'Banking Panics' and Islamic Finance Principles: Lessons from the Current Crisis

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Understanding the Current Crisis

Clearly, the recent 'bank panics' and global economic crisis occurred mainly due to the result of debt defaults in subprime mortgages. Firstly, default by home buyers for their loans repayment to the banks and secondly default by banks for their bond repayment in the mortgage bond market. If debt defaults can be avoided in the first place, bank panics and economic crisis will most likely not happen. This means that the origin of the problem is related to bank defaults in the Sub-Prime Model which arises due to poor credit evaluation by banks. Therefore the solution for the current crises should be focused on ways of avoiding debt defaults by borrowers.

Many economists believe that debt defaults that led to the current economic crisis are directly related to regulatory failure. The banks have violated some important principles required by Basel II accord regarding credit standards. These principles can be summarised into two main points as follows:

- Banks lending and selling. With the sale of subprime mortgages banks deliberately sold mortgage products to clients who could not afford to pay. Borrowers with poor credit histories, too, were granted housing loans. These types of borrowers would easily default when the mortgages reset. Thus some economists are of the opinion that the crisis was initiated by poor mortgage underwriting. Others do not agree that faulty credit standards have caused the current crisis, stating that the mortgage-backed securities were in fact rated by the rating agencies. The banks and institutional investors simply followed the investment grade ratings provided by the agencies. However, it was further argued that the credit ratings that were assigned to the subprime mortgage-backed securities by the rating agencies were based on significant errors.
- Lack of transparency. Greedy banks and borrowers are not transparent enough
 and are not revealing the real facts. Firstly, banks and mortgage dealers did
 not disclose the characteristics of the bond to the borrowers, e.g. that the bond
 is an adjustable-rate mortgage (ARM). An ARM is a costly mortgage and
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would directly affect a borrower's financial status after reset. This very characteristic should have been clearly explained to them so that they understood the cost and effect of buying such bonds. However, it seems that banks were purposely hiding the real characteristics of the bonds from the borrowers, fearing that the potential buyers would not acquire the bond after realising the real characteristics of the bond. Secondly, banks are often not concerned about the quality of the assets purchased by the borrowers. The banks packaged and repackaged the mortgages and sold them as asset-backed securities with a high credit rating and a high return, while the actual credit quality of the underlying asset was not exactly known.

In short, the practice of ARMs, the unscrupulous lenders and the predatory borrowers have been identified as major causes for 'bank panics' and the current economic crisis. These problems would not have occurred had there been a stringent credit regulatory system in place.

Islamic Finance Principles and the Current Economic Crisis

In terms of the *moral and Islamic dimension*, the Sub-Prime Model is clearly a model of financial innovation that is *not* based on the *sharīʿah*. Its mechanism is generally based on the sale of debt (*bayʿal-dayn*) which is allowed by Islam with certain conditions. Unfortunately the current practice of sale of debt is not in accordance with *sharīʿah* principles and consists of three elements prohibited by Islam, namely interest (*ribā*), uncertainty/deception (*gharar*) and gambling (*maysir*). However, the existence of these prohibited elements is not the main reason for the current economic crisis. Although, the new subprime mortgages are ARMs, it is not the interest rate which really caused the crisis. The real reason behind this problem was actually the unscrupulous/dishonest mortgage lenders, luring unsuspecting borrowers into a debt trap. Insincere banks did not reveal the real characteristics of the bonds, and on the other hand the greedy borrowers did not sincerely declare their financial positions and were also not really concerned about the characteristics of the bonds.

This means that the problem is not as much related to the system as to a generally prevailing 'moral hazard' issue, namely the predatory and greedy behaviour of lending and borrowing. If both parties would have been honest in their transactions by disclosing all the facts, the current problems faced by banks, borrowers and the whole world could have been prevented. Problems could have been avoided had there been a transparent financial advisory mechanism. Such a mechanism is actually missing in the current conventional financial system.

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From the perspective of Islam, this unethical behaviour relates to the issue of mutual consent $(rid\bar{a})$ and deception (gharar) in the contract. The $shar\bar{\iota}$ ah requires that both parties in any contract should reveal everything in order to avoid unknown elements $(jah\bar{a}lah)$ that may cause dispute in the future. Nothing should be kept secret. If everything is disclosed as required by Islamic ethics, it is unlikely that the mortgage bond market in the Sub-Prime Model could have developed in the first place.

Having *sharī* 'ah-compliant products *alone*, however, would not be enough. Although the sale of debt (*bay* 'al-dayn) is permissible and can be applied in any transaction of bank products, there must be a regulatory system that would protect the buyer's interest (*maslaḥah*). Similarly, *şukūk* (bond) and *şukūk* market are all allowed but only with proper regulatory mechanisms. However, applying only *sharī* 'ah principles, such as *mudārabah*, *mushārakah* or *ijārah* in any Islamic products such as *şukūk ijārah*, *şukūk mushārakah* or *ṣukūk mudārabah* would not necessarily secure the economy from crisis, because the problems related to risk management would still be there. The question of risk could only be managed by a proper regulatory system. Similarly, the problem of 'moral hazard' needs a proper regulatory mechanism.

What is needed is also the enforcement of the existing Islamic rules along with some fresh guidelines for the major stakeholders, especially the financial institutions. More rules are needed to regulate the Islamic capital markets to ensure the future success of Islamic finance.

Banks should moreover, respect the two pillars of Basel II. These two pillars are firstly, maintenance of regulatory capital calculated for three major components of risk that a bank faces, namely credit risk, operational risk and market risk, and secondly, maintenance of regulatory measures for other residual risks such as systematic risk, pension risk and reputation risk.

The Basel II accord thus implies that banks lend only to those that are creditworthy. This will ensure that borrowers do not run into financial problems, regardless of whether the system is conventional or Islamic.

Moreover, Islamic financial institutions should create *sharī* 'ah-based regulations on credit standards in order to guarantee that Islamic principles are adequately capitalised. Although Basel II is expected to be sufficient, some *sharī* 'ah guidance could also be considered:

- Implementing *sharī* 'ah-rules regarding debt and debt trading. The rule states that debt disbursement should be based on a debt/equity ratio of 33 per cent and that debts cannot be traded except at par value.
- Promoting asset-backed Islamic mortgages, supported by real quality assets.
 The sharī'ah requires that debts should be guaranteed by valuable assets.

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In case that no other asset can be used, the purchased asset can be used as mortgage instead. Islamic mortgages may require that the property changes hands twice. Firstly, the bank buys the house outright and then acts as a landlord, renting the house to the potential buyer. The buyer will pay rent as a contribution towards the purchase of the house. When the last payment is made, the property changes hand to the buyer.

Providing sharī 'ah-compliant risk-management solutions to the creditors
of Islamic financial products through a comprehensive consumer-protection
framework. The exact solution is left to the discretion of the banks.

Islam promotes transparency and avoids unknown elements between parties of contract. In the case of a loan offer, the borrower should be informed regarding the product offered. Similarly, the bank should be informed regarding the borrower's history and mortgage assets. All relevant information should be declared by all parties and without prejudice.

In sum, the core issue of safety in any banking system – regardless of whether it is Islamic or non-Islamic – is in its credit standards and regulatory measures. In this regard, Islamic banking is no different from other banking.