Islamic Finance Project

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The Relevance of Islamic Finance Principles to The Global Financial Crisis

Discussion Paper

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The Relevance of Islamic Finance Principles to the Global Financial Crisis

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"Let us make no bones about it. This financial crisis is a major spiritual crisis."[2]
-- Ann Pettifor

Context and overview

The current global financial crisis is causing a fundamental rethinking of the global financial system. Basic assumptions regarding the role of banks, the responsibilities of regulators, the treatment of customers, and the rules of financial innovation are being examined and revisited. Commentators are deeming the U.S. subprime mortgage crisis as a catalyst for exposing frailties in the current financial system that presented bundles of bad credit as creditworthy investments. Observers expect a "new financial order" to emerge from the crisis, redesigned based on the lessons now being learned.

The Islamic finance sector – itself a new global player – has not been immune from the current crisis. While several aspects of the Islamic banking model inherently provide insulation from the crisis, the financial markets and real economies of the Muslim world are clearly impacted by the global recession. At the same time, many, including the Vatican, see the crisis as reinforcing the relevance and merits of Islamic financial principles – principles worthy of examination by both the global financial community and Islamic bankers themselves. To quote an official Vatican publication, 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."[3]

The pace of global economic decline is the greatest in decades, and will lead to a fundamentally different economic landscape. Governments are actively engaging in interventionist policies in an effort to stimulate aggregate demand. Emerging and newly industrialized economies with fiscal surplus and cash reserves will increasingly be partaking in international collaboration efforts and steering groups. The crisis has the

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[2] "Face to Faith," *The Guardian,* October 11, 2008.

[3] Bloomberg, "Vatican says Islamic finance may help western banks crises," March 4, 2009.

potential to stimulate what many see as a much-needed shift from the Bretton-Woods era of international policy setting, to a forum reflective of the rise of the emerging markets.

Within this context, Islamic economic and financial principles bear relevance to the current crisis and to the design of the post-crisis financial order. Their relevance is significant today and likely to grow further due to three factors: (1) the conceptual applicability of principles inherent in Islamic finance; (2) the increasing importance of Muslim economies in an interdependent global economy; and (3) the increasing Shariah-affinity observed in key Muslim markets.[4] The current paper is focused on the first of these factors, and shall discuss the relevance of Islamic finance principles from a conceptual perspective.

Endeavoring to outline key themes on the interplay between the current crisis and Islamic finance principles, this paper is organized in four main sections:

I. Ethical perspectives on the current crisis;
II. Shariah maxims and the causes of the crisis;
III. Practices of Islamic financial institutions in light of Shariah maxims; and
IV. Practices from the Islamic finance sector relevant to addressing the crisis.

The paper seeks to provide a framework for – and help generate – robust discussion among seminar participants. It identifies themes for exploration, each of which can be explored more deeply in the ensuing discussion.[5]

Ethical perspectives on the current crisis

The role of ethics in governing financial activity is age-old and present throughout the ethical traditions of the world. Throughout history, societies have drawn on the shared values of their members to limit or curb commercial activities believed to be unethical, despite the material profit therein. The American tradition is ripe with examples of business activity curtailed due to ethical considerations – the abolition of the slave trade, prohibitions of casino gambling in most states, and laws against dealing or possessing narcotic drugs are all illustrations of this concept. The belief that business practices should be guided by ethical principles is deeply held in our social norms and evident in our legal system.

The world's faith traditions have, for millennia, sought to govern financial activity through both general principles and specific laws. The principles of fairness, honesty, responsibility and justice – found throughout the world's ethical systems – apply as much to financial activity as to other realms of life.

[4] Increasing Shariah-affinity is particularly evident in the GCC region and Malaysia, but is also occurring in other Muslim markets.

[5] The author is deeply grateful to seminar participants Pof. E. Roger Owen, Prof. Baber Johansen, and Prof. Samuel Hayes III for their fruitful comments on the paper and on the topic. Their comments have inspired a number of additions to the paper beyond the draft originally presented.

