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**Will The Islamic Financial System Fall Into The Financial Crisis Trap?
Some Lessons to be Learnt**

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Flows of Presentation

- Introduction
- The Framework of Conventional Monetary System
- The Instability of Conventional Monetary System
- Islamic Financial System; Principles & Its Development
- Conceptual Analysis & Findings
- Conclusion & Recommendation

Introduction

- *“The financial market crisis that erupted in August 2007 has developed into the largest financial shock since the Great Depression, inflicting heavy damage on markets and institutions **at the core of the financial system.**”*

- International Monetary Fund, World Economic Outlook, April, 2008

Table 1: Market Value for Selected Financial Institutions

Financial Institutions	Market Value (\$Billion) as of Q2 2007	Market Value (\$Billion) as of Jan 20th 2009
M. Stanley	49	16
RBS	120	4.6
Barclays	91	7.4
UBS	116	35
JP Morgan	165	85
Citigroup	255	19

Table 2: Unemployment (Annual % Change)

	2007	2008	2009*	2010*
			The sign (*) indicates the projections by IMF	
Advanced economies	5.4	5.8	8.1	9.2
Emerging economies	3.4	3.5	4.9	4.9
United States	4.6	5.8	8.9	10.1
Euro areas	7.5	7.6	10.1	11.5

Figure 1: World's GDP Growth

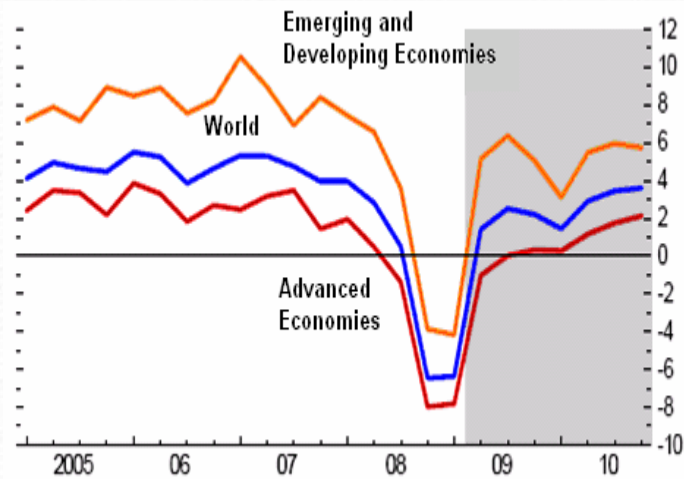


Figure 2: Consumer Price (Annual % Change)

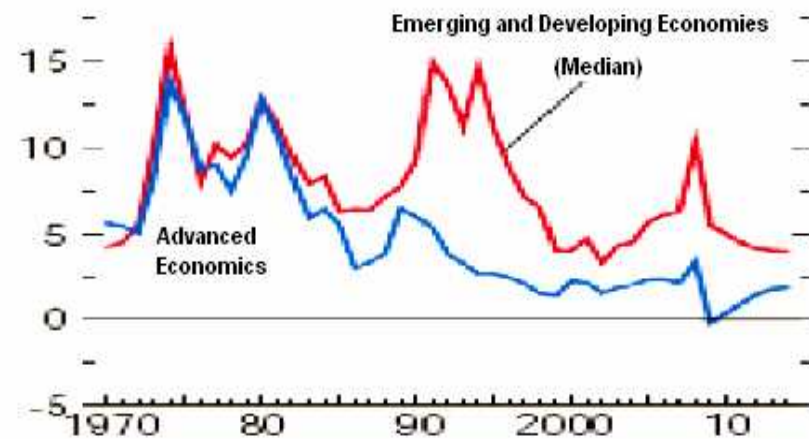
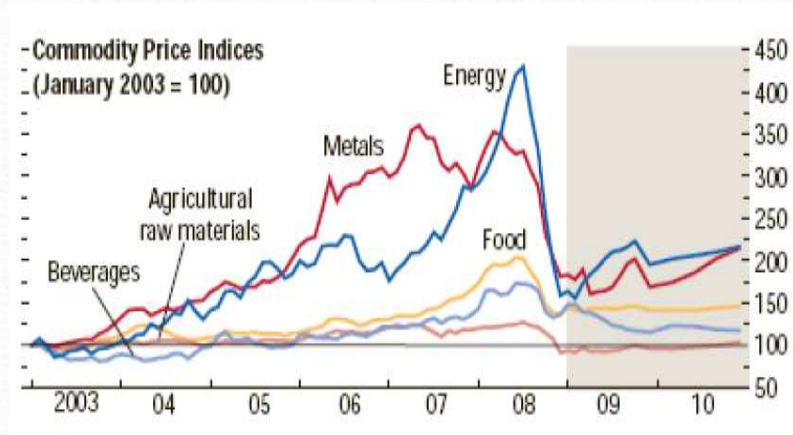


