot be accomplished by mean of PLS, Islam also suggests the way. However, rather than using direct borrowing-lending mechanism, Islam commands that the transaction shall be based on the sale or lease of real, not imaginary, assets by means of Islamic schemes such as *murabahah, ijarah, salam,* and *istisna.* For applying the schemes, the real assets involved on the transaction must be fully owned and possessed by the seller/lessor. Furthermore, it shall be done with the intention to make take-and-give delivery without any other camouflage stratagem; such as buy back (*bai al-'inah*). Additionally, in the case of default by buyers/lessees, the sellers/lessors have to entirely borne it by themselves.

Implementing the Islamic schemes above may bring some positive impacts. One of which is avoidance of gambling by third parties who bet for compensation for others' losses, as case of the CDSs transactions. Islam does not allow securitization of unreal asset, as well as debt, as done by its conventional counterpart. This ruling can inhibit the debt from rising far above the size of the real economy. Besides, the Islamic principle on fully ownership may anticipate short-selling practice which can harm the market by oversupply phenomenon, which later can lead to exorbitant decrease in asset prices during a crisis.

In addition, borrowing-lending process with charging interest, as mostly practiced in today economy, may bring big problem in the economy. This is because the creditor is not encouraged making such double assessment. As a result, the volume of unhealthy credit will substantially increase and lead to excessive leverage, and to an unsustainable rise in asset prices, living beyond means, and speculative investment (Chapra, 2008). Shall we connected with the “too big to fail” concept, the effect of this expansion of damaging credit phenomenon are even more harmful, since the central bank will definitely come to the big banks rescue and not allow them to fail. In Islamic finance principle, borrowing-lending cannot be categorized as profit making transaction (*tijarah*); instead, it has to be put under social activity (*tabarru*) which aimed to help the poor or needy people, eliminate poverty, expand employment and self-employment opportunities and, in result, to help reduce inequalities of income and wealth.

From the above explanations, it is definite that Islamic finance may become a solution on overcoming the current global financial crisis. However, there also some thoughts to be pondered on the current practice of Islamic finance. One of the causes is the lack of Islamic financial human resources who have expertise in both *sharia* and finance. This phenomenon may lead to the fact that due to “risk-prudential” reason, the practices of Islamic finance nowadays are still not dominated by PLS-based transaction. Most scholars view that Islamic finance practices are only replicating the conventional ones by changing the contract names from “credit” become "*murabahah* or *ijarah*" which still give fixed return to the financier and eliminate the word of "interest". Therefore, for Islamic finance to become unquestionable therapy in healing the global financial crisis, many aspects shall also be prepared, including human resources, regulations, as well as support by governments, practitioners, academicians to promote its prominence.

CONCLUSION

As most crises which happened in the last 20th centuries, the current global financial crisis was also caused by imprudent lending transaction which then worsen by the excessive derivative and speculative transaction on the capital market. When default could not be further avoided, the crash on capital market led to banking crisis, which later brought to crisis on financial sector and harm the real economy sector. Islamic finance, which prohibits the practice of *riba*, *gharar,* and *maysir*, may act as powerful medicine to heal the crisis. However, it has to be appropriately practiced as guided by the *sharia*. More importantly, supports from human resources, regulations, is needed to make the medicine working more effective.

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