An Islamic economic perspective on the global financial crisis

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What is Islamic Economics?

- Islamic economics is a branch of knowledge that aims at analysing, interpreting, and resolving economic problems with reference to the methodology of Islam.

- The revelation (the Holy Qur’an) conceives human beings as the vice-regents of God on earth, bound by voluntarily observing a compact (shari’a) regulating life.

- To a Muslim, all resources are God-given, and ownership of wealth belongs to God. Individuals are only trustees and are accountable to God for their actions.

- Embedded in the notion of trusteeship is a call for conduct based on a code of personal ethics and a blueprint for justice.
How does Islamic economics differ from conventional economics?

- Islamic economics broadens conventional economic analysis by exploring the religious and moral aspects of economic life.

- Conventional economics is a predominantly secular discipline maintaining a difference between the positive and normative.

- A Muslim accepts revelation as the basis of ethics and justice. Standard economics abstracts from values and ethical theory.

- Islamic economics widens the concept of utility in three ways:
  - utility encompasses the spiritual as well as the material
  - utility is extended temporally from this life to the hereafter
  - well-being requires a concern for the welfare of others

- The rational being is replaced by the ‘faithful’ being, bound by society and communal interest.
How is this vision implemented?

- Islam had to deal with monetized free market exchange from its inception.

- Trading was extolled. Needed to determine what particular forms of trade and exchange were unjust.

- A detailed framework prohibits usury, gambling, *gharar*, extravagance, hoarding, fraud and corruption, and encourages benevolence and mutual cooperation.

- While the market is retained, the aim is to reform it ‘internally’ and on an ethical footing - ‘justice in exchange’
Features of the GFC

- Path from ‘subprime surprise’ → ‘credit crunch’ → ‘global financial crisis’ → ‘the great recession’
- Origins were ‘mortgage equity withdrawal’ and ‘affordable’ housing
- 43% of US first-time home buyers given 100% valuation loans
- NINJA borrowers
- CDOs packaged individual loans into complex securities
- Issuing banks offered ‘liquidity puts’ (money-back guarantees)
- Lending boom fuelled under Greenspan - fastest growth in dollar liquidity and lowest real Federal funds rate in 30 years
What were causes of the crisis?

- Axel Weber, President of Deutsche Bundesbank, saw causes as
  - lax lending standards
  - weaknesses in the credit transfer process
  - overly optimistic assessments of structured securities such as CDOs

- From an Islamic perspective the causes are more fundamental.
  - greed
  - *gharar*
  - speculation
  - governance
  - fixed interest debt (usury)
  - financialization
Greed up and down the mortgage chain

- Wall Street bankers
  - fees from bundling and distributing MBS
  - created ‘synthetic’ CDOs using credit default swaps
- Hedge funds became large buyers of CDOs
- Banks lent to less creditworthy borrowers
- Mortgage brokers
  - signed up 80% of mortgages
  - higher commissions for sub-prime and Alt-A mortgages
- Homebuyers
  - attracted by low initial ‘teaser’ rates
  - no-recourse loans gave them a ‘put option’
How to counter greed?

- The Western response
  - greed treated as fact of life, endemic and incurable
  - countered by ‘external’ constraints through regulation

- The Islamic view
  - the Holy Qur’an accepts people as greedy and possessive
    ‘Truly Man is, To his Lord, Ungrateful;
    And to that (fact) He bears witness (By his deeds);
    And violent is he In his love of wealth’ (Al-Adiyat 100:6-8)
  - the faithful person relies on altruism, co-operation, brotherhood, fraternity, affection and mutual respect to rein in selfishness and lust for riches
  - self-restraint a discipline in areas that regulation cannot reach
Gharar

- *Gharar* signifies ambiguity, uncertainty or lack of specificity in contracts.

- Islam insists information be easily accessible to all.

- These requirements not met for option ARMs, ‘the riskiest and most complicated home loan product ever created’.

- 80% of option ARM borrowers made minimum payment, which did not cover interest.

- Shortfall added to balance (‘negative amortization’), and when balance rises to 110 or 115%, the loan resets.

- Not all understood that low payments temporary and that the less is paid initially, the more is added to the mortgage.
Speculation and gambling prohibited in Islam because it destroys the moral, economic and social fabric of society.

In the ‘old’ model of Western investment banking, risks limited to underwriting, and most revenue came from fees.

In the ‘new’ model, the Big Five earned 54% of revenue from proprietary trading.

In 2007, 60% of Big Five revenue paid in bonuses.

