

# In another time and place

Would an Islamic financial system have created the credit crunch that led to social and financial crises? Sayed Farook ponders that very question

**I**F THE WORLD FOLLOWED THE RULES OF Islamic investment, the current food price inflation, the subprime loan crisis and the collapse of some of the largest investment banks could have been avoided. This raises some interesting questions about where the world economy may be heading.

In most academic or intellectual gatherings of Islamic scholars or economists, one will tend to hear the relative benefits of the Islamic economic system, albeit completely normative statements without any substantial empirical evidence. Their response to the lack of evidence: there exists no real economy that follows full Islamic principles and where they do, such as in the case of Iran and Sudan, there have either been lapses in governance or modifications in the rules that have substantially altered the actual premise of Islamic economics. Hence we, as Islamic economists, are largely unable to detect the impact of following pure Islamic economic principles. Or so the story goes...

Either way, the parameters that define an Islamic economy are not clear to begin with. Indeed, many would argue that western states such as Canada, Australia and the UK are closer to the balanced Islamic economic ideals of recognition of property rights and trusts, wealth redistribution, fair trade practices and equal bargaining power—some of the major hallmarks of a so-called Islamic economic system. Most discourse on Islamic economics has largely been theoretical, with most practical advances in the micro-economic sphere, such as the development of Islamic financial Institutions.

However, looking at the crises affecting the world, what would happen if a full economic system based on Islam were to be implemented?

The two crises at the heart of this discussion include the subprime mortgage debt writedowns and the spiralling food price inflation, both of which have had a crippling effect on economies the world over (particularly poorer third world economies). They have raised the cost of debt and, therefore, access to finance and, more importantly, increased the cost of staple essentials.

So what are the causes of these crises and

where is the connection to Islamic economics? To begin, subprime mortgage debt writedowns and their subsequent large scale affects the world over, were for the most part, attributed to two factors: the first being the relaxing of mortgage credit criteria in developed economies on the assumption that real estate prices were on the rise and therefore there was sufficient collateral to risk providing loans to individuals without a substantial credit standing.

The second reason was the role of the financial markets in the securitisation and subsequent repackaging of such mortgage-based obligations into all types of securities with numerous tranches (or seniority status), without a substantial or exact trace to the underlying assets of the securities.

This, in turn, opened “a can of worms” in the financial industry, including the substantial malpractices of highly geared Investment banks, which potentially suffered from questionable risk management practices. More importantly, it raised questions on the integrity of the sophisticated financial system the modern world has developed over the past decade, a system in

which the regulators are trying desperately to catch up with market innovation, particularly in the space of derivatives and debt markets.

The current food price crisis, on the other hand, is not easy to figure out. The received wisdom from economists, traders and regulators blame such increases on the increased demand from emerging markets and decreased supply because of bad weather or geopolitical events. This hypothesis is becoming harder to defend, particularly when one considers the pace at which prices have jumped.

Many also attribute the effects to US government policies/subsidies that have skewed incentives to grow certain crops such as maize, which are the necessary ingredients of bio-fuels, in a bid to reduce the US dependence on Middle Eastern oil imports. This has caused reduced output of other staple foods such as wheat and rice, while demand has increased or at least remained steady. Some attribute it to reduced supply of wheat from the drought-stricken continent of Australia over the past several years, which may have caused reserves to decline substantially the world over, the effects of which

**SUBPRIME CRISIS** Such signs may not have been evident in an Islamic financial economy



are being felt in the market through increases in prices.

Another school of thought is emerging which attributes this largely to the role of speculators in the futures markets. They assert that the lacklustre performance of the real estate and equities markets in the developed world, has resulted in traders shifting their attention to commodities, which are proving to generate substantial returns. A large part of this commodities trading is done on futures markets, which some conjecture may have a substantial effect on today's prices, since current demand may be driven by future expectations of prices.

This school of thought has its supporters all the way up in the senior ranks of the US congress. Just a few weeks ago, Senator Joe Lieberman raised the issue of commodities trading by pension funds and other institutional investors, which has grown twentyfold to \$260 billion in the last five years. "This unbridled growth raises

justifiable concerns that speculative demand—divorced from market realities—is driving food and energy price inflation and causing a lot of human suffering," Senator Lieberman said.

In an interview with the *Los Angeles Times*, Professor Micheal Greenberger claims it has a lot to do with futures. "You've got futures exchanges that are rife with the ability to manipulate and excessively speculate," said Greenberger, a University of Maryland law professor who spent two years in charge of the Commodity Futures Trading Commission's trading and markets division. "Congress firmly believes that they've got to bring this speculation under control. And it is my thesis that if these markets were policed, the prices would drop very rapidly."

The same hypothesis is being bandied the world over, particularly in poorer countries, including one of the largest emerging markets, India. Since 8 May, India has banned the futures trading of potatoes, chickpeas, soy oil and rub-

ber. The move follows a similar ban applicable to rice, wheat and two types of lentils, which was imposed in 1997.

