



# Islamic Finance

## in the Age of Turbulence

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# Mr. Greenspan & the Age of Turbulence



- **1<sup>st</sup> day in office, August 11, 1987.**
- The Black Monday October 19, 1987.
- The 92/93 ERM problem.
- The 1994 Mexican debt Problem.
- The Japanese real estate bubble and the lost decade of the 1990's.
- The 1997/1998 Asian Crisis.
- The LTCM bail out in 1998.
- The 2000/2001 dot-com bubble.
- **Last day in office, January 31, 2006.**



# Some Aspects of the Turbulence Age (TA)



- The IMF has experience of 122 banking crises in the last few decades, [\*Strauss-Kahn, Jan. 26, 2009.\*](#)
- Burdensome features of most societies: debts, unemployment, inequalities ... etc.
- Huge Financial Losses.
- Real economies hit hard.
- Unprecedented measures and remedies.
- Dire Consequences.



# UK Striking numbers



- **1 in 33 people in work estimated to become unemployed in 2009.**
- **Total UK personal debt at the end of March 2009 stood at £1,459bn.**
- **Britain's interest repayments on personal debt were £69.0bn in the last 12months (£189m daily )**
- **More credit cards (71.3m credit) in the UK than people (60m).**
- **Every 10 minutes a property is repossessed.**
- **3,000 people made redundant every day.**
- **1 person every 4.5 minutes declared bankrupt or insolvent.**

*Source: Credit Action, 1st May 2009*



# Preliminary Costs of the Latest Credit Crunch

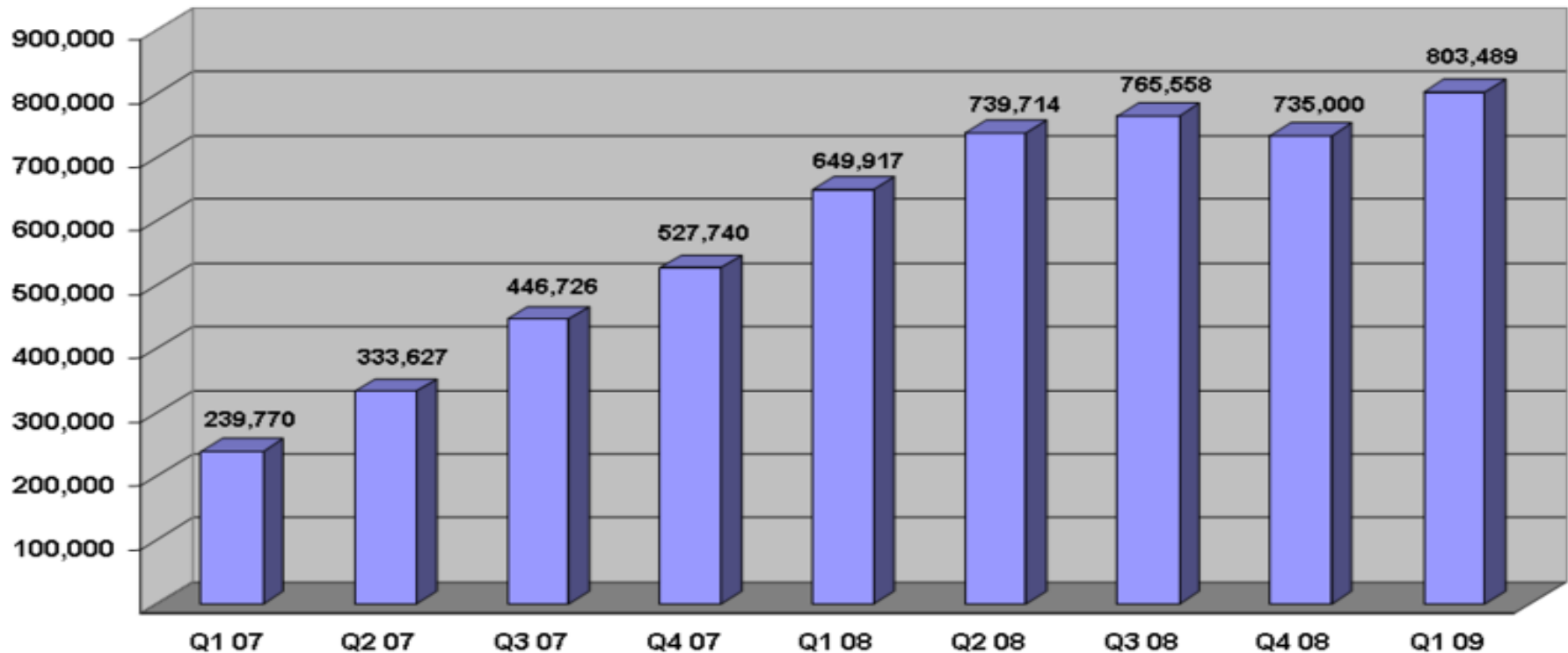


- The 1<sup>st</sup> 10% decline in housing prices reduced property values by \$2 trillion.
- Bet. June 2007 and November 2008, Americans lost more than a quarter of their net worth.
- Total home equity in the US, valued at \$13 trillion at its peak in 2006, dropped to \$8.8 trillion by mid-2008.
- Total retirement assets, dropped by 22 percent, from \$10.3 trillion in 2006 to \$8 trillion in mid-2008.
- During the same period, savings and investment assets (apart from retirement savings) lost \$1.2 trillion and pension assets lost \$1.3 trillion.
- Taken together, these losses total around \$8.3 trillion (that is 63 % of US GDP).
- Estimated cumulative losses of banks and other financial institutions globally would exceed \$4 trillion, [\*the IMF April 2009\*](#) .



# Foreclosure on Rise

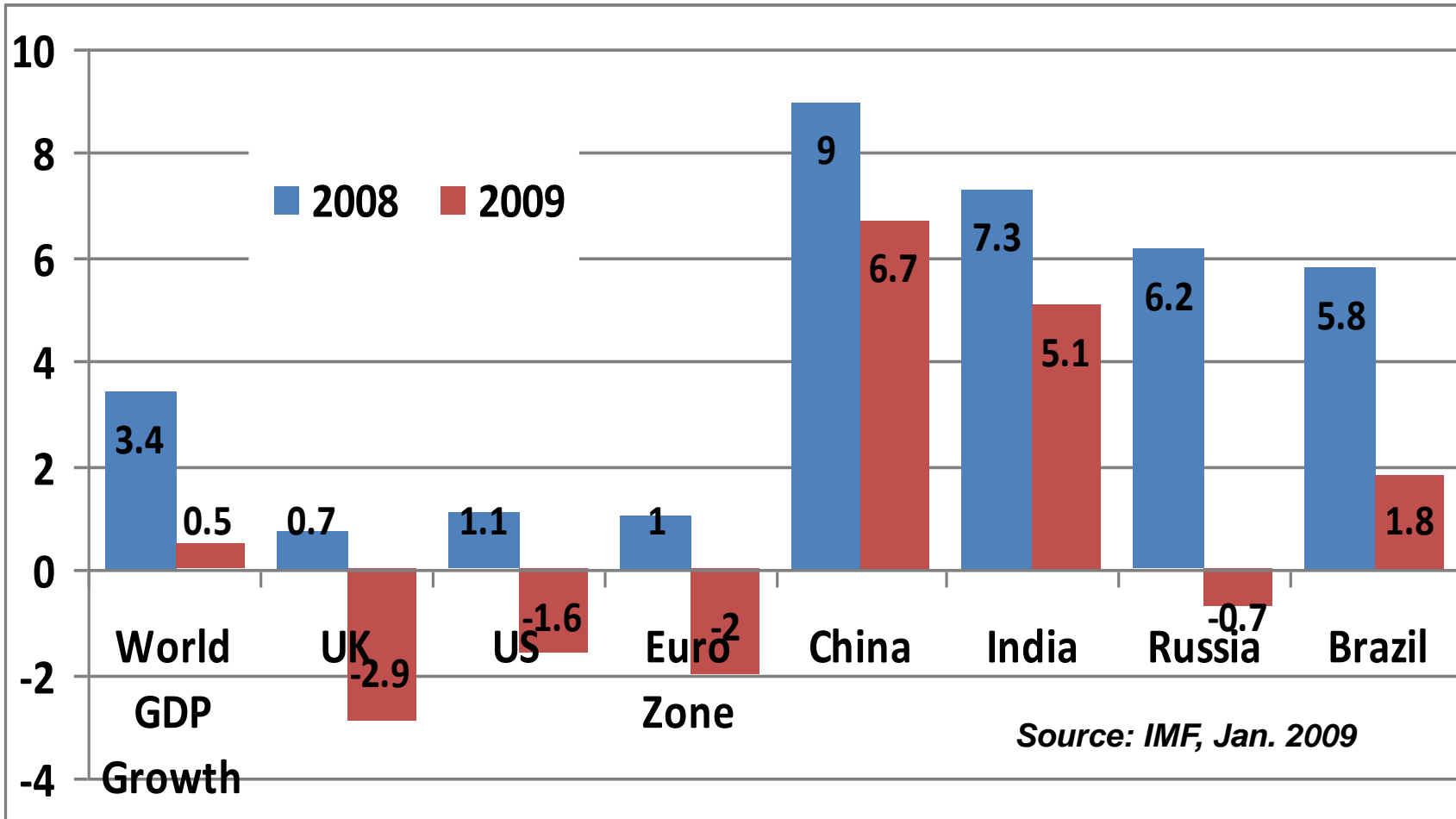
## Properties with Foreclosure Activity



Source Data: RealtyTrac Press Releases of "U.S. Foreclosure Market Report"  
Chart Created by Contributor