The behavior of financial actors leading up to the crisis represented, in several ways, departures from the ethical principles customarily expected to govern commercial activity. In some cases of subprime lending, lenders and their brokers reportedly misrepresented the risks involved and the long-term costs of debt. In the packaging and securitization of debt, the stated ratings and risk profiles of the debt instruments were often inaccurate, due either to genuine misunderstanding or the pursuit of better pricing. CEOs and senior executives often enjoyed significant financial rewards for short-term performance while their behavior put the institutions they led at longer-term risk. At the same time, borrowers, sometimes financially unsophisticated, took on unsustainable debt burdens – departing from the disciplines of financial responsibility and living within one's means. A wide range of actors in the financial system exhibited behavior contrary to universal ethical principles – no single party was solely responsible for the moral breaches.

Observers from a range of ethical traditions have noted the moral underpinnings of the current crisis. An official publication of the Vatican, for example, criticized the financial system for having "grown too much and badly in the past two decades." [6] In the same publication, the Vatican noted that "the great religions have always had a common attention to the human dimension of the economy,"[7] reflecting the understanding that religious systems share common perspectives on financial practices.

Economist Ann Pettifor, in a column published in *The Guardian*, identified spiritual failures at the root of the crisis:

> Let us make no bones about it. This financial crisis is a major spiritual crisis. It is the crisis of a society that worships at the temples of consumption, and that has isolated and often abandoned millions of consumers now trapped on a treadmill of debt. It is the crisis of a society that values the capital gains of the rentier more highly than the rights of people to a home, or an education or health. It is the crisis of a society that idolizes money above love, community, wellbeing and the sustainability of our planet. And it is a crisis, in my view, for faith organizations that have effectively colluded in this idolatry, by tolerating the sin of usury.[8]

Pettifor's comments touch on both general ethical principles and specific breaches in religious law. She sees the promotion of consumerism and materialism as contrary to general ethics, and characterizes excessive materialism as "idolatry." As for breaches in religious law, Pettifor singles out "the sin of usury" as a key cause of the current crisis.

Expounding on the "sin of usury," Pettifor noted that Christians "began to dilute the sin of usury as far back as the 1500s,"[9] when clergymen began to revise the previous ban on all interest-bearing lending. A modest interest rate (stated at 5% by John Eck) came to be considered a fair compensation for lending money, whereas high rates of interest were considered "usurious." Over time, a distinction between interest and usury became the

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[6] Bloomberg, "Vatican says Islamic finance may help western banks crises," March 4, 2009.
[7] Ibid.
[8] "Face to Faith," *The Guardian*, October 11, 2008.
[9] Ibid.

norm in Christian countries, and the conventional (interest-based) banking system expanded. The usury laws of most American states permit banks to charge up to double-digit interest rates and "national" banks are exempt from state-level limits.

To cite additional voices on the ethical origins of the crisis:

- The Archbishop of Canterbury, Doctor Rowan Williams, compared the UK stimulus measures to boost consumer spending to an "an addict returning to a drug."[10]

- The Archbishop of York, Doctor John Sentamu, criticized lenders in his Christmas message for their pursuit of "ruthless gain" and urged banks not to "enrich themselves at their poor neighbors' expense."[11]

- A statement issued by an international group of Christian and Muslim leaders, including the Archbishop of Canterbury and the Grand Mufti of Egypt, declared, "Clearly as religious leaders we want to say that the root problem is human greed, which is not specific to any one nation or even to the governing class or any one religion."[12]

As the crisis deepens, the chorus of ethics-based critiques of the financial system grows stronger. The similarity of views on this matter across a range of ethical and faith-based perspectives suggests potential for a coalition of activists seeking ethical reform. While the current crisis has material effects, there is increasing recognition that its origins have moral underpinnings.

Shariah maxims and the causes of the crisis

While experts worldwide continue to debate potential solutions, there is a remarkable level of consensus as to the key causes of the financial crisis. In summary, three key causes can be identified:

- Excessive lending to (and borrowing by) households, corporations, governments, and funds;

- Opaque financial securities, including mis-rated securitized debt instruments; and

- Failings on governance, at both the institutional and systemic levels.[13]

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[10] Ibid.

[11] Telegraph, December 26, 2008 – http://www.telegraph.co.uk/news/newstopics/religion/3949359/Religious-leaders-blame-bankers-greed-for-financial-crisis.html

[12] Middle East Online, October 16, 2008 -- http://www.middle-east-online.com/english/culture/?id=28338

[13] Iqbal Khan, Islamic Development Bank Forum on the Current Crisis, October 2008.

