

The Interconnections Between Islamic Finance and Sustainable Finance

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1.0 Introduction

The recent global financial crisis and the hardships it imposed on many people have raised many questions about the stability and sustainability of the conventional financial system. There are calls for alternative systems that could serve the long-term interests of average citizens around the world while adding value to the real economy. Many observers believe that the Islamic financial system can provide such an alternative, making significant contributions to the sustainable development of global financial markets. This report will contrast the misleading structured finance schemes that have epitomized the major debacles of the past 15 years with a more ethical structure grounded in the basic tenets of Islamic finance. Such a system may present an appropriate exemplar—or at the very least a contemplative model to study—of a much more benign, compassionate and socially responsible guide for bank behaviour: behaviour that is configured to serve the needs of the entire world community, including the middle class and the poor.

The principles of Islamic finance have strong ties to financial stability and corporate social responsibility within the global business context. They offer mutuality, sustainability, interest in the business of all parties concerned and interest in the success of the end result. Islamic finance principles serve to insulate the Islamic financial system from excessive leverage, speculation and uncertainty, which in turn contributes toward promoting financial stability and long-term sustainability. As a result, the implementation of Islamic finance principles is anticipated to grow, not only in Muslim countries' financial markets, but also in those markets concerned with socially responsible objectives and ethical financial solutions. It is further encouraged by the global ethical consumer movement, where socially responsible investment (SRI) is deemed to be a significant mainstream asset class in the near future.

This paper has benefitted from insights and comments of many stakeholders actively involved in Islamic banking and finance, particularly in the U.A.E, Bahrain and England. The study tour to Abu Dhabi and Dubai in January 2013 provided the authors with immense intellectual and practical background to the research topic for which the authors are most indebted to Mark Pritchard (Head of Money Market Sales and Islamic Coverage, National Bank of Abu Dhabi), Ezzeldin El-Massry (Head of PLG & ADMIN-CIBD, National Bank of Abu Dhabi) and Belinda Scott (Senior Manager, Corporate Sustainability at the National Bank of Abu Dhabi). The authors also greatly appreciate the generous assistance and illuminating comments they received from Issam Tlemsani from Zayed University in Abu Dhabi. The in-depth knowledge and constructive insights of Khaled Al Fakih, Secretary General AAOIFI, shared with the authors during the 12th Annual Islamic Finance Summit in London in February 2013, was of enormous incentive for future development of this research. The authors' special thanks also go to Abdelhak El Kafsi from Bahrain-based Islamic Finance Consultants B.S.C.; his depth of knowledge and expertise in the Islamic banking and finance was an immense contribution to the content and structure of this paper. Last but not least, authors would like to express their great gratitude to Abu Dhabi National Islamic Finance (ADNIF), Al-Hilal Bank, and Ethica Institute for Islamic Finance in Dubai for sharing their professional and academic experience and achievements with the authors.

2.0 The Recurring Financial Debacles

This paper posits that the recent major financial crises have been ushered in on the heavy heels of global capital markets' duplicity. It will examine the structured finance, debt manipulation schemes intrinsic to: (1) the Enron bankruptcy; (2) the subprime mortgage debacle; and (3) the European debt crisis (collectively referred to as the fraudulent "cornerstone" transactions), each of which served to engender the deleterious, systemic dysfunction that characterizes the world economic landscape even today. Invariably, the linchpin of these schemes has been on the manipulation of massive amounts of debt. Such debt was disguised by the relevant global banks primarily through the use of structured finance products with exotic names like "synthetic collateralized debt obligations," "prepaid commodity futures transactions" and "interest rate, currency, and credit default swaps," the details of which will be reviewed below.

2.1 The Enron Fiasco

Enron, the formerly high-flying energy company that was once the favourite of Wall Street, announced its bankruptcy in late November 2001. Its stock had declined from a one-time high of \$90¹ a share to \$0.61 per share at the end of trading on November 28, 2001.

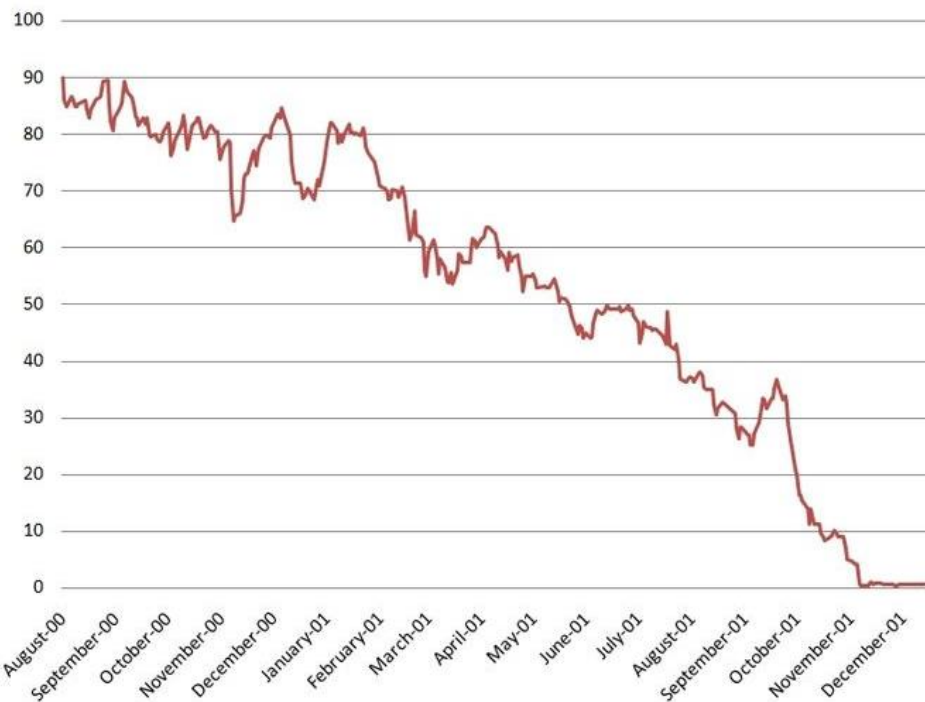


FIGURE 1. ENRON STOCK PRICE FROM AUGUST 23, 2000 TO JANUARY 11, 2002

Source: Thomson Financial/Datastream (n.d.).

¹ All figures in U.S. dollars

For many analysts, Enron's failure highlighted the risks of the post-September 11, 2001 economy and was emblematic of the stock market collapse. It has been widely acknowledged that Enron's opaque financial statements did not accurately reflect its true financial condition, particularly regarding the company's cash flow from operations and its enormous exposure to off-balance-sheet debt. At the time (and even today, to a certain extent), cash flow from operations was widely viewed as the most accurate barometer of a company's performance. Analysts believed that cash flow from operations could not be manipulated as easily as reported earnings, which were subject to vague and amorphous U.S. "rules-based," generally accepted accounting principles (GAAP). As a consequence, ratings agency analysts placed heavy emphasis on such cash flow in determining an appropriate credit rating for Enron. In turn, many of Enron's complex contractual relationships required an "investment-grade" rating for the company to avoid posting additional collateral that, in many instances, it did not have. Moreover, top management received the bulk of their compensation via stock options, the value of which was heavily influenced by credit ratings and short-term profitability.

2.1.1 Solution for Enron's Bloated Debt

Enron was under immense pressure from the ratings agencies to reduce its debt burden. However, Enron required enormous leverage in order to maintain its ambitious growth plans and to sustain management bonuses, which were largely driven by the company's expansion and the concomitant increase in share price. Enron sought the assistance of JPMorgan Chase ("Chase"), one of the largest global banks, to provide a creative solution for this pressing operational dilemma. Chase was one of the original financial innovators that created the structured finance market and the related derivative products that dominate the global financial landscape.² In the Enron situation, the big global banks like Chase and Citigroup actually conspired with Enron to 1) provide excessive leverage; and then to 2) hide this excessive leverage from the marketplace. Chase devised a plan for hiding such debt through the use of complex structured (derivative) financial products.

