

What are the impacts of the global financial crisis on Islamic banking system and how Islamic bank spared from the crisis?

Accounting  
Master's thesis  
Salad Addawe  
2012



Aalto University  
School of Economics

# What are the impacts of the global financial crisis on Islamic banking system and how Islamic bank spared from the crisis?

Master's Thesis  
Salad Araye Addawe  
Winter 2012  
Accounting

Approved in the Department of Accounting \_\_\_ / \_\_\_20\_\_\_ and awarded the grade

---

Salad Araye Addawe

## **Objective of the study**

The objective of the study was to investigate what are the impacts of the global financial crisis on Islamic banking system and how Islamic bank spared from the current global financial crisis. To understand the issue some important sub questions were investigated such as the differences between Islamic and conventional banking model, modes of financing by the Islamic bank, differences in corporate governance and how Interest-free banking system works in general.

## **Data and research method**

For the theoretical part of the research, books, academic research papers and organization's homepages were used as sources. The empirical part of the study is a qualitative and is based on open-ended questionnaire complemented with semi-structured interviews from two fully sharia compliant Islamic and two conventional bank's Islamic window managers who make investment decisions in their banks. The study is qualitative and descriptive in nature and investigates how things are rather than suggesting how things should be. All 6 senior Islamic bank managers have been interviewed.

## **Results**

The result indicates that Islamic banks are more resilient than conventional banks in the face of the global financial crisis. Because modes of financing and corporate governance of Islamic banking are different from those of conventional banking, this assisted the IBs to spare from the current global financial crisis. Factors that enabled the Islamic banks to shield form crisis were seen as asset backed financing; avoiding speculation and debt selling; avoiding invest in toxic assets and the use of profit and loss sharing mode of financing.

Keywords: Islamic Banking (IB), Conventional Banking (CB), Sharia Compliance, and Islamic Investments.

# TABLE OF CONTENTS

<b>Objective of the study</b> .....	1
<b>Data and research method</b> .....	1
<b>Results</b> .....	1
<b>1. INTRODUCTION</b> .....	5
<b>1.1 Background and the motivation</b> .....	5
<b>1.2 Research questions and its limitations</b> .....	7
<b>1.3 Research method and data</b> .....	9
<b>1.4 Definition of the concept</b> .....	9
<b>1.5 Structure of the research</b> .....	10
<b>2. LITERATURE OVER-VIEW ON BANKING SYSTEM</b> .....	11
<b>2.1 Justification for the existence of banks</b> .....	11
<b>2.2 Islamic banking</b> .....	13
<b>2.2.1 Shari,ah concept</b> .....	15
<b>2.2.2 Interest (Riba) and major religions views</b> .....	16
<b>2.2.3 Interest (Riba) the rationale behind the Islamic view</b> .....	17
<b>2.3 Difference between conventional banking and Islamic banking</b> .....	19
<b>2.4 Basic techniques used by the Islamic banks.</b> .....	22
<b>2.4.1 Musharaka (Equity participation)</b> .....	22
<b>2.4.2 Mudaraba or Trustee financing</b> .....	23
<b>2.4.3 Murabaha (Mark-up)</b> .....	25
<b>2.4.4 Ijara( Lease)</b> .....	26
<b>3. GLOBAL FINANCIAL CRISIS</b> .....	28
<b>3.1 Causes of the global financial crisis</b> .....	28

<b>3.2 Corporate Governance</b> .....	30
<b>3.2.1 Moral Hazard</b> .....	31
<b>3.2.2 Causes of the global financial crisis from the Muslim scholar's point views</b> .....	34
<b>3.2.2.1 Profit and Loss sharing (PLs)</b> .....	34
<b>3.2.2.2 Vast expansion of the size of derivatives</b> .....	35
<b>3.3 Islamic bank and the effects of the financial crisis</b> .....	36
<b>3.3.1 Modes of transactions of the IBs</b> .....	36
<b>3.3.2 Bank's performance during and after the financial crisis</b> .....	37
<b>3.3.3 Incentives compatible with PLs contracts</b> .....	42
<b>3.4 Conclusions from the chapter</b> .....	46
<b>4. RESEARCH METHODOLOGY</b> .....	47
<b>4.1 Research method</b> .....	47
<b>4.2 Data collection</b> .....	48
<b>4.3 Reliability and validity of the research</b> .....	49
<b>5. EMPIRICAL EVIDENCE OF THE GLOBAL FINANCIAL CRISIS IMPACTS ON ISLAMIC BANKING.</b> .....	50
<b>5.1 Overview of Kenya's Islamic banking</b> .....	50
<b>5.2 Islamic bank's Corporate Governance</b> .....	51
<b>5.2.1 Differences between CB and IB's corporate governance</b> .....	52
<b>5.2.2 Moral Hazard and Islamic banking</b> .....	55
<b>5.3 Reasons for the global financial crisis, IB's view</b> .....	56
<b>5.4 Main risks that bank face</b> .....	57
<b>5.5 Factors that enabled IB to to spare from global financial crisis</b> .....	64
<b>5.6. Banks performances during and after crisis</b> .....	66
<b>5.7 Future of IBs</b> .....	69

