How to Achieve Further Progress in Islamic Finance

Islamic finance is a fairly young industry. It’s only 30 years old. When I first began looking into the industry back in the late 1970s, the asset size was about US$50 million. The industry has now grown to reach US$1 trillion. This growth is a good sign; however, in order to progress further we need to learn lessons from the recent financial crisis and explore the path that we would like to travel in order to bring the industry forward.

Financial crisis happens when market expectation of rising return is not met. This is usually referred to as “bubble burst”. The expectation of continuous rising return will pump air into the asset bubble and when the bubble has been stretched to the maximum, it will burst and deflate the hot air in the bubble, bringing prices down with it.

FACTORS THAT BROUGHT DOWN THE FINANCIAL MARKET

Why did the crisis develop in Western financial markets? Without being simplistic, I believe it was due to two reasons—opaque instruments and shortfall in regulation. This is what I call the conventional (or usually cited) explanation. Much has been written about the complexity and opacity of the financial instruments that contributed to the financial meltdown. Thus, I wish to focus on regulation because I believe this is where Islamic finance industry can learn lessons to take home.

Alan Greenspan, the former Chairman of the Federal Reserve, was a firm believer in the perfect and efficient market hypothesis. Simply put, this...
hypothesis claims that prices reflect all information. Therefore no asset bubble will exist because, if there is a bubble, it means that there is no information and demand rises. When information is available, demand will decrease and price will correct the market. As a believer in this hypothesis, one would want to create as much security (i.e., financial instruments) as quickly as possible to encourage growth in the market. This then led to a hands-off regulation approach and lax monetary and fiscal policy. The hands-off policy was exacerbated by the governance policy of the financial institutions, which viewed greed positively.

In December 2007, Alan Greenspan said in the Wall Street Journal, “Bubbles develop, expand, and deflate. Neither monetary nor regulation can deflate them. The market will correct itself.” In summer 2008 the perfect market theory vanished, and in December 2008 Alan Greenspan concluded that he had been following a flawed model.

To sum up, the institutions were large, complex, and too big to fail, while the instruments they offered were large, complex, and opaque. Due to this complexity the regulators found it very challenging to control these markets, and the efficient market hypothesis supported the demarginalization move.

THE UNCONVENTIONAL EXPLANATION OF FINANCIAL CRISIS

Factors highlighted above are the conventional factors usually cited when discussing the financial crisis. It focuses on micro-factors that led to the crisis. There is a larger macro-factor that one needs to understand as well.

The capitalist society that relies on debt and leverage has an inherent seed of fragility in its system. Debt will create a credit boom, which will translate into asset bubbles that will eventually burst. The time to ensure that external borrowing is less than 25% of GDP. Unfortunately, the advanced economies did not implement this recommendation. The US, for example, refused to accede to a financial sector assessment that would provide a medical report on the health of each country’s financial system.

HOW CAN ISLAMIC FINANCE MOVE FORWARD?

The most important lesson Islamic finance can learn from the financial crisis is to reduce over-reliance on debt-based instruments and to introduce more risk-sharing instruments. This is not to say that murabahah is not Islamic. It is. However we shouldn’t be over-relying on it. The derivative world is explained by the theory of spanning where one basic instrument can be spanned into infinite numbers of instruments, like a ponzi-clone that has one base but can expand widely. Robert Stiller, a professor of economics at Wur University, is an advocate of risk-sharing instruments. He said that the glory of risk-sharing instruments has not yet began.

One practical way of implementing risk-sharing instruments in the economy is to start with government developmental projects, agricultural development, infrastructure development and the like. The government can issue participation securities in highway construction projects, for example, where the development expenditure is funded by the people in the country. Asian countries, well known for their high savings rate, represent fertile grounds to explore this option.

Participation securities in governments not only reduce the burden of budget deficit on government books, but also provide an alternative investment instrument for the masses instead of a guaranteed bank saving or risky equity shares.

One impediment that always comes to our mind is the missing element of trust in the society. For risk-sharing instruments to work, the partners in the project must be trustworthy, which unfortunately is not always the case today’s world. How should one manage this problem? We can substitute for trust with regulation and supervision. We must create a believable institution.

This instrument cannot, however, be offered in the commercial banking box. It must utilize market-based instruments, exchange-traded securities, for example. It is important to provide liquidity for the investors. If an investor wants to exit the investment, he can do so by selling his certificate to other investors. I suggest we start with government projects, as it provides a sense of security to the investors. People trust the banking system because the government stands behind it. We can apply the same sense of security to kick-start this risk-sharing instrument.

This approach not only reduces the burden of budget deficit on government books, but also provides an alternative investment instrument for the masses instead of a guaranteed bank saving or risky equity shares. Participation securities provide moderated equity-like return with a reasonable sense of assurance from the government. Although the suggestion is simple on paper, a number of practical implementation procedures must be put in place to ensure the success of the project. If there is no serious government will to support this instrument it will provide a neutral investment instrument for Muslims and non-Muslim alike.

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