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Banking on Integrity: The Prospects of Islamic Finance in a Diverse World

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Abstract

As expounded by Hyman Minsky, the present-day financial system demonstrates that stability can be ultimately destabilizing in the long run. The world is now in the midst of the worst financial crisis and desperately looking for a viable solution towards a sustainable financial system. Can Islamic finance provide an alternative and sustainable financial system? In the Islamic model, the risk-averse depositors will have security of deposit at all times given that their deposits will be ١٠٠% risk-weighted. The banks will also not be able to deploy the funds deposited in wadiah accounts. As a result, there will be no cause for bank runs and no need for a deposit insurance scheme and costly lender of last resort measures. In reality, deposit insurance schemes only end up subsidizing the banks by enabling them to mobilize risk-free low-cost deposits and channel them towards even more risky credits for higher return margins.

It is a well-researched fact that the major cause of the current financial turmoil and most of the previous financial crises is excessive leverage. Islam discourages debt in general, and in particular, incurring debt for living beyond one's means or to grow one's wealth. Instead, Islam encourages investments through direct risk-bearing ventures such as mudarabah (investment trust). Similar to the conventional investment trust, if the underlying mudarabah investment performs well, investors share in the higher return. Conversely, if the investments perform poorly they receive a lower return. In the Islamic model, the financial institution will not guarantee a fixed rate of return to the investors. The mudarabah investments will be treated as off-balance sheet assets and will be ٠% risk-weighted for capital adequacy purposes. Interestingly, this is comparable to the model advocated by the Chicago Plan in the ١٩٣٠'s and the prominent economists who opposed the fractional reserve banking. However, this alternative financial model, which is far stable than the existing one, has not been adopted for various reasons in the past. Will this alternative financial model get implemented now?

Key word: financial crisis, leverage, mudarabah, musharakah**,** financial Intermediation.

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١ The views herein are personal views of the author and any feedback can be sent to rafehaneef@yahoo.com.

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Introduction

The ongoing global financial turmoil has prompted many to question the integrity and the sustainability of the existing financial system. Regulators are blaming bankers' greed as the root cause of the unfolding crisis. Bankers are blaming regulators for prolonging a low-interest rate environment that forced banks to seek riskier assets to remain profitable. Mortgage lenders have been blamed for booking sub-prime assets and perpetrating predatory lending. Sub-prime lenders blame the securitization and credit derivative markets for forcing them to scrape risky assets from the bottom of the credit barrel. Others blame the ratings agencies for failing to analyze the risks involved in packaged securitized products, assigning inflated ratings for risky portfolios. Many blame investors for demanding high returns even in a low-rate environment; which prompted investment managers to assume risky strategies that yielded high returns. Accountants have been blamed for the off-balance sheet treatment of securitization vehicles like the Qualified Special Purpose Entities ("QPSE") that contributed to the excessively high leverage in the system.

The present-day system demonstrates that stability can be ultimately destabilizing in the long run. As expounded by Hyman Minsky, long periods of stability have lead to complacency in lending practices, causing debt to evolve from manageable debts (like amortizing home loans where the borrowers can afford both principal and interest payments), to speculative lending (like interest-only mortgage where the borrowers can only afford interest payments and principal will be payable at the end of the loan term), to eventually the riskiest "Ponzi" lending (like sub-prime mortgage, which required no initial down payment, a reduced fixed interest rate for two years, and an option to pay interest by adding back to the principal amount). When the Ponzi gamble failed, i.e. when house prices started falling and interest rates rising, the loan servicing became untenable, leading to defaults and asset sales, which further brought down asset prices due to the flood of supply on the market, and brought about the start of a downward cycle and "domino effect" which rippled through borrowers defaulting, creditors tightening and eventually the banking system nearly collapsing. The world is now in the midst of the worst financial crisis and desperately looking for a viable solution towards a sustainable financial system. The following discussion highlights the prospects of Islamic finance providing an alternative and sustainable financial system provided there is a strong political will to reform the existing financial landscape.