<b>6. KEY FINDING</b> .....	72
<b>7. DISCUSSION</b> .....	77
<b>7.1 Summary of the research</b> .....	77
<b>7.2 Conclusions of the paper</b> .....	77
<b>REFERENCES</b> .....	83
<b>APPENDEX</b> .....	86

# 1. INTRODUCTION

## 1.1 Background and the motivation

During the last decades, the financial systems have played an undisputed role in the development of the world economic growth (Chapra 2008). Banks whether Islamic or conventional banking system were the central factor of these economic developments. According to Chapra (2008), the ongoing financial crisis is not first of its kind. According to some estimates, there were around 100 crises (Stiglitz, 2003, p.54). Those crises affected both all geographical areas as well as all countries (Chapra 2008). Last financial crisis on financial system is however described as the worse financial crisis every witnessed by the financial sectors (Chapra 2008). While financial crisis that started from US and spread to the rest of the world are still present, recent turmoil in sovereign debt (government debts) markets in Europe has shown increased vulnerability of the banks in some Euro area. According to IMF, spreads on sovereigns perceived to face grater fiscal and growth challenges rose rapidly in the wake of Greece's funding difficulties ([www.IMF.org](http://www.IMF.org) 2010).

Research on the current financial crisis and its causes are widely available. Excessive and imprudent lending were some of the most important causes (Chapra 2008). On the other hand US congressional Research conducted after the crisis has listed what seem to be the most important causes of the current crisis. These are imprudent Mortgage Lending, Housing bubble, Global Financial Imbalances, Securitization Problems, Lack of Transparency, Rating Agencies, Market-to-Market accounting, Deregulatory Legislation, Shadow Banking System, Non-Bank Runs, Off-Balance Finance, Government Mandated Subprime Lending, Failure of risk Management, Financial Innovation, Complexity of some Financial Instruments, Human Frailty, Excessive Lending and short-term incentives (Jickling 2010).

While there is wide consensus about the cause of the financial crisis, there are different arguments on what the ultimate solution to the problem is. While western researchers argued that, the above mentioned factors can be resolved by enhancing banking supervision and more regulatory means, some Muslim researchers (e.g Chapra 2008) argued that, there are two factors that enable banks to assume that they will not suffer losses. First factor is collateral, which is indispensable and unavoidable in any financial systems for managing the risk of default. Chapra (2008) and others argued that, collateral itself is exposed to a valuation risk. They said collateral value could be impaired by the same factor that reduces the borrower's ability to pay back.

Those researchers advocate Sharia<sup>1</sup> compliance investment and argued; using PLs system may reduce this problem. They insist without profit and loss sharing system, banks may not always undertake a careful evaluation of the collateral and client's credit worthiness and will extend financing for any purpose (Chapra 2008).

Second factor that provides protection from default to the banks is the "too-big to fail" concept. This means that the central bank assures other banks to bail them out if such crisis occurred (Mishkin 1977, P. 61). However, banks that are provided with such a safety net have incentives to take greater risks than what they otherwise would do (Mishkin 1997, P. 62). "The false sense of immunity from losses provided to bankers as well as depositors impairs the ability of the market to impose the required discipline and this has led to an unhealthy expansion in the overall volume of credit, to excessive leverage, to even subprime debt, and to living beyond means" (Chapra 2008).

The notion of Islamic financing was born during the tumultuous identity politics years of the mid-20th century (El. Gamal 2006). As El. Gamal argued, Indian, Pakistani, and Arab thinkers contemplated independence from Britain and independence of Pakistani from India, within the context of "Islamic society" (El. Gamal 2006). According to this theory "Islam was assumed to inspire political, economic, and financial systems that are distinctive and independent from the western (Capitalist) and Eastern European (Socialist) models of epoch (El. Gamal 2006).

The increased importance of the Islamic finance and its rapid expansion as a viable form of financial intermediation is on the other hand still in infancy. Prior to the 1970, only retail banking system existed. First Islamic commercial banking system was established during 1970s. Property finance, syndication and Islamic insurances (Takaful) were created during 1980s. During 1990s equity funds, leasing and Islamic securitization were established. Contemporary Islamic banking is dealing with Advanced Treasury services, Balance Sheet Management and Innovative Asset Management (<http://www.ifsb.org> 2010).