2.1.2 Creation of New Assets That Were Neither Transparent nor Understood

According to widely reported accounts, including the July 2002 report of the U.S. Senate Permanent Subcommittee on Investigations ("Senate Subcommittee") dealing with "The Role of the Financial Institutions in Enron's Collapse," Enron and Chase collaborated to employ a new type of loan product³ that, in form, would be masked as a set of complex commodity (structured finance) transactions. In substance, however, it was a commercial loan from Chase to Enron. The parties disguised the advance of loan proceeds by Chase as "cash flow to Enron operations" and characterized the actual repayment of principal and interest by Enron to Chase by netting such amounts in the results of trade operations. Instead of appropriately recording the receipt of loan proceeds from Chase as debt, Enron disguised its obligation to Chase in an account that reflected trading operations.

² It is estimated unofficially that there are over \$600 trillion of derivatives in the global financial market. To put this into perspective, the U.S. annual GDP is approximately \$15 trillion.

³ It is alleged that JPMorgan Chase actually used a similar set of swap transactions in the late 1990s to assist certain European nations (including Italy) to disguise their debt.

2.1.3 A Tangled Web...

Chase set up a special-purpose vehicle (SPV) in the offshore Channel Island jurisdiction of Jersey, to which it gave the name Mahonia Ltd. This shell corporation served as an “independent” third party to disguise the loan transactions with Enron. Enron would initiate an ostensibly prepaid natural gas (“prepay”) transaction involving Mahonia,⁴ usually near the end of a financial reporting period, when it needed to report more cash flow (U.S. Senate Permanent Subcommittee on Investigation, 2002).

To initiate the disguised loan transaction, Mahonia would receive the principal amount of the loan from Chase and, on paper, agreed to deliver to the bank a fixed amount of gas at specified dates. The ostensible price paid for the gas was the estimated future price of the gas on the expected delivery date and, of course, as a shell company Mahonia was not in a position to deliver natural gas in any quantity.

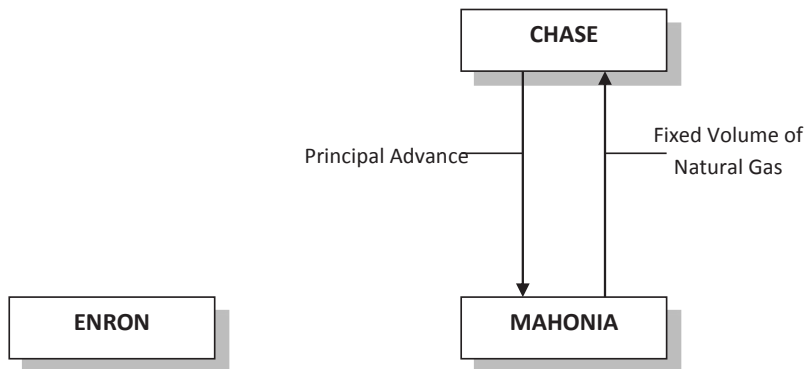


FIGURE 2. CHASE-MAHONIA PREPAY FORWARD CONTRACT LEG

Source: Author diagram.

Mahonia and Enron would then simultaneously execute a mirror contract where Enron would receive funds from Mahonia (the same amount that Mahonia received from Chase). In return, Enron agreed to deliver a fixed amount of gas to Mahonia. Chase ended up with title to the gas transferred from Enron to Mahonia and Mahonia to Chase. On paper, the SPV Mahonia appeared to be delivering the gas when in fact, Enron was ultimately the party obligated.

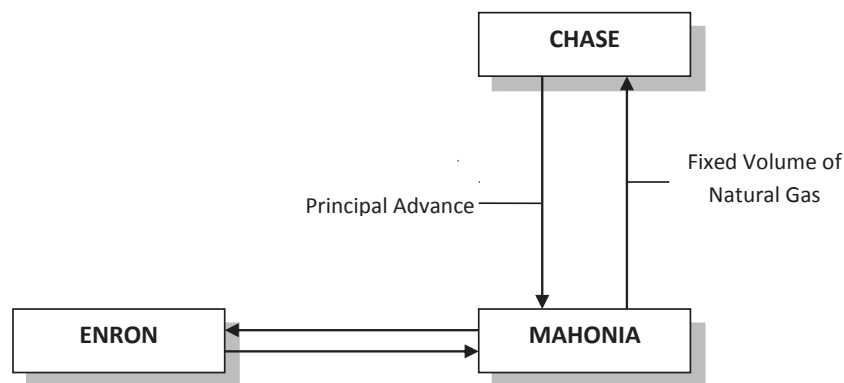


FIGURE 3. MAHONIA-ENRON PREPAY FORWARD CONTRACT LEG

Source: Author diagram.

⁴ Hence, the transaction has been dubbed the “Mahonia prepay” by financial pundits.

At the same time that the two prepaid contracts were executed, Enron and Chase executed a commodity swap agreement. Enron paid the bank a fixed-price and the bank paid Enron a floating price on the same gas. There was no transfer of title to the gas in this transaction and Enron paid the fixed-price in installments.

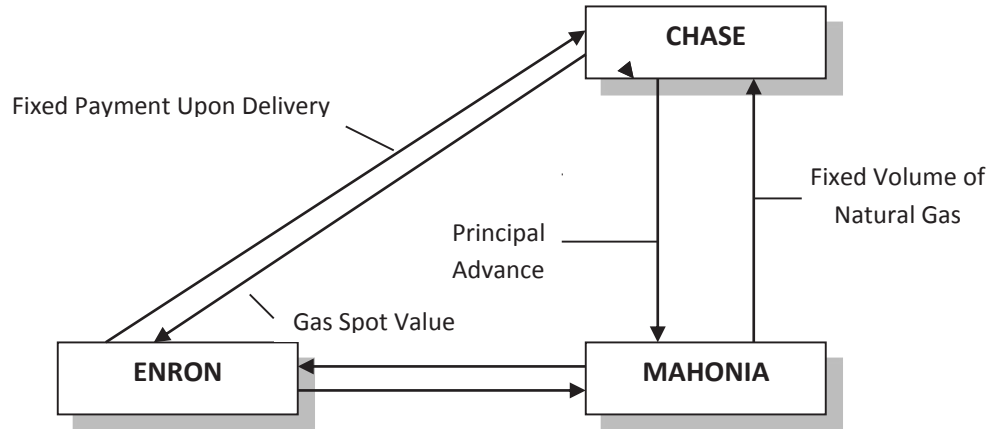


FIGURE 4. FINANCIALLY SETTLED COMMODITY SWAP LEG

Source: Author diagram.

Under the Mahonia prepay structure, Chase would advance the principal amount of the loan to Enron disguised as a payment to Mahonia for the future delivery of a fixed amount of natural gas. Chase never intended to purchase the gas from its controlled entity, Mahonia, since, Mahonia, as part of the plan, would simultaneously enter into an identical arrangement with Enron, serving as a “pass-through” so that the loan proceeds could be received by the borrower, namely Enron.

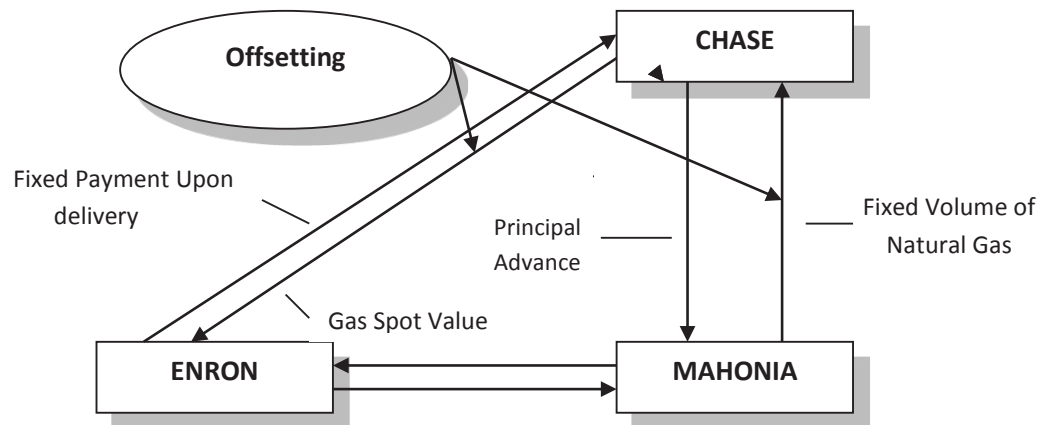


FIGURE 5. FINANCIALLY SETTLED COMMODITY SWAP LEG

Source: Author diagram.

