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After the Meltdown: New Perspectives on Islamic Finance

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The recent financial meltdown marked a turning point in the evolution of Islamic finance. Prior to the meltdown, Islamic finance was often dismissed in conventional circles, even among those who recognized its moneymaking potential. The idea of creating an alternative to conventional finance, and specifically the intrusion of the religious element in what was supposed to be a quintessentially secular realm, struck many as somewhat bizarre, especially at a time when conventional finance was riding high and seemed to provide a universally applicable model. A different kind of criticism was that Islamic finance was simply conventional finance dressed up in Islamic garb. It was thus at best an attempt to "reinvent the wheel"—and an expensive exercise at that—since the additional layer of control and documentation imposed by the *shari'a* boards added costs and generated inefficiencies.

The argument of this paper is that the global financial meltdown has recast the debate over Islamic finance. The Islamic sector resisted rather well to the meltdown. Indeed, those products and practices that were not normally allowed under Islamic finance—debt sales, complex derivatives such as credit default swaps, high leverage, unbridled speculation—were precisely those that led to the near collapse of the global financial system. The meltdown revealed excesses and dysfunctions and resulted in calls for alternatives to conventional finance. Two aspects of Islamic finance—its inherent conservatism and its preoccupation with ethics—made it look attractive and credible and thus established its legitimacy and viability as an alternative form of finance. This paper warns, however, against the temptation to consider Islamic finance as a panacea. Indeed, the industry, still in its youth, faces many challenges that remain, not least of which is that of closing the gap between abstract principles and actual practice.

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The Failing Paradigm

On the eve of the financial crisis, "American-style financial engineering was the global gold standard."[1] The paradigm of global finance, as epitomized by major Wall Street firms, commanded near-unanimous support and was aggressively exported throughout the world.[2] For almost three decades, since the dawn of financial deregulation, other approaches to finance had steadily been losing ground. To cite one example, the once vibrant sector of mutual finance was greatly reduced through a seemingly irreversible process of "demutualization."[3] In that context, the rise of Islamic finance was somewhat incongruous. Islamic banks seemed to be fighting an age-old battle and were usually on the receiving end of lectures essentially asking them to follow the cutting-edge of finance.[4] The discourse was often dutifully repeated within the Islamic world.[5]

This discourse proved spectacularly wrong, starting with the subprime crisis of 2007. The following year, only a massive government bailout saved the financial markets, which were assumed to be all-knowing and self-correcting, from collapse. Financial innovation was supposed to improve efficiency and liquidity, yet it brought forth an outright credit freeze. Risk management was dealt with as if it were an exact science, yet as critic Robert Kuttner observed, "Supposedly, these derivatives on top of derivatives 'spread risk,' but in truth they spread risk the way an epidemic spreads diphtheria."[6]

A number of statements by Alan Greenspan, the high priest of unfettered capitalism and the man dubbed "the maestro,"[7] captured the prevailing conventional wisdom as the bubble was inflating. In 2002, just as he lowered interest rates, he claimed that "bubbles cannot be prevented or defused by financial regulators." In 2004, he asserted that "a national severe price distortion seems most unlikely in the United States, given its size and diversity." In 2005, he added that a decline in home prices "likely would not have substantial macroeconomic implications." That year he also observed that "increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago." In 2006, shortly after he left the chairmanship of the Federal Reserve Board and on the eve of the bursting of the bubble, Greenspan said, "I think the worst of this may well be over."[8]

The near collapse of global finance brought to light the consequences of nearly three decades of unbridled deregulation and the unprecedented "financialization" of the economy and society.[9] Financiers were the main actors and beneficiaries of the new "gilded age" that preceded the meltdown. In the words of Sanford I. Weill, who had assembled the Citigroup conglomerate, "People can look at the last 25 years and say this is an incredibly

unique period of time. We didn't rely on somebody else to build what we built, and we shouldn't rely on somebody else to provide all the services our society needs."[10]