According to the Islamic Financial Board's report published in 2010, Islamic financial service industry represents approximately 1% of the global assets. However the growing rate is estimated between 15 – 20%. The current combined revenue of international Islamic finance services is about \$530 billion. The Islamic Financial Board estimates that by 2012, Islamic assets will reach about \$1600 billion, with revenue of \$120 billion. (<http://www.ifsb.org>). The rapid growth of Islamic

---

<sup>1</sup> Sharia Compliance refers to system of banking or banking activity that is consistent with the principles of Islamic Law (*Sharia*) and its practical application through the development of Islamic economics.



finance also attracted the conventional banks. There is also growing interest from the Western conventional banks towards Sharia based investment. Big banks such as Barclays and others have already established what they called conventional bank's Islamic Windows.

Given to this importance to the Islamic financing and investment, it is worthwhile to study the phenomena in more depth. While previous studies on the financial crisis focused on causes and consequences of the financial crisis, less emphasis were directed to the emerging Islamic Sharia compliance based investment and Islamic banking system.

Next are some relevant literature and research dealing with the issue: Chapra (2008) has analyzed in his article, the concept of Profit & Loss sharing financing. On the other hand Lewis (2010) examined the nature and structure of Islamic investment funds and evaluated their corporate governance. Also Simon & Rifaat investigated the Profit Sharing investment Accounts in Islamic banking from the perspective of regulatory problems. In addition to those researchers, Zineldin (1990) has investigated the interest-free banking system.

While studies conducted by Chapra (2008) and Lewis (2010) shed a light on the impact of the global financial crisis on Islamic financial systems and to governance of Islamic investment funds, fewer emphases were directed to the characteristics of Islamic investments and financial system. The impact of the latest global financial crisis on Islamic banking is not broadly dealt. On the other hand, less attention is given to what financing modes Islamic bank uses compared to the conventional banking system. Also empirical evidence about how Islamic banking system spared from the current global financial crisis is limited.

This study looks on these issues and tries to answer how Islamic banking system spared from the last global financial crisis. To investigate how Islamic bank spared from the global financial crisis some sub questions are analyzed and these are: what are the differences between Islamic and conventional banking model, what financing modes an Islamic bank uses, what are the differences between Islamic and conventional bank's corporate governance and how Interest-free banking system (Sharia principle based) work compared to the interest based banking system

## **1.2 Research questions and its limitations**

Global financial system runs into trouble in 2007. Subprime mortgage crisis was one of the starting point, however the collapse of Lehman Brothers<sup>2</sup> and Fannie Mae<sup>3</sup> were the most shocking to the

---

<sup>2</sup> Lehman Brothers was an investment bank providing financial services to corporations, governments and municipalities, institutional clients and wealthy individuals around the world.

world financial system. While many western banks defaulted during that period, no major Islamic bank default was reported during the crisis. The central question of this study is indeed what methods used by the Islamic banks to spare from the current crisis. The aim of the study is to investigate, the impact of the financial crisis on Islamic banking system. Emphasis will be given to the ethics behind the Islamic banking systems and how these banks spared from the global financial crisis. The aim is to identify whether different financing modes have impact on bank's performances. Also the concept of free interest rate will be analyzed and what methods an Islamic banks used instead of interest rate. This free interest rate concept will be analyzed as part of the Sharia compliance investment based concept.

While the current study deals above issues, it will not investigate in depth the concept of Sharia law and it will not go into details to the conventional banking system. The central theme of the study is to investigate and analyze how global financial crisis affected the Islamic banking systems and what are the main arguments of those who advocate for Islamic financial system and free of interest investments (LA RIBA concept).

The Current research's main and sub questions are as follows:

- What is the impact of the global financial crisis on the Islamic banking system and how Islamic bank spared from the crisis?
  - What are the differences between Islamic and conventional banking model?
  - What are the differences between the Islamic and conventional bank's corporate governance?
  - How Interest-free banking system (Sharia principle based) works compared to the interest based banking system?

By analyzing these sub questions I will be able to find out factors that were enabled the IB to avoid the crisis. These two first questions will be dealt in more depth while the last three questions will be analyzed briefly.

---

<sup>3</sup> Fannie Mae is a financial services company serving the American home mortgage industry. Fannie Mae offers banks and other mortgage lenders financing, credit guarantees, technology and services so lenders can make more home loans to more consumers.

### **1.3 Research method and data**

The current research is to be formed from two parts: theoretical part of the study and the empirical part. The theoretical part analyzes and presents current literature and research findings dealing with the concept of the global financial crisis and Islamic banking system. In the theoretical part of the study, books, academic papers are the main sources. Press releases and organization's home pages sources are also part of the theoretical study to gain support for the main arguments.

The empirical part of the study is a qualitative and descriptive in nature and investigates how things are rather than suggesting how things should be.

These banks are Islamic and conventional bank's Islamic windows<sup>4</sup>. Data for approaching the research problem was collected using open-ended questionnaires complemented with semi-structured interviews with individuals responsible for making decisions concerning the investment and asset management of those banks.

