The Credit Crunch: An Islamic Perspective[1]

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Over the last few months, it has been widely accepted that the “credit crunch” is the biggest financial and economic crisis to hit the Western world since the Great Depression of the 1930s. Virtually every individual has been affected directly or indirectly by the market meltdown and, for the first time in recent history, leading Western commentators have questioned the viability of the capitalist system and the fractional reserve banking model. This article seeks to explain the root causes of the credit crunch from both a Western and an Islamic perspective, before proposing an Islamic solution.

From a Western perspective, the credit crunch is widely blamed upon the ‘sub prime’ crisis which originated in America, where banks offered housing loans to those known in the industry as ‘ninjas’ (no income, no job, no assets). Such people often had poor financial track records. However these loans were subsequently repackaged into financial products known as ‘collaterised debt obligations’ (CDOs). They were then mixed in with ‘prime loans’ and sold on to other banks via the wholesale market. In theory, this trading in debts was meant to spread the risk of bad loans amongst many different banks, thereby reducing risk. In fact, it lead to the ‘sub prime’ problem infecting not just the banks that offered the dodgy loans in the first place, but a far, far greater number of banks who bought the ‘toxic’ loans via the wholesale markets. The knock-on effect of this was for banks to suddenly become unsure of the value of their ‘toxic’ assets and as a result to stop lending each other money, or to lend money only at much higher rates. As a result the London Interbank Offered Rate (LIBOR) shot up to unprecedented levels, which in turn massively increased the cost of providing loans to the general public.

The Western perspective also argues that this initial problem with ‘sub prime’ debts triggered a secondary problem whereby banks which relied for cashflow principally on accessing funds from other banks via the wholesale market, suddenly found they could no longer borrow enough money to meet their cashflow requirements. This is what led to the crisis with Northern Rock, which, more than any other UK bank relied on the wholesale market rather than its own depositor funds to meet the bank’s day-to-day cash requirements.

The paralysis in interbank lending led in turn to banks drastically reducing the money they lent to customers, as well as dramatically raising the cost of existing loans. This in turn substantially reduced demand for property and led to the ongoing crash in the property market. This is now feeding back to create a yet bigger problem for the banks because property is what they mostly hold as collateral for all the debts people owe them. Evidently this collateral is now worth a lot less than a year ago, and this will inevitably lead to a much higher rate of loan defaults and repossessions.

[1] In order to make this article as short as possible, we have as much as possible avoided quoting detailed statistics or figures.

The innovations in the banking system over the last seven years or so have led to a transformation in the banking model. Historically, banks used only the money they received from depositors to lend to borrowers. They were not able to obtain money from other sources other than depositors. However in recent years, banks were able to rely not just on depositors, but also on the wholesale money markets, where they could borrow money from other banks and then resell it onto their borrowers at a higher interest rate. This secondary market was in part made possible by the creation of 'credit default swaps' (CDS). These allowed a bank to effectively insure itself against the risk that a borrower might not pay back a loan. In turn this led to an illusion that loans were now much lower risk and allowed such loans to be bought and sold. This, in sequence, led to the creation of the CDO (colleterised debt obligations) mentioned earlier, which were bought by banks as interest bearing investments.

The net effect of these banking innovations was a massive increase in the amount of money being traded by the banks. Most people are not aware that banks only hold as deposit approximately £1 for every £20 lent out. The other £19 is created artificially by banks via a process known as 'fractional reserve'. The last few years has seen the fractional reserve being lowered so that banks typically lend out not just £20 but £30 or even £40 of debt for every £1 of deposits held.

Once the credit crunch started to bite, there began a rush to withdraw deposits from certain banks, notably Northern Rock. This 'run' on the banks had a huge impact on the banks' ability to lend money, as for every £1 of deposits they lost, they had to reduce their lending not just by £1 but actually by £30 or £40! This in turn reinforced the banks' reluctance to lend money.

Based on such trends it is apparent that if this situation is allowed to continue people will lose all confidence not just in the banks but in the economy itself, as banks will virtually stop lending money to anyone, and will become trapped in a vicious circle in which they refuse to lend money, leading to a continued downward spiral in property prices. Such a problem has already begun to affect house prices, where many banks have begun to repossess homes and other forms of collateral in order to resell them. This allows the banks to reduce their outstanding loans and improve their liquidity which in turn will finance other projects. However, because there are now large numbers of repossessed homes for sale, their prices have now dropped sharply, often many times below their original purchase prices. This means that such commodities will be unable to accrue the original amount of money lent. Such problems will have grave consequences for the wider economy and will reduce the value of the collateral held by the banks, and so on until we find ourselves in a severe economic slump, as was the case in the 1930s.

The above represents a very brief and simple Western analysis of the causes of the credit crunch. The conventional Western explanation for this crisis and how to solve it is quite simple: The banks became too greedy and simply lent out too much without carrying out proper checks. They also created too much artificial money via the fractional reserve system. The way forward is for governments to temporarily replenish the banks deposits, allowing them to resume lending, and this will slowly allow confidence to return to the system thereby allowing the banks to reduce their reliance on the state. Governments also seem keen to regulate banks better than they have done in the past. This should reduce the banks' reliance on the wholesale markets as well as new-fangled financial instruments like the CDOs and CDSs.

