

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

الحمد لله والصلاة والسلام على نبينا محمد وعلى آله وصحبه وسلم وبعد :-

His Excellency Dr. Rustomov – Governor Central Bank
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Brothers & Sisters
Assalamualiekum

This is a great opportunity.

I would like to thank IDB and the organizers of this form for this opportunity. Our aim is simply to present ideas and contributes, in the hope for a formation of an Islamic view, a stand on the current financial crises that reflects our thinking on the matter and to introduce our Islamic economic system albeit at a glance. More importantly to reveal to our own selves some aspects of the glorious Shari'ah when we discover safeguards

in the legal infra structure of the economy that only now we understand why they are there.

Brother & Sisters what went wrong with the world of financial system goes back to many decades ago. The roots lie in what was termed: the financialization of the economy. This is the crux of the problem and the kernel of the solution. The rest is just details. And this is also where we can see the greatness and splendor of our Islamic economic system.

Financialization of the economy can be defined as the progressive shift from the manufacturing of real goods and services to the creation of financial products.

In other words more and more of the value added appears to be created in the financial sector. This financial sector which consist mainly of banks,

hedge funds and money market players where debt instruments are traded becomes the core of the economy. Theoretically, the financial sector functions as merely a support to the real sector.

The real economy where real goods and services are produced but here the real economy becomes simply an escort an annexure to the ever expanding financial sector.

Manufacturing declines as its profits keep falling, while more and more money is being made in creating and trading financial products.

This phenomenon can be seen in many parts of the world, but it is nowhere more apparent than in the United States. Let us look at the numbers.

The proportion of profits earned by the financial institutions in the U.S. in 1950 was a mere 9.5% of the total profits earned by corporate America.

This proportion increased to 45% in 2002.

Between 2002 and 2006 profits of the financial institutions were growing at a rate of 16.5% annually and the size of the financial sector is growing almost limitlessly.

The Bank of International Settlement (BIS) estimated that both traded and OTC derivatives at the end of 2004 to an amazing amount of \$ 234 trillion.

By the year 2007 this size grew to a staggering \$ 516 trillion. This is only a portion of the total size of the financial sector. On the other side of the balance the total world GDP which is defined as the value of all goods and

services produced in the whole world in one year didn't exceed \$ 66 trillion at the end of 2006.

We think the financial sector as a lubricant to the real economy where labor and capital are mixed to create real goods and services. Well, at the end of 2006 that financial sector was 8 times the size of the real sector.

Moreover, the BIS estimated the daily turn over of foreign exchange worldwide in 2007 at \$ 3.2 trillion. This is 100 times the size of daily world trade which is a mere \$3.2 billion a day according to BIS.

This process of financialization was unleashed unto the world economy by what is termed "financial innovation". Finance, it is claimed is just like manufacturing. It can bring to the world useful products and inventions like

the automobile, electricity, wireless communications as well as the train and airplane, except that products in finance are less useful and more profitable.

It started with securitization transferring not only debt but every imaginable obligation to a traded security inaugurating the age of the CDO or Collateralized Debt Obligation. This collateralized debt obligation, was used to transfer debt obligation emanating from house finance, secured by mortgaging the housing unit, into securities that are traded in the market.

But you need much more than that to create assets totaling 500 trillion dollars.

Two things which were evolving at the same time reinforced the drift to financialization of the economy. The crave to create more debt assets that can be securitized gave rise to a propensity to relax the qualification of lending so that every Tom, Dick and Harry can get a mortgage despite every indication that he lacks the basic requirements of credit worthiness. People were encouraged to do first, second and third mortgages and purchase as many homes as they like repeatedly with little or no questions asked. As part of this process the non-recourse mortgage which became widely used in the United States in the last decade, no longer debt is an obligation on the individual debtor, it rather rests in the mortgaged house itself. So if the indebted customers went bust and were unable to pay, the bank can only foreclose on the home but cannot go after him for debt payment. One has

to be quite foolish to miss an opportunity. You purchase a house with no down payment and loan payments such that the first two years almost free. You can then sell in a price rising market and as they say: make a kill. If things went wrong, all you loose is the house which you paid very little for any way. If the price of real estate goes up you can reap an up normal return on your investment. If not, you only loose your payment which was artificially made very low in the first three years to seduce more and more customers.

The CDO market in the USA at the end of 2006 exceeded \$ 2 trillion and then the debt monster has gone global.

The obsession with the CDO drove financial engineers to start working on yet more innovations. It was not sufficient that they applied the usual

permutations of options on CDO's, indexed CDO's, futures on CDO's real and synthetic CDO. It is now time for the CDS.

To enhance the rating of the CDO thus attracting more and more investors, we need an insurance like product. It is a form of guarantee to cover credit risk and enhance its rating if an institution rated AAA can guarantee the CDO, then the CDO itself is rated AAA.