Upon closer examination, one finds relevant Shariah principles and rules addressing each of these causes.

Excessive lending and borrowing

Islam's prohibition of *riba* – generally understood to mean any interest-based lending or borrowing – was clearly violated in the cases of subprime mortgage lending and unsecured (e.g., credit card) lending. While some Muslim voices – in parallel to the shift of the Christian understanding of the matter discussed previously – have sought to differentiate between "interest" and "usury" or *riba*, the high rates of interest involved in credit card lending (particularly in the case of late payment) and in certain floating-rate subprime mortgages would qualify as *riba* or usury from most perspectives. As discussed earlier, Christian voices have also deemed such practices as reflecting the "sin of usury."

The prohibition of *riba* in Islam is understood to help prevent oppression and exploitation. In one form of pre-Islamic lending, for example, borrowers would remain perpetually in debt due to high compounding interest rates that were applied at each period of repayment.[14] Under such structures, it became extremely difficult for the borrower to climb out of debt and regain his financial freedom. Such forms of lending were common in pre-modern societies in various regions (e.g., feudal Europe), and acted to reinforce rigid class structures and social hierarchies.

"Interest-only" mortgages, available at the peak of the lending frenzy before this crisis, have a striking parallel to the *riba*-based lending condemned in Islam. The principal owed is not decreased during the "interest-only" period, and after this period ends monthly payments increase substantially. If the borrower is able to sell the asset at or above the amount of principal owed, he escapes the debt with a profit. If not, he takes a principal loss in addition to the cost of servicing the debt.

More subtle than the explicit prohibition of *riba* is Islam's overall perspective on debt. Debt-based financing is permitted in Islam, especially for productive assets such as equipment, land, and the like. Debt for consumption purposes, though permitted through asset-intermediated financing, is understood by Islamic economists to be discouraged. Slipping into negative net worth – that is, having debts greater than the value of one's assets – is considered particularly dangerous.

This understanding of the dangers of consumer debt is illustrated in the actions and sayings of the Prophet Muhammad. In a famous incident, the Prophet refused to offer funeral prayers for a member of the community whose debts exceeded his assets, until a person came forward to assume the debts of the deceased.[15] Further, it is reported that the

[14] It is important to note that – as evident, for example, in the Shariah-compliant structure of *murabaha,* – that the Shariah does acknowledge the "time value of money" or the opportunity cost of capital. The sale price of an item can differ based on the timing of delivery or the timing of payment. Compound interest, however, is not allowed.

[15] Sahih al-Bukhari: 3:37, Hadith # 488.

Prophet said that "a believer's soul remains in suspense until all his debts are paid off."[16] He would also say in his prayers, "O God, indeed I seek refuge with you from being overcome with debt."[17]

Lending and borrowing – especially for productive economic activity – are important for the functioning of an economy. Debt for consumption, however, should have a limited role according to the widely held views of Islamic economists.

<u>Opaque financial securities, including mis-rated securitized debt instruments</u>

A second major cause of the current crisis is the rise and spread of opaque financial securities, and especially securitized debt instruments with inaccurate credit ratings. These instruments spread the exposure to subprime lending far and wide through "toxic paper" that permeates the financial system but is difficult to identify. The uncertainty regarding where the "toxic paper" is being held has made the fallout more severe and deeply impaired trust among financial sector participants.

Securitized debt caused damage by two means. The first, which is a challenge inherent in the sale of debt, was the separation between the originator of the debt and the party left holding the credit risk. When debt is sold, the person or entity that originally extends the credit or "sells the loan" (the originator) is not the one bearing the ultimate repayment risk (the holder of the credit risk). The incentives of the two parties are not completely aligned – the originator is intent on selling the loan and collecting his fee, whereas the ultimate holder of the risk is exposed to the creditworthiness of the borrower.

This misalignment of incentives has been apparent in the crisis to date. Originators of loans – for example, brokers marketing mortgages – pushed for "document light" lending in which a fully robust credit assessment was lacking. The originator's goal was to book the mortgage – not to ensure the credit risk was well-understood. When packages of these mortgages were securitized and sold, the buyers of these loans often misunderstood and were always a step (or more) away from the original loan. This fact also leads to severe coordination problems in attempts at mortgage restructurings, as debt holders have difficulty contacting the ultimate borrowers and many holders may own the debt of a single borrower.