The language is interesting, first because of the building metaphor, but also because it suggests that finance, once seen as providing a service to the economy, had become a self-contained, self-centered and dominant realm. In the years preceding the credit crunch, "financial engineers" were at the cutting edge of finance.[11] Indeed, since the 1980s, investment banks and other financial institutions engaged in a massive effort to hire PhD graduates in physics, engineering, mathematics and other such disciplines to create increasingly complex and highly lucrative new financial instruments. The trend toward abstraction and the heavy use of mathematical symbols had created the illusion of scientific precision.[12] More worrisome, many in the financial community started taking the engineering metaphor literally. To quote finance professors turned bankers Eric Briys and François de Varenne: "On what grounds can one reasonably expect that a complex financial contract solving a complex real-world issue does not deserve the same thorough scientific treatment as an aeroplane wing or a microprocessor?"[13]

Perhaps, as later events would show, the house of cards metaphor[14] would have been more apt, but there are other advantages to the talk about engineering. It is value-neutral and makes preoccupation with ethics or morality superfluous, if not counter-productive. In an amazing display of groupthink, the seemingly irresistible rise of finance was cheered on by an overwhelming majority of every group that mattered—including the financiers themselves, as well as regulators, academics, analysts and journalists. It is no surprise then that the financial meltdown of 2008 seemed to take just about everybody by surprise.[15] The world of finance seemed to proceed on the assumption that, as Alexander Pope would have put it, "whatever is, is good."

It became easy to forget that models were only as good as their underlying assumptions. At the height of the boom, the same finance experts asserted that "there is no divorce between the real economy and the financial economy," just as they marveled at "the vast panoply of solutions offered by international finance," railed at "fallacies, such as the supposedly demonic trend of financial speculation and its destabilizing effects" and mocked those who "express deep concerns and denounce the ascendancy of the financial economy over the so-called real economy."[16]

The period between early 2007 and the summer of 2008 was dotted with scary episodes—the most dramatic being the government-engineered rescue of Bear Stearns by JPMorgan Chase in March 2008. Yet wishful thinking was still in order. There was a common belief that the worst was over and

that the "subprime crisis" had been contained, until the collapse of Lehman Brothers in September 2008, when the financial markets effectively froze and the dominant financial paradigm effectively collapsed.[17]

The financial meltdown was thus, at least in the minds of the principal players, sudden and totally unexpected. To quote Andrew Ross Sorkin, "In a period of less than eighteen months, Wall Street had gone from celebrating its most profitable age to finding itself on the brink of an epochal devastation. Trillions of dollars in wealth had vanished, and the financial landscape was entirely reconfigured."[18] Top officials were at a loss to explain what was going on. While the Lehman drama unfolded, a perplexed George W. Bush, a former businessman and the first American president to hold an MBA, said to Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson, "Someday you guys are going to need to tell me how we ended up with a system like this."[19]

The deluge of books praising the magic of the market was suddenly replaced by works chronicling the disastrous mistakes made by financial "geniuses." (Often, the same authors who sang the praises of the infallible market later engaged in a critique of the arrogance of financial theory.)[20] Even Alan Greenspan changed his tune, conceding that he had "found a flaw" in his bedrock belief of "40 years or more" that markets would regulate themselves. "I made a mistake," he acknowledged.[21]

The Impact on Islamic Finance

The recent financial crisis could be divided into three phases. During the first phase, the decline in U.S. real estate prices drew attention to subprime loans, which had found their way onto the balance sheets of major international financial institutions through securitization. During the second phase, losses suffered by such institutions triggered claims for which major Wall Street firms and other companies, such as insurer AIG, were utterly unprepared. Indeed, through highly lucrative and unregulated credit derivatives known as "credit default swaps," high-flying financial firms had, in effect, insured countless institutions (and one another) against defaults, and now they had to pay up. As the world's leading global financial institutions discovered the time bombs on their balance sheets (in the form of toxic assets and unfunded liabilities), they realized that they were essentially insolvent: the ensuing credit freeze caused a global financial meltdown which soon spread to the real economy. The third phase of the financial crisis was thus a global economic recession, which would have turned into a depression were it not for massive government intervention worldwide to the tune of $11.4 trillion, according to the OECD.[22] It is only then that Islamic banks started to feel the effects of the meltdown.[23]