This is done by Major Corporation like AIG issuing what is called CDS or Credit Default Swap which itself became a security.

CDS which started as a simple a guarantee, itself became a traded security.

Theoretically, if you are holding a CDO, you do this because you are owed a debt by a mortgagee. You buy a CDS to cover the credit risk of that obligor.

However, since the CDS is now a traded security, anybody can actually buy it, thus it became itself an investment instrument. This simply meant that it is possible even for those who are not holding any CDO i.e. who are not creditors to any mortgagee to purchase a CDS.

But what does this mean?

It means that if our Tom, Dick or Harry went bust, the holder of this CDS will be compensated as if he was a creditor when infact he was only holding a CDS. A gambling casino par excellence. This was the only game in town

It is not difficult to see as the process of financialization firmly implants itself in the economy that more and more of the profits are being made in the financial sector not the real sector.

But is it possible for any economy to sustain growth relying solely on finance?

The answer is no. The financial sector is merely a facilitator for other markets. Once it starts flying solo, then it is decoupled from the real sector and becomes self determining.

In the words of the Nobel prize laureate in economics for 1981 Prof. Tobin: “when more resources are thrown into financial activities not in production of good and services, this makes private rewards higher and disproportional to social productivity” Tobin called this the “paper economy”. This is the story of the current financial crises.

The moral of this story is that such thing can never happen in an Islamic economic setting, because in such setting money can never become itself an industry real and monetary sectors are firmly cemented. This can never take place. To make sure financial sector is growing in tandem with the real sector is an objective of both Islamic and conventional policy makers.

Shari'ah was aware of this problem as it has a built in safe guards that systematically assures that a dichotomy between real and financial sector doesn't happen. While modern world tries to do this by reliance on centralized authorities and via interference in market mechanism in the Islamic economic system. This is done through the Shari'ah regulation of exchange contracts which doesn't permit generating profit from purely money for money transactions. Each time money is exchanged, it must be

exchanged for a real good or service if such exchange is to create profit.

Therefore, in their normal practices, if they adhere to the Shari'ah

injections, they do protect the stability of the system which keeps the real

sector always supreme and never create the dichotomy between real and

final.

How this is achieved:

The core of Islamic law in the realm of finance is the prohibition of usury.

Fundamentally every stipulated increase in a loan contract is prohibited.

Profit in trade is legitimate even if part of such profit is against time. But

once the price is a debt obligation, it can't increase. Such increase will again

be usury. Rescheduling of debt thereof is strictly prohibited, as well as the

sale of debt obligation at a discount which again is considered usury. The

outcome of such prohibition is closing the door to earning income from just pure monetary transaction. This is because profit can only be made in the real sector. Time value money is recognized but only when the transaction involves the exchange of money for a non-monetary items. Money here means any medium of exchange which is considered a measure of value. It will then be just money for money which is prohibited in Shari'ah.

When we talk of financial markets most of us would assume that we are talking about forums where savings are directed to investment presented by shareholding in public companies and the like. In fact, these markets are basically exchanges for trading debt obligations. In 2009 the world total size of bonds i.e. debt securities was \$82.2 trillion. While world stock market was only \$36 trillion. These markets are clearly forums for trading in debt

instruments like corporate and government bonds and other such instruments. If we add all the derivatives which again fall under the money for money transaction then equity securities will only be a tiny portion what real value is being created by trading debt instruments? Nothing so if you make money out of this trade you are actually siphoning profits from the real sector. From Islamic law perspective, this is all prohibited why? The answer we may take from a Noble prize laureate Mories Allies. In a lecture he delivered in Jeddah as an invited lecturer of IDB, Mories Allies made it very clear that the debt pyramid if left unchecked will wreck, in his words western civilization itself.

I find it very remarkable that Islamic law actually prohibits this debt trading because it is simply one form of usurious transaction as defined by Shari'ah.

It is even more astounding to know that Islamic jurists appear to know exactly why such sale is prohibited because the majority had permitted sale of debt if it was sold for non-monetary price. Sold this way, sale of debt will never create this financialization drift since every such sale actually solidifies the link between real and financial sector.

It is almost blindly assumed by modern economics that money markets are no different from goods and services market. They are both forums for exchange where you give something and receive something else in return and that the same rule applies to such markets regardless of whether that thing is real goods and services for monetary price or simply money for money. Price is determined by the forces of supply and demand. When the subject of exchange is money for money the price is interest rate. They find

the idea of distinguishing between money for money and money for goods and services rather dubious. But not all economists. In their book "Towards a New Paradigm in Monetary Economics" the authors, Noble prize laureate Joseph Stiglitz and Bruce Greewald has gone to pain to prove that they are not the same. Exchange involving money now for money in the future can't be similar to exchanging apples for dollars or for oranges for that matter. Interest as a price is different from the price cleared by the interaction of the free moving forces of supply and demand in the market.