# Hit Economies

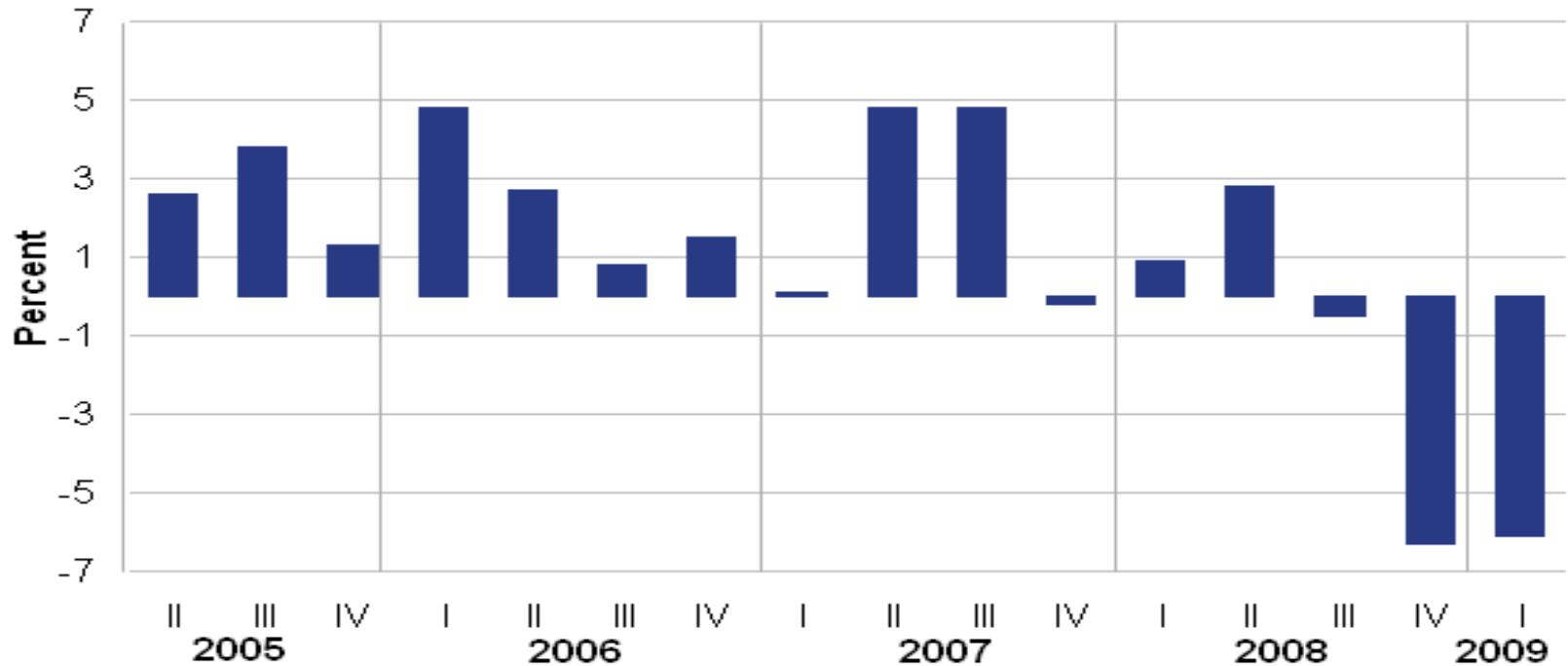




# US Economy Hit Hard



### Quarter-to-Quarter Growth in Real GDP



*Real GDP growth is measured at seasonally adjusted annual rates.*





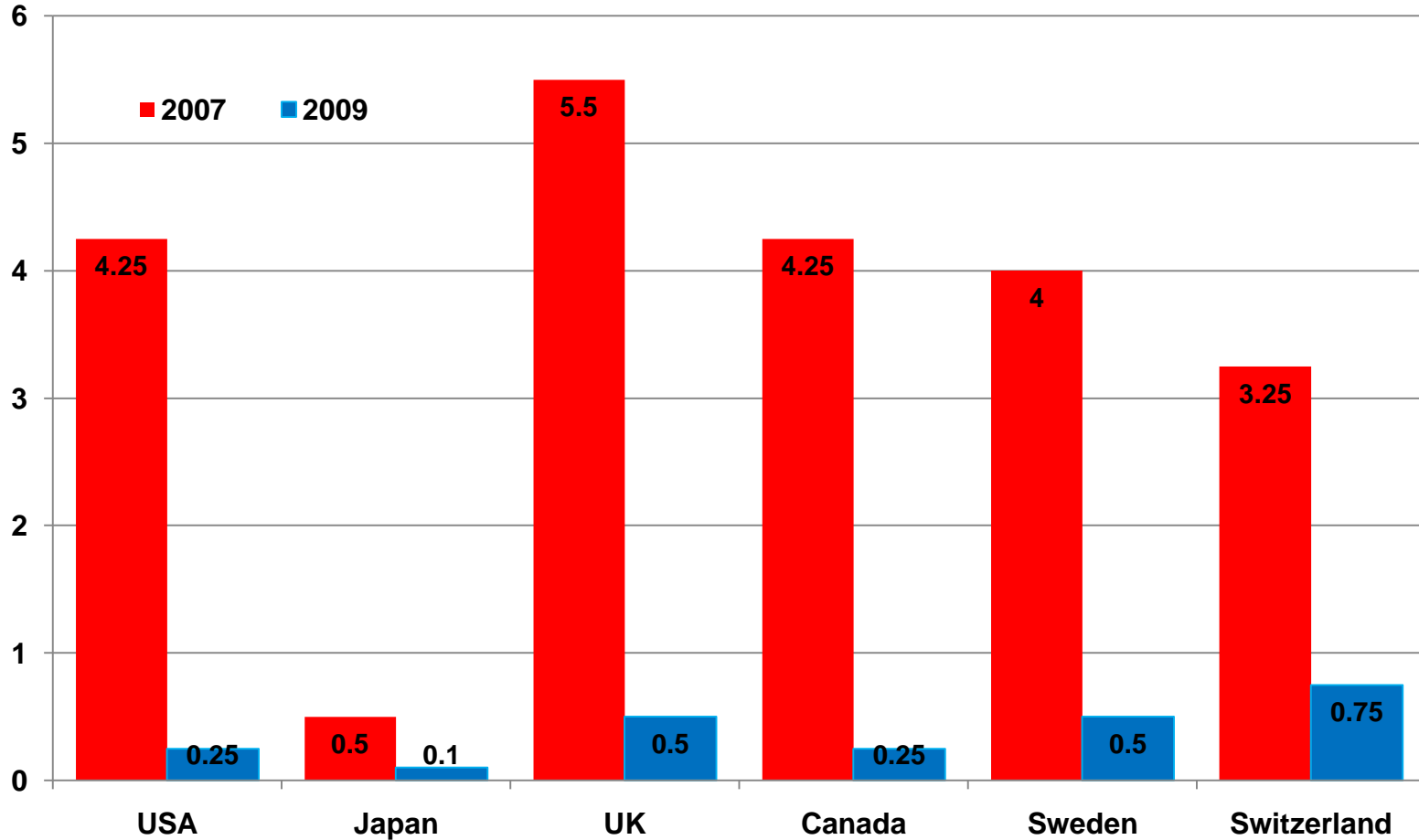
# Unprecedented Measures



- Zero Interest Rate Policy (ZIRP).
- Quantitative Easing Policy (Japan) .
- Credit Easing Policy (USA).
- Nationalization.
- Public Entities for Waste or Toxic Assets (e.g. PPIP in USA).