The second source of damage was the frequently inaccurate rating of securitized debt instruments. Financial engineers packaged loan books of different risk qualities and managed to position them as high-quality (AAA or AA) instruments when in fact the securities were more risky. Buyers of these securities, looking at the ratings, believed that default risk was minimal. In fact, the risk was substantial. Hence the spread of "toxic paper" – believed to be of a certain quality but in fact being of another – to otherwise conservative investors.

[16] Reported by al-Tirmidhi (1078).
[17] Sahih al-Buhkari, 4:92, Hadith # 143.

The Shariah perspective on the securitization of debt is compelling: the majority of Islamic scholars deem the sale of debt impermissible.[18] The discounting of cash flows inherent in the sale of debt (e.g., selling a $100 receivable for $97) is seen as a form of *riba* and therefore not allowed.

The implications of the ban on selling debt (called *bay' al-dayn* in Arabic) are sweeping. First, the separation between origination and bearing credit risk is removed, and the originator is forced to take on the credit risk. This will naturally lead to more careful lending. Second, the lack of a transfer of the debt would mean that the holders of credit risk would retain a "line of sight" to the actual loans, making them better aware of the risks. Rather than relying solely on credit ratings, lenders would have access to information specific to the underlying transactions.

In fact, it is the ban on selling debt that led the Islamic finance industry to develop *sukuk* instruments – often referred to as "Islamic bonds." While the details of *sukuk* transactions are beyond the scope of this paper, in summary *sukuk* can be understood as an equity-based structure in which investors hold shares in an entity that in turn either leases or sells identifiable, productive assets to the "issuer" in return for a stream of payments. One major difference between conventional bonds and *sukuk* is that *sukuk* require the clear identification of the assets being financed, and the attachment of a payment stream to those assets. Corporate lending, therefore, occurs as an asset-intermediated financing activity – not merely the provision of unrestricted cash in return for future payments.

Opaque financial instruments, generally speaking, could be proscribed under the Shariah principle prohibiting *gharar* (excessive uncertainty). Islamic standards of transparency require clarity on what is being bought and sold. For example, to sell "the contents of one of three boxes" without disclosing the contents would be deemed a case of *gharar* or excessive uncertainty. Such a sale, reminiscent of the game show "Let's Make a Deal," may be deemed more akin to gambling than legitimate commerce. The prohibition of *gharar* does not mean that all risk-taking in banned – in fact, risk is essential in Islamic contracts if one wishes to secure a reward.

The Shariah's prohibition of the sale of debt is arguably the clearest mechanism by which a major cause of the crisis may have been averted. That said, it is noteworthy that Islamic alternatives to the conventional mechanisms of pooling financial securities are still in the early stages of development. The expansion of financing enabled (for better or for worse) by conventional securitization and debt markets cannot yet be matched by the nascent Islamic capital market.

Failings in governance

Shortcomings in governance – at both the corporate and systemic levels – have broadly been cited as a contributing cause of the crisis. Among those frequently cited are executive compensation schemes that generously rewarded executives for short-term

[18] "Principles of Shari'ah Governing Islamic Investment Funds", Mufti Taqi Usmani: p-8 http://www.accountancy.com.pk/frameit.asp?link=docs/islam_investment_funds.pdf

gains while shareholders suffered in the long term. Another well-acknowledged breach of governance was inadequate risk management and risk reporting systems, by which senior executives, directors, and shareholders were not provided a clear picture of the financial risks being undertaken by their firms. Third, observers have pointed out potential conflicts of interest between ratings agencies and the owners of assets they rate – agencies are paid by the one selling the assets, whose incentive is to portray risks as minimal in order to improve pricing. Meanwhile, it is the buyers who must rely on the agencies' ratings to make investment decisions.

In addressing these issues, the Islamic system offers a similar set of core principles as found in other ethical traditions. Excessive executive compensation could be curtailed by a sense of fairness and equitability, in line with the risk–and-reward sharing principles inherent in Islamic finance. The misrepresentation of risks, where willful, could be seen as analogous to the deception prohibited by the Prophet in his saying "whoever deceives us is not from among us."[19] In fact, Islamic ethics require that any flaws in goods be clearly communicated to buyers prior to sale.