### **1.4 Definition of the concept**

In this subsection the definition of banking system in general and in particular Islamic banking system is introduced. Commercial, and investment banks and what tasks they perform will be also defined briefly.

The technical term "banco" emerged only at the end of the middle ages; it was a Latin translation of the ancient Greek word "tarapesa" which refers to table. It refers to a bench or table where a professional banker displays his money and his records (Sineldin 1990). According to this theory, "the reason why this word related to the banking business was then the prevailing habit of Lombardian money changers (when trade and exchange of money flourish in northern Italian cities at the end of the Middle Ages) of using wooden desks to carry on their business in the market of buying and selling the various currencies" (Sineldin 1990). The etymology of the word of bank can be also traced to the French word "banque" or "Chest". Chest refers to the safekeeping function, and "banco" (bench) refers to transaction function (Zineldin 1990).

According to these theories, it is impossible to establish the first starting period of the banking business, however need for banking emerged and developed with the use of money as means of exchange at the beginning of organized culture, industry and trade (Zineldin 1990).

---

<sup>4</sup> Conventional banks are establishing branches that work in compliance with Sharia law to some degree but not fully compliance.

Next I will briefly define Investment banking and commercial banking to have an idea what task they perform.

An investment bank is a financial institution that helps governments and corporations in raising funds. Investment bank performs underwriting and performs activities such as issuing of securities, merger, mergers and acquisitions. Commercial bank is an institution that provides services such as accepting deposits and giving loans. ([www.investopedia.com](http://www.investopedia.com))

Islamic banking is primarily the same as the conventional banks but works according to the Sharia principles and is guided by Islamic economic law. The basic principles behind Islamic banking are prohibition of collecting and payment of interest and profit/ loss sharing arrangement ([www.investopedia.com](http://www.investopedia.com)).

## **1.5 Structure of the research**

The rest of the study is constructed as follows: Chapter 2 examines in more depth theories on banking system and main ideologies behind it. In the second chapter, the concept of free-interest investment and the question of what are differences between an Islamic and conventional banking will be analyzed.

Chapter 3 analyses the questions on how global financial crisis affected the Islamic banking system and what methods used to spare from the crisis. The concept of Islamic Sharia based corporate governance and what financing modes Islamic bank uses will be included in the third chapter.

Chapter 4 summarizes briefly the methodologies used, data collection methods and validity and reliability of the research.

Chapter 5 deals with the empirical part of the study by analyzing the data collected from the selected banks and compare the findings to the previous research and academic literature.

Chapter 6 sums up the key findings and chapter 7 concludes the study and suggests further research. Bibliography and appendices are attached at the end of paper.

## **2. LITERATURE OVER-VIEW ON BANKING SYSTEM**

The chapter covers the theories behind the banking system in general and gives an idea how conventional and Islamic banks undertake their operations. As mentioned early, Islamic bank follows Sharia principle, which is based on profit and loss sharing principle. The chapter then defines the Sharia concept and main ideas behind it and then investigates how Islamic banks differ from the conventional banks from the existing literature's point view. In this research, banking system refers to mainly commercial banking because commercial banks undertake different tasks such deposit taking and investment in assets or projects.

### **2.1 Justification for the existence of banks**

According to Zineldin (1990), the purpose of the financial intermediaries is to act as middlemen between investors and depositors. Banks collect savings from scattered individual depositors and businesses that make more than they spend and lend the proceeds to individuals, government's agencies and entrepreneurs that spend more than they make (Zineldin 1990). There are at least five theories that describe why banks exist (Casu, Girdardone, Molyneux 2006). These theories are "delegated monitoring; information production; liquidity transformation; consumption smoothing; and the role of the banks as a commitment mechanism".

- First theory that is put forward is "delegated monitoring", the explanations given in this theory is related to the role of the banks as monitors' of borrower. Because monitoring credit risk is costly, it is efficient for surplus units (depositors) to delegate the tasks of monitoring to specialized agent such as the banks. Banks have broad expertise and at the same time have the economics of scale in processing information on the riskiness of the borrowers. A depositor who is willing to invest in assets does not have this expertize and economic of scale to search and identify all these relevant information needed from the borrower.
- Second theory that deals with this issue is "information production" the second theory is also related to the information costs. Because information about potential investment is not free, agents such as banks may find it valuable to produce information. Investors who are willing to invest in assets will incur substantial search costs if they decide to seek out borrowers directly.
- The third theory is concerned with "liquidity transformation" In this matter, banks provide financial to depositors that have superior surplus liquidity compared to direct claims such equity and bonds (Casu, Girdardone, & Molyneux 2006). According to these authors, bank

deposits can be considered as contract that offer high liquidity and low risk that are held on the liability side of the bank's balance sheet. These liquid assets are financed by relatively illiquid and higher risk assets such as loans that are held on the asset side of the balance sheet.