Empirical evidence on the causes of such crises is likely to trickle in over the next couple of years. However, one can argue that certain activities in sophisticated financial markets may be partially blamed for these crises, at least for the subprime mortgage meltdown. These include the substantial repackaging of billions of dollars of debt into different securities and the role of speculators in futures markets.

So what does all of this have to do with Islamic economics? And what chances are there that this would not have occurred in an ideal Islamic economy, particularly if one considers the examples of Iran or Saudi Arabia (two of the only Islamic states based on Shariah rule and influenced substantially by Islamic scholars).

Both have had significant economic crises of their own to deal with; one of which had a lot to do with speculation. In addition, the word "Islamic" usually implies that everything adheres to Islamic principles. In fact, most of these Islamic states are work in progress.

Two of the hallmarks of the current crises would not have existed in pure Islamic economies—those based on sound Islamic financial principles. For one, the trading of debt, as in the case of the mortgage backed securities, is seen as usurious in the annals of Islamic commercial jurisprudence (for most schools of thought). Hence, the re-packaging of debt obligations into several layers without a substantial trace to the underlying asset is largely frowned on by Shariah scholars.

Islamic securities should be asset-based. A direct link to the asset is the substantial basis of the asset generating returns—although, this may not be true for all Islamic securities, which have largely succumbed to the influences of conventional securities.

Second, futures-markets trading is largely disallowed. Goods that do not exist, goods that the seller does not own or cannot deliver cannot be the subject matter of an Islamic contract, which means all types of futures contracts are disallowed in Islamic economies.

The only exceptions to this rule are the contract to construct (only applies to specific customisable goods made to order, not commodities) and the contract otherwise known as *salam*, which allows for future delivery of non-existent fungible commodities, albeit with extensive prohibitions including the full payment of the price in advance. That full payment has to be made upfront in *salam* is itself a great disincentive to engage in speculative trading unless there is a

*'If speculative markets were policed, the prices would drop very rapidly'*



**FOOD** Rising prices have had a crippling effect on global economies



**SENATOR LIEBERMAN**

**'Unbridled growth has raised justifiable concerns'**

genuine need for the underlying commodity by the buyer. Even if there is no genuine need by the buyer of the commodities and the buyer would like to speculate by holding the assets, Islamic commercial law disallows the trading of such future obligations until the asset is actually delivered. This is markedly prohibitive compared with the conventional futures trading in the West, which allows for futures trading without payment and without settlement until the contractual date.

The irony is that these "market discipline" rules, a taste of which have been given, were not man-made, nor were they derived from some sort of Islamic empirical evidence. These rules were derived by pre-modern Shariah scholars based largely on authentic divine sources, namely the *Koran* and the traditions of the Prophet. To think that an individual more than 1400 years ago could conjure up a rule that affects macro-economic stability in these modern sophisticated financial markets is quite extraordinary, if not incredulous.

Critics of Islamic finance and Islamic economics are wary of the form-based legal stratagems employed by Islamic financial institutions and are happy to give the whole system a lashing based on their received wisdom. They argue that Islamic finance plays out only in the form of the contracts, while the substantial basis of Islamic finance replicates all the characteristics of conventional finance, along with its weaknesses.

Some of these accusations do contain substantial truth, particularly where certain financiers and advisors have twisted the law to suit their underlying need without regard to the objectives of the law. Notable controversial examples include the contemporary mechanisms of *tawarruq* or fixed income *musharaka* sukuk.

However, to argue that Islamic finance is merely a disguised version of the conventional substance is superficial when one considers the substantial macro-economic effects of some of the rules we, as humans, are yet to appreciate. These include the two important rules prohibiting trading in debt and trading in futures. If it weren't for these crises, Islamic economists would not have any substantive proof of the benefits of the Islamic economic system and what the Islamic economic system would definitely avoid.

But this is not the premise on which Islamic economics or Islamic law is based. Islamic law, economics or any other Islamic discipline is founded largely on the belief that what the infinitely knowledgeable divine has appointed for us is significantly better than what we ourselves have learnt through both our limited experience and empirical evidence.

Hence, a commitment to Islamic finance can come from those individuals who believe not only in its visible ethical and social justice rules but also in the greater wisdom of the divine source, regardless of whether the benefits of such rules are apparent or measurable.