Apart from these general principles, Islamic financial principles offer a concrete enhancement to corporate governance in the form of Shariah governance systems. In addition to commercial review, transactions undertaken by Islamic financial institutions are subject to Shariah review. The prevalent practice in the Islamic finance industry is for Shariah review to be undertaken by an independent Shariah Committee composed of specialist scholars.

In adding a layer of oversight, Shariah governance can potentially prevent lapses in supervision that might otherwise go unnoticed. Were the funds offered by Bernard Madoff subject to Shariah review, for example, investment principles and trades would be subject to investigation by a set of eyes other than those of the investment firm, its accountants and auditors, and government regulators. This additional review theoretically would have uncovered irregularities that more commercially oriented actors may have overlooked.

Practices of Islamic financial institutions in light of Shariah maxims

The preceding discussion may suggest that Islamic finance principles inherently include mechanisms to prevent crises like the current one. To probe the matter more deeply, however, it is appropriate to examine the actual practices of Islamic financial institutions in light of the Shariah maxims discussed above. Doing so suggests that there are certain areas in which Islamic financial institutions are applying these maxims in ways that which fundamentally differentiate them from conventional institutions. At the same time, there are other areas in which – for a variety of reasons –such practical differentiation is not apparent for a variety of reasons.

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[19] Sahih al-Muslim: The Book of Transactions.

In keeping with our earlier framework, the first area to probe is the matter of excessive lending and borrowing. As discussed, the Shariah generally discourages debt for consumption and instead promotes a savings and investment orientation. Financing is to be asset-intermediated and focused on productive assets that have an impact on real economic activity.

To prevent excessive lending and borrowing, some Muslim countries have restrictions on personal debt as a percentage of a consumer's income.[20] These limits may arguably have some link to Muslim values (or could be attributed more generally to financial conservatism) but – importantly – come from governments and do not apply only to Islamic banks. Lending limits are applied to both Islamic and conventional institutions, and have not been initiated by Islamic institutions. In countries where governments provide no defined limit on personal debt (e.g., the US and UK), we have not yet seen Islamic banks unilaterally adopting such guidelines. This would suggest that while the principle of limited debt may be broadly embraced, formal mechanisms for abiding by this principle have not (to date) been pro-actively forthcoming.

As far as promoting savings and investment (rather than consumption and debt), Islamic financial institutions – like their conventional counterparts – have adopted this principle to varying degrees. A trend may emerge by which Islamic banks promote savings and investment more than their conventional competitors do, but at this time no such trend is evident.

As much as a savings and investment orientation may be a goal of Islamic financial institutions, there are real challenges in implementing such an orientation within banking models as currently practiced. Generally speaking, the easiest way for banks – Islamic or conventional – to generate incremental profit has been to lend more money to the same set of customers. Acquiring new customers is costly and difficult, and savings products typically offer thinner profit margins than lending products do. It therefore requires a real commitment to a savings and investment orientation – along with business models to support such an orientation – in order to push the industry in that direction.

- Illustration: Risk-sharing diminishing *musharaka* home financing

  A salient feature of the current crisis is the phenomenon of homeowners with "negative equity" – owing more to the bank than their home is currently worth. This phenomenon came about when homeowners took on mortgages with little or no down payments and their homes subsequently lost value as a result of the declining housing market. It is expected that nearly 16 million American homeowners may find themselves in "negative equity" situations by the fourth quarter of 2009.[21]

  Islamic finance principles promote modes of financing in which lenders genuinely take asset ownership risk. One example is a partnership-based home financing

[20] Reuters: Credit cards drive Gulf consumer debt, 19 June 2007.
[21] "Mortgage bailout to aid 1 in 9 US homeowners," *Wall Street Journal*, March 5, 2009.

structure called a "diminishing *musharaka*" or diminishing partnership. Under this structure, the lender takes equity in the home being financed and is bought out over time by the homeowner.

The diminishing *musharaka* structure could, theoretically, be designed is such a way to make "negative equity" impossible. The terms of the partnership could be written such that the value of the home is assessed periodically and the equity is transferred at the market value of the home at each interval. That way, if a home loses value the loss is shared by both partners – the lender and the homeowner.

