BBC NEWS

How Islamic finance missed heavenly chance

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Amid the confusion and consternation of the global financial crisis, Islamic banking had a gilt-edged chance to step into the breach.

It is hard to remember amid screaming headlines proclaiming record bonuses for the bankers of Wall Street and the City.

But just over a year ago, the conventional financial system was on its knees.

"When Western banking collapsed, one sector should have escaped unscathed: Islamic banking," says Mohammad Saeed Rahman, chairman of a US-based think tank, the Institute for Halal Investing.

But from Mecca to Malaysia, the world's Islamic bankers were paralysed and failed to take advantage of the opportunity.

And now Dubai's debt problems have soured the sector's image, with property developer Nakheel asking for the trading of some of its Islamic bonds to be suspended.

So what happened?

Another way

Lehman Brothers was first to collapse - destroyed by murky, missold mortgage products originating in the trailer parks of North America, an appetite for excessive risk and over-leverage.

FEATURES OF ISLAMIC ECONOMY

- Dealing in interest, liquor, pork, gambling or pornography are prohibited under Sharia law
- Islam forbids all forms of economic activity which it deems morally or socially harmful
- Individuals must spend their wealth judiciously and not hoard it, keep it idle or squander it
- Muslims have a duty to contribute a percentage of their wealth to deprived and poor sections of Muslim society

Lehmans was the first to fall, in a domino snake that might have brought down the whole free-market financial system.

Governments across the world fell over themselves to avert such a scenario.

They signed up their electorates to decades of deficits and spending cuts, all to bail out the bankers who were caught with their pants down and hands in the till.

In return for the lifeline that taxpayers threw the financial elite, the Cristal-swigging, Armani-clad banking classes temporarily sported sackcloth and ashes - in a strictly metaphorical sense, that is.

At that time, the world needed another hero. A way of doing business that was free from rampant speculation, free from excessive risk and was banking back-to-basics - taking deposits from savers and lending to borrowers for a profit.

Arising from the glittering new cities of the East, primarily Dubai and Singapore, was the champion of Islamic banking.

Faith in finance

"Technically, Islamic banks should have sidestepped the falling grand piano," says the Institute for Halal Investing's Mr Rahman.

"The industry was not allowed exposure to CDOs, derivative products and the kind of intra-financial counterparty risk that crippled the conventional banks.

"It couldn't play the sub-prime mortgage game, was backed by real money in the form of petro-dollars and manufacturing export receipts. It was simple, straightforward banking."

The two main principles of Islamic banking are an avoidance of interest and an avoidance of uncertainty.

Islamic economics is a well-documented system, practiced by the Prophet Mohammed, a merchant, and his companions. The core of the Islamic economic system is an avoidance of usury.

Islam is not anti-moneymaking. In fact, the Thatcherite dogma of self-reliance and entrepreneurship is championed in the Islamic sacred book, the Koran.

What is discouraged is making money from money.

Risk-sharing and trading is the central tenet of Islamic economics.

The financial institution goes into partnership with the borrower and both share from the profits of the venture. It is very similar in approach to private equity.

Principle and practice

The other prohibition is an avoidance of uncertainty or gambling. If Islamic economics had been at the centre of the global financial system, the type of speculation that has led to the emergence of bubbles and then runs on stock would not have occurred.

Finally, the need to have all lending fully covered by cash deposits, and the risk management that this would entail, would have never seen the emergence of sub-prime lending.

Conceivably, such a system, based on ethics and principles of fairness, could have created a "third way" between control-style and free-market economics.

However, principle is a long way from practice, and Islamic bankers are no more and no less greedy than conventional bankers.

The modern Islamic banking industry is very much in its infancy, with a history of less than 40 years.

But in an attempt to compete with the conventional finance industry - its fees, its bonuses - much of the modern Islamic finance industry has aped the practice of the conventional.

Sharia opportunities

Arguably, the modern Islamic finance industry and its cohorts of scholars, who give the official religious seal of appeal to the products of finance firms, have been set up to circumvent the principles of Sharia law.

Scholars and bankers have become more and more sophisticated in finding ways to get around the prohibition of interest and of uncertainty - and create a shadow of the conventional finance system.

> “ **The Islamic banks and the Islamic bonds they issue will default, and are doing so as we speak** ”

"Both share the same material goals and adopt the same institutional structures, with the result that the products promoted by the Islamic finance industry are often indistinguishable from those of interest-based institutions," says Tarek El Diwany, an analyst for London-based

Sharia finance consultancy, Zest Advisory.

He explains that a serious and nimble response to these concerns is often hindered by a lack of intellectual honesty within the Islamic finance industry itself.

Platforms are rarely provided to scholars who wish to take one step back and question some of the fundamental concepts that are being applied.

Few questions are raised regarding the validity of Islamic debt financing, limited liability structures, speculative methods of market trading or the nature of the monetary system.

Such matters are given little attention in the headlong rush to copy interest-based methodologies.

Money trap

This has resulted in a number of embarrassing paradoxes.

For example, while some Islamic investment managers attempt to develop Sharia-compliant short-selling techniques, several Western authorities are banning the practice, on account of the instability that it causes.

The missed opportunity for Islamic finance is that in the "sunshine years" when all assets seemed to be heading northwards, the industry morphed into a soft version of the conventional industry and became vulnerable to the same systemic failures.

The Islamic banks and the Islamic bonds they issue will default, and are doing so as we speak.

The banks, and the governments that finance them, have fallen into the trap of creating money and then making money from it and will suffer from boom and bust.

For Islamic finance to step into the mainstream and offer a third way, there will have to be a reconsideration of the objectives, institutional frameworks and contractual methodologies of the modern Islamic banking and finance industry.

This effort must encompass the full range of technical and scholarly opinion, and it must have sincere political support.

Soberingly, "Christian" banking started off prohibiting usury and evolved into the Wall Street and City we know today. Islamic finance must try to avoid doing the same before the process becomes irreversible.

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