Time to Replace the Fractional Reserve Model

Under the current system, risk-averse depositors place their funds in bank deposits which usually pay a nominal interest rate. Under the fractional reserve banking model, the banks will retain a certain amount (average ٨%) of deposits and deploy the rest through loans at a higher interest rate to a diversified pool of borrowers. In reality the risk-averse depositors (savers) are lending money to banks at low rates without any form of security (other than deposit insurance) or restrictive covenants to monitor the lending activities of banks. In theory, the savers rely on the banks ability to lend prudently and diversify their loan portfolio based on the banks' ability to gather and monitor information on borrowers; but given that banks always keep such information private this often leads to adverse selection and moral hazard problems. Banks often end up making loans to risky borrowers to earn

higher returns to the detriment of the depositors who don't share in the bank's upside and lack the incentive and ability to monitor the lending activities of the banks.

Following the Great Depression in the ١٩٣٠s, a group of economists from the University of Chicago presented a banking reform plan to President Roosevelt. The Chicago Plan primarily proposed the abolition of the fractional reserve model and the separation between commercial and investment banking (i.e. payment and capital deployment activities), among other banking reforms. The opponents of the fractional reserve system have included prominent economists such as Irving Fisher, Frank Knight, Milton Friedman, Murray Rothbard and Ludwig von Mises. Unfortunately, the Chicago Plan was only partially adopted under Roosevelt's New Deal program. Despite the ١٩٣٣-٣٥ periods seeing one of the greatest dislocations the U.S. economy and the collapse of the financial system, the proposal to abolish the fractional reserve system was dropped due to strong lobbying by bankers, who directly benefited from the status quo model. Ultimately, fractional reserve banking has left the door open for banks to assume even greater risks and expose the depositors to bank failures.

Principle of "No Risk, No Reward"

In working to alleviate the systemic banker-depositor incentive mismatch which, as currently seen, can spiral out of control, an Islamic financial system proposes for the risk-averse savers to deposit their savings in wadiah accounts (like demand deposits) which will not generate any returns to savers. The key Islamic principle that governs all investments is "al-ghurm bil ghunm" (risk is with reward or, conversely; no risk, no return). Since the savers demand no risk, they are not entitled to any return. The banks will also not be able to deploy the funds deposited in wadiah accounts, which will have to be ١٠٠% risk-weighted. The banks may end up charging a service fee to the risk-averse savers for keeping their deposits safe and providing the payment functions through branches, ATMs, etc. Further, the depositors will be liable to pay zakah (a form of wealth tax) if the funds kept in the wadiah accounts meet certain zakah conditions. Interestingly, this is comparable to the model advocated by the Chicago Plan and the prominent economists who opposed the fractional reserve banking. In the Islamic model, the risk-averse depositors will have security of deposit at all times given that their deposits will be ١٠٠% risk-weighted. As a result, there will be no cause for bank runs and no need for a deposit insurance scheme and costly lender of last resort measures.

Deposit Insurance Scheme Subsidizes Banks

Instead of strengthening the banking system by abolishing the fractional reserve model, various governments across the globe have introduced deposit insurance schemes that insure depositor funds up to a certain amount, for example up to $٢٥٠,٠٠٠ in the US. Many, including President Roosevelt who established the Federal Deposit Insurance Corporation (FDIC) during the New Deal era, have opposed deposit insurance schemes on moral hazard grounds. Due to political expediency, the Roosevelt administration ended up introducing the deposit insurance scheme in an effort to strengthen the fractional reserve system. In reality, deposit insurance schemes only end up subsidizing the banks by enabling them to mobilize risk-free low-cost deposits and channel them towards even more risky credits for higher return margins. The risk-averse depositors are content with the low rate of return as long as their deposits are insured. Even uninsured depositors are not too

concerned with the excessive risks taken by the banks given that FDIC have often protected uninsured depositors when “too big to fail” or “systemically critical” financial institutions get into trouble. As pointed out elsewhere, the subsidy in fact increases in value for the banks as they take on progressively greater risk, providing an additional incentive for a risk preference.