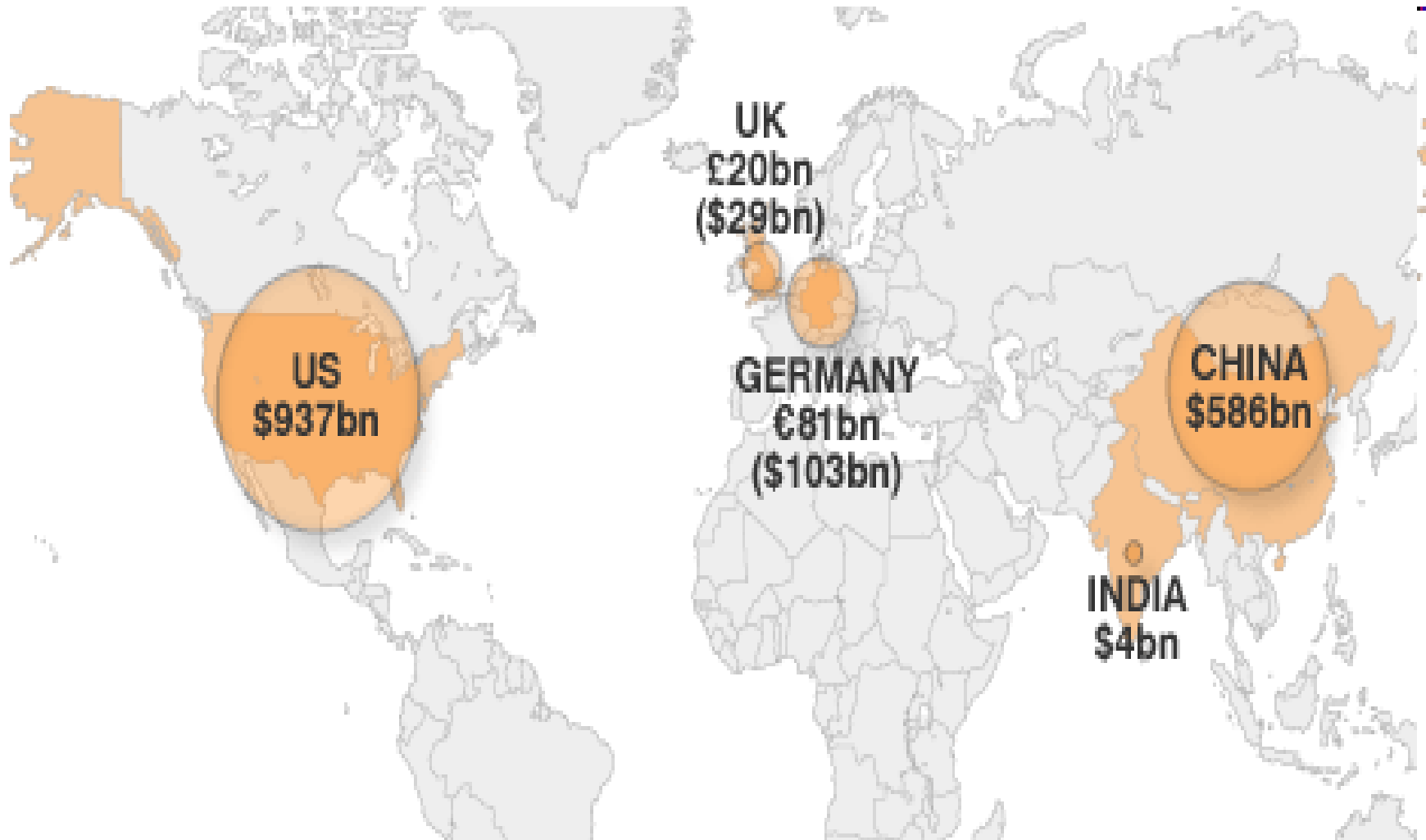


# Historical Cuts in Base Rates



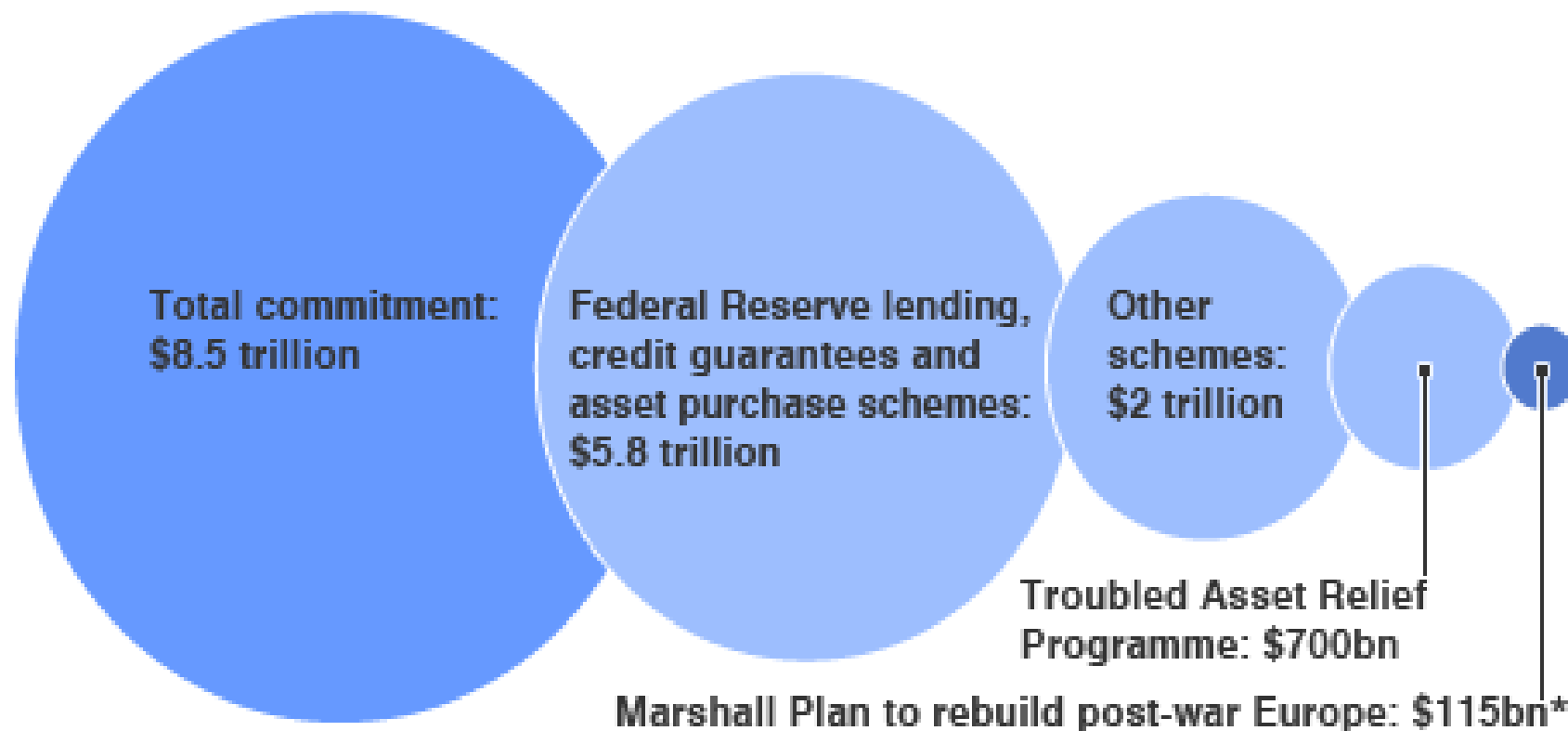


# Huge Stimulus Packages





## & Bail Outs



\*Adjusted for inflation

SOURCE: Bloomberg, US Treasury, Federal Reserve, US National Archive



# Dire Consequences



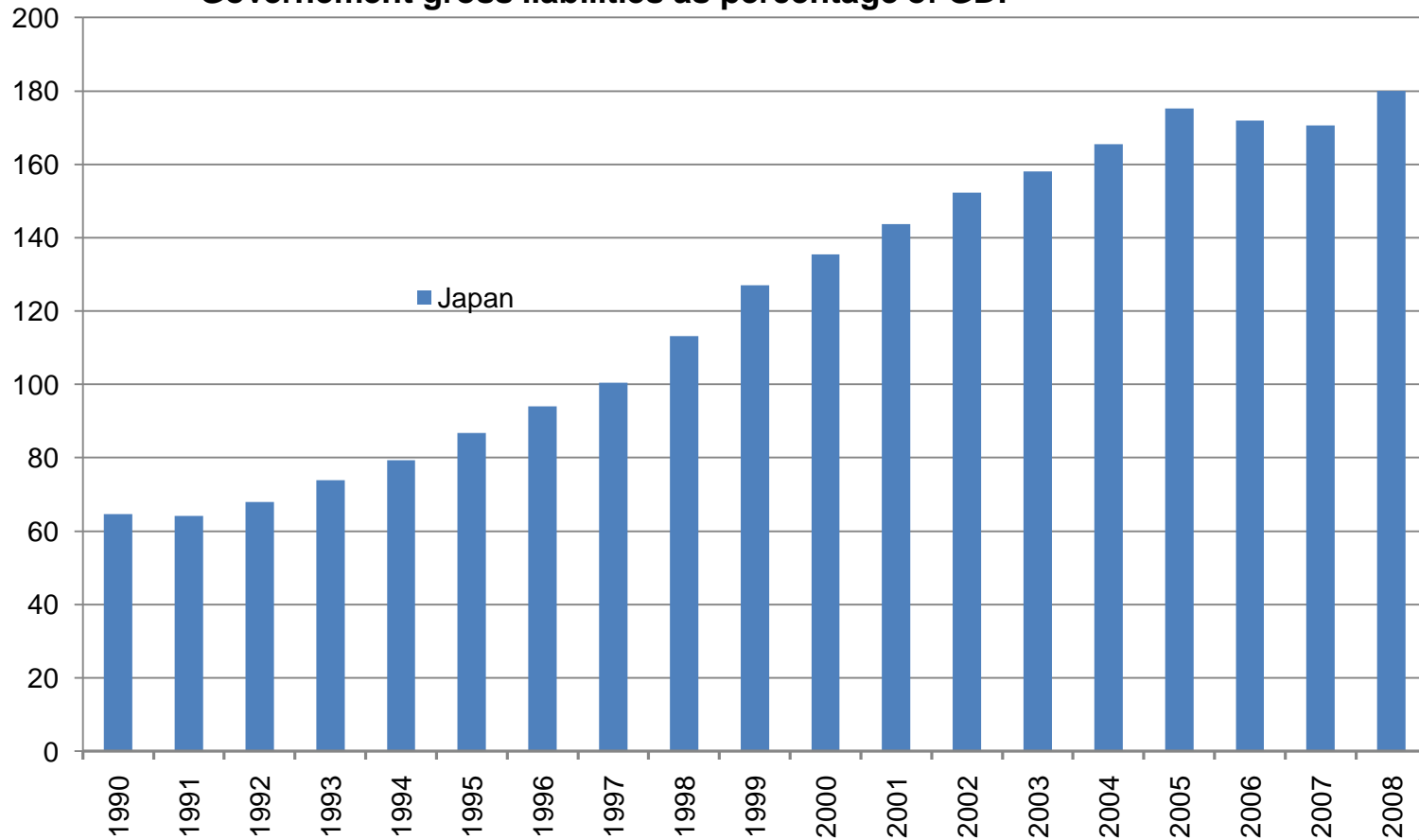
- Economical, Social, Mental, Health ... etc.
- More than 50 millions are expected to be added to the unemployed “community”.
- 200 millions extra people to be in absolute poverty.
- 30,000 Committed suicide in Japan during the lost decade.
- Can a banking crisis break your heart? (**a system-wide banking crisis increases population heart disease mortality rates by 6.4% in high income countries, Stuckler, Meissner and King, 2008**)



