

The Road Ahead?: An Islamic Financial Ethicist's Observations on the Current Economic Crisis and Possible Recovery Strategies

Beginning with Name of God I greet you with the greeting of “Peace”.

Thank you for the lovely introduction. I last time visited the beautiful Wesleyan campus when I attended the graduation of my brother in the late 90s. My brother always speaks fondly of his undergraduate years here. I will try to be on my best behavior, therefore, so as to not embarrass him at his *alma mater*!

The title of my brief talk this evening is “The Road Ahead?: An Islamic Financial Ethicist's Observations on the Current Economic Crisis and Possible Recovery Strategies.”

In comments that he made during a recent interview on National Public Radio, Niall Ferguson--the noted Harvard economic historian and author of the recently published work, *The Ascent of Money: A Financial History of the World*--observed that one of the consequences of the current financial crisis is that our confidence in the economic models that were (and still are) championed by our economists has been shaken. That is to say, one of the outcomes of the global financial crisis **may** be that the economic and financial models that have been accepted among, and championed by, economists--particularly in the last few decades with the rise of radical free market ideology--have been shaken to the core. Presumably, Professor Ferguson is referring to the financial models that supported the creation and wide spread dissemination of securitized debt instruments, such as collateralized debt obligations (CDOs). He was also presumably referring to the risk models that allowed for the use of derivatives,

such as credit default swaps (CDS) and similar contracts, as risk management mechanisms.

Such sentiments have been echoed by noted commentators other than Professor Ferguson.

The Noble-winning Columbia University economist, Joseph Stiglitz, has made intensely critical statements about the financial system. In a recent CNN commentary, entitled 'How to Prevent the Next Wall Street Crisis,' Professor Stiglitz frankly stated: "... at the center of blame must be the financial institutions themselves. They-- and even more their executives-- had incentives that were not well aligned with the needs of our economy and our society." Elsewhere, he has been intensely critical of the performance of the management of the US' largest financial institutions, claiming that they failed to allocate capital and manage risk, which are ostensibly their primary responsibilities.

As the media watchers among you will know, anger at financial institutions and their leadership is wide spread among the American populace. Public discontent with the perceived mismanagement of the October 2008 "bailout" funds, by CEOs and other C-suite level leaders of entities such as CitiGroup and AIG, suggest that the American public itself may be prepared to consider deep changes to the American financial system. Therefore, it is interesting to consider the following questions: how should we respond as a society to the current financial crisis? What changes need to be made to our financial system in order to mitigate the harm resulting from the crisis? What are

the principles that should govern our reform of the dominant financial system so that such crises are less likely to occur again?

My comments will not be those of an economist and finance academic, as I am neither (although I have occasion to work with them in my work as an Islamic financial ethicist). Rather, I am a student of traditional Islamic ethics and law, known as *fiqh*, an Arabic term that literally means “deep understanding” in the Islamic intellectual tradition. The system of ethics that consists of the ethical values associated with human actions is known as the *sharīʿa*, Islamic sacred ethics. Islamic ethics, like other systems of ethics is concerned with right and wrong, what human beings ought and ought not to do. Like other systems of religious ethics—particularly the traditional ethics of its fellow Abrahamic religions, Judaism and Christianity—Islamic ethics rely primarily on scriptural sources. Specifically, Islamic ethicists rely primarily on two revealed sources: 1) the Qur’an, the book that Muslim recognize as *verbo Dei* (a communication from God himself to humankind) and 2) the authoritative example of the Prophet Muhammad (upon whom be peace), whom Muslim recognize as the last of prophets, a line beginning with the father of humanity, Adam, and including individuals known to the Judeo-Christian traditions, such as Abraham, Moses and Jesus. It should be noted that Islamic ethics relies on various secondary sources as well. What is worth emphasizing here is that although normative Islamic ethics is characterized by the deontological tendencies that one would expect (i.e. things are right or wrong because God has made them so) most traditional Muslim ethicists recognize what we might call a consequentialist or teleological bias to Islamic ethics as well (i.e. actions are right or wrong because of the consequences associated with them). The apparent tension between these two principles is a matter this has been

worked out by theologians and ethicists over the centuries. In the Islamic intellectual tradition, one of the ways in which this apparent tension has been addressed is through the elaboration and application of ethico-legal maxims. In Islamic ethics, maxims are pithy expressions that capture principles that apply to broad areas, if not all, of the law. It should be noted that maxims make it easier for us to discuss Islamic ethics in a comparative ethical context.

