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ISLAMIC FINANCE: A SAFEGUARD AGAINST CONTEMPORARY GLOBAL FINANCIAL CRISIS

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Abstract

The aim of this study is to discuss the roles of Islamic finance to overcome financial issues in Malaysia as the country continues to recover from the recent global financial crisis. This study follows a qualitative approach which reviews and analyses authentic data from relevant literature and published documents on the role of Islamic finance in coping with the global financial crisis. The significance of this study comes from the fact that a new contribution is achieved by exploring various viewpoints and suggestions from Sharīʿah point of view to overcome financial issues in Malaysia. Through a comparative analysis of the performance of Islamic financial institutions during previous financial crises, this study underscores the potential of Islamic finance to mitigate systemic risks and promote sustainable economic growth. The study also examines challenges and prospects for the wider adoption of Islamic finance on a global scale. Ultimately, this study contributes to the discourse on alternative financial systems that can potentially provide a more stable and ethically sound foundation for the contemporary global economy. From the teachings of the Quran and Sunnah, it can be concluded that the Sharīʿah point of view is much stricter than other ordinary laws because Sharīʿah focuses more on protecting wealth for the benefit of people.

Keywords: Global Financial Crisis, Islamic Finance, Malaysia

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1. Introduction

The global financial crisis, which still has a lingering effect until today, has caused an unprecedented economic downturn worldwide, where many nations around the world are still struggling to deal with it, regardless of their level of development. Deemed to be the worst crisis to hit the world economy since the Great Depression, the global financial crisis was spread into the real economy, which included cross-border trade in goods, as well as goods and services. Due to the severity of this crisis, the underlying principles of the capitalist financial system had to be examined, where suggestions and solutions were sought after from experts. As investigation continues to search for its cause, various researchers had reflected this crisis to go beyond how monetary policy is run and how the financial sector is regulated. Deeper deficiencies in areas such as corporate governance and competition policies are also discovered. A false view on how financial markets work was also identified as a cause which had fostered many of these shortcomings. This issue has also contributed to the recent movement toward financial deregulation.

In the past, Malaysia has experienced its own share of economic crises. However, what was experienced by the country for over the past ten years has been very different from the global financial crisis, which occurred during present time. Given that this crisis was triggered by several external factors, the country's growth plan had to be thoroughly reviewed over a longer period of time. For example, short-term improvements were needed due to a financial crisis that occurred in 1997, and some foundations were adjusted (e.g. the implementation of capital controls, as well as restructured financial and banking system).

As such, a new way of thinking is needed to address this financial crisis, especially with regards on how Malaysia should position itself afterwards. This is with consideration towards preconceived notions that form the basis of Malaysia's growth strategy that was broken by the crisis. This paper starts with the global financial crisis and factors that influence Islamic finance in the global financial crisis. The role of Islamic finance’s application is also examined in this paper, especially factors that would guide practitioners to overcome and prevent another financial crisis by applying relevant policy suggestions based from the Sharīʿah point of view. For the final part of this paper, significant policy recommendations is provided for future improvements.

2. Literature Review

2.1. Global Financial Crisis

The world had once again experienced a financial crisis from 2007 to 2009. This crisis was considered to be the worst financial crisis since the Great Depression in 1929. This crisis was said to have occurred due to the failure of the financial system which was adopted by the United States Central Bank. There were various reasons cited on how the crisis had started, however the primary causes to this crisis was said to be based on three factors: inadequate market discipline in the financial system, excessive use of derivatives, and inappropriate regulations (e.g. too big to fail) which had led major financial companies to fall one after another by offering risky investments with lenders money (Chapra, 2011). The crisis was

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additionally said to be caused by improper administrative measures embraced by regulators to ensure customer security, as well as monetary and products transparency which emerged from securitization of credits (Trabelsi, 2011).

This crisis started with excessive and imprudent lending that occurred in the United States. This practice was rampant within the area of subprime mortgage, for which a loan is given to creditors who have poor credit scores. Subprime mortgage was pushed by the demand for real estate assets. As higher demand was expected to give higher profit to both the bank and investors, banks decided to lend numerous amount of loan to subprime mortgage customer. This situation indicates that the bank has failed to prioritise quality over the quantity of the loan lending towards subprime borrowers. Many of the subprime borrowers subsequently failed to repay their due, which resulted with an uncertainty that led to a doubt of repayment. Since borrowers eventually fail to repay their loan, the bank decided to confiscate their houses with an intention to sell these house back into the market.