# Huge Borrowings



Government gross liabilities as percentage of GDP



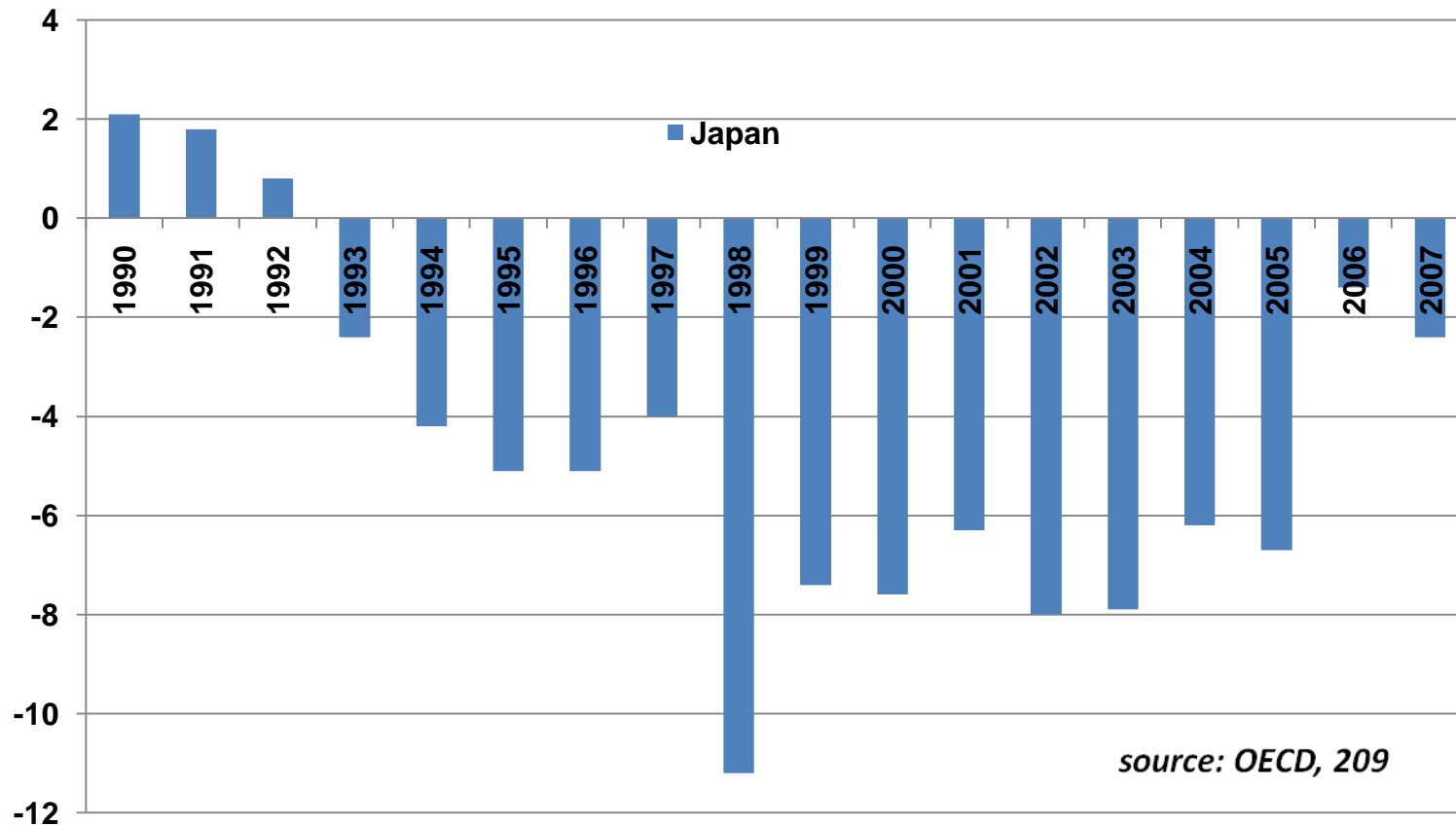
source: OECD, 209



# ... Deficits

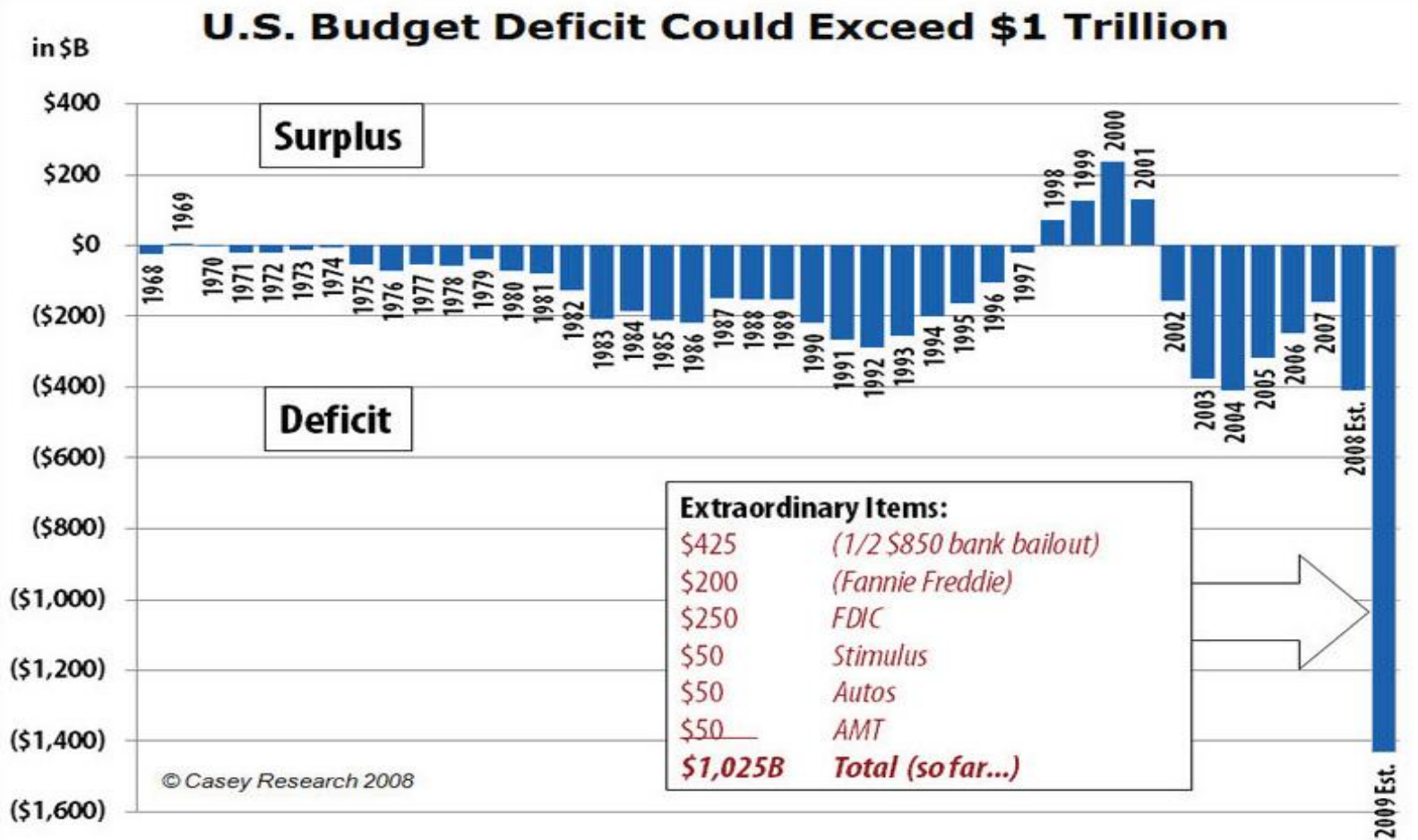


Government net borrowing/lending as percentage of GDP





# ... Deficits



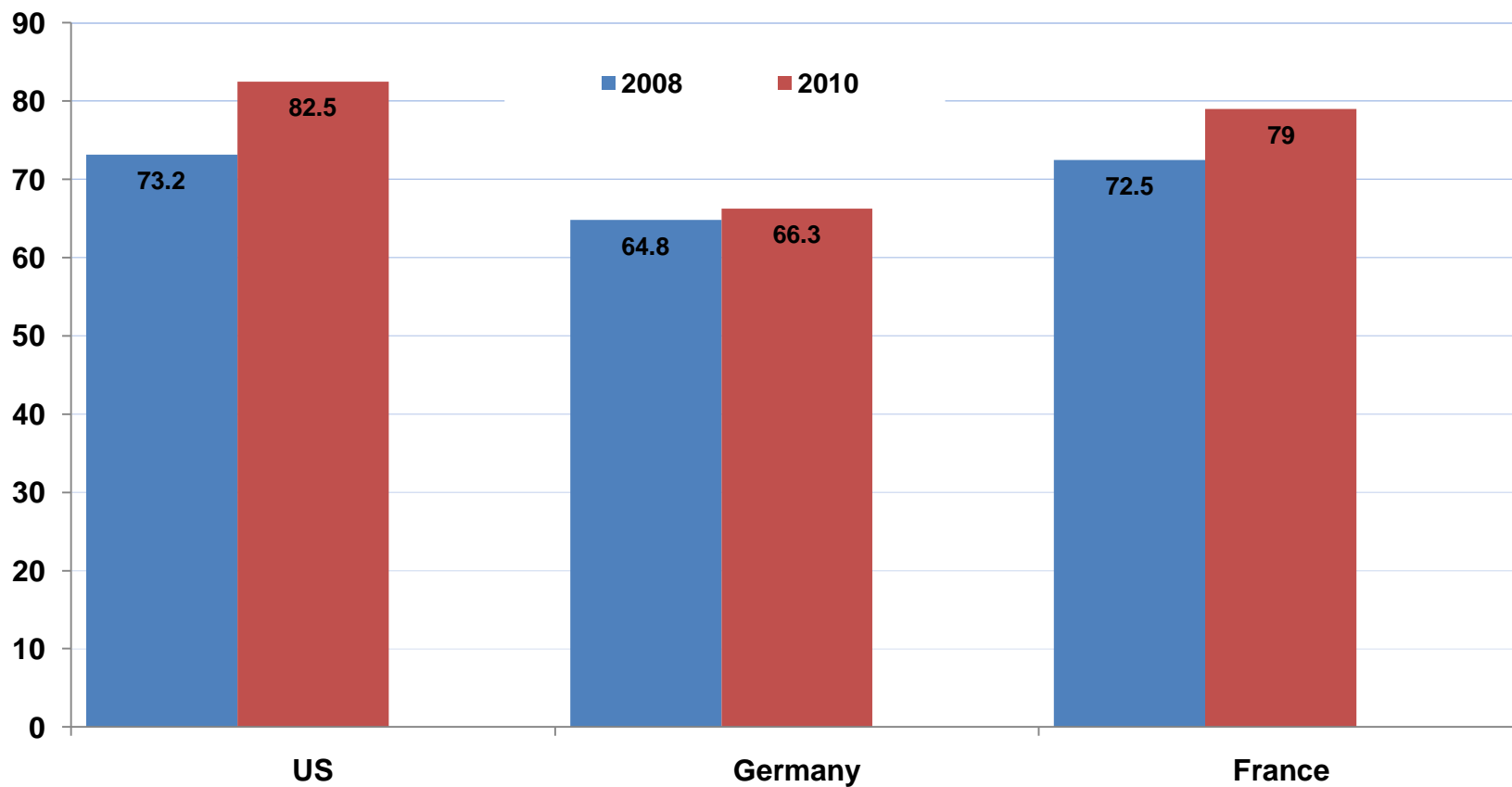




# ... Debt Legacy for years to come



Financial liabilities as percentage of GDP



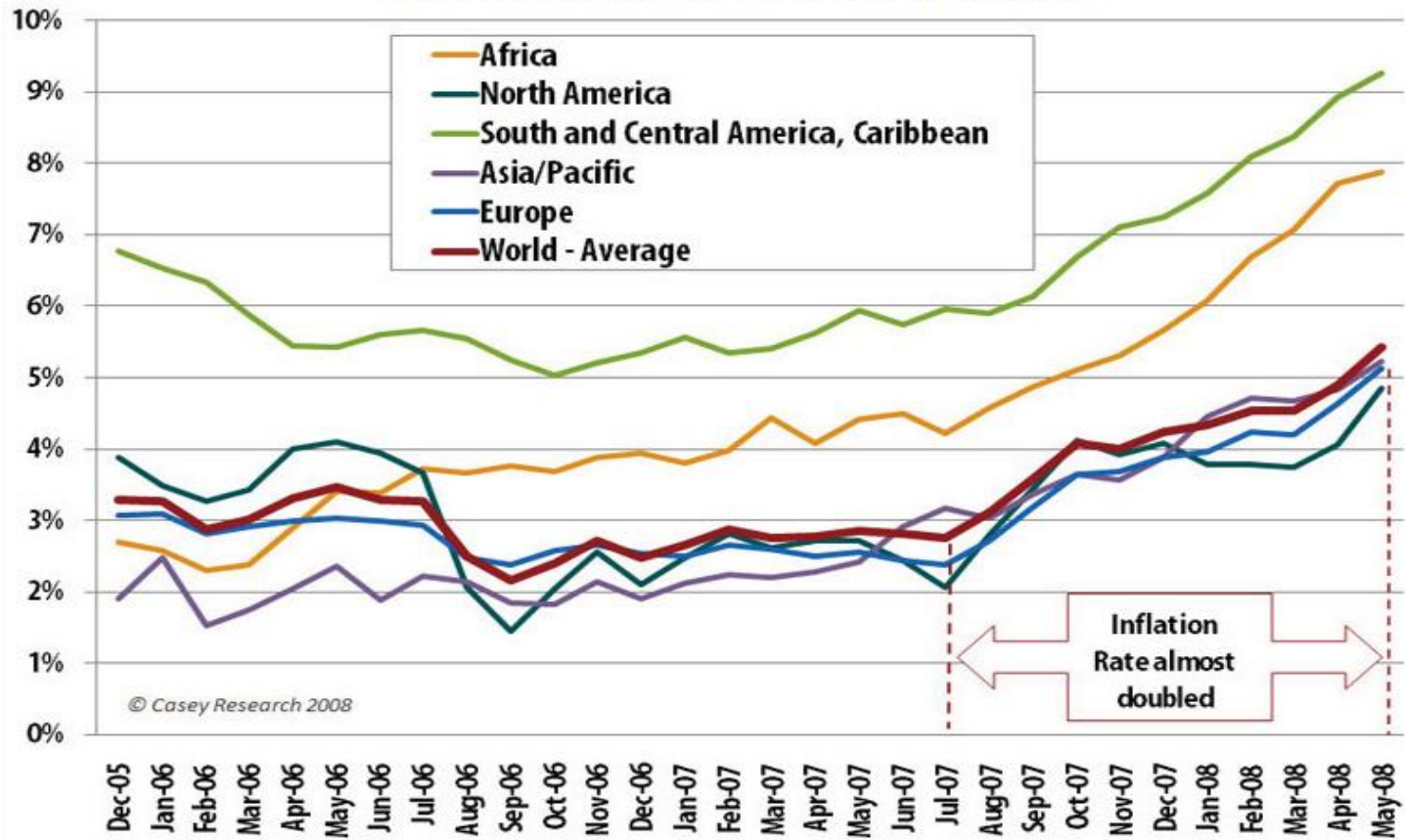
source: OECD



# & Inflation on Rise



### Global Inflation Is on the Rise



© Casey Research 2008



# Implications



- Stability is the key missing ingredient.
- 1985: in search for Financial Stability the past 50 years (FRB of St Francisco).
- 1999: the Institute Financial Stability established.
- 1999: the Financial Stability Forum (FSF) came to being.
- 2009: the Financial Stability Board (FSB) replaces FSF.
- 2015: in search for Financial Stability the past 80 years (projected event to plan for).



# From the Ashes of the TA



- **“We do not want communism... but we do need a more humane brand of capitalism, based not only on better regulation but better values.”**

*Richard Layard, founder, London School of Economics, The Centre for Economic Performance*

- **“Capitalism is changing in fundamental ways ... a new capitalism is likely to emerge from the rubble.”** *Robert Peston, business editor, BBC*

- **“We need a financial sector but not one like this, nor do we need Wall Street hitting us for its gambling debts”,** *Kotlikoff and Leamer, Profs. Of Economics at Boston University*



# In the Meantime



- **Increase in sales of Marx “testament”**: Capital  
(Sales of Capital have increased in Germany 300% in recent months)

*German Media, 17 Oct 2008*

- **Curious Remarks about Islamic Finance:**
  - *We are all Islamic Bankers.*
  - *Is Islamic Finance the answer?*



