Impact of Global Financial Crises on the Islamic Banking System

Analysis of Islamic Financial System during Financial Crunch 2008

Azam Shafique. (1), Muhammad Asim Faheem (2), Iqra Abdullah (3)

(1) Assistant Professor, Hailey College of Commerce, University of the Punjab, Lahore, Pakistan
(2) Lecturer, Hailey College of Commerce, University of the Punjab, Lahore, Pakistan
(3) MS Scholar Department of Management Science COMSATS Institute of Information Technology, Lahore

Abstract

Recent global financial crisis have badly affected the conventional banking system everywhere in the world. Islamic banking system has also affected by the global financial crisis but performance of Islamic banks during global financial crisis is better than conventional banks. Risk in Islamic banks is less than conventional bank because of its interest free nature. Literature indicates that because of global financial crisis there is increasing demand of Islamic Financial system in Western world. This paper tests the validity of the view that Islamic banks are most stable during global financial crisis as compared to conventional banks.

KEY WORDS: Islamic Banking System, Conventional Banking System, Financial Crisis

Introduction

For some of the readers the concept of Islamic Banking is new. An Islamic bank refers to banking institutions directing all known banking activities including borrowing and lending without interest. It manages the funds on basis of Mudaraba and Wakala and accepts demand deposits as interest free loan these banks organizes funds on profit and loss basis (Al-Jarhi, 2001). According to (Hull, 2002) business organizations are formed for the purpose of making profit and Islamic banks are also
one of the organizations that provide services and products. Islamic banking created multiple threats and opportunities to meet quality services to meet customer expectations and there appears a stiff competition between Islamic and conventional banks. Islamic banking system is superior to conventional banking because enables more stable financial sector (Khan, 1986). The interest is prohibited in Islamic ways of banking as it is also obvious from Quran. In Quran ALLAH Almighty said that; “O you who believe! Do not devour Riba multiplying it over and keep your duty to ALLAH that you may propose” (Surah Al-Imran). Same kind of prohibition regarding fixed interest is also mentioned in (Surah-Al-Rum), (Surah Al-Nisa) and (Surah Al-Baqrab) of Quran. Financial system has played an active role in the development of world economy (Stiglitz, 2003). The system is now affected by severe crisis and now according to estimation during last four decades this financial system is affected by more over 100 financial crunches. Islamic financial system may be able to promote justice for these purpose financers should share the risk and equitable share of financial sources to spread equality. It is not possible to achieve development without justice. According to (Ullah & Jamali, 2010) every Muslim has a right to be respected and if he is not being respected by the institution in which it has made its investment then he has the right to withdraw his money. And Islamic banking system is more near to the above explained system.

This study discusses the view that Islamic Banking system is more safe from the global financial crises as compare to conventional banking system and if this opinion is true then how the Islamic Banking system is safe from the Global crises. For testing this view recent financial crisis of 2008 is considered along with the performance of Islamic Banks during this crisis.

Discussion

World Financial Crises

The great depression was started in 1929 and ended between 1930’s to 1940’s for different countries as because it is the most important depression in modern history. It is treated now as the bench mark for whole world’s economy. The great
depression started in US with stock market crash on October 29, 1929 known as Black Tuesday. With the end of world war 2nd this depression ends in US. The financial crises began from developed countries and spread to the rest of the world and it collapses all emerging economy like Russia, china, India, Brazil and East Europe.

The financial crises that stated in 2007 were a real challenge for fast growing financial crises. These crises create challenge both for the foundation of Islamic culture and also for its rapid expansion. According to recent IMF study (Hasan & Dridi, 2010) Islamic banking performs better than convention banking in terms of profitability, credit and asset growth.

**Primary Cause of the Crises**

Cause of such financial crunches is excessive lending and excessive lending is the combined influence of three forces including greed of banks to earn more profit and disobeying the market discipline regarding over flow of credits and finally disobeying the system reforms such not following the prudential regulations resulting in increased crises. (Mishkin, 1997) has indicated two factors assures bank that they will not suffer losses including collaterals and the assurance that the central bank will bail them out. According to (Kayed & Hassan, 2009) main cause of financial crises is the laxity of lending i.e. greed and appetite for higher returns.

**THE SUBPRIME MORTGAGE**

Subprime mortgage means loans to those individuals who do not qualify for loans at interest rate higher than the normal rate of interest. Almost all crises are the product of cheap lending means that mortgages became more affordable and in more quantity. According to (Wilson R., 2007) existence of sub-prime borrower causes the financial crises and these borrowers are characterized by the defaults on mortgage obligations. According to Islamic scholars and practitioner current crises are the result of the failed morality (Siddiqui, 2008). The failed morality is the cause of corruption and greed and as a result of this greed there is failure of relationship between investment originator and investors (Loundy, 2008). The failure is due to
the poor working of the institutions which have granted loans while ignoring the risks associated with such investments. Through effective regulation the excessive risk taking should be reduced, and there should be detailed focus on the disclosure of information regarding assets by financial institutions (Mirakhor & Krichene, 2009).

**Which Banking System performed better in Financial Crises 2008?**

According to (Parashar & Venkatesh, 2010) because of recent global financial crisis conventional banks badly affected everywhere in the world. Although Islamic bank also affected by the global financial crisis but performance of Islamic banks during global financial crisis is better than conventional banks. Further studied that Islamic banks suffer in term of leverage, capital ratio and return on equity despite of this performance of Islamic banks during 2006-2009 is better than conventional banks. Report of World Bank by (Beck, Asli., Kent, & Quarda, 2010) compared the performances of Islamic and conventional banks during recent financial crisis and founded that although both Islamic and conventional banks affected by the crisis but Islamic banks superior in liquidity reserves and credit risk. Performance of Islamic banks is better in financial crisis as compared to conventional banks.