However, since the number of default mortgages became too large, the amount of house supply in the market eventually blew up. High supply with low demand hence caused the real estate market to fall. This situation caused the banks to find it difficult to find extended financing for their operations. As such, numerous banks in the United States, the United Kingdom, Europe, and a number of other places have failed, had to be bailed out, or nationalised by their respective governments.

Another impact discovered from the failure of borrower repayment was the rise of risk aversion behaviour between investors. This hence raises trust issues between investors and lenders that led to an excessive diversion towards derivatives, mainly the Credit Default Swap (CDS) to gain protection of their investment. CDS is used as protection from any form of default by lenders, where sellers of CDS (a hedge fund) are obliged to compensate (in case the debtor defaults) lender in return of a premium paid by the lender.

Be that as it may, support reserves sold the swaps not to the loaning bank as how it should be, but rather to a huge number of others who were willing to wager on the debtor's default. In turn, these swap holders sold their swaps to other parties, hence this pattern is repeated into a loop. This caused the hedge funds and banks to have difficulty in paying their amount due to swap holders, since there are several parties that needed to be compensated with the fall out of retail assets industries in the United States. The total of CDS outstanding compensation at that time was $54.6 trillion, and the amount of all kinds of derivatives outstanding was said to be ten times bigger than the size of the world economy at that time, which was around $600 trillion.

This crisis was also triggered by the failure of financial system discipline applied by financial institutions. Investment banks failed to be transparent in disclosing the true information with regard to the credit situation where questionable mortgage holders were approved of their loans. In the end, greed and improper market system discipline have caused the global financial crisis, just like a domino’s effect.

2.2. Islamic Finance

Islamic finance takes an arrangement of money-related administrations in agreement with Sharīʿah point of view, where its laws, standards, and rules are referred to as a point of reference. Sharīʿah prohibits transactions involving short sales, gharar (uncertainty), riba (interest), maysir (gambling), and

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other financing activities that are considered to be detrimental to society. Furthermore, both risks and benefits of business transactions must be shared fairly between related parties and must have real economic objectives without speculation or exploitation by either party.

Since 2009, Islamic finance has become the fastest-growing global financial system, with an estimated compound annual growth rate of 17 percent from one of its segments, namely Shariah Compliant Financing (SCF). According to the Asian Development Bank (ADB), the industry's global assets were estimated to have reached at least $1.9 trillion in 2015. Islamic finance eventually came to a point of reaching systemic significance in several Asian countries, thanks to the continuous expansion of the industry in countries such as Bangladesh, Brunei, and Malaysia. In these countries, Islamic finance has achieved at least a 15 percent share in the countries' domestic banking sector. On the other hand, countries whose population is not dominated by Muslims have started to open their gates to Islamic finance after looking into the industry's exponential growth. Countries such as China, the United Kingdom, Hong Kong, South Africa, and Luxembourg had issued their own state Sukuk or Islamic trust certificates. Issuance of this financial instrument was projected to be produced at least twice as oversubscribed. This showed a fairly strong demand for SCF globally.

After the financial crisis in 2008, extensive research on Islamic banking and finance was conducted in line with the idea of performance and growth factors. As a result of its significance and growth, regulatory authorities have also decided to include it in the curricula of various education institutions (Alshater et al., 2022). At the start of its implementation, it was challenging for regulators to standardise items relating to Islamic finance across multiple states. Hence, worldwide standards-creation organizations were created to guide Islamic economic activity at an international scale. Since 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which is based in Bahrain, has published Shariah-compliant accounting, auditing, and financial reporting standards. Islamic Financial Services Board (IFSB), which was established in Malaysia in 2002, is placed to be in charge of formulating regulatory and supervisory standards and recommendations. IFSB also provide support to regulatory bodies to implement these standards and directives where appropriate.

3. Research Method

The study is mainly based on secondary data. Secondary research is a research method that involves the use of existing data. Existing data will later be summarized and structured to improve overall research effectiveness. Secondary research includes published research materials in the form of articles, research reports, and similar documents. These documents are usually available in public libraries, websites, data obtained from completed surveys, etc. Several government and non-government agencies also store data that can be used for research purposes. Secondary research is much more cost effective than primary research, as it uses data that already exists, unlike primary research where the data is collected directly by the organization or business or they may employ third parties to collect data on their behalf.