The ‘banking bonus racket’. Executives and traders took profits in the boom, and shareholders bore losses in the bust.
Governance went missing

- In the ‘shadow banking system’ large banks formed SIVs.
- SIVs bought long-term high return assets (e.g. CDOs) and borrowed 15-20 times their equity.
- Banks were not meant to be backstopping SIVs, but took failed loans and bad assets onto their balance sheets, following ‘runs’.
- This off-balance sheet activity escaped regulation. Bank boards went missing and did not protect shareholders.
- In the Islamic system discipline is provided by religious auditing.
Debt and leverage

- Islam prohibits *riba* (usury) and interest debt.

- Sir Ralph Hawtrey, Irving Fisher, Bernanke and Gertler argued that debt and leverage can magnify small economic shocks into larger investment and output fluctuations.

- High debt and leverage in the US housing market
  - Household ‘income gearing’ and ‘interest gearing’ at record levels

- High leverage was a feature of Wall Street
  - Big Five leverage jumped from 30:1 in 2002 to 41:1 in 2007.
  - If leverage is 33:1, a drop of 3% in portfolio can wipe out bank capital.
Financialization

- Islam rejects debt and prefers PLS financing
  - Position undermined by use of *murahaba, bai’muajjal, istisnaa, ijara, sukuk* (the ‘*ijtihadi*’ instruments).
  - These look like interest, but differ from conventional finance.
- In the West with growth of ‘financialization’
  - the value of financial assets greatly exceeds that of tangible assets
  - in some European countries financial claims are multiples of GDP
    *(in the UK four times and Iceland eight times*)
- In the Islamic system financing is based on real goods.
  - Financing expands with the growth of the real economy, constraining excessive debt and credit creation.
  - No decoupling of financial activity from tangible asset investment as in the West.
Islamic precepts are in the way of preventative medicine.

The body politic has been made to suffer because of:
- greed
- unwarranted hazard in financial contracts such as option ARMs
- excessive speculative trading
- poor governance of banks and other institutions
- too much leverage and debt
- an explosion of financial activity relative to real tangible investment.
Resolving the crisis (continued)

- From an Islamic economic perspective
  - if greed can be tempered internally by self-restraint
  - if mortgage borrowers had fully been informed
  - if speculation and risky trading is forbidden
  - if religious principles are written into bank governance
  - if usury is banned and financing based on concrete assets
  - If the financial sector does not outstrip real activity then the conditions that arose might have been avoided and the crisis might not have happened.
As preventative medicine, Islamic economics offers few prescriptions.

Stimulus packages involve printing money and budget deficits.

The debasement of money is not allowed, via analogy (qiyas) from the Qur’anic prohibition of corrupting weights and measures.

As to budget deficits

- the Prophet Muhammad borrowed interest-free for emergency needs only
- no borrowing by the four rightly-guided Caliphs.

Classical scholars treated borrowing as the last resort

- concerned that authorities may fail to repay the loans, or
- would impose burden on future generations via taxation
One of the most important objectives of Islam is to realize greater justice in human society.

The financial system may be able to promote justice if it satisfies two conditions.

First, Islam gives prominence to market disciplines. It requires both the financier and the entrepreneur to share equitably in profit as well as losses. The double assessment of risks by all parties should help inject greater market discipline in the system.

Second, Islam emphasizes inner moral governance. Regulations will not be effective unless there is a greater moral consciousness among individuals to abide by the regulations. There are always areas where regulations cannot reach. Individuals must be motivated to adhere to values voluntarily under all circumstances even when it is against their self-interest and there is little chance for them to be detected.
Four systems need to be compared

1. The idealized Adam Smith model of the invisible hand with good incentives, checks and balances, market disciplines and low moral hazard.

2. The market system that evolved with moral hazard, too big to fail, lack of checks and balances, and perverse incentive systems.

3. The idealized Islamic system with no interest, no debt, no speculation, and profit and loss sharing principles based around asset-based systems.

4. The current Islamic system based on debt and interest in all but name, and even divorced from assets in *tawarruq*. 
Getting out of the mess

Alan Blinder’s War Plan (IHT April 11-12, 2009)

1. Stimulate aggregate demand
   - President Obama’s fiscal stimulus in February 2009
   - Cutting Federal Funds rate to zero, ‘quantitative easing’

2. Limit foreclosures
   - $50 billion to help homeowners avoid foreclosures

3. Rehabilitate the ‘shadow banking system’ (credit transfer system)
   - Public-Private Investment Program of March 24, 2009
   - FDIC guaranteed $300 billion debt issue program (IHT April 17, 2009)

4. Recapitalize the banks
   - Extend the Citigroup ‘debt/equity swaps’ (IHT April 21, 2009)