When the offsetting transactions are eliminated, what is left is an amount advanced by Chase to Enron (the loan principal amount) in exchange for a fixed payment from Enron which represented the return of the principal amount advanced plus interest. The parties did not intend for the physical commodity (i.e., natural gas) to be purchased or delivered—

such window dressing was a charade. Any economic consequences of the physical delivery of the commodity were intentionally eliminated by the terms of the financially settled commodity swap. Thus, the commodity transactions offset each other and had no economic substance.

According to the Senate Subcommittee, in 2000 (the last year before Enron’s bankruptcy), “Enron initiated \$1.935 billion or more in prepay [i.e., disguised loan] transactions, the proceeds of which were included in Enron’s financial statements as ‘cash flow from operating activities.’” This would be as if an individual obtaining a home loan to purchase his residence reported the loan proceeds as cash flow from his business, i.e., as revenue instead of debt. In addition, the Subcommittee staff estimated that Enron had \$4 billion of outstanding *disguised* debt on its balance sheet as of December 31, 2000.⁵ Enron’s actions in 2000, by utilizing the Chase disguised loan transactions, allowed it to hide the fact that Enron had reduced its actual debt outstanding from \$14.2 billion to \$10.2 billion, a reduction of approximately 28 per cent. This reduction in reported leverage allowed Enron to maintain its investment grade rating and buttressed its bloated stock price.

Regarding the economic substance of the Chase-Mahonia transactions with Enron, the Ranking Member of the Senate Permanent Subcommittee on Investigations, Sen. Susan M. Collins stated (U.S. Senate Permanent Subcommittee on Investigations, 2002):

While these transactions were incredibly complicated, they essentially boil down to the following scenario. Enron entered into a contract with an offshore entity to deliver oil or gas at a date certain in the future in exchange for an up-front cash payment. The offshore entity, created by or at the behest of the bank, made the up-front payment to Enron with funds provided by the bank. In many cases, no oil or gas ever really changed hands. The banks understood up-front what their ultimate return would be because they hedged their risk, sometimes with Enron itself. The offshore entity supposedly participating as a trading counterparty, in reality, made nothing but preset fees, and Enron received an infusion of cash without having to disclose it as a loan on its balance sheet.

The following chart was prepared by the Senate Subcommittee to demonstrate the effect of Enron’s manipulation of the disguised “prepay” loans on its critical financial ratios.

TABLE 1. ENRON MANIPULATION OF CRITICAL FINANCIAL RATIOS

	2000 REPORTED FINANCIALS	ADJUSTMENT	2000 ADJUSTED FINANCIALS
Total Debt	\$10.2 billion	\$4.0 billion	\$14.2 billion
Total Equity	\$14.8 billion		\$14.8 billion
Total Capital	\$25.0 billion		\$29.0 billion
Debt/Equity	69.2%		96.2%
Debt/Total Capital	40.9%		49.0%

Source. U.S. Senate Permanent Subcommittee, 2002.

Similarly, the Senate Subcommittee reporting on the involvement of money centre banks with Enron produced the following table, which demonstrates that, at the relevant time, the failure to include the disguised debt on Enron’s balance sheet resulted in an implied market price that was actually twice what it would have been if the appropriate debt level had been reported by Enron.

⁵ This amount included other structured finance “prepay” transactions with Citigroup.

TABLE 2. ENRON'S IMPLIED VERSUS ACTUAL SHARE PRICE

	BALANCE SHEET DEBT	ADJUSTMENT	BALANCE SHEET DEBT + PREPAYS
Enterprise Value	\$23.4 billion		\$23.4 billion
Subtract Debt and Pref. obligations	\$13.1 billion	\$4.8 billion	\$17.9 billion
= Equity Value	\$10.3 billion		\$5.5 billion
Divide by Shares Outstanding	744 million		744 million
= Actual/Implied Market Price per Share	\$14		\$7

Source. U.S. Senate Permanent Subcommittee, 2002.

The Senate Permanent Subcommittee on Investigations hearing, which concentrated on the Enron activities of money center banks, Chase and Citigroup, brought considerable focus on the Chase-sponsored Mahonia transactions. The Committee's reaction to the overall conduct of Chase and Citigroup can be summarized by the statement of Committee Chairman, Senator Carl Levin (2002):

I think most will conclude after we hear today's testimony that Enron's use of these prepays to *disguise debt* was an accounting sham, and to carry out the deceptions Enron had the help and knowing assistance of some of the *biggest financial institutions in our country—including Chase and Citigroup* [emphasis added]. By the way, Enron was not the only company using sham prepays in the way it did. Both Chase and Citicorp have shopped the prepay structures around, and other banks and other companies have engaged in similar transactions.

As is customary (and highly criticized) the SEC permitted Chase to settle the matter for \$125 million without admitting or denying the allegations of the complaint. Citigroup settled for \$120 million on similar charges (Securities and Exchange Commission, 2003).⁶ What is clear is that with its "structured finance" product, the Mahonia prepay, Chase had found a way to market loans and excessive leverage to corporate clients, while assisting their clients in avoiding recognizing the existence of the debt; at the same time, Enron, with the cooperation of Chase, could misleadingly treat the loan proceeds as cash flow from operations. This is the financial equivalent of transmuting lead into gold. Accounting standards, however, precluded this bit of financial alchemy.

2.2 The Subprime Debacle

A "shadow banking industry" was created by the global investment banks—an unregulated enterprise that was enabled by capital provided from institutional and other investors from around the world to subprime mortgage originators. Subprime loan originators, driven by the intoxicating lure of low risk and high profits, employed abysmal underwriting standards to bring unqualified borrowers into homeownership situations for which they were clearly in over their heads. Indeed, such non-bank mortgage originators underwrote home loans to these subprime borrowers according to the lowest standards in history.

⁶ According to de la Merced (2012), U.S. Atty. Gen. Eric Holder was quoted as saying "I am concerned that the size of these institutions [banks] becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute—if we do bring a criminal charge—it will have a negative impact on the national economy, perhaps even the world economy." This is the first time that the U.S. attorney general has acknowledged that it has not pursued criminal prosecution of big banks out of fear that an indictment could jeopardize the financial system.

Inadequately capitalized structured finance bond insurers provided enigmatic credit default swaps (see discussion below) that gave the illusion of insurance to cover the enormous credit risk that the global investment banks held on subprime structured finance products that they could not sell. This allowed the investment banks to deceive the credit rating agencies. The ratings agencies were themselves hopelessly conflicted because they were only paid when they provided the desired investment grade rating to their investment bank customers. The ratings agencies compromised their standards in exchange for fees paid by the investment banks for “investment grade ratings” that pension plans and other institutional investors relied upon to ensure the safety of their investments.

When the subprime mortgage “house of cards” began to crumble, the “too big to fail” investment bank sponsors hid behind phony quasi-insurance products called credit default swaps that were issued by “bond insurers,” such as AIG. However, the bond insurers did not have the financial wherewithal to pay the investment bankers upon the default of the shaky mortgage bonds issued by the big banks. In order to understand how the global investment banks were able to shift the risk to unsuspecting investors, it is necessary to explain the mechanism by which a credit default swap (CDS) is supposed to work.

A CDS is simply a fancy name for an insurance contract between one investor (counterparty) that seeks protection from the decline in value of a particular reference entity (e.g., a bond) and another counterparty that is willing to provide such protection in exchange for insurance premiums to be paid by the counterparty seeking protection.

The position of the “protection seller” is analogous to an investor who purchases the bond and receives an income stream in the form of interest but, instead of interest, the investor receives premiums from the “protection buyer.” The protection buyer will realize a gain on the CDS transaction if the recovers (i.e., payments for the declines in value) due to the occurrence of credit events (defaults) exceed the amount of premiums the protection buyer pays. Since the protection buyer makes money if the reference entity defaults, it is said to have “shorted” the reference entity. Conversely the protection seller is said to have a “long” position with respect to the reference entity.