Why did Islamic institutions escape the first two phases relatively unscathed? Quite simply because many of the practices that caused the financial freeze would not pass muster with *shari'a* boards. Indeed, neither the securitization of subprime loans (which is a sale of debt) nor credit default swaps (which are the sale of promises and are rife with *gharar*) are acceptable.

Similarly, negative Islamic attitudes toward short selling were vindicated by the role short selling played in many aspects of the financial crisis[24] and subsequent limits placed on short selling of financial stocks in London, New York and elsewhere. Some old-fashioned principles, such as the distrust of excessive leverage and of open-ended innovation, proved well-founded.[25]

Reassessing Islamic Finance

A central question in the assessment of Islamic finance is whether it truly offers an alternative. The early objective of a partnership-based financial system, which would bring social and economic development to the Islamic world, was not quite fulfilled. Islamic finance chose instead to mimic many aspects of conventional finance (and there is nothing inherently wrong with this since Muslims have the same financial needs as non-Muslims), albeit through Islamic contracts and within boundaries imposed by religion.

Hence, the inevitable and legitimate question: Is Islamic finance necessary? Stated differently, does it add anything of value to the conventional banking system? Before discussing the issue, two points should be stressed. One is that the gap between promise and performance could be attributed to the youth of the industry. Modern Islamic finance only started in earnest in the mid-1970s. Its evolution has been marked by a constant process of trial and error, and its shortcomings may be unavoidable growing pains. The second point is that it would be unfair to judge Islamic institutions too harshly, considering the world's most prominent conventional institutions have not proven to be exemplars of either probity or strategic acumen. Although it could be argued that Islamic finance could still fulfill its original objectives, my argument is that the recent financial meltdown has recast the debate about the role and contributions of the Islamic sector.

The excesses revealed in the wake of the 2007–2008 financial crisis painted a different picture of the state of conventional finance. Differences between conventional and Islamic finance may, by the standards of the early promoters of Islamic finance, be modest; they are nonetheless real. And those differences, as revealed by the recent crisis, now cast Islamic finance in a different light. So, to answer the question asked earlier, Islamic finance does offer an alternative. To be sure, it is mostly by default, since for the past 30 years or so, finance has been moving toward a single model, and whatever

checks and balances existed previously, through regulatory agencies, consumer groups, academics or the media, whether for reasons of ideological hegemony or cooptation, have ceased to function properly.[26] The large Wall Street firms became the superstars and the guiding lights of that system, stressing the goals of efficiency, convergence, leverage and deregulation. Governments stayed out of the way to allow the magic of the marketplace to operate. Yet innovation was not pursued, despite the underlying rhetoric, for the benefit of the economy and society. It was pursued for its own sake—and for the fat fees it generated. It is this unanimity (here we are reminded of Margaret Thatcher's assertion of TINA: There Is No Alternative) that in hindsight made the Islamic sector appear as one of the few organized systems of alternative finance. This explains why the principles, if not the actual practice, of Islamic finance have come to hold undeniable attraction well beyond Islamic circles.