AMLAK, Dubai based mortgage provider was in financial lie-down and Kuwait institute defaulted and was unable to issue its SUKUK. But Islamic finance remained comparatively positive and tough regardless of the misery and instability of the dominant fiscal crisis. Normally the entrance of the current financial crunch in Islamic capital market is not possible due to several reasons including: the Shariah has not allowed the sale of debt against debt and one cannot sale the assets until the person possesses the real asset and Islam prohibits such risky speculative transactions.

Moreover lending in Islamic finance is based on assets backing and the mortgage loans are provided against solid assets where as in conventional banking the reason of present crises is just because huge amount of loan granted by these conventional banks without the collaterals. Islamic regulatory control system is a system where
investors are aware of risks and return both. According to (Ozturk, 2008) implementation of profit and loss sharing transactions results in full disclosure and transparency as a result market discipline can be well understand and as a result there appears a judicious control over unnecessary lending that improves he Islamic financial system.

**Performance of Islamic Banks during Financial Crises 2008**

Global financial crisis pushed the developed countries to develop a new financial system who tackle the problem of crisis. Recent global financial crisis forced the developed nation to lowering the bank rates and introducing the new financial system that is based on Islamic principles of interest free financial system. Capitalist system which has failed after global financial crisis looking a system who solve the speculation problems and financial crisis is Islamic financial system that is save from all speculation activities and interest as an alternative (Ilias, 2010). Capitalist financial system badly affected by the severity of the current financial crisis. (Trabelsi, 2011) identified failure of risk alleviation at different level is cause of crisis. Capitalist economy is looking for the system that is risk free. Author suggested various ways in which risk in Islamic finance can be minimized in order to be stable and flexible. It is good time for Islamic finance to get lessons from conventional banking crisis because current financial crisis reveal the weakness of conventional financial system.

Despite of many challenges and crisis Islamic financial instructions is growing steadily. Countries like U.A.E, Bahrain and Malaysia are hub for Islamic finance that working for Islamic finances development. World’s leading financial centers like New York, Singapore and Hong Kong using Islamic finance side by side with conventional banking for improving liquidity and risk management. Sukuk bonds are leading example of growth of Islamic finance (Ahmed H., 2009).

According to (Dewi & Ferdian, 2009) speculative transition and careless lending transaction lead to global financial crisis in 20th century. These global financial crisis further lead to crash of capital market, banking crisis and crisis on financial sector.
In Islamic finance Riba, Gharar and Maysir that is prohibited may act as safeguard in Islamic finance during financial crisis. Riba, Gharar and Maysir act as medicine to heal the financial crisis and because of this Islamic finance are consider as flexible and relatively stable as compare to conventional financial system. The authors suggest that there should be competent and knowledgeable human resource in Islamic finance that has knowledge of finance and Sharia. Due to the safe financial system, (Yudistira, 2004) founded that during global crisis in 1998-1999 Islamic banks suffered but after crisis Islamic banks performed very well. The author tested the efficiency of Islamic banks which indicate that inefficiency of Islamic banks but quite low as compared to conventional banks inefficiency. Islamic banks are financially sound and stable because Islamic banks derived their financing from deposit rather than from borrowing. Islamic financial system is considering alternative for financial solution after economic recession, global financial crisis and end of Wall Street and Lehman Brothers (Wilson R., 2009). As the study of (Hassan K., 2009) shows that recent global financial crisis not occurred in Islamic financial system. The author suggested that if there are Nobel ideas, greater transparency of transaction the recent crisis can be solved under Islamic financial system. Recent financial crisis have proved that Islamic financial system is powerful economic system to alleviate the current problems. In order to restore and stability of economies, advanced countries have recognized the importance of Islamic financial system.

According to (Ariss, 2010) competitive condition in Islamic and conventional financial system and founded that Islamic banks are less competitive when we compare with conventional banking system. Profitability of Islamic banks significantly increases but not much as compare to conventional banks. Islamic banks have less financial risk because of higher capitalization. Islamic banks show greater flexibility and durability to global financial crisis of 2007. Western bank also benefited from Islamic banks after global crisis for tackle the crisis for restoration of their financial stability.
According to (Chazi & Syed, 2010) the Islamic financial institutions tackle the recent global financial crisis in terms of management of risk. Finding indicates that Islamic banks are better able to control risk as compare to conventional banks. Islamic banks also have better capital ratio. The finding also indicates that Islamic banks safeguard themselves during recent global financial crisis because of Islamic principles which are interest and Gharar free transaction which remove uncertainty and risk. Islamic finance based on the ethical and moral principles and proper check and balance which work for interest of all people.

**Study Design**

This study is analysing the view that Islamic banking system is safer from different global crises as compare to conventional banking system. For testing this view performance of Islamic banks are evaluated during global crisis of 2008.

The research work is based on the descriptive study. For the sake of developing a sound conclusion extensive paper review has been done. All the arguments of each paper are considered without biasness and impact of Islamic banking system its progress risk management and development is being reviewed by extensive research work.

**Conclusion**

So it is proved from all reports, past records, famous authors and experts views that there is a less impact of global financial crises on Islamic banking system which is an integral part of the Islamic finance as compared to conventional banks.

Therefore it is high time for beginning of universal Islamic values to the market players, economists, commentators and the general public. They study shows that Islam is much more than the prohibition of interest (riba) and alms
Zakah), but a broad system to fulfil society’s basic requirements (food, clothing and shelter). Islam focuses on people and their desires, rather than production. In presenting Islamic economic policy, all the Shariah rules increment each other. This means Islam is more than proficient of being practical and, in fact, has a flourishing history of dealing with economic harms.

References


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Surah Al-Imran. In Al-Quran (p. 3:130).

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