Why Islamic Banking Is Successful?
Islamic Banks Are Unscathed Despite of Financial Crisis

By Prof. Rodney Wilson
Professor-Durham University

The collapse of leading Wall Street institutions, notably Lehman Brothers, and the subsequent global financial crisis and economic recession, are encouraging economists world-wide to consider alternative financial solutions.

Attention has been focused on Islamic banking and finance as an alternative model. What lessons can be learnt, and how resilient have Islamic banks been during the current crisis?

Islamic Banking Principles And Sub-prime Lending

The religious teaching underpinning Islamic finance is concerned with justice in financial contracts to ensure that none of the parties is being exploited.
The bank may advance the clients an interest-free loan to enable them to continue their payments during the recession in anticipation that they will pay in full when the economy rebounds.
Riba(interest or usury) is one source of exploitation, especially, as in the case of sub-prime lending, the highest rates were charged to lower earners. Such discriminatory charging by conventional banks was justified as being a reflection of the risks involved.
Those on lower incomes, with poorer prospects of finding new employment in the event of redundancy, were less likely to be able to service their interest payments.
Islamic housing finance involves risk sharing between the bank and the client, rather than transferring all the risk to the latter.
Under the most commonly used diminishing musharaka (partnership) contract, the bank and the client form a partnership, with the bank providing up to 90 percent of the purchase price, and the client at least 10 percent.
Over a period of usually 10 to 25 years, the client buys out the ownership share of the bank which makes its profit from the rent paid by the client for the share the bank owns.
In the event of a rental or repayments default, the bank may advance the clients an interest-free loan (qard hassan in Arabic) to enable them to continue their payments during the recession in anticipation that they will pay in full when the economy rebounds.
The client retains their home rather than being faced with eviction— like the victims of the sub-prime crisis.
Of course Islamic banks have to appraise credit risk, and indeed are more cautious about who they should finance than conventional banks.
The banks in the United States charged high arrangement fees for sub-prime borrowers which were used to pay bonuses for those signing up new clients.
As the mortgages were sold on to Freddie Mac and Fanny Mae, the arrangers were unconcerned that the sub-prime borrowers might be unable to meet their financial obligations.
Indeed, gifts were provided to entice the feckless to sign up, and the mortgages often exceeded the value of the property.

The banks in other words became mere booking agents, with no long term commitment to their clients.

The Islamic Banking Record

Consequently when the credit crunch came and borrowing from wholesale markets was halted, Islamic banks were not exposed.
In contrast to conventional banks, no Islamic bank has failed and has needed government recapitalization which ultimately becomes a burden on hard pressed taxpayers.
All Islamic banks comply with the Basel II capital adequacy requirements and the Islamic Financial Services Board (IFSB)- the body which advises regulators with respect to Islamic finance- has produced detailed guidelines on compliance. The IFSB has an on-going relationship with the Bank for International Settlements-the institution which developed the Basel standards- and is certain to be consulted as Basel III guidelines are drafted for capital adequacy which are likely to be implemented globally in the coming decade.
The soundness of Islamic banks is accounted for by the fact that they use a classical banking model, with financing derived from deposits, rather than being funded by borrowings from wholesale markets.
Consequently when the credit crunch came and borrowing from wholesale markets was halted, Islamic banks were not exposed. However, Islamic banks are not immune from the effects of the global recession, and the fall in oil prices will inevitably have a negative impact on 2008 results of Gulf-based Islamic banks. The situation will become clearer from February once the audited financial statements start to appear.
Two Islamic housing financial institutions, Amlak and Tamweel are being merged, as both have faced problems given their exposure to the Dubai property market.
In Iran where all financial operations have been shariah-based since the Law on Usury Free Banking was introduced in 1983, banks have been relatively insulated from the financial crisis, ironically because United States sanctions meant they could not deal with institutions such as Lehman Brothers which were trying to place large amounts of toxic debt with Middle Eastern banks.
The sanctions therefore proved to be a blessing in disguise for Iran— although the Islamic banks there have been adversely affected recently by the fall in gas prices. Nevertheless being state owned, institutions such as Bank Melli, the largest Islamic bank in the world, are well placed to ride out the global financial storm. With assets of over $50 billion, and 2007 profits exceeding $540 million, it has more than adequate resources to cope.

Islamic Financial Stability

Investors seeking shariah compliance have portfolios which are more heavily weighted in sectors such as healthcare or utilities.
Islamic banks enjoy a built-in stabilizer to help them cope with economic downturns, as instead of paying interest to depositors, those with investment mudaraba accounts share in the banks profits.
Thus, if profitability declines in an economic downturn, depositors receive lower returns, but if profits rise they enjoy higher returns.
This profit sharing reduces risk for the banks and means they are less likely to become insolvent. However as the banks build up a profit equalization reserve, which can be

used to finance pay-outs during difficult years, depositors benefit from some protection of their returns during economic downturns.
The last year has been difficult, if not disastrous, for equity investors, given the fall in stock market prices globally.
Investors in equities screened for shariah compliance have also suffered, but less than their conventional counterparts, because they have not invested in the shares of riba-based banks which have fared especially badly during the global financial turmoil.
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Prospects for Islamic Finance

There are already five wholly Islamic banks in London, and the first Islamic bank will open in France in 2009.
Islamic banking provides a viable alternative to conventional banking and is less cycle prone. The spread of Islamic finance into western markets demonstrates that it now being treated seriously by regulators and finance ministries.
There are already five wholly Islamic banks in London, and the first Islamic bank will open in France in 2009. According to the conservative estimates of the Banker in October 2008, Islamic financial assets globally exceed $500 billion, a figure that could easily double over the coming decade.
The experience of Islamic banking in the United Kingdom has been extremely positive.
Islamic Bank of Britain has been operating as a retail bank for over four years, and has attracted over 40,000 customers. HSBC Amanah, the Islamic finance subsidiary of HSBC, has been operating for ten years in London, focusing mainly on institutional clients and business finance.
Alburaq, the Islamic finance subsidiary of Arab Banking Corporation, has become the market leader for shariah compliant home finance in the United Kingdom.
None of these institutions has been affected by the global financial crisis, and their resilience bodes well for the future.
Sukuk Are Real Assets
The United Kingdom authorities promoting London as a international centre for sukuk issuance to rival Bahrain, Dubai and Kuala Lumpur.
In addition to banking, Islamic sukuk security issuance has enormous potential. Unlike conventional bonds and notes, sukuk are backed by real assets, which provides assurance to investors.
Although global sukuk markets were adversely affected by the global recession in 2008, longer term prospects look promising, with the United Kingdom authorities promoting London as an international centre for sukuk issuance to rival Bahrain, Dubai and Kuala Lumpur.
The Malaysian ringgit sukuk market has been largely unaffected by the global turmoil in securities markets, and issuers such as the Saudi Arabia Basic Industries Corporation, one of the world's largest petrochemical producers, view sukuk as a desirable instruments to raise funding for plant expansion.
There can be no doubt that Islamic finance has an exciting future, and the quest for a financial system based on moral values rather than greed and fear, is bound to enhance its position in the global system.

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