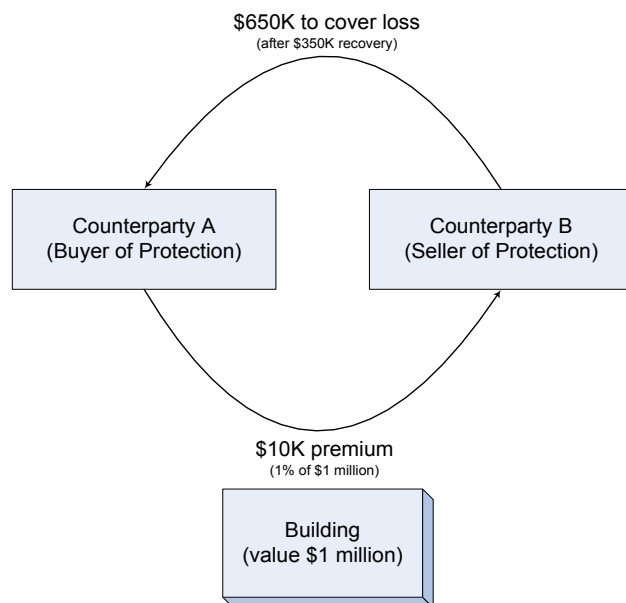


FIGURE 6. STRUCTURE OF COUNTERPARTY INSURANCE

Source: Author diagram.

Put simply, the credit default swap contract represents a transaction where the counterparties make opposite bets on how the reference entity (entities) will perform. The shorting counterparty makes money if the referenced entity defaults and goes down in value, while the protection seller (party taking the long position) must cover the amount lost by the buyer of protection. But again, if there are no losses due to credit events, the protection seller pockets the premiums without ever having to make payments to the protection buyer.

Clearly, the interests of the protection buyer and the protection seller are opposed. Given the choice, the protection sellers (i.e., investors) would like to have a reference entity (entities) with solid creditworthiness so that the possibility of default (“credit event”) is extremely remote. This is the position of the holders of debt and equity issued by the synthetic CDO. However, this position conflicts with the deal sponsor, who is the buyer of protection and who will only get compensated (often enormously) if the reference entity defaults. In the subprime mortgage industry, the global investment banks that issued the synthetic CDOs made enormous sums of money when their investors lost money because the banks had bet against the interests of the investors—a loss to the investor was a gain to the investment bank.

A synthetic CDO, such as the Goldman Sachs Abacus⁷ deal that was attacked as fraudulent by the SEC (SEC, 2010) is, in essence, a credit default swap embedded in an offshore special-purpose vehicle (SPV) that issues various tranches of debt graded by risk level. During the pre-credit crunch era, the sponsor (or arranger) of a synthetic CDO was typically a global investment bank, which also functioned as the buyer of credit protection on a portfolio of reference entities, while the investor, often a pension or hedge fund, was the seller of protection. Synthetic CDOs, which were sponsored to the tune of hundreds of billions of dollars and sold by various Wall Street bankers, often resulted in huge losses to the pension or hedge fund investors, while they garnered massive profits for their investment banker sponsors who shorted⁸ the reference portfolios as counterparty to the underlying credit default swap. Rather than incur the risk of owning the toxic subprime securities they had created, the global investment banks deceived investors into providing them insurance against losses through the credit default swap mechanism.

This was a problem because many of the pre-credit crunch sponsors of synthetic CDOs were also large originators and/or purchasers of abysmally underwritten subprime mortgages that were subsequently packaged by those bankers into toxic residential mortgage-backed securities. By 2006, many of these investment bankers were saddled with these same toxic assets on their balance sheets. A perfect solution was to market a synthetic CDO product with toxic reference entities that were on the sponsor’s (or a related party) balance sheet. The sponsor of the synthetic CDO would purchase protection from losses on assets it was exposed to by marketing the CDO to unsuspecting investors who were willing to sell such protection. Of course, a conflict exists where the sponsor/investment banker doesn’t disclose that it actually is hoping that the reference entities—and therefore its investors—lose money.

A sponsor (or arranger) of a synthetic CDO such as Goldman’s Abacus puts the deal together using an SPV and, among other things, is responsible for hiring the portfolio manager and attracting investors. The investors in a synthetic CDO deal such as Goldman’s Abacus take the “long position” on the reference entities selected by the portfolio manager and “sell” protection on the deal while the sponsor (Goldman, in the case of Abacus) takes the “short” position as the counterparty buying protection.

⁷ Perhaps the classic, but by no means only, example of a large global investment bank’s exploitation of its investors is provided by the Abacus synthetic CDO, for which Goldman Sachs paid a record \$550 million fine to settle SEC charges that Goldman misled investors in a subprime mortgage product just as the U.S. housing market was starting to collapse. It is the largest ever penalty paid by a Wall Street firm.

⁸ That is, bet against the performance of the bonds referenced by the CDO which were sold to their investors.

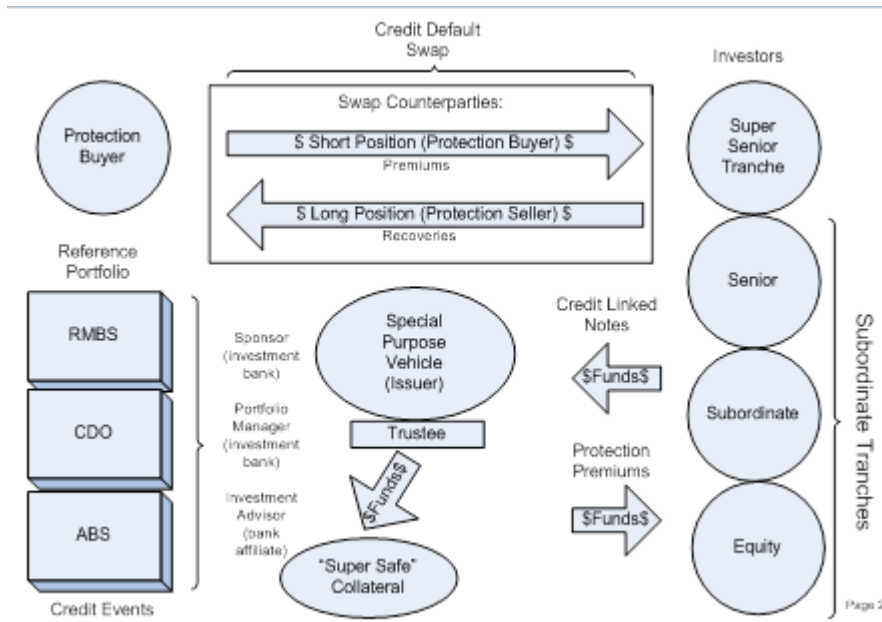


FIGURE 7. STRUCTURE OF PARTIALLY FUNDED SYNTHETIC CDO

Source: Author diagram.

Ironically, the sponsor, who must obtain investors for the deal, only makes money if those investors lose money. A deal sponsor will benefit from reference entities that perform poorly, while the investors will lose in that situation. Obviously, an objective, unbiased process for selecting the reference entities is of critical importance. Ideally, the portfolio manager, who is charged with objectively selecting the reference entities, is independent of the deal sponsor. Unfortunately, this was rarely, if ever, the case.

2.3 The Greek Debt Debacle

This section examines the increasingly worrisome, and potentially catastrophic, European debt crisis. The genesis of Europe's current economic dilemma can be found with the issue of the enormous Greek debt which, together with the excessive debt of other member countries, continues to threaten the underpinnings of the European Union. As we shall see in the following discussion, the inappropriate use of structured finance products, which are prohibited under fundamental Islamic finance law, played an intrinsic role in the current European debt crisis. Indeed, Wall Street tactics similar to those that created the problems for Enron, and later the subprime mortgage crisis, exacerbated the financial crisis facing Greece, and in turn the European Monetary Union, by creating a scheme to permit European member governments to hide their burgeoning debt.