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4. Results and Findings

4.1. Factors Influencing Islamic Finance in Global Financial Crisis

The global financial crisis that occurred in the United States in 2008 had affected the entire economy of both developed and developing countries. One of the issues that arose at the time of this incident was directed towards the Cypriot financial crisis that occurred in Europe. This issue highlighted many weaknesses in the banking sector, which became the main cause of the global financial crisis. Many efforts was since taken by developed and developing countries to avoid further damage from the global financial crisis.

There were several causes identified from the crisis which are closely aligned with the perspective of Islamic finance, such as creating interest, selling subprime mortgage debt, short selling, and the absence of risk sharing. With many discussions being put in place, it was discovered by various parties that there is a need for an alternative to prevent future financial collapse. One of the suggestions provided was by making the capital market work more effectively through financing as a form of alternative to the banking system. The Islamic financial system is considered to have proper control by introducing greater discipline to real economic growth. There is no doubt that usury and maysir emerged as the main factors causing the global financial crisis.

In the Islamic financial system, interest-based transactions are prohibited, as Islam encourages fair and lawful business or trade. This is so that the risks faced by customers are not fully borne by the customers who suffer losses. Through profit-loss sharing (PLS), these risks can be shared across multiple customers, in other words they would be sharing the risk. This alternative was introduced to avoid subprime mortgage practices, which were a root cause towards the global financial crisis. In the last three decades, Islamic Financial Institutions (IFIs) have established a world presence with an indication that the asset base of these IFIs will continue to grow in the longer run (Trabelsi, 2011).

Therefore, it can be said that the Islamic financial system is able to at least minimise the severity and frequency experienced from financial crises by eliminating the major weaknesses of the conventional system. Asking investors to share risk is one way of introducing greater discipline into the financial system. Allowing credit, especially for the purchase of real goods and services owned by sellers, is able to link real economic growth with credit expansion, which is already an advantage to buyers. The Islamic financial system also prohibits the sale of debt by requiring creditors to assume the risk of default. This instrument helps to ensure that creditors would assess their risks more carefully. Furthermore, Islamic finance is also able to help the financial sector to minimise problems arising from subprime borrowers by extending credit to them on agreed terms. These instruments have the potential to save billions of dollars spent after the crisis to save wealthy bankers. However, this may not help the poor, as it is possible that their homes may have been foreclosed on or auctioned off at giveaway prices (Chapra, 2011).

4.2. Role of Islamic Finance to Overcome the Global Financial Crisis

Implementing Islamic financial system would enhance economic discipline and link loan expansion towards the actual economic growth. The implementation of this system may also minimise the

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severity and frequency of financial crises. Subprime borrowers remains a constant worry in this system, however Islamic finance may be able to help reduce risks by providing loans with appropriate terms. In theory, gharar prohibits Islamic banks from making extremely risky subprime and toxic asset investments or trading in zero intrinsic value derivative contracts. Hence, these banks are made to be are more resistant towards shocks, as compared to conventional banks. As a result, billions of dollars that are currently being used to bail out wealthy bankers can be saved. Asset-based paradigm of Islamic finance encourages risk sharing rather than risk transfer. Investment in wealth-creating activities would inherently curb excessive leverage.

In contrast, direct borrowing and lending are restricted by the Islamic financial system due to the production of debt. Instead, through sales or lease-based forms of financing, banks would need to borrow money via sales, productions, and leasing of tangible assets (Ahmed, 2010). Islamic regulatory frameworks demand that for sales or lease-based financing, the item being sold or leased need to be genuine; the item is not hypothetical or notional, and the seller owns and possesses the things being sold or leased. When the debt cannot be sold, the risk associated with it cannot be transferred to someone else. As such, transactions must be presented at real time, with both the buyer and seller intending to provide and receive the asset. In order to reduce a majority of speculative transactions, the requirements of Islamic system would be helpful. The financing of Islamic products can only increase according to real economic growth, which prevents excessive credit expansion (Siddiqi, 2006).

Islamic scholars have emphasized the importance of a provision that prohibits creditors from selling debt and transferring risks to third parties. This will help to eliminate speculative and derivative transactions, where delivery and receipt are unexpected. Furthermore, it will help to avoid unnecessary explosions in transaction volume and value, as well as a significant increase in debt which is relative to the size of real economy. Additionally, this instrument will allow for a significant amount of financial resources to be provided to the real economic sectors, which will help create jobs and chances for self-employment, as well as providing goods and services that are needed by the real economy (Hassan & Kayed, 2009).