- Fourth theory that explains why banks exist is “consumption smoothing” Investopedia defines consumption smoothing as “the ways in which people try to optimize their lifetime standard of living by ensuring a proper balance of spending and saving during the different phases of their life time”. This theory suggests that banks enable economic agents to smooth their consumption by offering insurance against shocks to a consumers' path. Because economic agents do not sure about their expenditure in the future, this creates a demand for illiquid asset (Casu, Girdardone & Molyneux 2006).
- The final justification for banks existence is “commitment mechanism” this final theory tries to explain why illiquid bank assets such loans are financed by demand deposits that enable consumers to come to the banks and ask for liquidation of those illiquid assets. To control risks taking propensity of banks, demand deposits have developed because changes in the supply and demand of these instruments will reflect in financing costs and this commits banks to behave prudently. This discipline ensures that, banks will keep sufficient liquidity and capital resources.

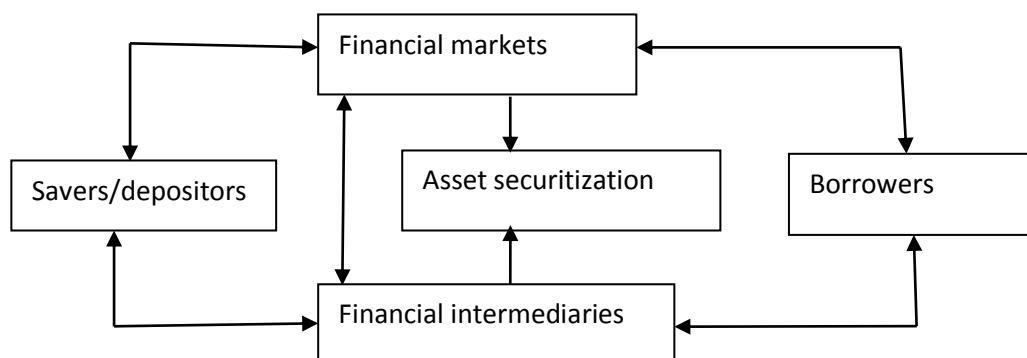
To understand why banks exist, it is may be paramount to understand the role of the banks. According to Casu, Girdardone and Molyneux (2006), banks perform three roles. These are size, maturity and risk transformation. First, “size transformation” refers to the willingness of the depositors or savers to lend. According to this theory, savers are eager to lend small money than the amount borrowers would borrow from the bank. In this role, banks collect money from many small size savers and repackage them into large size loans. In this, banks perform size transformation function by exploiting economic of scale (Casu, Girdardone & Molyneux 2006).

The second role is “maturity transformation” In this role; banks transform funds lent in short term bases to medium and long-term loans. According to Casu, Girdone and Molyneux (2006), bank's liabilities such as funds collected from the depositors are usually repayable on demand. On the other side bank's assets such as funds lent to borrowers are repayable in the medium or long-term. Here it is obvious that banks are borrowing on a short term and lending on a long term. In this process banks face what is called “mismatch” meaning that banks mismatch their assets and liabilities and this process results in liquidity risk for the banks.

Third role “risk transformation” means that borrowers carry credit risk meaning that they may default. On the hand, depositors are willing their funds to be safe and want to minimize risks. Banks solve this problem by diversifying individual investments, pooling risks, screening and monitoring borrowers and holding capital and reserves as a buffer for unexpected losses.

Conventional banking theories assume that banks earn profits by purchasing savings or deposits from the savers at a low interest rate. Banks then resell those funds to the borrowers at higher interest rate. Banks’ profit is therefore the spreads between the interest rate received from the borrowers and interest rate paid to savers. Next figure is taken from the book of Casu, Girdardone & Molyneux (2006) and was reshaped.