While we wait for the empirical evidence to turn up on the causes of these economic crises, perhaps we should ponder on whether these rules constraining Islamic finance and Islam do have some divine sources behind them; wisdom that is able to foresee the macro-economic effects of our micro-economic decisions such as the trading of a simple obligation. ■

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## Conferences & Events



Parkroyal Kuala Lumpur



Sandton Convention Centre, Johannesburg

### AUGUST

31 July - 1 August  
*Islamic Project and Infrastructure Finance, Singapore*  
[www.terrapinnfinancialtraining.com](http://www.terrapinnfinancialtraining.com)

5-6 August  
*Introduction To Risk Management In Islamic Financial Institutions: Shariah Compliance Perspective, IBFIM, Kuala Lumpur, Malaysia*  
[www.ibfim.com](http://www.ibfim.com)

5-6 August  
*Workshop on Data Warehousing, Grand Millennium Hotel Kuala Lumpur, Malaysia*  
[www.globalpro.com.my](http://www.globalpro.com.my)

5-6 August  
*The 2nd Global Islamic Finance Conference 2008, Parkroyal Hotel, Kuala Lumpur, Malaysia*  
[www.islamicmortgages.co.uk](http://www.islamicmortgages.co.uk)

6-8 August  
*Takaful: Islamic Insurance, Kuala Lumpur, Malaysia*  
[www.islamicfinancetraining.com](http://www.islamicfinancetraining.com)

10-14 August  
*Senior Executive Finance, Kempinski Hotel, Mall of the Emirates, Dubai, UAE*  
[www.iirme.com/sef/](http://www.iirme.com/sef/)

11-13 August  
*MIF 2008 Issuers & Investors Forum, Mandarin Oriental, Kuala Lumpur, Malaysia*  
[www.mifforum.com/main.php](http://www.mifforum.com/main.php)

12- 13 August  
*Risk Management for Financial Services Conference to discuss risk management in conventional and Shari'ah-compliant finance, Kuala Lumpur, Malaysia*  
[www.globalpro.com.my](http://www.globalpro.com.my)

14-15 August  
*Conference On Islamic Financial Planning & Asset Management, Grand Millennium Hotel, Kuala Lumpur, Malaysia*  
[www.globalpro.com.my](http://www.globalpro.com.my)

14-15 August  
*Structured Islamic Finance & Investment Products, Kuala Lumpur*  
[www.islamicfinancetraining.com](http://www.islamicfinancetraining.com)

17-21 August  
*Islamic Product Development & Financial Engineering, Dusit Thani Hotel Dubai, UAE*  
[www.iirme.com](http://www.iirme.com)

19-21 August  
*IFRS in the Oil & Gas Industry, Al Murooj Rotana Hotel, Dubai, UAE*  
[www.iirme.com](http://www.iirme.com)

20-21 August  
*Marketing & Business Development for Islamic Financial Services, Prince Hotel & Residence, Kuala Lumpur, Malaysia*  
[www.globalpro.com.my](http://www.globalpro.com.my)

25 August  
*2nd International Conference & Worlds largest Event on Islamic Banking & Finance, Aiwan-e-Iqbal Lahore, Pakistan*  
[www.alhudacibe.com](http://www.alhudacibe.com)

25-26 August  
*Islamic Financial Markets, Indonesia*  
[www.islamicfinancenews.com](http://www.islamicfinancenews.com)

25-28 August  
*Islamic Finance & Investment World Africa 2008, Sandton Convention Centre, Johannesburg, South Africa*  
[www.terrapinn.com](http://www.terrapinn.com)

26-27 August  
*Letter Of Credit-i: In-Depth Understanding, IBFIM, Kuala Lumpur, Malaysia*  
[www.ibfim.com](http://www.ibfim.com)

### SEPTEMBER

3 September  
*Detailed Structuring Of Islamic Securities, IBFIM, Kuala Lumpur, Malaysia*  
[www.ibfim.com](http://www.ibfim.com)

8-10 September  
*Service Apartment Asia 2008, Le Royal Méridien Shanghai, China*  
[www.terrapinn.com](http://www.terrapinn.com)

8-11 September  
*Hedge Funds World Asia 2008, Hong Kong Convention & Exhibition Centre - Hong Kong, China*  
[www.terrapinn.com](http://www.terrapinn.com)

8-11 September  
*Retirement Communities World Africa, Southern Sun Grayston - Johannesburg, South Africa*  
[www.terrapinn.com](http://www.terrapinn.com)

9 September  
*Islamic Real Estate Investment Trusts, IBFIM, Kuala Lumpur, Malaysia*  
[www.ibfim.com](http://www.ibfim.com)

9-10 September  
*Electronic Trading Asia 2008, Hong Kong Convention & Exhibition Centre - Hong Kong, China*  
[www.terrapinn.com](http://www.terrapinn.com)

9-10 September  
*The 13th Euromoney Russia & CIS Conference 2008, Mobilising long-term capital, Radisson SAS Slavyanskaya Hotel, Moscow, Russia*  
[www.euromoneyconferences.com](http://www.euromoneyconferences.com)

11-12 September  
*SME Banking in Europe, Crowne Plaza, Brussels*  
[www.fleminggulf.com](http://www.fleminggulf.com)

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