Three elements could be singled out. One has to do with Islamic products and instruments, which despite their relative lack of originality retain specific features. Even as they sought in their broad outlines to mimic conventional products, Islamic products, such as *murabaha*, have specific contractual features stressing ethics and risk-sharing. These can be consequential when problems arise and the debtor is unable to pay. In contrast to conventional finance, where banks have no qualms about taking advantage of distressed borrowers, the attitude of Islamic institutions is that they must in such circumstances forsake some of their profits, typically by extending a *qard hasan* (interest-free loan) to help the distressed borrower.[27]

Second, a number of financial products and practices, often among the most lucrative ones—from selling debt to exotic derivatives or from short selling to highly leveraged transactions—are simply off-limits to Islamic institutions. Nor are practices deemed predatory, such as payday loans or "vulture funds," acceptable. Third are screening mechanisms that prevent Islamic companies from investing in or doing business with companies belonging to non-halal sectors or companies whose financial ratios or ethical practices are not deemed acceptable.

This brings us to the alleged "loss of efficiency" endemic to Islamic finance, particularly due to the extra layer of control and documentation imposed by *shari'a* boards. In conventional finance, efficiency was reflexively associated with innovation, but that was before innovations nearly brought down the financial system. So maybe the *shari'a* boards played a salutary role in the end. The systematic vetting of new products by *shari'a* advisers could be looked at as an "outside the box" perspective, a useful corrective to the groupthink that had overtaken conventional finance. At a time when conventional finance was unable to be self-critical or resist the lure of easy

profits, *shari'a* boards provided badly needed checks and balances, by scrutinizing every innovation on the basis of criteria other than profitability—always the best way of reining in excesses.[28] By insisting on ethical and prudential guidelines at a time when Wall Street was playing pied piper, they may have placed useful limits to the mimicry of conventional finance.

The question of leverage provides an interesting illustration of differences between the Islamic and the conventional sectors. Islam favors equity and is suspicious of debt. The requirement that loans be fully backed by an asset greatly reduces the potential for leverage. The "one-third rule" (limiting the debt-to-asset ratio to one-third) is where the Dow Jones Islamic indexes and other screening mechanisms initially drew the line. In contrast, conventional finance has been agnostic on the issue, since the findings of Modigliani and Miller suggest that the debt-to-equity ratio has no bearing on value. Yet, with the increased focus on profitability and the steady weakening of prudential rules, conventional finance became increasingly partial to debt at the expense of equity. Indeed, the single-minded focus on profitability favored pushing leverage to the limit. It is thus no surprise that conventional firms on the eve of the credit crunch were still, with the acquiescence of regulators, finding creative ways of piling debt upon debt to increase their leverage. In 2004, the Securities and Exchange Commission (SEC) decided to permit investment banks to increase their permitted leverage from 10 to 1 to 30 to 1.[29] Shortly before its collapse, leverage at Lehman Brothers was at 44 to 1, with $748 billion in assets standing atop $17 billion in equity.[30]

More generally, since the dawn of the age of financial deregulation, which roughly corresponds to the entire lifespan of modern Islamic banking, conventional banking was transformed almost beyond recognition. Beyond the question of leverage, a number of changes are worth noting. Since 1978, caps on usury ceilings (usury in the conventional banking sense of excessive interest) were effectively removed, opening the door to considerable abuse.[31] The relationship between debtor and creditor was transformed by the practice of securitizing loans. In 2001, the value of pooled securities in America overtook the value of outstanding bank loans. The market for derivatives, which barely existed before deregulation, grew exponentially, with a corresponding increase in complexity and opacity. According to the Bank for International Settlements (BIS), in 1997, the notional value of derivatives contracts was $75 trillion, or 2.5 times global GDP. A decade later, it mushroomed to $600 trillion, or 11 times world output.[32] The whole incentive structure within the financial industry changed, favoring reckless and short-term behavior, which generated bonuses yet ignored the impact of such open-ended innovation on the economy and society.