# Islamic Finance (IF) at Glance

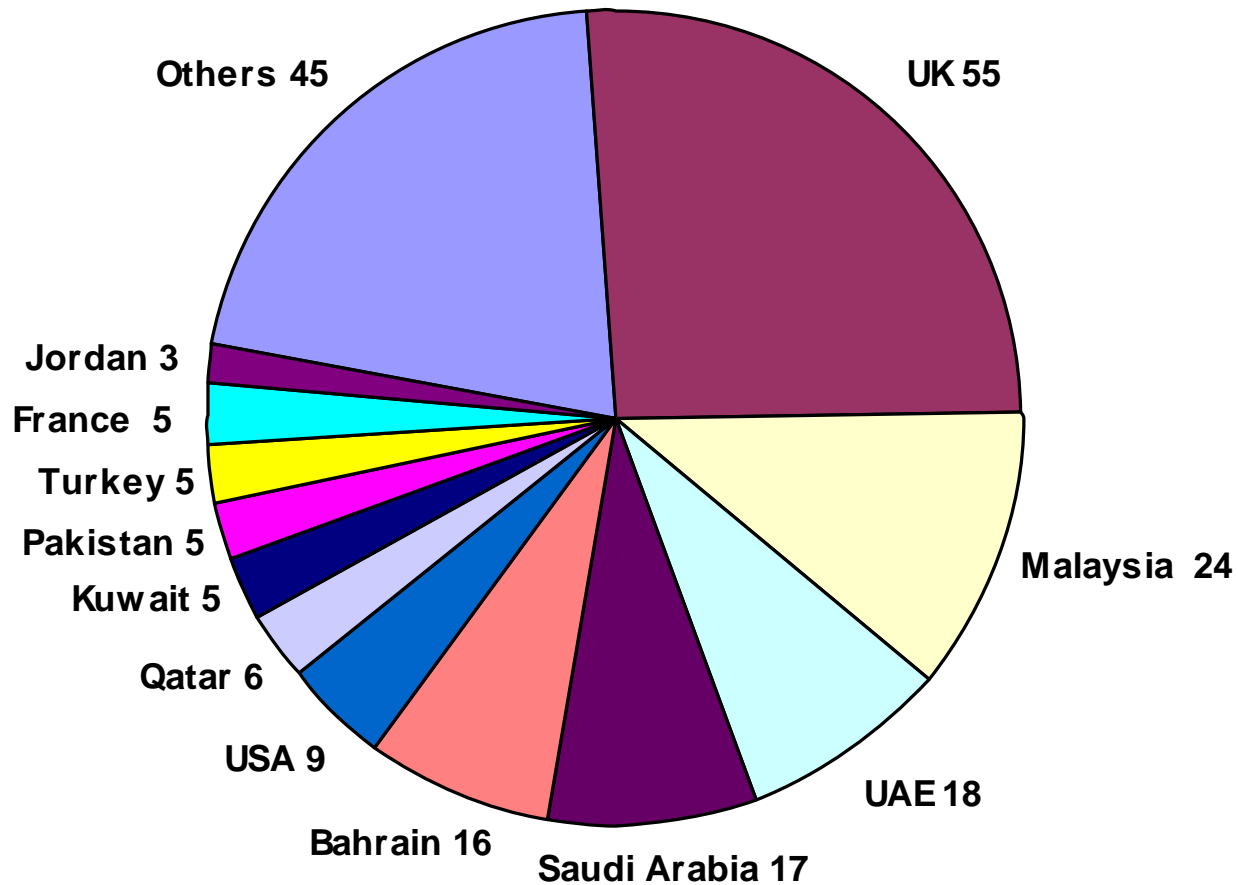


- From 1 institution in 1 country in 1975, to over 350 in over 75 Countries.
- Double digit growth; 15-20% per annum (around 27% in 2007).
- Total assets worth over \$700 billion (1% of global banking assets), expected to reach \$1 trillion in 2010.
- Not confined to Muslim countries: some countries like UK, France, Hong Kong are striving to become a Hub for IF.
- UK is number 1 in number of institutions offering IF Education and qualifications.

*source: Moody, IFSL, PWH, EIU, CIBAFI.*



# Institutions offering IF Education & Training



Source: IFSL, February 2009



# Basic Principles

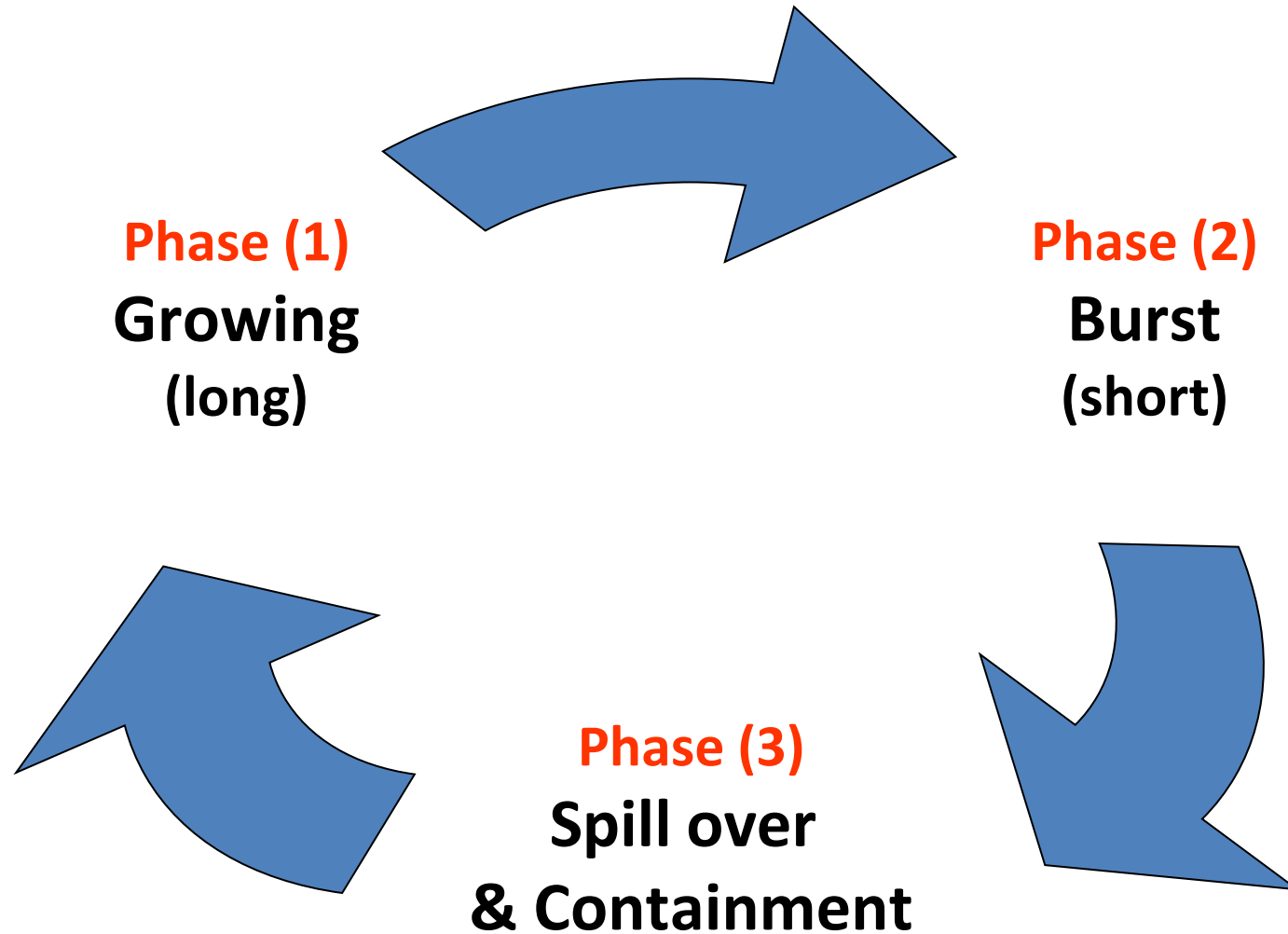


- Prohibition of ***Riba*** (interest ).
- Prohibition of ***Gharar*** (Alea or excessive risk).
- Asset-backing: financing is linked to real activities.
- Profit and Loss Sharing; no gain without the risk of loss.
- Prohibition of certain activities.