Whilst deposit insurance schemes may prevent bank runs and contagion effects in the short-run, they often encourage excessive risk taking that in the long-run increases bank failures and financial crises. Since the FDIC’s inception in ١٩٣٤, a total of ٣٥٦٥ bank failures have been noted - averaging around ١٠ per year between ١٩٣٤ and ١٩٨١ but rocketing to between ١٠٠ and ٣٠٠ per year from ١٩٨٢-١٩٩٢ (peaking at ٥٣٤ failures in ١٩٨٩). There may be even more banking failures in ٢٠٠٩, with already ٢٨ failures recorded between ٢٠٠٧ and ٢٠٠٨.[٣] Further, deposit insurance schemes always run the risk of mispricing the insurance premium payable by banks due to the fact that premiums are calculated on ex-ante basis. For example, FDIC’s total pay-out to insured depositors of failed banks often exceeds the total inflow from bank insurance premiums. Even the newly introduced risk-based premium does not remove the moral hazards risk. It is very hard – and costly- for a deposit insurer to even evaluate the bank’s loan book, let alone a complicated portfolio of financial derivatives.

Debt-based Financial Intermediation is Unsustainable

Because banks have access to cheap deposits subsidized by the deposit insurance schemes, banks are able to offer cheap and easy credit to their customers. For banks to achieve revenue growth, consumers are enticed and bombarded through clever marketing to borrow and live beyond their means. Corporations invariably resort to high leverage to improve their return on equity to appease shareholders. Such excessively high leverage in the system inevitably leads to excessive aggregate demand in the economy which rapidly builds inflationary pressures. To avoid a financial crisis, regulators will usually respond by shrinking the money supply through interest rate hikes or other monetary tools with the hope of reducing credit expansion and aggregate demand. When credit becomes expensive and scarce, individuals and corporations will struggle to repay their debts and bankruptcy, insolvency and unemployment rates will increase. The process of deleveraging will begin and increase the severity of the financial crisis. Some regulators dread this painful process and opt for a softer landing which sometimes leads to a bigger problem. The current US financial crisis is a case in point.

When the investors ‘irrational exuberance’ fueled by excessive leverage led to the stock market bubble in the US in the ١٩٩٠s and subsequent collapse, the Federal Reserve decided to cut interest rates to avoid a financial crisis. The Fed maintained a low-rate environment for almost a decade and banks consequently went on a lending-frenzy. The lower cost of deposits incentivized banks to offer even more easy credit at even cheaper rates. Predictably, the corporate and personal debt levels increased to unprecedented levels. For instance, the household debt level in the US and UK increased rapidly from around ٦٠% of GDP in the ١٩٩٠s to more than ١٠٠% of GDP by ٢٠٠٨. Further, the low-interest rate environment facilitated prime credit to borrow at incredibly low rates. Banks were then

[٣] http://www٢.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=١٩٣٤&EndYear=٢٠٠٨&State=٢

compelled to lend to risky credit grades at higher rates in order to boost their profitability in an otherwise low return environment.

Basel II Failed to Discourage Excessive Risk-taking

Under Basel II, banks that partake in higher risk lending - in pursuit of higher returns - are required to allocate higher capital to commensurate with risk levels assumed. In theory, banks will avoid excessive risks in order to avoid allocating more risk-weighted capital to their reserves, which in turn reduces their return on equity. However, due to accounting loopholes banks were able to devise off-balance sheet solutions which gave them access to risky assets and excessive leverage without the need to commit any capital. The banks incentivized intermediaries - such as mortgage brokers - to book sub-prime assets which the banks underwrote and securitized through the off-balance sheet vehicles in return for a high fee income. Banks were prepared to extend loans to risky borrowers given they ultimately packaged and sold on the risk, hence keeping their balance sheet free from risk exposure. But, when the off-balance assets become non-performing due to the economic downturn, the banks were forced to treat them as on-balance sheet due to their ‘retained interest’ in the off-balance sheet assets or due to reputational risks. Suddenly, the leverage ratio of banks increased multi-fold and led to high profile bank failures due to inability to inject more capital to meet regulatory requirements.