In contrast, the Islamic approach favored, in theory though not always in practice, a conservative and ethical approach to finance, two qualities that came to be prized following the financial meltdown. The excesses revealed in its wake were accompanied by a backlash and calls for a return to the basics of banking, to deleveraging and simplifying finance.[33] Whereas finance is prone to overkill and hubris, religion—any religion and for that matter any durable secular philosophical system—stresses temperance and is likely to object to the conceit of omniscience. Nassim Taleb, in response to those who sought comfort in financial models, stated, "It's easier to say 'God knows' than 'I don't know.'"[34]

On the specific matter of ethics, the world of finance had adopted a cynical attitude. As told by a Stanford business school professor, "In the early eighties, the faculty here started getting snotty comments about how they were contributing to greed on Wall Street and training modern day pirates and buccaneers. After a while, it got hard to laugh off. So the faculty said, 'Hey, let's just put an ethics unit in the curriculum. That'll shut everybody up.'"[35] A whole generation of what may be called "non-practicing ethicists" arose, whereby talking a lot about ethics provided cover for the perpetuation of ethical lapses. The same is true about governance, transparency, risk control and other reassuring concepts. In an Orwellian twist, high-sounding principles were invoked, just as they were violated in practice.[36] On the eve of a massive destruction of value, all the talk was about how financial innovations were creating value. Risk management took on the airs of an exact science, just as risk managers were about to prove that they had been clueless all along.[37]

Just as excesses spawned an interest in simplifying finance, the "amorality" of contemporary finance has generated an interest in "moralizing" it. And whereas Western or Judeo-Christian finance had become thoroughly secularized (the religious origin of many financial institutions has long receded from the public consciousness),[38] Islamic finance stood apart in still asking age-old questions about the dangers of making money with money, the need to tether finance to the real economy and more generally questions of ethics and morality. In the quest for a free-enterprise system that is circumscribed by moral norms and codes, religion and Islam—a religion that holds a positive view of economic activities while providing for strict guidelines—became more attractive. The Vatican newspaper *L'Osservatore Romano* recently wrote, "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."[39]

Even secular observers have noted that Islamic finance could be a restraining factor in the rise of transnational criminal networks and other

unsavory phenomena that have come to be associated with globalization[40]—what some have called "rogue economics." In the words of Loretta Napoleoni, "Above all, Islamic finance represents the sole global economic force that conceptually challenges rogue economics. It does not allow investment in pornography, prostitution, narcotics, tobacco or gambling. Since the fall of the Berlin Wall, all these areas have blossomed thanks to globalization outlaws under the indifferent eyes of the market-state."[41]

A Cautionary Note

When the financial tsunami hit, bringing conventional finance to its knees, there was a mood of soul searching within mainstream finance. In parallel, there was a sense of triumphalism among promoters of Islamic economics and finance. Some did not hesitate to present Islamic finance as a panacea that would solve all the world's economic ills and as the model that conventional banks had to adopt to get out of their predicament.[42]

Yet soon afterward, the extension of the crisis from the financial realm to the real economy exposed the vulnerability of a sector that is mostly asset backed, though its inherent conservatism somehow mitigated the effects of the economic downturn.[43] This showed that Islamic finance was not after all a panacea, and that a faith-based system is not automatically immune to the vagaries of the financial system.

On balance however, the Islamic sector weathered the financial meltdown better than the conventional sector. If nothing else, there was an acknowledgement within conventional circles that the principles and strictures of Islamic finance were not without merit. This, in turn, created a renewed sense of self-confidence within the Islamic sector, which also weakened the hand of those who equated progress with uncritical imitation of conventional banks.

In sum, as the financial crisis has brought about a rare moment of reflection and critical thinking, the logic of Islamic finance can no longer be dismissed out of hand. At the same time, it may be dangerous to overstate the virtues of Islamic finance and present it as a panacea, especially since its principles state what is permissible and not what is necessarily advisable. To quote Mahmoud El-Gamal: "The claim that Islam has the perfect solution is questionable in economics, just as in politics."[44] Caution is also called for to avoid the dangers of moral hazard. Islamic finance is now at a crossroads. It is unclear how Islamic institutions will respond to the new environment, and many other uncertainties remain. How much change in regulation will happen as a result of the meltdown remains an open question, the answer to which will also determine the future evolution of Islamic finance.

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