Figure 3: Commodity Prices Indices



The Basic Framework of Conventional Monetary System

- **Fiat Money**

- Paper money that is not backed by gold or any tangible assets

- Meera (2002) classifies fiat money is money created out of nothing by the power of an issuing authority especially central banks

- Created by government and commercial banks

The Basic Framework of Conventional Monetary System (cont'd)

- **Fractional Reserve System**

- Banks keep only a fraction of their deposits in reserve (as cash and other highly liquid assets) at central bank and lend out the remainder
- The amount of reserve required is less than 100 percent
- Can be used by the central banks as a tool it to act as lender of last resort to the financial institutions which are under unfavorable circumstances

The Basic Framework of Conventional Monetary System (cont'd)

- **Interest Based System**

- Can be found from the lowest level of intermediation (interest bearing consumption loans) until the highest degree of monetary policy.

- The interest rates are computed on compounded basis and they expand exponentially

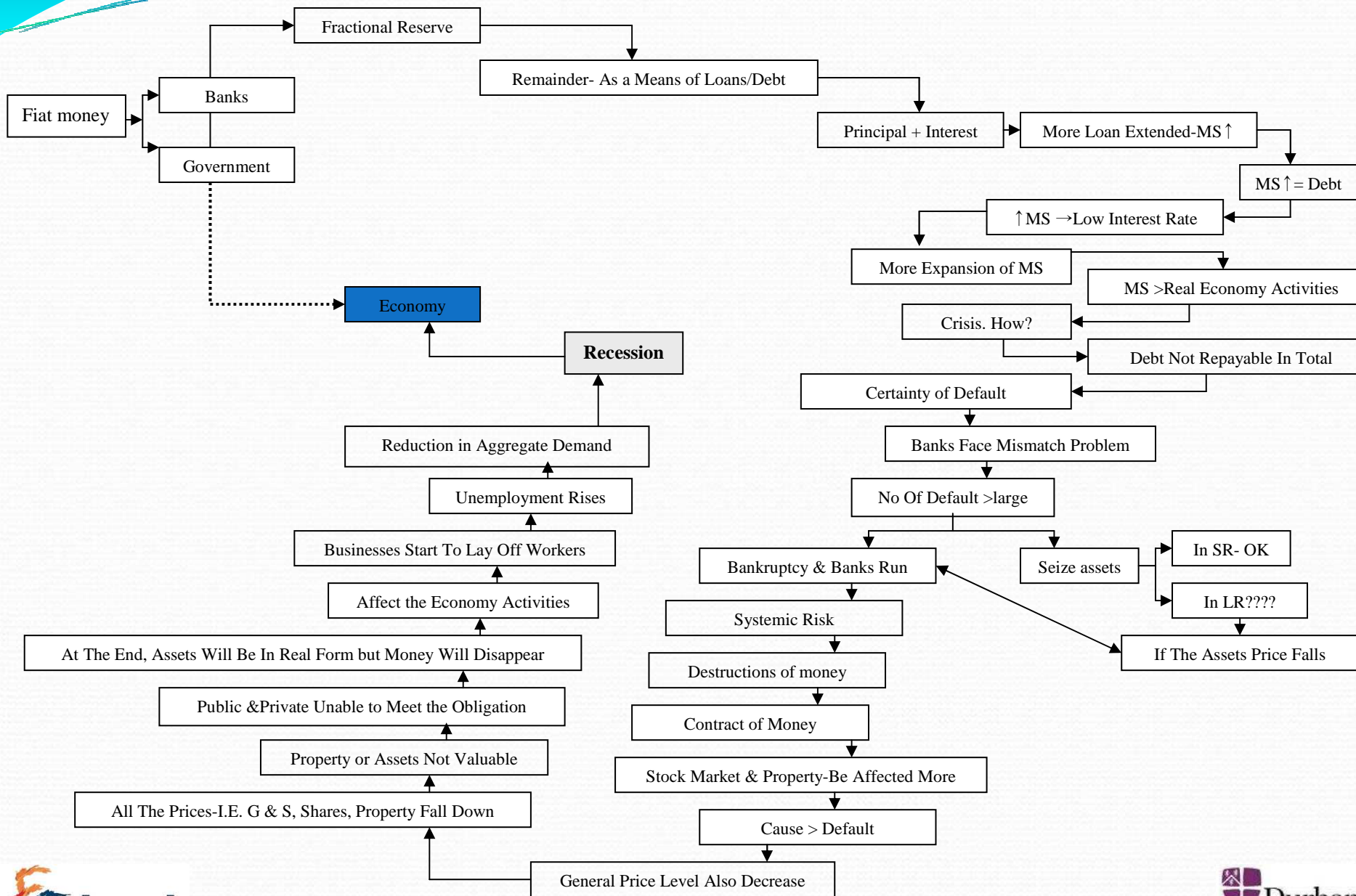
The Instability of Conventional Monetary System