Shift Towards Equity-based Financial Intermediation

It is a well-researched fact that the major cause of the current financial turmoil and most of the previous financial crises is excessive leverage - an inherent consequence of the current debt-based financial system. Islam, on the other hand, discourages debt in general, and in particular, incurring debt for living beyond one's means or to grow one's wealth. Debt should be considered as a last resort in economic transactions. To promote a debt-free lifestyle, Islam strictly prohibits the loaning of surplus funds on interest. Instead, Islam encourages investments through direct risk-bearing ventures such as mudarabah (investment trust). Similar to the conventional investment trust, if the underlying mudarabah investment performs well, investors share in the higher return. Conversely, if the investments perform poorly they receive a lower return. In the Islamic model, the financial institution will not guarantee a fixed rate of return to the investors. The mudarabah investments will be treated as off-balance sheet assets and will be ٠% risk-weighted for capital adequacy purposes. Given that the financial institution and investors have to share the risk and reward of the underlying investments, the financial institutions will become more prudent and engaged in managing the assets. If their portfolio is not performing well the financial institutions will not be able to attract more investments. There is no deposit insurance to help them attract cheap deposits. Additionally, investors may liquidate their investments in a low-performing portfolio and re-invest with another manager offering a better performing portfolio.

It is believed that the Islamic model will ensure that: (i) financial institutions are more prudent in managing the assets and disincentivized from taking excessive risks; and (ii) investors would be incentivized to exercise adequate market discipline on financial institutions. Interestingly, a similar approach was proposed by the Chicago Plan which advocated: (i) a ١٠٠% reserve for all demand deposits; (ii) a ٠% reserve for investment trusts; and (iii) no deposit insurance. More recently, the Narrow Banking and Core Banking

proposals have also advocated the separation between the deposit-taking and lending activities of banks. Arguably, most savers are risk-averse and are envisioned to place their deposits in "risk-free" wadiah accounts, which will remain as idle capital and create a drag on the economy's growth potential by constraining the flow of capital in the system. However, the Islamic model has a number of factors that incentivize the risk-averse depositors to invest more of their savings in mudarabah investment accounts through the following deterrents: (i) a wadiah account "custody" fee, (ii) zero wadiah account return, (iii) zakah obligation (exclusive to Muslims), and (iv) general inflationary pressures. Financial institutions will also be incentivized to create a range of investments with a broad risk-reward spectrum to attract investors with different risk profiles. For example, if savers prefer a low risk-low return profile, the financial institutions will offer mudarabahs which invest in low risk investments, such as government asset-backed obligations. The financial institutions will have to differentiate themselves on superior investment and risk mitigation strategies, and returns within the risk spectrum to attract and retain funds from investors. They will also prefer investments in productive assets and will avoid "unproductive" assets to remain competitive.

The Islamic system will also need to be regulated to ensure, among others, that (i) the wadiah funds are safe and secure; (ii) investors are given adequate information disclosure on mudarabah investments; (iii) there are no conflict of interest or illegal investments; and (iv) the marketing is not misleading, confusing or deceiving. To put some "skin in the game", the regulators can require financial institutions to also co-invest in their fund portfolio (known as musharakah or partnership financing). The nature of regulation, hence, may be a hybrid between banking and securities industry regulation. Certainly, a lot more research needs to be conducted to ensure the gradual transition to the alternative Islamic model is not disruptive to the economy. Without such a transition, Islamic finance will never become an alternative and sustainable financial model.