2.3.1 Goldman Sachs and the Greek Debt

Eurozone member states created rules at the Treaty of Maastricht in 1992 relating to the permitted amount of sovereign deficit and debt. To rein in fiscal excess, the Stability and Growth Pact of 1996 set two significant targets for member states: Deficit/GDP less than or equal to 3 per cent and debt/GDP less than or equal to 60 per cent. Of the two ratios,

the deficit/GDP is generally considered to be the most significant. The deficit rules called for the assessment of a significant fine on euro area member states that exceeded the limit for the budget deficit. Clearly, founders of the union recognized the inherent dangers of excessive debt.

It has been widely reported that Wall Street conceptualized and implemented sophisticated currency swap transactions to cosmetically reduce the publicly reported debt and deficit ratios enabling certain euro member states to circumvent the rules (see e.g., Story, Thomas Jr., & Schwartz, 2010). Such reports indicate that, as early as 1996, Italy began using swap transactions to eliminate the effects of its expansive debt so as to ameliorate its burgeoning debt and deficit ratios. Below, we discuss the situation with respect to Greece that existed in early 2002, shortly after Greece joined the euro single currency in early 2001. At the time, the Greek economy was characterized by high deficits and high inflation. Because its debt/GDP ratio was consistently elevated, Greece's interest costs were considerably in excess of what was paid by its Eurozone peers. Accordingly, in early 2002 the European Commission chastened Greece to reduce its exorbitant interest costs and inordinately high debt ratio and at the same time called for greater transparency regarding Greece's financial operations. Reacting to such a mandate, Greece proceeded in an unorthodox and ill-fated manner by engaging in a scheme involving cross-currency swaps, engineered by Wall Street principals to maintain Greece's profligate borrowing practices, while at the same time allowing Greece to meet the otherwise unattainable Eurozone deficit criteria.

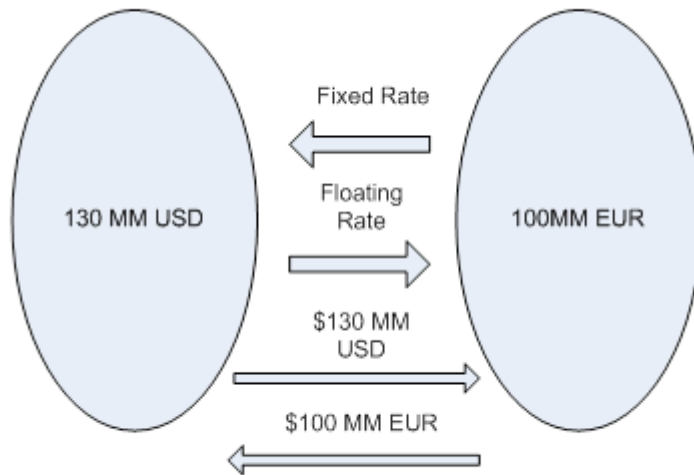
According to Story, Thomas Jr., and Schwartz:

In 2001, just after Greece was admitted to Europe's monetary union, Goldman [Sachs] helped the government quietly borrow billions, people familiar with the transaction said. That deal, *hidden from public view because it was treated as a currency trade rather than a loan* [emphasis added], helped Athens to meet Europe's deficit rules while continuing to spend beyond its means ... With Greece groaning under the weight of its debts and with its richer neighbors vowing to come to its aid, the deals over the last decade are raising questions about Wall Street's role in the world's latest financial crisis. As the American subprime crisis and the implosion of the American International Group, financial derivatives played a role in the run-up of Greek debt. *Instruments developed by Goldman Sachs, JPMorgan Chase and a wide range of other banks enabled politicians to mask additional borrowing and Greece, Italy and possibly elsewhere* [emphasis added].

This technique used cross-currency swaps that were employed in a manner that was uncannily similar to the commodity swaps employed by JPMorgan⁹ and Citigroup with Enron to disguise that company's debt. The end goal for both Enron and Greece was to disguise massive debt and, in the case of Enron, to convert that debt into current income. This scheme allowed Greece to meet its strict Stability and Growth Pact deficit ratio requirements. According to *Der Spiegel*, Greece entered into a large deal with Goldman Sachs in 2002 involving derivatives, specifically cross-currency swaps, "in which government debt issued in dollars and yen was swapped for euro debt for a certain period—to be exchanged back into the original currencies at a later date" (Balzli, 2010). According to the article, Greece employed a cross-currency swap scheme designed by Goldman that featured "fictional" currency exchange rates. This allowed Greece to exchange currencies and debt, while at the same time disguising what was, in substance, a loan in the

⁹ According to del la Merced (2012): "JPMorgan also happens to run one of the most active and best financed lobbying operations within the commercial banking industry... Mr. [Jamie] Dimon has made 10 visits to regulators to discuss Dodd Frank, principally at the Treasury Department. JPMorgan officials have visited government regulators either on their own or as a part of an industry group 72 times, according to the Sunlight Foundation's database."

form of an upfront payment from Goldman to Greece at inception and an increased stream of interest payments to Greece throughout the duration of the swap. The transaction was structured so that Goldman would recuperate the nonstandard cash flows at swap maturity through receipt of a large “balloon” payment from Greece.



Exchange Rate: 1.3 USD: 1.0 EUR

FIGURE 8. STRUCTURE OF A CROSS-CURRENCY SWAP

Source: Author diagram.

Although there was nothing insidious about the use of cross-currency swaps—one of the earliest over-the-counter derivatives to be traded—such deals are typically struck referencing the notional amount of the debt using the prevailing spot foreign exchange rate. Structured in this fashion, the cross-currency swaps have zero present value initially and would not have had any impact on Greece’s borrowings or deficit ratio. However, the distinguishing feature of the swaps that Goldman arranged for a reported fee of \$300 million (Story, Thomas Jr., & Schwartz, 2010) was the use of a contrived foreign-exchange rate (i.e., a rate other than the prevailing spot rate) in the contracts, which created a mismatch between the different currency swap notionals. According to published reports, and adding insult to injury, Goldman then proceeded to short (i.e., bet against) the credit risk of Greece, which Goldman itself had exacerbated, by entering into a credit default swap with Frankfurt-based Deutsche Pfandbriefe bank (Depfa) bank.

As there is little doubt over the deceptive behaviour of big financial players in the conventional markets and its role in the worldwide collapse of financial markets, global citizens today seek an alternative system that respects and adheres to principles of fairness and equity. In the following section, the principles of Islamic finance as an alternative to the conventional system will be reviewed.

3.0 Islamic Finance: Some factual background

Islamic finance, in its modern terms, came into existence in the 1970s, when the first Islamic banks were established to offer commercial products on an interest-free basis. Since then, significant development has been made in Islamic financing, creating a new generation of more diverse and innovative Islamic financial institutions which are prepared to meet the evolving needs of global financial markets. As stipulated by Warde (2000), perhaps the most important development in Islamic finance has been its growing integration into the global economy. There is now a Dow Jones Islamic Market Index and many foreign institutions such as Citibank and HSBC have established Islamic banking subsidiaries, offering Islamic products to a wide range of clients.

Islamic finance is one of the world’s fastest growing financial markets, with an estimated annual growth rate of 20 per cent. According to a report by Ernst & Young, published in December 2012, Islamic assets were valued at about \$1.3 trillion in 2011, representing about 1 per cent of the global financial market. It is also estimated that Islamic finance global assets could potentially have grown a further 17 per cent in 2012 to reach \$1.8 trillion by 2013, representing an increase of about 250 per cent from \$509 billion in seven years since 2006, and with double digit growth expected to continue (Ernst & Young, 2012).