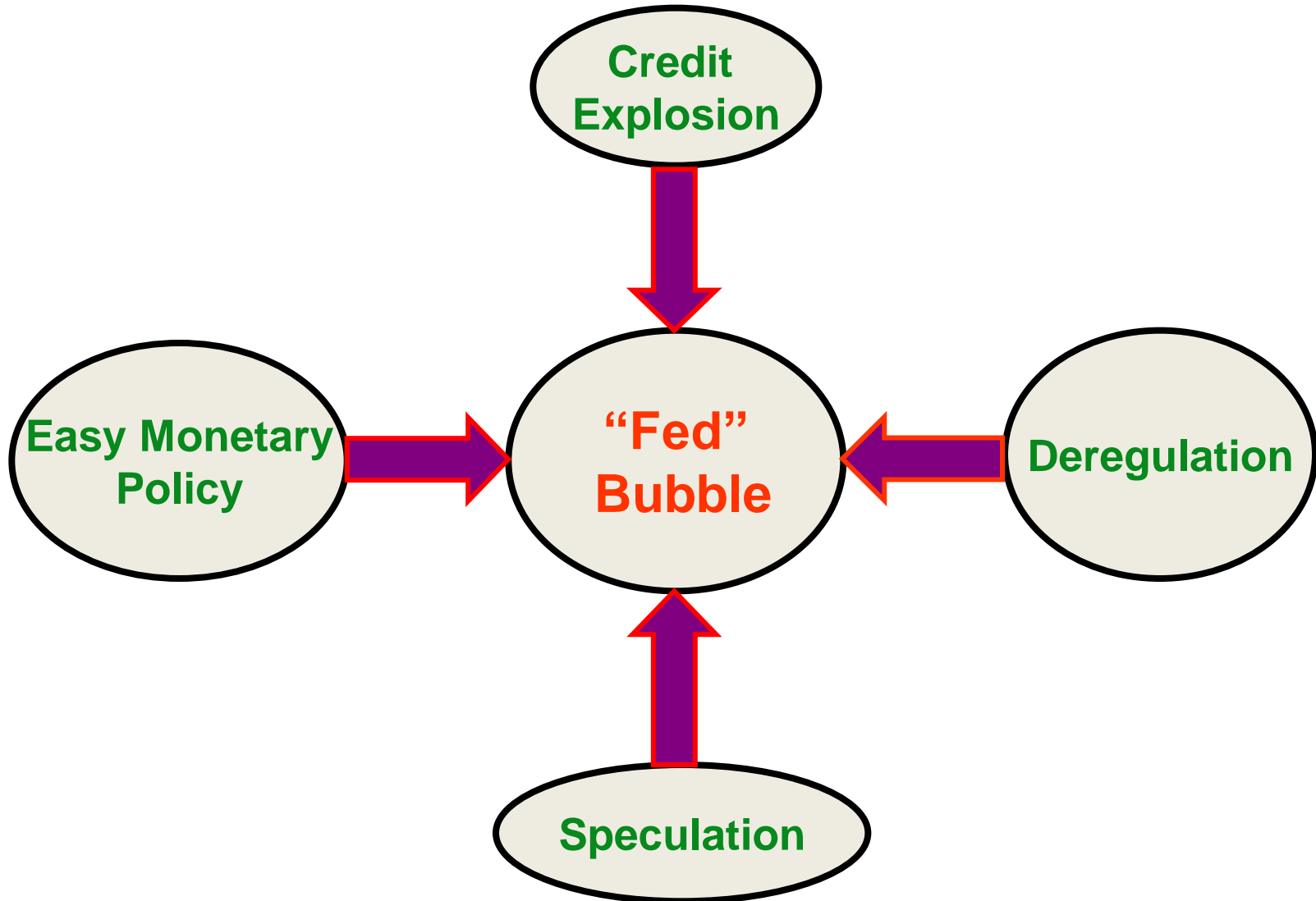




# Bubble Phases



# Islamic Finance principles & Ballooning Factors

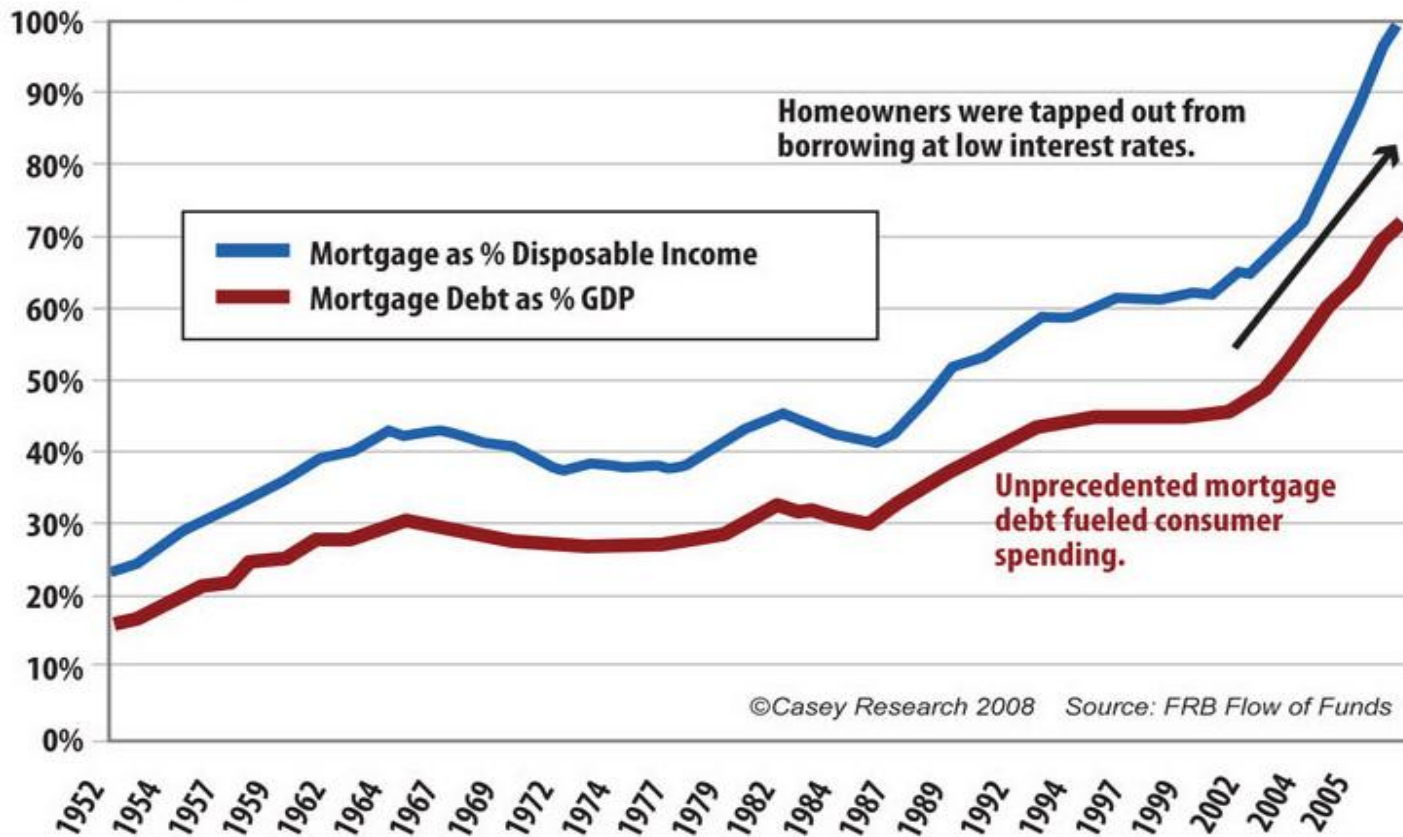




# Low Interest & the Debt Trap



## Mortgage Debt Exploded in Proportion to GDP and Income





# Interest and Credit Explosion



- It is well acknowledged that credit explosion is at the heart of recent bubbles: **too much money chases too few assets.**
- When a bubble is building up, the debt of individuals in a country is also building up.
- The people forget about the nature of debt growth vs. real assets. That will result the negative equity dilemma.



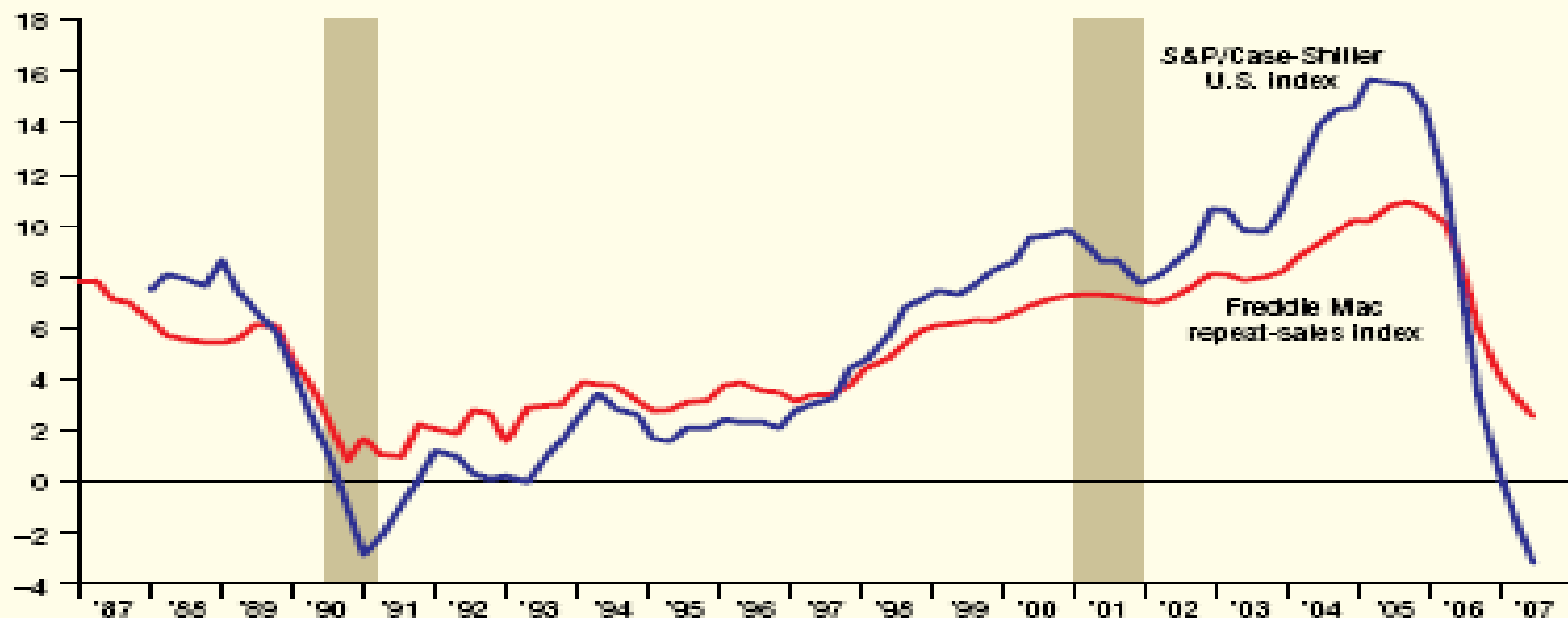
# The Negative Equity Dilemma



Chart 5

## Home-Price Appreciation Plunges into Negative Territory

Percent (year-over-year)



NOTE: Shaded areas indicate recession.

SOURCES: Freddie Mac; Standard & Poor's/Case-Shiller.