**Figure 1 shows modern financial intermediation of conventional banking**



**Figure 1. Financial intermediation of conventional banking**

## 2.2 Islamic banking

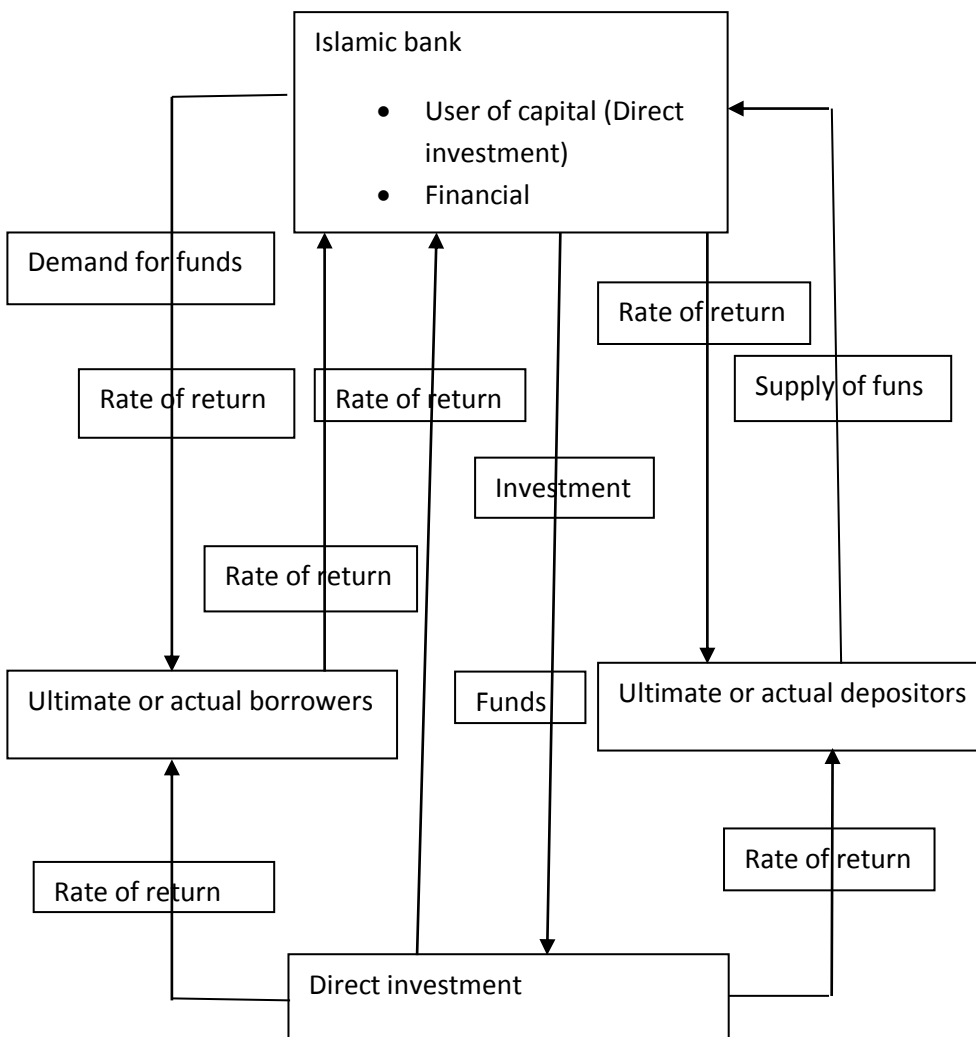
Islamic bank as the conventional bank is a deposit-taking banking institution whose scope activities included all known banking activities that conventional banking undertake except borrowing and lending on the basis of interest rate. Islamic bank is also major contributor to information production and helps address the asymmetric information problem (adverse selection and moral hazard). Islamic bank like conventional bank reduces also transaction costs and facilitates diversification for small savers. It also manages the operational liquidity and other types of risks. On its liability side of the balance sheet, Islamic bank mobilizes the funds on the basis of Mudarabaha (Trustee financing) or Wakalah (agent) contract. It also accepts demand deposits that are treated as interest-free loans from the clients to the bank. On the asset side of the balance sheet, it advances funds on a profit-loss sharing in accordance with the principle of Sharia.

Bank deposits can be divided into demand and time deposits. Demand deposits are guaranteed and bank would not give any benefit but works just as a safe-keeper. On the other hand, bank invests the

time deposits or investment deposits on the basis of Mudarabaha (Trustee financing) contract and shares the profit with investor of time depositors. As can be seen from this definition, Islamic bank plays the role of an investment manager for the owners of time deposit accounts because it searches potential investment targets for the owners of time deposits accounts. Also equity holding and commodity and asset trading are part of the Islamic banking operations.

As I mentioned above, Islamic bank follows the Sharia principles in its operations. Next subsection will give some clues about the Sharia concept in order to understand what differentiates Islamic bank from the conventional bank. Figure below is taken from the book of Zineldin (1990) and was reshaped.

**Figure 1 shows financial intermediation of Islamic banking**



**Figure 2. Financial intermediation of Islamic banking**



### 2.2.1 Shari,ah concept

Sharia refers to a set of rules, regulations, teachings, and values that govern the lives of Muslims. Sharia consists of five main elements: First is the “Quran” (Koran) which Muslims believe as a word of God and was revealed from God (Allah) to Prophet Muhammad) verbally through the angel Jibril (Gabriel). The second element is the “Hadith” or records of actions and sayings of the Prophet Muhammad by reliable witnesses. The Third element is “Sunna” or the ideal of human conducts such as tacit approvals of the Prophet and what the Prophet himself did or did not. The fourth element is called “Ijm’a “, meaning the consensus of Muslim scholars on a point of view of the Islamic law. The final element of the Sharia element is called “Ijtihad” which is based on the Science and adapting and interpreting existing doctrine to changing the economic or social circumstances by some method such analogy and derivation of meaning from other than revealed text such as reasoning (Zineldin1990).