I make mention of some of the philosophical bases of Islamic ethics and law above because in the remainder of this talk, I will discuss proposed strategies for recovery in light of Islamic financial ethics and law.

I will approach the task of discussing what went wrong and more importantly how we can fix it in the near- and long term by examining the suggestions of several economists and finance academic. It is a principle of Islamic ethics in general that deference is given to expert on the **matters of fact** associated with their areas of expertise, as long as their conclusions do not run counter to establish determinations in Islamic normative ethics. To put it briefly, the Islamic financial ethicist comments on what type of practices are unacceptable or acceptable ethico-legally; while economists and finance academics experts would suggest mechanism and solutions and comment on the expected results associated with each. This is a pattern of collaboration that prevails in the *sharī`a*-compliant financial sector.

It should be stressed that I am not maintaining that the leading economists and finance academics that I will mention favor adoption of the “Islamic” solutions that I will describe. No doubt many might oppose them. Rather I want to show that solutions

consistent with Islamic financial ethics are already being suggested by thought leaders in this space.

As some of you may know there is an Islamic finance sector that exists as a niche financial sector (also known as shari`a compliant finance or *halal*—i.e. permissible—finance) composed of investment banks, retail banks, insurance companies, fund managers and other entities. The sector is concentrated primarily in the GCC (the Arabian Gulf) and Malaysia, but also has significant presence in areas outside the traditional Muslim world, such as the UK.

Professor Samuel Hayes, the eminent Harvard Business School Professor of Investment Banking emeritus and co-author of *Islamic Law and Finance: Religion, Risk, and Return* (1997), along with Prof Frank Vogel, commenting several months ago on the performance of Islamic banks in the crisis noted that “Given their constraints, they actually don’t hold any conventional debt or conventional mortgages. They don’t have any of these derivatives or outright subprime loans. There’s no doubt that they have weathered this better than the conventional banks.”

Accordingly some of my comments will revolve around the answer to the question: what has protected *shari`a* compliant financial institutions from the same degree at least of harm that has been experienced by conventional banks and what is it then that can be adopted in the US from the practice of Islamic finance as part of a sound response to the US and global financial crisis.

Let see what see how this plays out in the recommendations of some experts.

The **current plan** for reform of the US financial sector that has been described by US Treasury Secretary, Tim Geitner, is thought to consist of 1) a review the banks' books with the intention of revealing what toxic (or troubled) assets they actually have and 2) creation of a public-private investment fund (or a similar entity), often called a so-called "bad bank", that will gather these troubled or toxic assets (non-performing loans, CDS, bonds secured with mortgage and credit card debt and the like) and facilitate the creation of a market for them, thereby allowing the private sector to purchase them at acceptable prices.

Returning to Professor Ferguson's calls for structural changes in the US financial system: He suggested that shareholders of banks should be "wiped out," that the creditors should take a "hair cut" and that depositors should be protected—as is presumably the case, given the FDIC system, for bank deposits—at least for deposits below the established.

He also calls for what he admits is essentially "nationalization", for a limited time, of banks. He suggests that it is imperative that the US financial system avoid the perceived mistakes of the Japanese financial system during the so-called "lost decade." During the 90s according to many economic historians and expert observers, Japanese banks were not forced, as the observers say that they should have been, to divulge their non-performing loans and other "sour" assets. In retrospect, critics have said, the Japanese banks should have been more aggressively closed by regulators.

Similar comments are made by other experts. Professor Noriel Roubini, professor at New York University's Stern School of Business, is credited by journalists and his peers with anticipating much of the credit crisis. In an op-ed in the February 19 edition of the Washington Post, co-written with his fellow NYU Stern School professor, Matthew Richardson, Roubini calls for a strategy similar to what that of the Swedish government in their earlier 90s banking crisis. Interestingly, Roubini and Richardson apparently elaborate on their ideas in an upcoming book to which they are contributing, entitled *Restoring Financial Stability: How to Repair a Failed System*.