- Leaven and Valencia (2008), about 400 financial crises had happened since after 1970s
- Include systemic banking crisis, currency crisis, and debt crisis which is associated with the financial institutions
- Financial institutions and real economy activities are interrelated
- Due to this reason, financial crisis hampers the economy activities at the end.

The Instability of Conventional Monetary System (cont'd)

- What are the roots causes for recurrent financial crisis (not just limit to the current global financial crisis but since after 1970s)??????
- Due to the mechanisms of current monetary system, namely fiat money, fractional reserve system and interest based system

Circular Flow of Financial Crisis



Islamic Financial System

Shariah Principles Pertaining to Transactions

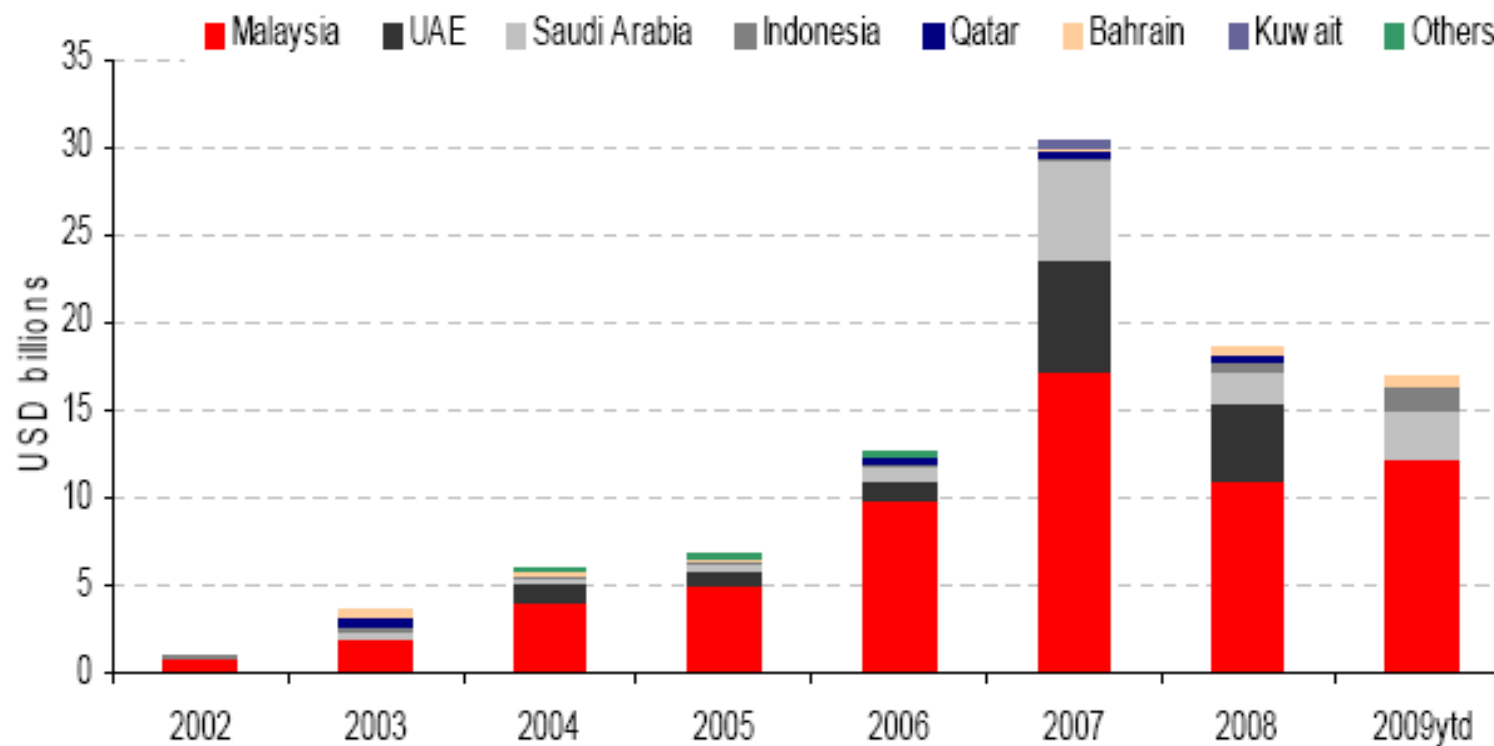
(*Muamalah*)