In practice, however, diminishing *musharaka* products generally involve the transfer of equity at a price that is not dependant on the market value of the asset at the time of each transfer. The reasons for this are understandable: in good times, few customers would be willing to share the "upside" of the appreciation of their home values with the bank. Conventional mortgages have conditioned homeowners to expect that the appreciation of their home values should accrue only to them.[22] In bad times, few banks or lending institutions would want to take a real risk on the property value of homes. They see themselves as experts in lending, not in real estate investment.

Thus, the diminishing *musharaka* in theory offers a genuinely alternative model to conventional home financing – an alternative that could prevent "negative equity" situations. Due to the realities of the banking system to date, however, the structure has to date generally been implemented in a manner that largely replicates a conventional mortgage.

As discussed earlier, avoiding the sale and purchase of debt marks a clear difference between Islamic and conventional financial institutions. While this practice helps insulate Islamic banks from crises like the present, a lack of deep secondary markets may be seen to present real challenges for the long-term growth of the Islamic financial sector. Leading thinkers and financial professionals have been exploring innovative solutions to develop deeper Islamic capital markets, and it is hoped that such solutions will reflect both the authentic spirit of the Shariah and commercial demands of contemporary finance.

In the realm of governance, the adoption of Shariah governance systems in Islamic financial institutions is another clear source of differentiation. Shariah Committees of Islamic financial institutions undoubtedly have power and influence – they approve product and transaction structures and represent Shariah compliance to customers, shareholders, and other stakeholders.

While Shariah Committees today play an important role, Islamic financial institutions vary in the degree to which Shariah oversight is integrated into daily operations. Best practices set by industry standards bodies call for regular and robust Shariah audits, in

[22] I am grateful to my colleague Rafe Haneef for his valuable insights on market pressures related to *musharaka* products, and on Islamic finance principles overall.

which the Shariah Committee and/or its agents monitor the institution's operations frequently to ensure compliance with the Shariah Committee's guidelines. Audits are therefore essential, and should be encouraged with vigor.

The role of Shariah Committees in assessing business practices beyond the structuring of financial products is a key area for thoughtful consideration. Shariah input on the fairness of business practices, customer service, product marketing and the like can serve as important inputs in ensuring the Shariah authenticity of an institution. At the same time, it must be remembered that Shariah Committee members generally focus on rule-based matters of structuring, whereas matters of business practices are often more principle-based and less conducive to precise rulings.[23]

Practices from the Islamic finance sector relevant to addressing the crisis

Despite the current limitations in application of Shariah maxims by the Islamic finance sector, the concepts behind Islamic finance are highly relevant to addressing the global financial crisis. In particular, five practices are worthy of consideration as policy makers worldwide consider the architecture of the new financial order:

1. <u>Increased emphasis on asset-based financing</u>

   Due to its asset-orientation, Islamic lending should theoretically be limited by the value of real collateral.[24] This practice can help prevent upward spirals of debt, particularly unsecured consumer debt. Measures to increase the linkage between actual assets and the financing offered can add greater conservatism and prudence going forward.

2. <u>Limits on the sale of debt</u>

   The sale of debt has become a cornerstone of global capital markets. In designing an evolved system, select limits on the sale of debt may be worth considering. For example, measures to align the incentives of originators of credit and holders of credit risk could be explored so as to promote greater responsibility.

3. <u>Greater transparency in the transfer of debt</u>

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[23] Seminar attendee Dr. Muhammad Al-Awan contributed an important observation on this point. He noted that, since the onset of the crisis, it appears that executives within Islamic financial institutions are showing an enhanced appreciation of Shariah maxims and of the views of Shariah Committees.

[24] A key exception to this principle is the practice of lending through a monetization structure known as *tawarruq*. Though an asset is involved in the transaction, the intent of *tawarruq*-based lending is to provide cash financing – the borrower has no interest in the asset behind the transaction. Shariah scholars, economists, and financial professionals alike have recognized the risks of *tawarruq*-based lending, despite its growing popularity in the marketplace.

When debt is transferred, the broad principle of maximum transparency is key. To the degree a "line of sight" can be maintained back to the original transaction, greater stability can be expected in securitized debt markets.