Islamic Finance in a Subsidized Conventional Financial System

Over the last three decades the Islamic finance industry has been slow to establish a meaningful presence as an alternative and viable financial system. Its roots are based in economic values cherished by all humanity, such as the equitable distribution of wealth and sustainable economy achieved through a fair system of capital intermediation. Islamic banking, established with these values in mind, had in the beginning tried to promote capital intermediation through profit and loss sharing mechanisms involving mudarabah and musharakah. The savers were invited to invest their surplus funds through mudarabahs managed by the Islamic banks in return for a share of their profit. The Islamic banks neither guaranteed the principal nor the returns. The Islamic banks then offered Muslim customers (e.g. corporates) to obtain financing on a mudarabah and musharakah basis. The Islamic capital intermediation model is comparable to the investment trust model (٠% reserve) advocated by the Chicago Plan. It is a fairer system compared to the prevailing financial system which is built on debt intermediation. Savers would generate a higher return when corporates earn greater profits during an economic boom period, and a lower return (or may even lose their investment) during an economic downturn. Hence corporate financing would be linked to their operating cash flow, paying more during good times and less during bad times. There would be no bank runs per se in bad times due to the fact that the banks do not guarantee the principal used in investing. Undoubtedly, the investors will be exposed

to the risks and moral hazards of mudarabah and musharakah investments and will need to mitigate those risks by choosing the right manager with the right track record and investment strategy. Obviously, this will require effort and due diligence on the part of the savers and some, if not most, will not have the expertise or capacity to evaluate the risks and mitigants involved. According to conventional wisdom, due to the depositors' lack of expertise or capacity, their savings in bank deposits must be protected through deposit insurance and lender of last resort measures.

When the Shariah promotes mudarabah and musharakah investments, it is not oblivious to the fact that not all savers will have the same the capacity to understand and measure the risks and mitigates. The Quran clearly states that:

انْظُرْ كَيْفَ فَضَّلْنَا بَعْضَهُمْ عَلَى بَعْضٍ وَلَلآخِرَةُ أَكْبَرُ دَرَجَاتٍ وَأَكْبَرُ تَفْضِيلا

"See how we have bestowed more on some than on others; but verily the Hereafter is more in rank and gradation and more in excellence. (Al-Isrâ' [١٧:٢١])"

If some of the investors fear that they do not have the capacity to evaluate the risks in mudarabah investments and to assume the risks involved, the shariah does not force them to invest in mudarabah or musharakah investments. The Quran emphatically states that:

وَلا نُكَلِّفُ نَفْسًا إِلا وُسْعَهَا وَلَدَيْنَا كِتَابٌ يَنْطِقُ بِالْحَقِّ وَهُمْ لا يُظْلَمُونَ

On no soul do We place a burden greater than it can bear: before Us is a record which clearly shows the Truth: They will never be wronged. (Al-Mu'minûn [٢٣:٦٢])

For those who do not have the capacity or appetite to assume mudarabah risks, the Shariah alternates are for them to store their money at home or in a wadiah account with Islamic banks. The Shariah maxim makes it very clear that unless savers assume risk, they are not entitled to any return. Unfortunately, when Islamic banking emerged, conventional banking practices were already deeply entrenched in the Muslim world. Savers were accustomed to receiving nominal returns on their bank deposits – which, as previously highlighted, are effectively government, guaranteed risk-free investments. Naturally, Muslim savers also wanted a risk-free Islamic product alternative. To remain competitive, Islamic banks were forced to offer hybrid mudarabah and wadiah accounts to their customers. The mudarabah investment accounts were treated as on-balance sheet liabilities of Islamic banks, similar to a conventional deposit, and banks would be required to set aside a portion of their capital reserves to protect the Islamic saver deposits, identical to the treatment for conventional deposits. Islamic banks provided mudarabah returns which were structured to be invariably similar to a subsidized conventional risk-free deposit. For example if a ٣-month conventional bank deposit pays ٣%pa, the profit sharing in a ٣-month hybrid mudarabah investment will be 'structured' to offer a similar return of ٣%pa.Islamic banks also make a periodic 'gift' (hiba) to those savers who place their funds under wadiah accounts which are also provide comparable returns to conventional bank deposits. From a classical Islamic jurisprudence (fiqh) perspective, a mudarabah is not a risk-free investment and should be treated as off-balance sheet. In addition, there is no justification for a discretionary gift payment to wadiah deposit account holders in the classical form of the contract. By contrast, in light of the risks involved, mudarabah investors should be entitled to a higher return compared to the risk-free conventional deposits, and wadiah depositors could be required to pay a fee to the banks for safe-keeping of their funds.