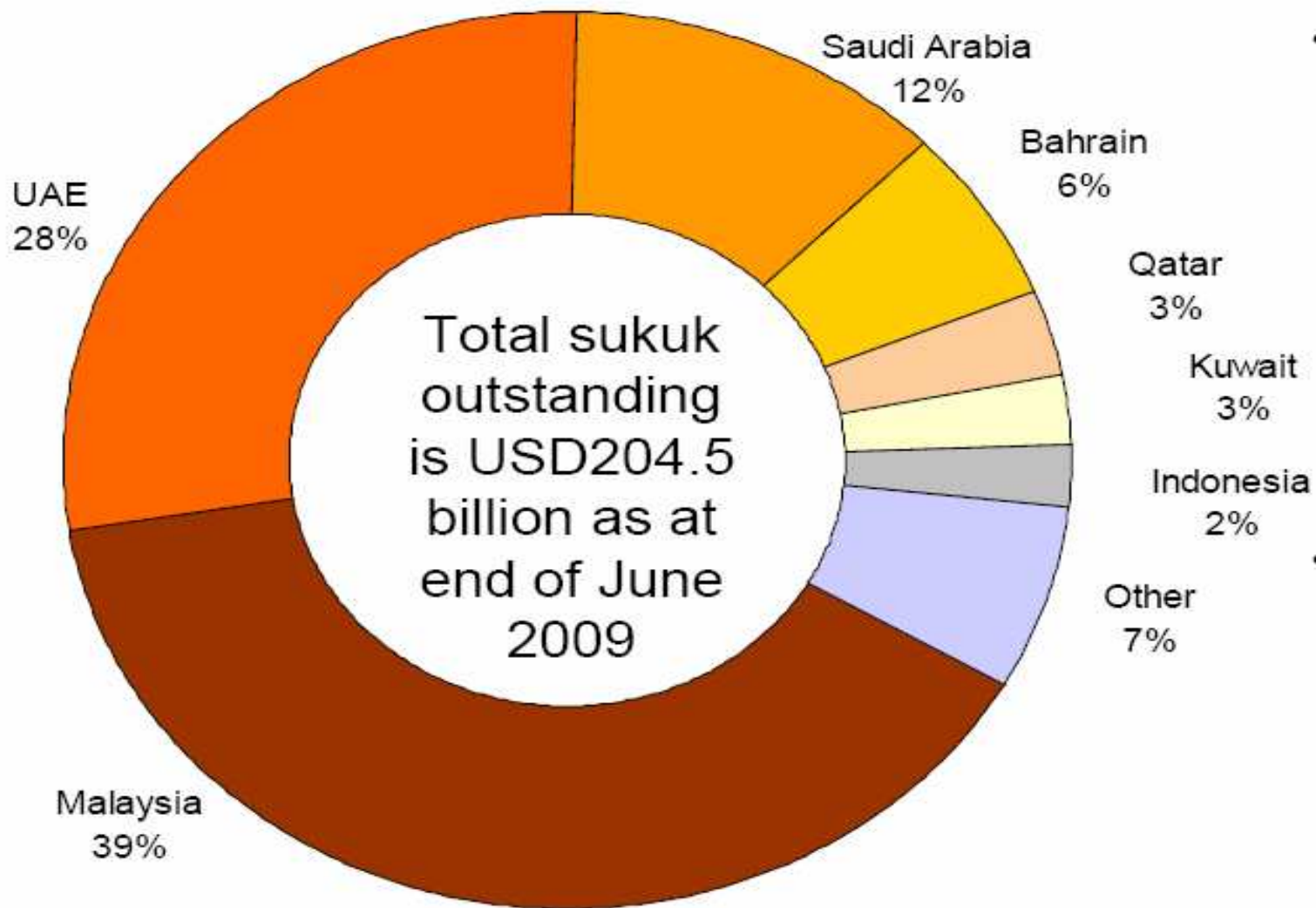
- Financial contract must be both *Halal* (permissible) and *Sahih* (valid)
- Based on justice, equal distributions, mutual cooperation, and fairness
- *Shariah* also seeks for risk sharing transactions, emphasizes more on productivity and put forward on the moral dimensions
- Prohibitions of *Riba*, *Gharar*, *Maysir*, *Ihtikar*,
- *Shariah* also justifies the profit based on the concept of *Iwad* which means the profit is made from effort (*Al-Kasb*), risk (*Al-Ghurm*) and liability (*Al-Dhaman*)