For some time, Islamic economists have been calling for national and global economies, and in particular, national financial sectors and the global financial system to be redesigned (or evolved) so that there are **direct and immediate** connections between so-called real, tangible assets (goods—such as land, infrastructure, buildings, factories, vehicles, etc—and services associated with them), on the one hand, and banks and other financial intermediaries, on the other. They have also called for the removal through regulation and legislation of excessive leverage.

So, for example, Islamic ethics **might** suggest that one support the move to regulate financial players (such as hedge funds) more aggressively, with the aim of phasing out or eliminating certain risk management tools, such as short selling and other derivative contract that are characterized by major non-specificity or non-realizability. Such derivative contracts can be replaced with synthesized derivative contracts that are based on the coordinated sales (or leases) of real assets. Such alternative hedging and risk management contracts have begun to be used more and more in the Islamic finance sector recently.

Islamic financial ethics as realized in the shari`a compliant finance sector also suggests that all home repossessions associated with the reset of variable interest rates, or in cases in which there is financial difficulty, such as unemployment or under employment, be frozen immediately, by legislation or governmental authority, subject to further review.

Furthermore Islamic ethics would suggest that all existing mortgages should be reduced to 0% over original purchase price. Banks, or mortgage holders, that refuse or resist these reductions should be either incentivized to comply or penalized for their resistance. Similarly, bankruptcy judges should be allowed, and encouraged, to reduce mortgage loans that are being serviced by service entities.

The basis for these suggestions is 1) the wrongfulness of imposing interest payment stipulations on loans and 2) the scriptural encouragement that creditors reduce the debts of their debtors who are in financial difficulty.

One of the primary concerns of economists, when it comes to suggestions that government relief (or aid) be directed toward indebted corporate or natural persons (although it seems to be more of an issue when dealing with later than the former!) is the issue of moral hazard. Economists ask “Won’t people who purchased ‘too much house’ and other bad actors be encouraged to act poorly in the future if others assume responsibility for their recklessness.” Islamic ethicists are quite sensitive to argument. Islamic financial professionals, accordingly, when advancing financing tend to perform due diligence that screens out individuals who are unlikely to be able to repay

their financing. However an Islamic ethicists would recognize interest-bearing lending itself as a wrong, and that, therefore, the 'perverse incentive' exists on both sides of the transaction. When we add considerations of predation and the mass applicability of system practice, the focus of systemic remediation is likely to shift primarily to the lender.

Professor Stiglitz in the aforementioned commentary, summarized his recommendations in 6 points. To quote him in brief

1. correct incentives for executives... We should mitigate the incentives for excessive risk-taking and the short-term focus that has so long prevailed...
2. Secondly, we need to create a financial product safety commission, to make sure that products bought and sold by banks, pension funds, etc. are safe for "human consumption."... What we need is more innovation addressing the needs of ordinary Americans, so they can stay in their homes when economic conditions change.
3. We need to create a financial systems stability commission to take an overview of the entire financial system, recognizing the interrelations among the various parts, and to prevent the excessive systemic leveraging that we have just experienced.
4. We need to impose other regulations to improve the safety and soundness of our financial system, such as "speed bumps" to limit borrowing...
5. We need better consumer protection laws, including laws that prevent predatory lending...
6. We need better competition laws. The financial institutions... should not be in situations where a firm is "too big to fail." If it is that big, it should be broken up.

In consideration of time, in my comments, I have not addressed personal financial issues, such as over-consumption of interest-bearing personal debt (credit cards and other consumer loans) or the other ills of hyper-

consumerism. These are issues of a psycho-spiritual nature that the Islamic world view, with its balance between this-worldly and afterlife-related concerns, is ideally situated to address. It should be noted that the Abrahamic religions—and most world religions, to be frank—would also recognize the solution to these issues. Nor have I dealt with issues of under-employment, unemployment and the challenges of globalization. My focus has been on structural issues in the financial systems.

To conclude, the Islamic ethicist would call for deep structural changes to the prevailing financial system characterized by 1) the elimination of interest-based debt financing mechanisms in favor of asset-based financing mechanisms and 2) the elimination of risk-shifting risk management tools in favor of their risk sharing, tangible asset-based counterparts. This evolutionary path, while it may seem radical and strange to some, is, in fact, not. Rather such changes, to a large extent, consistent with what several economists and finance academics have already been calling for and are likely to continue to call for in the near future.

I look forward to your questions. Thank you.