

Islamic Financial System and Current Crisis

“The Islamic system has come for the whole of humanity”

“And we have sent you (O Muhammad SAW) not but as a mercy for the ‘Alamîn.” [TMQ 21:107]

It is a system not thought up by the minds of men; rather it is from the creator of all humankind Allah (swt) and is the perfect system for humanity. Let us all work to re-establish this system once again. Before going through the strengths and weaknesses of Islamic banking or rather Islamic economic system in the current financial crisis, let me shed some light on what happened in the sub-prime fiasco.

What went wrong?

When three years back Warren Buffet, the richest man on the planet, called some financial instruments like derivatives and credit default swap (CDS) “financial weapons of mass destruction”, few of us took notice. Derivates can be described as like putting mirror in front of another mirror, allowing a physical object to be reflected into infinity.

To me the entire western financial model is based on greed and speculation; buying without money in the pockets (bulls) and selling what you do not posses (bear). Bankers lent aggressively to finance cars, homes (the largest chunk), clothes, TVs and even for holidays to those who had no means to repay. Because of their low ability (which later became no ability) to pay back debt, they were classified as “sub-prime customers” and therefore charged with the higher interest rates. Even after taking these reckless and greedy decisions banks were not prepared to take on any risk so they insured risky loans through CDS (a form of derivative) and credit insurance. A debt created on a single asset was sold to about half a dozen parties by the original lender, thus widening the scope of potential destruction.

With a slight increase in interest rates and decline in the value of properties these sub-prime customers began defaulting. Lenders tried to sell the collateralized properties to recover their money but there were no takers. Thus big defaults led to huge losses for banks as this dangerous financial game was played under “**Extreme Capitalism**”.

At the most basic level interest based financing attracts a fixed return; the capital provider cares less about the benefits recipient get out of lender’s money. So even if the recipient incurs losses, they are legally required to pay back the money. Thus, this system by privatizing profits and socializing losses created two section of society; **super rich and super poor**. Under this system a UK based Indian industrialist can buy a 300 million pound house while more than 300 million Indian survive on less than half a pound a day. This economic disparity is not confined to industrialist alone. The gap of income is widening between top executives and average employee. Therefore, many experts are calling it a “**catastrophe of human values**” instead of financial crisis.

To summarize following three factors created current financial tsunami;

- (1) Reckless lending for greed of money, the lust for profit that caused over stretching of finance to persons who cannot continue paying their debts, also the expanded consumerism in the society participated in creating unbearable debt mountains
- (2) Issuance of derivative instruments, non real and speculative transactions
- (3) Short selling and speculation, no one can predict the future with accuracy

From the perspective of Islamic economics

Allah (swt) says: "You are the best of the nation raised up for mankind because you enjoin what is right and forbid the wrong and believe in Allah" [Ali-Imran 3:110]

Allah (swt) has blessed us as being the best nation raised up from humanity because we enjoin the good and forbid the evil – we need to realize our responsibility of speaking out against the evil and injustice that we see globally today. One of these great evils we see around us is the economic injustice and oppression caused the world over by the current capitalist world order

Of course in a short article such as this it is not possible to go through the entire Islamic economic system in detail. My aim is to cover its key aspects especially in relation to how an Islamic system holds the key to solving the current financial crisis.

Islam views the economic problem in a radically different way than Capitalism and Socialism. Islam focuses on the distribution of wealth not just the production. The problem of poverty will not be solved by producing more and more for the rich to consume rather it will be solved by ensuring that basic needs of every individual are satisfied completely. Islam looks at every individual by himself rather than the total of individuals who live in the country.

The Islamic economic system is neither entirely Capitalist where the market is left free to lead to the disasters that we are seeing nor Socialist where everything is owned and controlled by the state. Islam distinguishes between public property, state property and private property. It forbids the private ownership of the large resources such as the Oil and Gas that we see the Western companies fighting over in the Muslim world.

The crisis represents an opportunity for all Muslims to present the Islamic economic system as an alternative. When Carl Marx wrote his theories of Communism in the 1800's whilst sitting in Britain, his ideas were seen as a viable alternative by many. I think, Socialism was created in reaction of "exploiting capitalism" and Marx would have accepted the Islamic financial system as an alternative if the same was known to him.

Therefore today it is vital for us to present Islam as an alternative. It is important to show Islamic economics as much more than just Islamic finance and Banking.

Battlements of Islamic banking

First of all Islamic banking has not been much affected by the global financial crisis because it is not much prevalent among the countries which have been worst affected by the current disaster.

Secondly, Islamic banking has been relatively new in the financial arena, its lending and investment practices are generally more conservative compared to their conventional counterparts.

Thirdly, because of the inherent trait within Islamic banking system, it is largely immune against such crisis. The most important of these factors are;

- ⇒ Assets backed financing - Islamic financing is always backed by tangible assets. Any decline in the price of underlying assets can be mitigated by the customer's participation which provides natural margin to an IB.
- ⇒ Prohibition of debt trading - a debt cannot be traded, discounted or securitized, thus the financial markets cannot be stretched beyond the real assets. In fact, the financing shall always be less than the real value of assets as the certain portion of the transaction is financed by the customer himself. Non-real transactions (derivatives) are essentially speculative in nature and do not add value to an economy
- ⇒ restriction on short selling - you cannot sell what you don't possess/own
- ⇒ Islamic banks are more involved / concerned about the profitability/viability of customers businesses as (a) all Musharaka transactions are based on profit/loss sharing (b) even in Murabaha transactions an IB cannot charge mark-up for delayed period
- ⇒ No Extravagance (live within your means) – No personal loans in Islamic banking even credit cards are not generally accepted as a Shariah compliant product by the scholars.

However, if the crisis persists, it will be inevitable that IBs will be affected to a certain degree as they are part of the wider global financial system and consequently will be influenced by all global financial dealings in an indirect manner.

Hasan al Basri narrated that Allah's Messenger (saw) said: "He whom death overtakes while he is engaged in acquiring knowledge with a view to reviving Islam with the help of it, there will be one degree between him and the Prophets in Paradise." [Al-Tirmidhi]