As highlighted, access to cheap deposits subsidized by the government allows the conventional banks to offer cheap loans to the customers. At attractive rates, debt enables a “buy-now-pay-later” consumer culture, and enables corporates to increase their return on equity for their shareholders. However, if Islamic banks were to offer mudarabah financing to corporates sourced from unsubsidized mudarabah deposits (which offer higher returns to its depositors compared to conventional deposits), corporates will have to part with a higher profit amount with the Islamic banks in good times given the profit-and-loss sharing nature of the transaction. The effective cost of the mudarabah financing would be greater than the cheap loans conventional banks would be able to offer. Profit-maximizing corporates would consequently prefer the cheaper conventional loan than the mudarabah financing alternative.

As a result of the market realities, the described typical corporate behavior forced Islamic banks to shift from a classical mudarabah financing structure to debt-type financing such as the hybrid murabaha, ijarah and istisna structures, where customers incur a fixed financing rate similar to the conventional loans. Arguably, there will be a minority of customers who prefer the classical mudarabah and musharakah solutions, which have been successful in some markets such as Sudan, Iran and Indonesia (during the aftermath of the Asian financial crisis). But a closer analysis evinces that the cost of debt financing in those countries was so high so as to almost equal to the cost of equity financing. In such a high inflationary environment, the customers were rather agnostic towards debt or equity financing given the parity in costing. In fact given the macro circumstances, there may have been a preference for equity financing given the fact that the loss is also shared by the banks, unlike in conventional debt financing. Indonesia saw the issuance of a number of mudarabah sukuk - with true profit-and-loss sharing economics - during the late ١٩٩٠s. However, when the Indonesian economy recovered after the Asian Crisis, most of mudarabah Sukuk were quickly refinanced through debt financing alternatives when the fund market became amenable. There has not been a classical mudarabah Sukuk since then in Indonesia.

Conclusion: Promote Good and Forbid Evil

The stark reality is that due to the fractional reserve system and deposit insurance scheme prevalent in the conventional banking system, the Islamic banks are facing an unlevel playing field in terms of pricing dynamics. Savers are not incentivized to invest in classical mudarabah investments. In addition, Muslim savers also demand the benefits of risk-free accounts in addition to returns, which require Islamic banks to offer hybrid mudarabah and wadiah accounts. Furthermore, corporates have no incentive to share their upside with Islamic banks under a classical mudarabah financing when they can obtain cheap loans from the subsidized conventional financial system. Islamic banks are induced to offer hybrid murabaha, ijarah, istisna, mudarabah and musharakah solutions with fixed returns to cater to market demands. The prevailing practices of Islamic banks have provoked severe criticisms from many quarters, including recently, from the eminent scholar Sheikh Taqi Usmani. The underlying constraint is that due to the prevailing subsidy in the conventional financial system, it is almost impossible to promote the sound financial products and solutions of Islamic banking. The Quran unequivocally states:

كُنْتُمْ خَيْرَ أُمَّةٍ أُخْرِجَتْ لِلنَّاسِ تَأْمُرُونَ بِالْمَعْرُوفِ وَتَنْهَوْنَ عَنِ الْمُنْكَرِ وَتُؤْمِنُونَ بِاللَّهِ

You are the best of Peoples, evolved for mankind, enjoining what is right, forbidding what is wrong, and believing in Allah.

This verse reminds us of the collective responsibility to promote the goodness in Islamic banking as well as to correct the wrongful practices in conventional finance. One cannot harvest the goodness of Islamic finance unless the wrongs of conventional finance are made good. This is one of the many valuable lessons that we can learn from the current global financial crisis. What is needed now is strong political will to initiate and complete the gradual transition process of the conventional financial system as advocated by the Chicago Plan and other similar proposals towards a Narrow Banking and Core Banking framework. Only then can a truly Islamic financial system be nurtured that is in line with the letter and spirit of the glorious Shariah. President Roosevelt missed a great opportunity seven decades ago. Let us not miss this opportunity now.