# ***Gharar, Derivatives & Securitization***



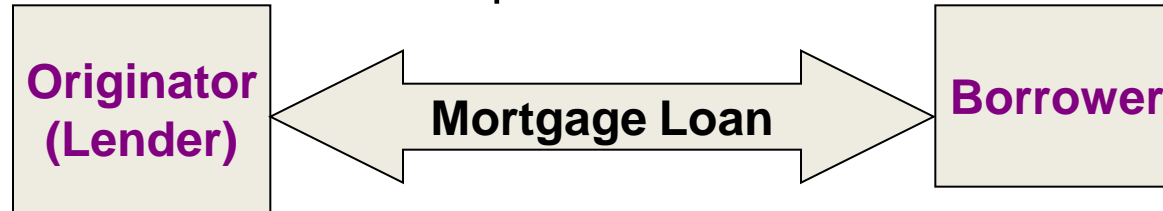
- **Markets have been stuffed with sophisticated products, many did not understand huge risks embedded in them.**
- **These products have grown at unprecedented rates, they have “divorced” the real activities.**
- **And they have created more risks instead of reducing them.**
- **They turned risks into tradable commodities, and dispersed them all over.**



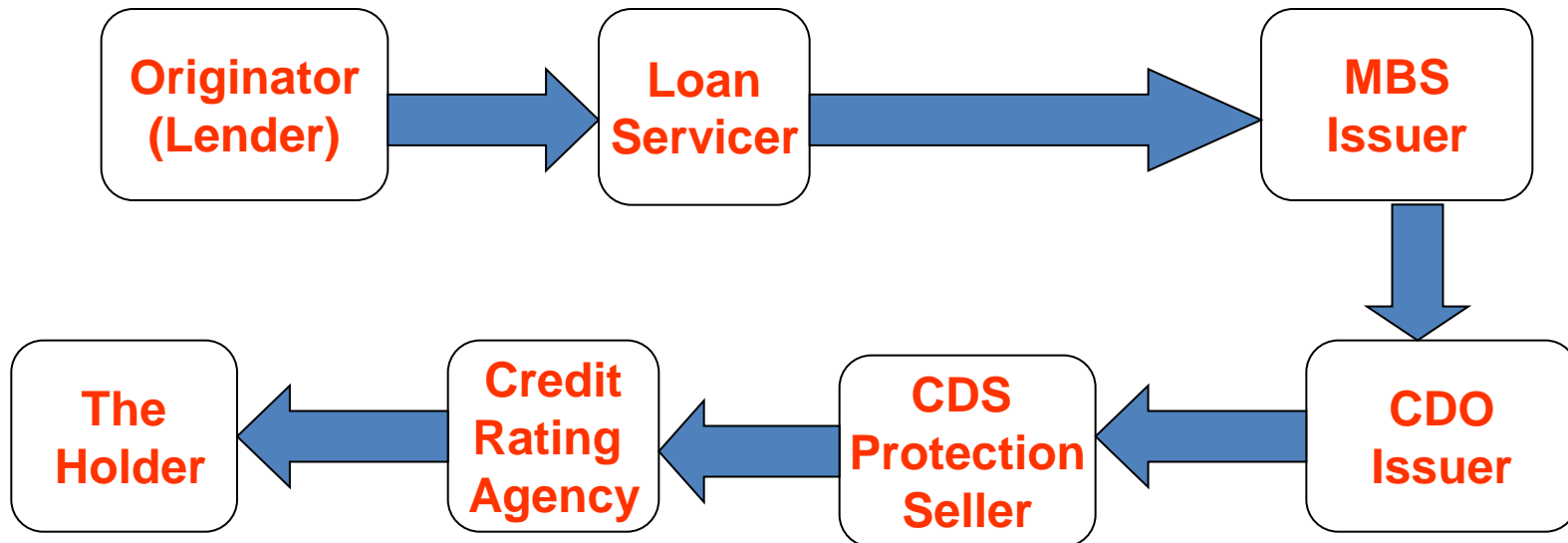
# From Simplicity to Complexity



The Simple structure



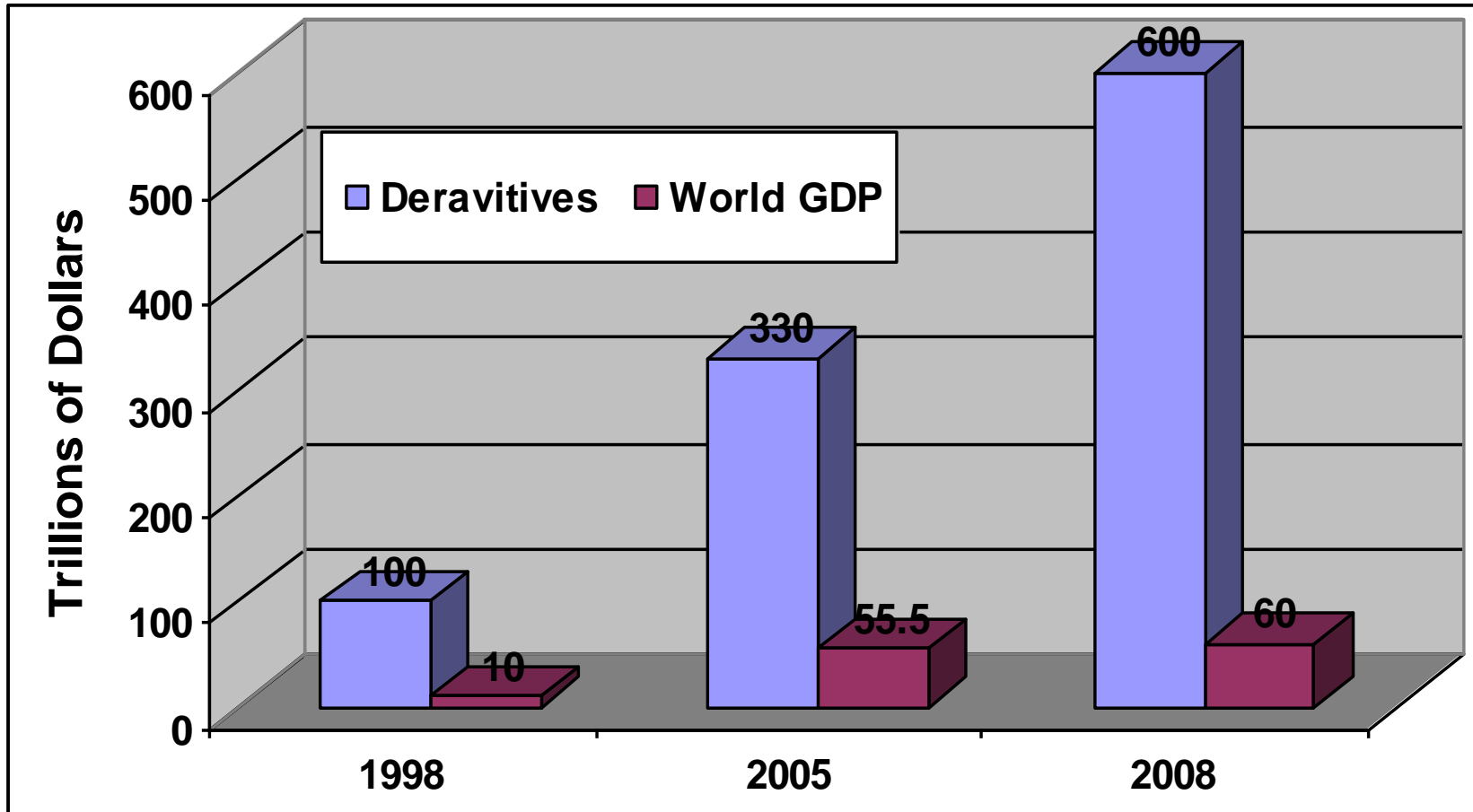
The Complex Ordeal (originate-to-distribute model)



MBS= mortgage backed security, CDO= collateralized debt obligation,  
CDS= Credit default swaps



# Huge Disparity between Real and Financial Sectors



Chapra 2009, (Derivatives: 684 BIS Nov. 2008, & WB GDP 54 in 2007)



# Limits and Pitfalls of Innovation

Derivatives are  
“time bombs”

& “Financial  
weapons of  
mass destructions





# Some IF guidelines in limiting these practices



1. The asset sold/leased must be real, not imaginary or notional.
2. The seller must own and possess the goods.
3. The transaction must be a genuine.
4. Credit expansion linked to the growth of the real economy to avoid *gharar* and Gambling.
5. The debt cannot be sold, and thus the risk associated with it must be borne by the creditor.

*Chapra, 2008*



# IF Encouraging Signs



- **The industry is still in good shape: no major setback reported so far.**
- **Total value of Bahraini IBs assets increased by 50 per cent in 2008 to \$24.6 billion, *Gulfweekly June 2, 2009.***
- **“Islamic FIs in the GCC have displayed strong resilience amid the current global financial debacle ... because [+ strong growth & Conservatism] the core principles of Islamic banking have protected them from elements of the crisis”. *Moody, Oct. 27, 2008.***



# Some Issues for Reflection



- The industry is too small (1% of the global finance).
- Commercial Banks account for more than 70% of *Shari'ah* compliant assets. *AFP 12/05/09*
- *Sukuk* suffered a sharp drop in the value in 2008 (down to US\$20b from US\$42b 2007), *IFSL, Islamic Finance 2009*.
- “IF appears to be mimicking most of the products of conventional finance ... it is time for it to pause and think of the direction it is taking”, *Prof. Habib Ahmed, Durham University*.



# So formidable Task Ahead



- Identify clearly the factors behind the “resilience” in the crisis.
- Adopt more HIT rules and procedures.
- Distance itself from conflict of interest perception.
- More stakeholder approach.
- Ready and prepared for SAC for its operations and practices.
- “Keep it simple” a guiding rule for documentation and product structuring, so that risks and benefits can be easily assessed and obtained.



# Concluding Remarks



- **Financial turbulences have become an apparent feature of the capitalist system, the severity and dire consequences are growing over time.**
- **These turbulences have exposed the core foundations of the system; laissez faire, efficient markets ...etc.**
- **There is real urgency for fundamental changes to the practices that have brought us into this terrible mess.**
- **The IF principles offer interesting insights about causes and remedies of financial turbulences, but they have to be developed coherently and rigorously.**
- **In practice there is a formidable task for IF to present itself as a viable and appealing alternative to the current system.**
- **IF has to be ready and accepting to be critically scrutinized and examined.**
- **No significant progress can be achieved in building a stable and equitable financial system without a genuine dialogue and exchanges of views and ideas between all stakeholders from various religions and cultures.**



*Thank You*

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