In addition, intimate linkages between the financial sector and the commercial nature of real estate sectors may help to prevent future bubbles and technical speculation in both sectors. Stricter oversight by owners of investment accounts could force banks to adhere towards market discipline and maintain the stability of the overall nation’s financial system.

4.3. Current Issues in Malaysia

4.3.1. 1998-1999 Economic Crisis

One of the main reasons to the 1997 economic crisis in Malaysia was directed towards unfavorable perceptions of the Malaysian economy in a wake of the swift collapse over the Thai economy. Foreign investors and international rating agencies have not considered these underlying risks to the Thai economy. Fearing a continual currency devaluation throughout the area, foreign portfolio investors have pulled out of the region's markets (Nambiar, 2009). Their evaluation of Malaysia was impacted by this view, which had caused the ringgit exchange rate to decline. The ringgit experienced intense selling

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pressure when the Thai baht was the target of speculative attacks in mid-May 1997, falling from 2.40 to 4.90 against the United States dollar (Lee, 2020).

4.3.2. 2008 Global Financial Crisis

The 2008–2009 global financial crisis, which had its roots in the US, was mainly brought on by excessive bank lending, especially in mortgages. This debt was repackaged by banks and sold to investors. Borrowers started to become defaulters due to the housing bubble burst, which undermined the United States' banking sector and ultimately led to the bankruptcy of various banks in the country. Malaysia had then experienced subsequent damage to its banking and commercial lines. Malaysia, which depends mainly on commerce, experienced severe trade and investment losses (Lee, 2020). Malaysia's qross domestic product (GDP) fell marginally to 0.1 percent in the last quarter of 2008, which was due to the deteriorating global economic conditions and a significant correction in commodity prices updated in the second half of 2008. The result shown that the country's economy had tremendously suffered impact from the global financial crisis. The first quarter of 2009 saw a 6.2 percent decline in the overall impact of world recession (Ibrahim, 2010).

Due to experts predicting a global recession in 2023, Malaysia has been encouraged to prepare and brace for impact. An undesirable economic sign in late 2022 projected that Ringgit Malaysia would continue to decline against the United States dollar in the later half of 2022, breaking the record set during the Asian financial crisis (AFC) in 1998 (The Star, 2022). According to projections made by TA Securities Research, at the worst-case scenario, Malaysia's actual GDP could increase by 2 percent to 3 percent in 2023, as the country's economy got past the experience of having a deep recession. However, it has been observed that the local demand has been significantly declining, which is not a good sign for 2023.

Regardless of the obstacles that might come moving forward, the Islamic finance sector would continue to thrive in the face of global challenges as it has yet to unleash its full potential of value-based finance to address the economic needs for today's society. There is a need to continue and foster an appreciation towards Sharīʿah core values among market participants and their embodiment in Bank Negara Malaysia (BNM) via solutions, services, and financial behavior. It is hence necessary to align the entire ecosystem with values of Islamic finance to improve its operations. To fully implement the proposal beyond profit, Islamic financial institutions, shareholders, investors, businesses, households, regulators, and all other participants must understand and accept the fundamentals of Islamic finance.

In conclusion, if the Sharīʿah standards such as the concern of risk-sharing were effectively enforced, financial crisis of the current time would not occur. Commercial banks would be far more selective when deciding which deals that they are able to finance if they were compelled to partake in the gains and losses of their clients, regardless of it being in the form of business ventures or in the form of mortgages. The Shariah Advisory Board of Bank Negara Malaysia has listed seven core values of Islamic finance that will help avert a financial crisis, namely to prevent harm and gain benefits; money only as a means store of value or medium of exchange; to generate profits by taking or sharing risks; to create wealth in balance with the transfer and circulation of wealth; to ensure transparency and traceability; fulfill Sharīʿah compliance; fairness and achievement excellence (MalayMail, 2022).

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4.4. Challenges in the Adoption of Islamic Finance

This paper found several challenges in developing Islamic finance institutions in Malaysia. One of the challenges to Islamic finance's adoption in Malaysia revolved around the misunderstanding of concepts and a need to standardize Islamic financial concepts. According to Gerrard and Barton Cunningham (2003), there is a tiny minority of Muslims who might be familiar with Islamic banking procedures, while there could be almost no non-Muslims that is able to thoroughly understand the Islamic financial culture. These observations showed that consumer knowledge of the Islamic banking industry is still lacking. Therefore, Malaysian customers would still require more information with regards to the Islamic banking services.