But we know all this 15 hundred years ago. This is evident by the total prohibition of exchanging money today for money in the future with a difference in amount which the riba of loans. In fact the difference between markets for real goods and markets for exchange of money was so crystal

clear to our jurists that have separated their rules in the books of jurisprudence from one's involving money for goods and services. They even have a very clear idea about what falls under the rules of money. It doesn't have to be gold, silver or paper money.

A major jurist who lived in 9th Gregorian (second Hijri) century stated that even if people decided to use pieces camel hide as a medium of exchange, he would prohibit exchanging pieces for the same camel hide today for a future delivery with an increase.

On the issue of non recourse mortgage:

The non-recourse mortgage means that the debt itself is no longer born by the mortgagee (i.e. in Dimmah) but sustained by the housing asset which

constitute the collateral. Therefore, the creditor has no recourse to the borrower or his accounts or other assets. Creditors only have a recourse to the collateral itself even if such collateral is worth much less in value than the outstanding debt. This type of mortgage was quite fashionable in America during the decade leading to the crises and contributed significantly to the havoc that struck the financial sector in that country.

This form of mortgage works beautifully when real estate prices are going up relentlessly. But once they start going down they at one point reach the level where it makes no sense for the mortgagee to continue paying the debt. The bank then forecloses and sells the property at a price lower than the outstanding debt thus realizing a loss. As more and more foreclosures takes place prices are pushed down and more and more losses are suffered

by creditors. I found it quite fascinating when I realized that such form of mortgage was prohibited by an authentic Hadith of the prophet PBHU. It shows how miraculous is Islamic law. Addressing issues which now we realize how pivotal they are in ensuring the stability of the system.

On the issue of Gambling:

It is a cliché to say that financial markets are nothing but a legalized gambling. They are a big casino no different than the ones you find in Monte Carlo or Las Vegas. Certainly there are merits to such verdict. This is the natural conclusion of a process that doesn't distinguish between money for money and money for good and services. But the interesting question is that such a development can't happen in an Islamic economic setting. One of the basic requirements of the validity of exchange contracts in Islamic

Shari'ah is that they have to create rights and obligations that are fair and equitable. For this purpose Shari'ah firmly prohibits Gharar defined as contractual uncertainty. I would say 95% of the known derivatives will fall under this state of contractual uncertainty. Again, one may say derivatives are necessary because they are tools for risk management. The answer is correct. We do have several forms of contracts that do qualify as tools for risk management. But it is really amazing how the Shari'ah based forms of contract have a safe guard, a preventive measure. Example: one of the most common conventional transactions is short sale where one sells something he doesn't own at that time. This is one of the first instruments to be prohibited in the mist of this crisis by many western countries. There is no question that this instrument is useful hence it was not prohibited in

Shari'ah, but was designed to close door to instability by requiring payment of the full price and not a margin. It is no longer a wagering tool but a useful instrument. Now one of the suggested reforms being discussed is to permit short sale but to increase the margin. There will come one day when they realize that a 100% margin is the only solution.

On the issue of ethics:

We heard many times that the financial crisis is essentially a crisis in ethics. Everybody was participating in a game that everyone know goes against the basic elements of ethics but they continue playing in unethical way sometimes Shari'ah is confused with ethics. Shari'ah is the Islamic law. Certainly it is ethical but the application of its rules is compulsory for all Muslims. Ethics is necessary for the social peace and stability of the society

but it is not a substitute for the law. The current crises are crises in ethics because everyone knows that what they were doing borders on the immorality but didn't want to miss the boat. They did need opportunity though it goes against the expected minimum level of morality. The outcome would be different if each financial institution has an "ethics board" which will be watchful to only the ethical side of the business and ring the bell at the right time for everyone to step and ponder.

Let me summarize: permitting money for money transaction lead to a dichotomy between the real sector this is where real goods and services are produced and the financial sector, this is the lubricant. The financial sector start making a rate of growth and profits that makes impossible for the real sector to compete. But we know profits are made in the real sector. Hence,

this process of financialization of the economy means the financial sector is just siphoning the profits from the real sector thus leading to instability and collapse.

I claim this thing can't happen in an Islamic setting. The reason is that every transaction that is effectively money for money is prohibited. Primarily, lending on the basis of interest and trading debt and making money out of money is derivatives and the like.

Well, this is what every Islamic bank has basically the function of the Shari'ah board is to draw the line for the institution regarding the ethical aspects of its business, it will have no problem ringing the bell even before havoc strikes.