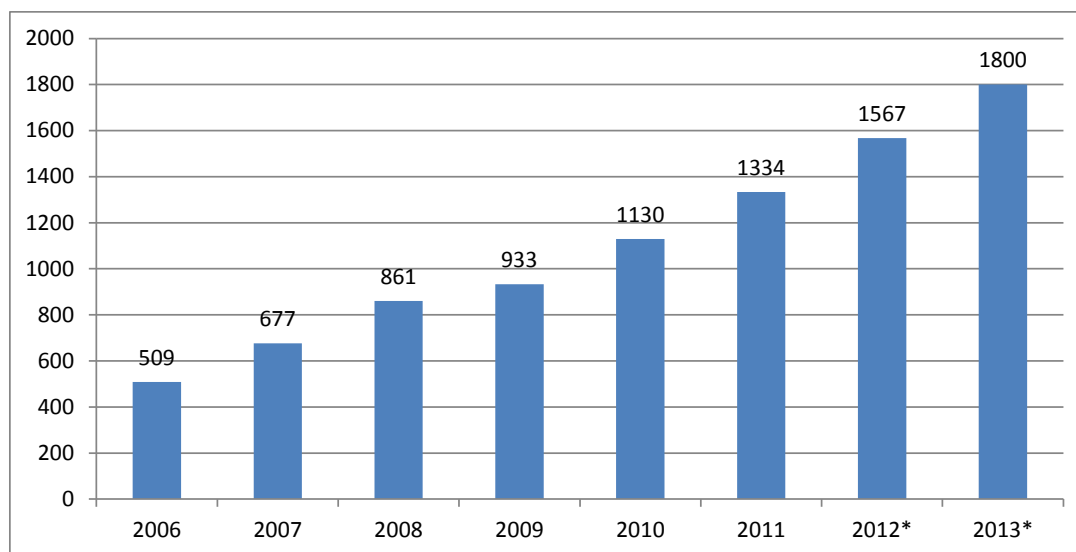


FIGURE 9. GLOBAL ASSETS OF ISLAMIC FINANCE (\$ BILLION)

Source: *The Banker*, UKIFS, * Ernst & Young estimates

A major part of the growth was seen in the *Sukuk* markets, where in 2011, approximately \$84.4 billion *Sukuk* were issued—representing an increase of 62 per cent from the \$52 billion issued in 2010. The growth in *Sukuk* markets can mainly be attributed to increasing interest from issuers in both Muslim and non-Muslim countries to fund their mega-projects using Islamic financial products. Today, in many countries the banking system provides dual financial services, simultaneously offering conventional and Islamic products, though through separate windows and portfolios. The number of financial institutions offering Islamic finance products was 275 in 2011, representing a presence in 75

countries around the world. In addition, in 2011, Thomson Reuters launched an Islamic Interbank Benchmark Rate (IIBR), based on rates contributed by 16 Islamic banks and Islamic sections of conventional banks, thus demonstrating the maturation of the Islamic money market in the global financial markets.

Despite its rapid growth and given the global market's size, Islamic finance is still a niche market. However, the prospects for the worldwide development of Islamic finance is bright mainly due to strong demand for Islamic financial services from a large segment of the world's 1.5 billion Muslims and the need to diversify investment portfolios in light of rising international savings.

4.0 Principles of Islamic Finance

Islamic finance is based on the notion that Islamic banks are not only responsible to their immediate shareholders, but owe a fiduciary duty to the society as a whole. Generally, the Islamic financial model emphasizes fairness and requires everyone involved in a transaction to make informed decisions, so as not to be misled. It seeks social justice and economic prosperity of the whole community and discourages concentration of wealth in a few hands. Islam encourages the right of individuals to pursue personal economic well-being, while adhering to strict principles. The sustainability and viability of Islamic finance come from fundamental requirements set by principles of the *Sharia* law. Islamic transactions should strictly adhere to the permissible (*Halal*) and abstain from the prohibited (*haram*). As will be reviewed below, these requirements are implied by divine rules that include prohibition of *riba* (interest), *gharar* (ambiguity), *maisir* (gambling) and commodities such as intoxicants and pork.

4.1 *Riba* (usury/interest)

One key tenet of Islamic finance in economic activities is the strict and explicit prohibition of *riba*, usually described as usury or interest. According to *Sharia* principles, contracts where one party has unjust enrichment at the expense of another party's loss are considered void. Based on a number of verses in the Holy *Qur'an*, receiving a monetary advantage without giving a counter value is forbidden on ethical grounds. Depending on the interpretation, *riba* may only refer to excessive interest; however, to many scholars, the whole concept of interest is *riba*, and thus is unlawful. Even though there is a wide spectrum of interpretation on the point at which interest becomes exploitative, many modern scholars believe that interest should be allowed up to the value of inflation, to compensate lenders for the time value of their money, without creating excessive profit.

Riba may also predetermine a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor. However, under modern Islamic banking, a mechanism has been developed to allow interest income to be replaced with cash flows derived from productive commercial activities where both parties share profit and loss. According to Mirakhor and Zaidi (2007), the main difference between an Islamic, interest-free financial system and the conventional, interest-based financial system is that, under the latter,

the interest rate is either fixed in advance or is a simple linear function of some other benchmark rate, whereas, in the former, the profits and losses on a physical investment are shared between the creditor and the borrower according to a formula that reflects their respective levels of participation.

4.2 *Gharar* (uncertainty)

Gharar in literal terms means to deceive, cheat, delude, lure, entice and any act that causes uncertainty. In Islamic finance, *gharar* refers to contractual uncertainty characterized by ambiguity that may lead to dispute between the contracting parties. An example might be the execution of a contract before the price, subject matter or the transacting parties are definitively known (Ethica, 2013). Under *Sharia* law any uncertainty (*gharar*) as to one of the fundamental terms of a contract is prohibited, and such uncertainty renders the contract void and null. According to Kamali (2002), the majority of Islamic scholars view *gharar* as "both ignorance of the material attributes of the subject matter of a sale, and also uncertainty regarding its availability and existence." *Gharar* is derived from the root concept meaning "deception"; hence, as emphasized by Abdulkader, Cox, and Kraty (2005), there is no *fiqh* (*Sharia* jurisprudence) or linguistics by which to consider *gharar* as "trading in risks" as contended by some western scholars.

4.3 *Maisir* (speculation)

Maisir or speculation is generally defined in Islamic finance as the act of gambling where an easy profit is gained by chance rather than productive activity. It is regarded as morally unacceptable, because it results from the desire to win at the expense of others, and potentially leads to hostile behaviour. In Islamic finance, for example, the transaction must be genuine with the full intention of giving and taking delivery; the debt cannot be sold, and thus the risk associated with it cannot be transferred to someone else. This principle of the Islamic system could have eliminated most of the speculative transactions, since financing through Islamic products can expand only in step with the rise of the real economy.

Both the concepts of *maisir* and *gharar* involve excessive risk that engenders volatility and uncertainty while, at the same time, facilitates potential fraudulent behaviour. Accordingly, Lewis and Algaoud (2001) have asserted that the use of all conventional derivative instruments is impossible in Islamic banking.

4.4 Asset-Backed Financing

One of the most significant characteristics of Islamic financing is that it is asset-backed (Usmani, 1998). In conventional markets, banks and financial institutions deal with money and money papers only, whereas in Islamic financing, money is only a means of exchange and has no intrinsic utility (Usmani, 1998). Since interest-based transactions are prohibited in Islam, businesses are encouraged to generate fair and legitimate profits from productive commercial activities. Most financial instruments in Islamic finance, such as *Murabahah*, *Ijarah*, *Salam* and *Istisna'a*, which are alternatives to debt-based instruments in conventional finance, require the existence of real assets in order to ensure their legitimacy for Islamic finance. In conventional financial instruments, risk is generally separated from the underlying assets; as a result, risk management and wealth creation may at times move in different—even opposite—directions. These instruments also allow for the commoditization of risk, leading to excessive leveraging and disproportionate distribution that can result in higher systemic risks and increase the potential for instability and inequitable concentration of wealth (Mirakhor & Zaidi, 2007).

4.5 Profit-Loss Sharing Principle

Unlike conventional banks, which put emphasis on receiving the interest payments irrespective of the project's high or low level of profitability, Islamic banks rigorously follow the business activities of the debtor and the return on the physical investment as “[their] own profitability is directly linked to the real rate of return” (Mirakhor & Zaidi, 2007).