Secondly, there is a limited number of market-based financial intermediation and product. Askari et al. (2011) stated that IFIs are at risk of liquidity issues with little capital risk and significant yields which comes as a result from an absence of stable market and short-term assets such as treasury bills and securities. These financial instruments are prohibited from a Sharīʿah point of view because the profits obtained are not based on productive and real business. At present, the market has already seen substitute products which offer similar liquidity features as the original product (e.g. Bai' al-inah, Bai' bithamanajil, Murabahah, and Mudarabah). Islamic financial institutions struggled to deal with liquidity shortages and excesses since the Sharīʿah point of view prohibited them from conducting riba-based lending activities.

Thirdly, the operations of IFIs involve concentrated banking, which has limited risk management functionality. According to Iqbal (2007), IFIs would usually avoid direct competition by concentrating on a few niche industries. One Islamic bank for instance, would place focus on lending to information technology businesses, while another which has yet to diversify into other industries, would place focus on financing the agricultural sector. Lacking a formal marketplace to mitigate risk and create diversity, this approach severely limits the potential for risk transfer. As a result, Islamic banks are highly vulnerable towards cyclical shocks in specific sectors (Iqbal, 2007).

The last challenge concerns more on the legal aspects governing IFIs. According to Oseni (2011), the Malaysian legal system has been amended multiple times in an effort to eliminate disagreements, especially when determining which transaction or situation is considered halal and haram. One of the efforts made in the Islamic finance scoop was the establishment of the Muamalat bench at Kuala Lumpur high court to encourage a sort of expert determination of Islamic finance disputes, albeit through jurisdiction. Despite the effort, it is still faced with problems in determining the right judgment, especially in the manpower aspect that lack of mastering Islamic finance. Customers of Malaysian banks are ultimately more inclined to subscribe to consumer-friendly financial institutions, especially when it comes to dispute resolution in ensuring that the transaction carried out is in accordance with sharia.

Islamic banking plays a vital role in Malaysia's financial industry. Therefore, it is crucial to consider elements that influence its ability for further expansion among both Muslims and non-Muslims. As such, various parties need to work together in overcoming challenges which are being faced from the development of Islamic banking sector in Malaysia.

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5. Conclusion

The global financial crisis from 2007 until 2009 had impacted many parties in nations worldwide. This financial crisis, which was said to be the worst incident since the Great Depression in 1929, was mainly caused by three reasons, namely inadequate market discipline in the financial system, excessive use of derivatives, and inappropriate regulations (e.g. too big to fail) (Chapra, 2011). From an Islamic finance viewpoint, this crisis happened because of the presence of interest, short selling, selling activities of subprime mortgage debt, and the absence of risk sharing. To overcome this crisis entirely, the development of Islamic finance is considered as an alternative solution that can be used in complementary to the conventional finance practice.

Islamic finance adheres to an asset-based model which helps to limit excessive leverage by promoting risk sharing in wealth-creating activities. Islamic finance also prohibits short sales and adopts the occurrence of debt through the sale, production, or lease of tangible assets (Ahmed, 2010). These features would lead to an ideal situation where Islamic financing products can grow in line with the growth of the real economy (Siddiqi, 2006). Since Islamic finance practice is based from the Sharīʿah point of view, which directly originates from the Quran and Sunnah, the practice of riba, maysir, and gharar became strictly prohibited. As such, this system is able to help protect sellers and buyers simultaneously by encouraging fair and lawful business, which would lead towards risk-sharing practice.

However, Islamic finance is still facing challenges in becoming a more stable establishment, especially in Malaysia. Islamic finance is still facing misconceptions amongst the citizen. The lack of standardization of its concept also made this concept to be rather foreign within society. Even among Muslims themselves, there are still a limited number of people who have clear understanding about Islamic finance (Gerrard & Barton Cunningham, 2003). Limited market-based financial intermediation and product had also led towards liquidity problem among IFIs (Askari et al., 2011). In addition, there are still needs for IFIs to be more diverse in the industries they choose to provide financing to, so that the fear of direct competition among IFIs can be reduced (Iqbal, 2007). Therefore, it is essential to create a regulation that can assist in developing Islamic finance in Malaysia. In response to legal problems surrounding the industry, the Malaysian legal system has undergone numerous revisions in response to development in the civil justice system.

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