The first two elements (Koran and Hadith) are the most import in the Islamic law followed by Sunna (ideal of human conducts) and Ijtim’a (Muslim scholar’s consensus).

Defined the Sharia law as set of rules, regulations and values that dictates the lives of Muslims, Islamic economy system must be different from its western economic system. One very important aspect is how private property is perceived by different social systems. Capitalism believes in free enterprise that makes necessary private ownership of the material means of production. (Zineldin1990). In the Capitalist economy, one has the rights to buy and sell any factors of production. In the Capitalist economy the owner of money has the freedom to invest, to save, to receive and to accumulate wealth. In the Socialist economy the ownership of property does not entitle private individuals to acquire means of production.

In the Islamic economy the owner of wealth has the right to buy, to sell, to inherit and to accumulate under the condition that the wealth is not acquired by unlawful means. In this context “unlawful” means that, the property was obtained by following the rules of the Sharia law. In the Islamic economy one has the right to keep his wealth or invest but Islam does not give any freedom to amass and lend money with interest. Islam encourages obtaining wealth through work or trade but prohibits the increase of wealth without efforts. As the Quran States: “*man hath only that for which he make the effort*” (Qur’an, 53:39). Islamic economy differs also from the Capitalist economy because in the Islamic economy it is not acceptable to invest such assets that Sharia law prohibits. For example Sharia law does not permit to invest in Alcohol and Gambling products.

In the next sub chapter the concept of interest and its prohibition is analyzed and some underlying reasons will be put forward.

### **2.2.2 Interest (Riba) and major religions views**

In this sub section debt and riba (interest) are analyzed from the perspectives of major religions and particularly from Sharia's perspective. First, riba (interest rate) is defined and reasons behind its prohibition will be investigated

The term "Interest" is derived from the Medieval Latin word *Interesse*, and the word "Usury" comes from the Latin word *usura*. *Interesse* refers to an increase on principal while *Usura* means enjoyment acquired from money lending. In the Canon law<sup>5</sup>, usury refers to the intention of the lender to obtain more money in return from the loan than the principal amount due (Mehboob 2005). Both Usury and Interest are Riba and have the same meanings of "increase or excess" First of all, interest was prohibited in all three major religions such Judaism, Christianity and Islam. However Islam is the only religion that still maintains the prohibition of interest (Mehboob<sup>6</sup> 2005). According to Mehboob (2005) in the Old Testament, there are three references on usury (Riba or interest) but one of them is dealt here. Judaism (Fundamental code of Jewish law comprising written law) prohibits any Jew to participate in any usurious transaction or to act as intermediary/agent of surety or witness in such transactions between Jew and Jew. (Mehboob 2005).The following verse is derived from Torah.

*"If thou lend money to any of my people that is poor by thee, thou shall not be to him as usurer, neither shall thou lay upon him usury (Exodus 22: 25)"* On the other hand, in the Bible (Old Testament) there are four occasions where interest was prohibited. The first verse that deals with the interest in the Old Testament states: *"The servant who returns the talents as he received them is castigated by the nobleman for not having, put my money to the exchanges, and then at my coming I shall have received own with usury"* (Matthew 25: 14-30). And the second verse stated: *"Do well, and lend, hoping for nothing again; and your reward shall be great, and ye shall be children of Highest"* (Luke 6: 35) (Zineldin 1990).

---

<sup>5</sup> Canon law refers to a Catholic Church's legal system.

<sup>6</sup> Mehboob Ul Hassan was a Ph. D Candidate. post graduate School of Economics in Nagoya City University in 2005

<sup>6</sup> Ust Hj Zaharuddin Hj Abd Rahman is an Academic Fellow / Lecturer, International Islamic University University, Malaysia

In the Quran (Koran) there are twelve references about the interest (Riba) but two of them will be mentioned next. "Allah has permitted trade and has forbidden interest" (Koran 2:275). The second verse of the Koran is clearer and is contained strong language. "O you, who believe fear Allah (God) and give up what remains of your demand for interest, if you are indeed believers. If you do not, take notice of war from Allah and His Messenger: but if you repent you shall have your capital sums; deal not unjustly and ye shall not be dealt with unjustly" (Baqara, 2:278-279). As can be seen here, in all three major religions (Judaism, Christianity and Islam) interest was not permitted in any form. Jewish allowed their members to charge interest to non-Jewish but prohibited charging interest among them. Later, Christians and Jews abandoned the prohibition of interest as secularists gained the upper hand in these societies but Muslims still maintain (Zineldin1990).