In conventional markets, the financier and entrepreneur are two separate elements of production. While the former gets interest based on a fixed rate of return for providing capital, the latter is entitled to profit only if there is a surplus after distributing the fixed return to land, labour and capital. According to Mufti Taqi Usmani (1998), one of the leading *Sharia* scholars, in Islam every person who contributes capital to a commercial enterprise assumes the risk of loss, and hence is entitled to a proportionate share in the actual profit. In other word, instead of fixed return as interest, the financier is entitled to share the profit with the entrepreneur. As a result, profit-and-loss sharing contracts promote greater stability in financial markets, encouraging banks to focus on the long run in their relationships with their clients.

The principle of profit-loss sharing in Islamic financial transactions also requires a high level of disclosure and transparency in the Islamic finance system. Such a principle, which is required by *Sharia* injunctions, provides built-in checks and balances ensuring the financial stability and sustainability of the Islamic finance system. It also encourages risk management and provides confidence through transparency of the roles and responsibilities defined in the contract.

BOX 1. ISLAMIC FINANCE PRODUCTS

In order to comply with *Sharia* principles, a number of financing products have been developed to facilitate everyday banking activities. Below a number of popular Islamic financial products being marketed worldwide by Islamic banks and financial institutions is reviewed.

Murabahah (cost-plus financing)

In *Murabahah* the bank agrees to buy an asset or goods from a third party, and then resells the goods to its client with a certain profit added to its cost. The basic feature of *Murabahah* is that the bank discloses the actual cost it has incurred in acquiring the commodity and then adds a mark-up. In *Murabahah*, the client purchases the goods either at spot, or on a subsequent date agreed upon by the parties. Some observers critically view *Murabahah* as an implication of deferred payment, which is popular in conventional banking. However, a major difference between *Murabahah* and interest-based lending is that the mark-up in *Murabahah* is a bank services fee and is not stipulated in terms of a time period. Thus, in *Murabahah*, if a client fails to make a deferred payment on time, the mark-up does not go beyond the agreed price owing to delay.

Mudarabah (finance by way of trust)

Mudarabah is a form of partnership where one partner finances the project, while the other party manages the money and invests it in a commercial enterprise. This form of financing does not require establishment of a company; the bank or financial institution provides all of the capital and the customer is responsible for the management of the project. In *Mudarabah* profits from the commercial activities are distributed based on a fixed, predetermined ratio. It should also be highlighted that *Mudarabah* differs from what is known as speculation, which includes an element of gambling in buying and selling transactions (Accounting and Auditing Organisation for Islamic Financial Institutions [AAOIFI], 2013).

Musharakah (partnership)

Musharakah is a form of partnership between the bank and its clients whereby each party contributes to the capital of partnership in equal or varying degrees and all partners share the profit or loss of the joint enterprise (AAOIFI, 2013). *Musharakah* is perceived to be the preferred Islamic form of financing, as it complies most closely with the principle of profit-and-loss sharing. Profits are shared between partners on a pre-agreed ratio; however, losses are shared in proportion to the capital contributed by each party. The profit-loss sharing principle embedded in *Musharakah* encourages the bank to invest wisely and take an active interest in the productivity of the investment.

Ijarah (leasing)

Ijarah is an Arabic word that literally means “to give something on rent.” It is a form of contract under which the bank buys and leases out an asset or equipment required by its client for a rental fee. In Muslim countries, leasing originated as a trading activity and later on became a form of finance. In *Ijarah*, for a pre-agreed period, the ownership of the asset remains with the lessor, and he assumes the risk of ownership. During this period, the lessor is also responsible for the asset maintenance and insurance.

Salam (advance purchase)

Salam is a sale whereby a commodity is purchased for deferred delivery in exchange for immediate payment according to specified conditions, or sale of a commodity for deferred delivery in exchange for immediate payment (AAOIFI, 2013). *Salam* is limited to “fungible” commodities and is mostly used for agricultural products by providing needed capital prior to delivery. Generally, Islamic banks use a *Salam* contract to buy a commodity and pay the supplier in advance, specifying the chosen date for delivery. The bank then sells this commodity to a third party on a *Salam* or installment (EI-Gamal, 2006).

BOX 1. ISLAMIC FINANCE PRODUCTS CONTINUED

Istisna'a (commissioned manufacture)

Istisna'a is a contract in which the purchaser orders a manufacturer to manufacture a specific commodity, using the purchaser's raw materials at a given price (AAOIFI, 2013). It is necessary for the validity of *Istisna'a* that the price is fixed with the consent of the parties and that the required specifications of the commodity are fully agreed upon by the parties. *Istisna'a* resembles *Salam* in that it provides for the sale of a product not available at the time of sale; however, unlike *Salam*, the price in the *Istisna'a* is not paid when the deal is concluded.

Sukuk

Sukuks, also sometimes referred to as Islamic bonds, are financial certificates representing a proportionate interest in underlying assets and revenues. Under *Sharia* law, so far as a bond certificate is supported by an asset, and is transformed into an object of value, it qualifies to become an object of trade, and hence eligible for trading in primary as well as secondary markets. Although *Sukuks* are sometimes considered as the Islamic equivalent of bonds or capital market instruments, there is a basic difference between conventional bonds and *Sukuk* which lies in the way they are structured and offered. In conventional markets, the interest rate is at the core of all transactions, including bond issue and trade. Islamic *Sukuks*, however, are structured in such a way that the issue is based on the exchange of an approved asset for a specified financial consideration. Also in *Sukuk* the primary credit risk is that of the originator, who is obliged to pay the *Sukuk* holder regardless of the performance of the underlying asset.

5.0 Sustainability of Islamic Financial System vs. the Conventional System

The principles of Islamic finance, as reviewed above, offer a just and fair socioeconomic system where there is a strong commitment towards the well-being of society. One of the most important objectives of Islam is to realize and promote greater justice in human society. According to the *Qur'an*, a society where there is no justice will ultimately head towards decline and destruction (*Qur'an*, 57:25). One of the fundamental elements for ensuring justice is a set of rules and moral values, which are faithfully accepted and adhered to by members of the society. However, the behaviour of financial actors that led to the recent financial crisis represented, in many ways, deviations from some universally accepted ethical principles, including justice, fairness and honesty, causing (a) too much debt, (b) overleveraging of assets, (c) excessive securitization and creation of new assets that were neither transparent nor understood and (d) diversification of risk, based on unreal models (Mathews & Tlemsani, 2010). The resulting dysfunction in capital markets led to massive systemic risk, the “too big to fail” problem and the need for bailouts.

In Islam, economic activities are recommended, and the profit motive, to a reasonable extent, is acceptable; this is a major difference between conventional and Islamic economies. In a capitalist economy, the profit motive and private ownership are given unbridled power to make economic decisions; interest, gambling and speculative transactions tend to concentrate wealth in the hands of the few, base human instincts are exploited to make money through immoral and injurious products; and unbridled profit making creates monopolies that paralyze market forces and hinder their natural operation (Usmani, 1998). There is a reasonable level of agreement among observers with regards to the main causes of the recent crisis in financial markets. These causes—which include excessive leveraging, opaque financial securities and governance failure—all have their roots in the lack of moral values among conventional market players. Compared with the principles of Islamic finance, one may conclude that the recent financial crisis was a major spiritual crisis where a society valued the capital gains of the *rentier* class more highly than the rights of average citizens to homes, education and health.

In conventional markets, the Islamic principle of prohibition of *riba* was clearly violated in cases of excessive lending and borrowings. Although there are arguments among scholars as to what precisely constitutes *riba*, the high rates of interest charged in credit card lending, certain subprime mortgages and the fraudulent manipulation of debt could be qualified as *riba* or usury from most perspectives (Rahman, 2009).

The Islamic principle of asset-backed financing could also have prevented the upward trend of debt, particularly unsecured consumer debt. In Islam, debt-based financing is permitted, provided that it is for a productive commercial activity. Thus, debt should not be promoted for nonessential consumption and unproductive speculation. The Islamic financial system allows the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing (*murabahah*, *ijarah*, *salam*, *istisna'a* and *Sukuk*), while adhering to certain conditions, including (Usmani, 1998):

- The asset that is being sold or leased must be real, and not imaginary or notional.
- The seller or lessor must own and possess the goods being sold or leased.
- The transaction must be a genuine trade transaction with full intention of giving and taking delivery.
- The debt cannot be sold and thus the risk associated with it must be borne by the lender himself.