Development of Islamic Financial System

- Its market share of assets has raised from 2 per cent in the late 1970s to 15 per cent up to the mid-1990s (Yousef, 1996).
- There are about 300 Islamic financial institutions across 70 countries, holding capital investments worth US\$500-800billion, with an average annual growth of 15 per cent (Arekat, 2006).
- The Sukuk market had, until 2008, doubled in value every year since 2004, although its issuance had dropped in 2008 (down 54.5 per cent from 2007 to US\$15.1b).
- The *Takaful* industry also expected to grow at between 30% and 40% annually in the next three to five years.
- Islamic banks also present as niche players in Europe and the United States.

Total Sukuk volume issued globally close to USD 100 bn.





Conceptual Analysis & Findings

- The stability of Islamic finance has become a main concentration by many financial experts, analysts and economists especially in the present days
- Due to the ability of Islamic finance to withstand from the global financial crisis
- But how far the truth that Islamic finance will not fall into the financial crisis trap?
- If there is possibility to fall into the crisis, what lessons can Islamic finance learn from the current global financial crisis

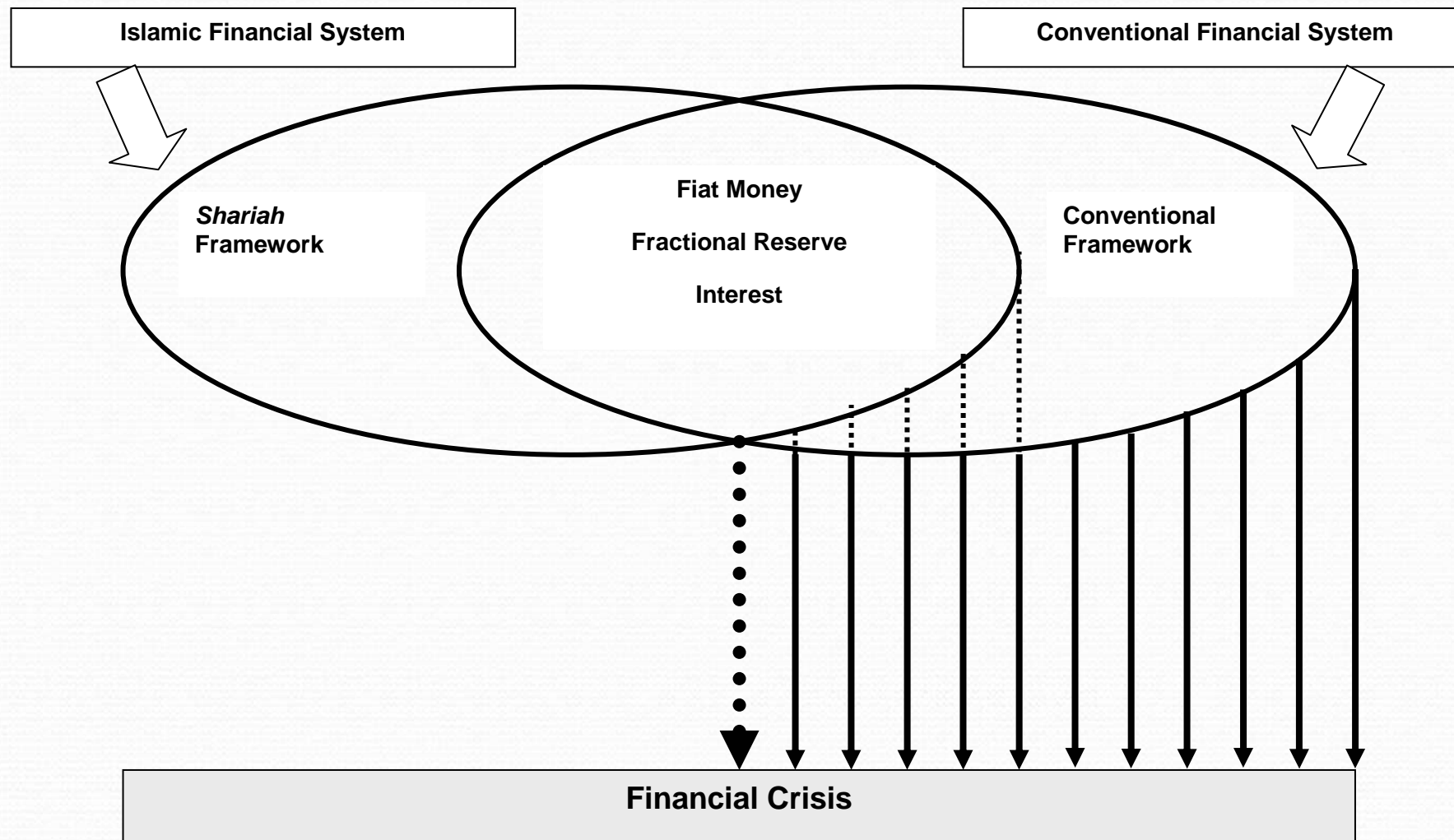
Conceptual Analysis & Findings (cont'd)