4. Introduction of "Ethical Supervisory Boards"

The concept of "Ethical Supervisory Boards" for the world's financial institutions is worthy of exploration. Creating such bodies – and granting them an appropriate level of authority – could have a significant impact on both financial practices and customer trust of financial institutions. Interestingly, this practice could be seen as an extension or institutionalization of the ethics-based "shareholder activism" witnessed globally in recent years.

Care must, of course, be taken to ensure that such boards not have excessive scope or vague mandates, and that they act as enablers rather than hindrances on business. That said, a strong ethical check on financial activity seems worth having.

5. Separation of risk-free and risk-bearing accounts

One core principle of Islamic finance is that if a party seeks gain, he or she must also be willing to risk loss. The concept of a "risk-free return" – meaning a gain with absolutely no chance of loss – is not consistent with this principle.

A clear distinction between risk-free accounts (whose primary purpose may be for enabling the flow of payments, protecting savings, and safekeeping) and risk-bearing accounts (whose primary purpose is to grow savings through investments) is a natural consequence of the principle discussed above. Such a distinction is a hallmark of the "narrow banking" model[25] through which deposit-taking banks and investment houses were long separated. One major benefit of such a model is that it keeps the deposit-taking entities on which the payments system is dependent relatively low-risk, thus minimizing the need for (and potential cost of) bailing out such institutions.[26]

Introducing ethical principles in financial reform

As much as ethical perspectives – from Islamic finance and beyond – have relevance to helping shape the post-crisis financial order, to have an impact they must effectively reach key policy makers. In this respect, several steps appear essential.

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[25] For more on the case for narrow banking, see the work of the Bank of England's Kevin James at http://www.bcb.gov.br/Pec/seminarios/SemMetInf2007/Port/KevinJames.pdf

[26] Some prominent observers, including my colleague Rafe Haneef, have extended this line of thinking further and have identified other systemic shortcomings of the current conventional banking model. Haneef has identified two fundamental ways in which governments "subsidize" conventional banking: (1) government-backed deposit insurance, and (2) the tolerance of the fractional reserve banking model. Though the current paper calls for more modest reform, the observations of Haneef and others warrant due attention.

First, advocates of ethics-based solutions need platforms for articulating their principles and recommendations. Those interested in communicating Islamic principles as a relevant source may seek the attention of the two Muslim countries represented at meetings of the G20 – Turkey and Saudi Arabia. Other multilateral organizations, such as the OECD and World Bank / IMF, do have exposure to the Islamic ethical system but proportionately it is a less significant component of their overall activity. It must be remembered that ethics find their way into law through state mechanisms and sovereign actors. The efforts of ethical coalitions might therefore be well-served to focus on influencing state actors to the degree feasible.

Second, deeper consideration is called for regarding the transitional implications of introducing such principles and strategies. Guidelines regarding the sale of debt, for example, would need to be carefully thought out so as not to disrupt existing capital markets in potentially harmful ways. Likewise, risk-sharing forms of home financing would require significant changes in how lenders operate and would therefore require gradual introduction and testing. Those seeking to introduce ethics-based reforms must carefully assess their impact on the viability of the overall economy; lest their well-intentioned efforts inadvertently lead to discrediting of the principles for which they stand. The challenge is to craft a system that is – at the same time – both authentic and vibrant.[27]

Third, it is important that ethical principles be rooted in universal values rather than the religious laws of any single faith tradition. Considering the diversity of our global system, any consensus principles are likely to come from shared values more than from a particular religious tradition.

Closing thoughts

The current crisis marks a defining period for the global financial system. The truly global nature of the crisis has highlighted the increased interdependence of the world's economies. As the impact of the crisis is universal and not limited to a small set of countries, the sources explored for potential solutions should be diverse and inclusive of the world's ethical traditions.

This paper has argued that, as policymakers work to craft a new financial order, certain concepts and principles from the realm of Islamic finance merit consideration. At the same time, one must acknowledge the nascent nature of the Islamic finance sector and the fact that it has not fully developed alternatives to pre-crisis, conventional practices.

As the world treads forward on an uncertain path, our shared values can be a source of strength and guidance. A new financial architecture that affirms and embraces ethics may prove more stable, resilient, and sustainable than the practices that led to the current crisis.

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[27] The author thanks Prof. M. Nejatullah Siddiqi for his valuable comments on this topic.