The first condition can help to eliminate a large number of derivative transactions that involve gambling by third parties who aspire to claim compensation for losses that have been actually suffered only by the principal party and not by them (Rahman, 2009). For example, in the case of “credit default swap” characterized as a derivative instrument, the tenets of Islamic finance were, per se, violated in that the swap contracts did not link to a specific hard asset. That is, one can make a bet regarding a specific asset without actually owning that asset. Also the damage from the subprime financial crisis was exacerbated by the fact that many counterparties were able to speculate on bonds that they did not own through the use of credit default swaps. As a result, excessive uncertainty resulting from the sale of toxic papers clearly infringed the Islamic principle of prohibition of *gharar*, where parties to a transaction are strongly encouraged to achieve full clarity and transparency on what is being bought and sold. Also, the implication of the ban on selling debt is that it, first of all, removes the separation between originator and the party holding credit risk and forces the originator to take on the credit risk. Secondly, the lack of transfer of the debt would mean that the holder of credit risk, rather than relying on credit ratings, would retain a “line of sight” to the actual loans, making them better aware of the risks (Rahman, 2009).

The numerous mortgage-originating companies violated yet another fundamental tenet of Islamic finance by not sharing the risk of ownership in the mortgage assets they created. Instead of holding the mortgages and sharing the risk with their borrowers, these shadow banking mortgage originators sold the mortgages to investment bankers, who themselves avoided risk of ownership by placing the mortgages into exotic securitization structures. The risk was ultimately borne by unsuspecting investors around the world who purchased the toxic subprime bonds. It is interesting to note that investors were attracted to these subprime products because of the higher interest they offered, which masked the inherent weakness of the defaulted mortgages that served as collateral. Unlike with Islamic finance, there was no contemplation of risk sharing with the investment bank sponsors who had sold investors the toxic residential mortgage-backed securities and CDOs.

The growth of opaque financial securities, particularly securitized debt instruments with dishonest credit ratings, was a consequence of the disconnect between the financier and the debtor, where the interests of the parties were no longer aligned; the financier was only concerned about selling the loan and collecting the fees, while the ultimate holder of the risk was left with full exposure to the creditworthiness of the debtor. In conventional financial markets, the investment bankers delegated the mortgage-underwriting task to compliance underwriting companies that sprang up in the wake of the massive amounts of capital generated by the shadow banking industry. Such compliance underwriting companies, instead of employing appropriate due diligence, were motivated to approve as many mortgages as quickly as possible, in order that the global investment bank sponsor of securitizations would have enough mortgage product to create more securitizations and CDOs. Islamic financial principles offer a clear perspective on the securitization of debt. The majority of Islamic scholars believe that the sale of debt is impermissible because the discounting of cash flows inherent in the sale of debt is deemed as a form of *riba* and hence prohibited. Some observers even stipulate that the *Sharia* prohibition of the sale of debt is arguably “the clearest mechanism by which a major cause of the crisis may have been averted” (Rahman, 2009).

Governance failures have also been identified as a major contributing factor in the crisis. Executive compensation schemes are frequently mentioned as a major cause of the crisis, where executives were generously offered bonuses for short-term gains at the expense of long-term losses by shareholders. Inadequate risk-management and risk-reporting systems were another indication of governance failure where the executives, directors and shareholders were not provided with an accurate and clear picture of the financial risks being undertaken by the firm (Rahman, 2009).

Under Islamic finance principles, however, excessive executive compensation is ruled out by urging adherence to the ethical principles of fairness, equitability and risk and profit sharing. It also prohibits any deliberate misrepresentation of risks, that are considered analogous to deception. In addition, the Islamic financial system requires a *Sharia* governance system where all products offered and transactions undertaken by an Islamic financial institution are subject to *Sharia* review by an independent *Sharia* Committee composed of *Sharia* scholars.

The Islamic financial system, therefore, offers the required principles which could have prevented or minimized the severity of the recent financial crisis by eliminating some of the major weaknesses of conventional markets. It offers greater discipline to the financial system by requiring lenders to share in the risk. The Islamic system also requires credit expansion to be proportionate with the growth of the real economy; meaning that the credit should be granted for the purchase of real goods and services that the seller owns and the buyer wishes to take delivery of (Ahmed, 2010). It also requires the financier to bear the risk of default by prohibiting the sale of debt, ensuring that risk is evaluated more prudently.

TABLE 3. THE ECONOMICS OF ISLAMIC FINANCE AND “MARKET FAILURES”

ISLAMIC FINANCE PRINCIPLE	INTUITIVE DESCRIPTION	LINKAGE TO “MARKET FAILURES”?
<i>Riba</i> Prohibition	“Earning money from money,” or interest, is prohibited. Profit, which is created when “money” is transformed into capital via effort, is allowed. However, some forms of debt are permitted where these are linked to “real transactions,” and where this is not used for purely speculative purposes.	A real return for real effort is emphasized (investments cannot be “too safe”), while speculation is discouraged (investments cannot be “too risky”). This might have productive efficiency spill-over benefits (“positive externalities”) for the economy through linking returns to real entrepreneurial effort.
Fair profit-sharing	Symmetric profit-sharing (e.g., <i>musharakah</i>) is the preferred contract form, providing effort incentives for the manager of the venture, while both the investor and management have a fair share in the venture’s realized profit (or loss).	Aligning the management’s incentives with those of the investor may (in contrast to pure debt financing) once again have productive efficiency spill-over benefits for the economy, through linking realizable returns to real entrepreneurial effort.
No undue ambiguity or uncertainty	This principle aims to eliminate activities or contracts that are <i>gharar</i> , by eliminating exposure of either party to excessive risk. Thus, the investor and manager must be transparent in writing the contract, must take steps to mitigate controllable risk and avoid speculative activities with high levels of uncontrollable risk.	This may limit the extent to which there are imperfect and asymmetric information problems as part of a profit-sharing arrangement. Informational problems might, for example, provide the conditions for opportunistic behaviour by the venture (moral hazard), undermining investment in all similar ventures in the first instance.
<i>Halal</i> vs. <i>Haram</i> sectors	Investing in certain <i>haram</i> sectors is prohibited (e.g., alcohol, armaments, pork, pornography and tobacco) since they are considered to cause individual and/or collective harm.	Arguably, in certain sectors, there are negative effects for society that the investor or venture might not otherwise take into account (negative externalities). Prohibiting investment in these sectors might limit these externalities.

Source: M. Iqbal and Llewellyn (2002), cited in Oxera (2007, p. 2).

6.0 Conclusion

While the global financial market is facing unprecedented challenges of closures and bankruptcies, Islamic finance has demonstrated growing market participation through adherence to fair, equitable and socially responsible principles. Islamic finance may not be strong enough yet to meet the challenges posed by the current credit crunch; however, the global demand for creation of a “New International Economic Order” has offered numerous opportunities for Islamic finance scholars and practitioners to promote a more sustainable global financial system. What is clear is that the moral turpitude and duplicitous behaviour of the various “too big to fail” global investment banks has not served the needs of the world’s global community—especially the middle class, the poor and the disenfranchised. Regardless of religious considerations, the Islamic finance microcosm provides a contemplative model for serious ethical reform.

Islamic markets thus can provide a model for socially responsible, sustainable changes in the financial system. There are many emerging avenues of research on global development of Islamic finance; some of the most important of could include:

- The prospect for harmonization of Islamic financial principles: A response to the increasing need for globally accepted Islamic financial principles.
- Innovation in Islamic finance (e.g., liquidity management and commodity financing), information and other technology advancement;
- Islamic funds and exploring sources of *Sharia*-compliant liquidity for investment in least-developed nations.
- An appraisal of *Sukuk* issuance in the Middle East and North Africa: A promoting guideline for Western investors.
- Opportunities and challenges of expansion of Islamic banking in the U.S. financial markets.

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