- Evidences show that Islamic finance now converging back to its conventional counterpart (Meera and Larbani, n.d)
- Mirakhor (2009) claims that without its own institutional framework, Islamic finance become indistinguishable from a conventional system.
- Islamic finance in some ways is moving more and more closely to the conventional finance by mimicking most of the products of conventional finance (comments by Professor Habib Ahmed, from Durham University)

Conceptual Analysis & Findings (cont'd)

- Overall, we can say that the Islamic financial system is operating within the mould of the conventional monetary system framework in line with fiat money, fractional reserve system and interest based system
- These elements become a parameter to say that the Islamic financial system might fall into the financial crisis trap through convergence with the conventional framework

The Conceptual Framework and Reasons of Financial Crisis



Cont'd..

- The reliance of Islamic financial system on conventional framework will lead to certainty to fall into financial crisis if the gap (the length of arrows are used to reflect the gap) fully converge at the point where both systems interrelated at maximum point (midpoint of the open shape of circle)

Justifications

- Is there Islamic financial system has its own institutional framework?
- Is there newly printed money (money creation by Islamic banks) backed by any commodities or gold?
- Does the Islamic financial system operate without fractional reserve system?
- Is there any other benchmarks used by Islamic finance instead of interest rate itself?
- We can say - **‘NO’**

Justifications (cont'd)

- Money is printed out of thin air or created out of nothing
- Both government and Islamic banks together create or inject the money into the economy system and this situation will bring harm to economy system at the end as discussed in earlier part
- Instead of where these elements come from, the current Islamic financial system tends to answer how to use such as money according to *Shariah* principles.

Justifications (cont'd)

- Though the Islamic banking system is different from the conventional banking system in terms of its theoretical principles but in terms of operational, Islamic banking seems to converge with the conventional's framework
- The tenets which belongs to Islam such as justice, equality and fairness will not be uphold if Islamic financial system mixed their operations with the conventional monetary system's framework
- In LONG RUN- Islamic financial system might fall into financial crisis trap

Conclusion and Recommendation

- In today's global banking systems, both Islamic and conventional financial institutions are highly volatile due to these mechanisms (fiat money, fractional reserve system and interest based system)
- These three major mechanisms are becoming a main culprit of the monetary system where the problems are the continual financial crises

Conclusion and Recommendation (cont'd)

- The need of a new financial architecture to replace the existing financial system.
- In this context, the Islamic financial system can be considered as an effective solution for current financial crisis and alternative financial system if it operates within its own institutional framework instead of imitating conventional institutions which is already impaired.
- There is a hope that Islamic financial system can become a new financial architecture system which promotes the stability and sustainability accordance with the *Shariah* principles.

O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, **take notice of war from Allah and His Messenger:** but if ye turn back, ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly.

Al-Baqarah: 278-279

Thank You!