Having covered a secular analysis, we now turn to Islam which proposes a very different explanation and solution for these problems. Firstly, Islam does not consider money to be a commodity which can be traded at a profit, that is to say a transaction which is interest (or usury) based. Thus the reality of negating this Islamic consideration provides us with the first part of the problem. Interest, known as *riba* in Arabic, is one of the major violations of God's law, and when it spreads through society becoming an established norm without any condemnation nothing can be expected but divine wrath. Allah curses those who are involved in the usury process, regardless of whether they are the prime or secondary beneficiaries. Such a strong condemnation is intended to caution people to disassociate themselves from any activity related to this destructive sin. Consequently, He, the Most High, promised to wage war against those who consume *riba*, and has said:

> "*Oh you who believe! Be afraid of Allah and give up what remains (due to you) from riba (usury) (from now onward), if you are (really) believers. And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums*"[1].

In addition to prohibiting *riba*, Islam requires money to be fully asset backed. This would result in banks only being able to offer loans on a ratio of £1 lent out for every £1 held in deposits. The ability to artificially create another £20, £30 or even £40 would be outlawed and viewed as fraudulent activity. Indeed the reality is that the fractional reserve system allows banks together with the very wealthy entrepreneurs who, on account of their large collateral, are always given the lion's share of the money available to enrich themselves by devaluing the worth of real assets and diluting the wealth owned by the rest of society. Banks have been criticised of being "too greedy". Does this mean that if they had not been greedy the problem would not have arisen? Does this also mean that there may be some acceptable level of 'fractional reserve' whereby £1 can create £10 safely?

An observation of any modern interest based society demonstrates that *riba* is the enemy of charity and that the two (interest and charity) cannot coexist. Charity here is not in reference to a few coins afforded to a homeless individual, but rather charity that provides liquidity which subsequently contributes towards building societies and ensuring financial stability. *Riba* ultimately alters society's morals and principles from value-based ones into exchange-based ones. Inevitably, our ethical and moral values are the primary victims in any interest based society, and as we have seen with current events, the less fortunate do not have the ability to keep up with such an exchange which ensures that they become victims of a system in which the benefits tend to be in one direction. When the European Committee for Fatwa and Research issued its *fatwa* (religious verdict) allowing Muslims in the West to buy property using conventional interest based mortgages, many Muslim scholars condemned it and advised Muslims against it. We have never believed conventional mortgages to be a solution for the housing problems facing Muslims in Europe. On the contrary such mortgages will simply increase the scale of the problem such as the proper role of charity being totally neglected as is evident with today's economic system.

Islam neither endorses the capitalist nor the communist financial model, and instead is a belief system that cannot be compared to either, nor rivalled. However, both the capitalist and socialist systems share certain elements (all the while attracting Islamic condemnation for those that are not shared) with Islam such as encouraging people to work, to be productive and earn as much as they can, nevertheless, Islam encourages the aforementiones within certain moral guidelines that

[1] 2:278

are divinely ordained. Furthermore, since Islam promotes an awareness of the hereafter in the hearts and minds of believers, it instructs them not to be overcome by greed being excessively attached to money. If an individual earns a lot, he is encouraged to take part in spending from his earnings. This means that the more he acquires, the more he spends and the more other people benefit from his wealth. Adversely, many people have incurred huge amounts of debt and are now struggling to pay off their monthly instalments for house mortgages and loans. Whilst one can justifiably argue that those who spent recklessly should now face the consequences of their actions, it is also worth bearing in mind that the banks also have a duty to lend responsibly, and that there are large numbers of people who are financially illiterate and in need of greater protection.

To summarise, a banking system based on true Islamic principles would prohibit both the paying or receiving of interest as well as the artificial creation of money via the process of 'fractional reserve'. So how would the banks operate within such a system? Firstly, the banks would need to fundamentally alter their approach and become much more like investment partners to those who need money to purchase a home or business. The bank would therefore become a joint owner of the property/business and base its returns on the rental income/profits generated by the property or business (akin to the shared ownership schemes a number of housing associations are currently operating). Furthermore, the banks would only be able to recoup their original capital by reselling their share of the property/business at the prevailing market value. However, as real partners, banks should have no objection to owning real assets and hence would be ready to share the consequential risk. This scheme, although seemingly inconsequential constitutes a major relief for the bank's clients as they would no longer live under the burden of debt and fear of repossession.

Sadly however, this type of banking system does not operate anywhere in the world at present although a little progress in the right direction has been made in the last decade by Islamic finance providers responding to demand from the Muslim masses for Shariah-compliant finance. Proponents of Islamic banking contend that by adopting such a system and preventing interest from being charged and money being created artificially, not only would the economic boom and bust cycle become much smoother, but economic growth would become more sustainable, and crucially, the wealth created by economic activity would be shared much more fairly by all of society.

The current crisis has caused many people to question the very principles upon which conventional banking is based, and thus we have before us a rare and valuable opportunity to seriously consider developing much better alternatives to the existing banking model. We do not pretend there to be a ready-made blueprint or a tried and tested alternative model set up and ready to go, but rather the key principles governing the development of this model are very clear, and, just as the current banking model took centuries to evolve, so alternative models will also take time to develop. The current crisis dramatically underscores the need for us all to move away from that which has clearly failed.

Guided by belief in the infinite wisdom of our Creator, we would urge non-Muslims to study the Islamic economic system with an open mind. Intelligent individuals (of whom there are many) will realise that such a perfect system can only be divine in origin. They will also note that such a system provides humanity with actual peace and security both in this life and in the hereafter.

For a more detailed explanation of the above please read the guide '*The problem with interest based banking*' which can be downloaded for free from www.1stethical.com