### **2.2.3 Interest (Riba) the rationale behind the Islamic view**

Lewis (2009) lists five reasons that Muslim scholars justified for prohibition of the interests: *1. That riba is but the exacting of another's property without any counter value while according to the saying of the Prophet a man's property is unlawful to the other as his blood.*

*2. That riba is forbidden because it prevents men from taking part in active professions, and earning their livelihood by way of trade or industry.*

*3. That the contract of riba leads to a strained relationship between man and man, which results in friction and strife and strips society of its goodliness.*

*4. That the contract of riba is a contrivance to enable the rich to take in excess of the principal that is unlawful and against justice and equity.*

*5. That the illegality of riba is proved by the text of the Holy Qur'an and it is not necessary that men should know the reasons for it. We have to discard it as illegal though we are unaware of the reasons (Lewis (2008)).* The first four justifications are arguable but the last is not because Muslims believe that the Quran is word of God and that it should be obeyed without knowing the reason.

To be prohibited under the Islamic law, interest (riba) has to fulfill at least three conditions. First, interest (riba) should be fixed ex-ante. Because future is unknown and loss can also occur, Islam objects fixing the interest. Second, interest (riba) is tied to time period and amount of the loan. This means that during this time of fixed period, it is not always possible for the debtor to make profit. And third, the payment of the interest (riba) is guaranteed regardless of the outcome of the investment project. In conventional banking system, the lender always gets the interest even if the

debtor makes losses (Chibli 1990). The notion behind the prohibition of pre-determined rate of return is that, the profit that may occur in the future is not known in advance and there is possibility of loss. Thus charging a fixed rate of return on investment cannot be morally justified in Islam. According to the Islamic teachings, the provider of the capital should also share the risk if he/she is willing to share the profits with the entrepreneur. According to the Sharia, it is not permissible to generate income without physical effort or risk (Mehboob 2005). However Western scholars view is that, there is an effort because the provider of the capital postpones his consumption of his/her wealth while he/she is able to make his/her consumption at the present time. In this regard there are no arguments about the efforts but the argument is about fixing the interest rate of return regardless of the outcome of the contract. Also the provider of capital should also be subjected to profit as well as loss.

Muslim writers criticized the view of western ideology that recognizes interest as a reward for savings in the form of abstinence. According to Lewis (2008), writers like Saddiqi (1980, 1982 and Chapra (1985) argued that such reward from saving is only justified from the economic view point only if such savings were used for investment to create additional capital and wealth. These authors argued that, although marginal productivity of capital may enter as one factor in to the determination of the rate of interest, interest itself has no necessary relationship with capital productivity. Those Muslim writers argued that interest is paid on money and not on capital and it has to be paid regardless of capital productivity.

One other view concerning the interest (riba) is concerned about the Islamic law of property. Muslim scholars argued that Islam recognizes two types of individual rights to property: property that is obtained by combining a creative labor and natural resources and a property that is obtained through exchange (Chibli 1990). Islam prohibits exploitation and supports fair and equitable dealing among humans. Charging interest from a person who is not capable of borrowing to meet his/her essential consumption needs is considered as exploitative practices in Islam. Exploitation can occur if for example one person who is very poor borrows from a rich person. If they sign a contract which guarantees the lender a rate of return of 10%, the amount of money return to the lender will double and redouble in years while it is possible that the borrower is not able to repay his/her debt. On the other hand, debt created on interests cannot write off. This practice will create inequalities in the community meaning that poor communities or people will become poorer and rich people become richer. An example of such inequalities currently exists between poor and rich countries.

Poor countries are trapped in to an interest based debt while rich countries are becoming richer (Mehboob 2005).

### **2.3 Difference between conventional banking and Islamic banking**

This subsection explains what tasks conventional and Islamic banks perform in their operations. Their main differences will be also analyzed.

Perhaps the most important difference between Islamic and conventional banking is the prohibition of interest (riba). According to Lewis (2008), early Islamic writers emphasized the social welfare aspect in terms of those activities that increase utility and those that do not. While it is obvious that the main difference is the prohibition of the Interest, the list below represents the main differences. First, Islamic and conventional banks differ in their functions and operating modes.

While conventional banks are based on fully human made principles, an Islamic bank is based on the principle of Islamic law (Sharia). Profit & Loss sharing (PLs) arrangement is the mode of financing for Islamic banking while conventional bank differ in this regard by assuring the investors a predetermined rate of interest. As already mentioned, early Muslim thinkers emphasized the social welfare aspects and for this reason, Islamic bank aims at maximizing the profit as the convention banks but works in the framework of Sharia restrictions meaning that it cannot invest in any product that is available in the market. Needless to mention early the Muslim

writer's views because prohibition of interest is a command from the creator of the humans (God) and every Muslim has to follow despite knowing the purposes behind its prohibition.

One of the most important differences between an Islamic and conventional bank is their relationships with their clients. The relationship between conventional bank and its client is based on creditor and debtor. On the other hand, Islamic bank and its client's relationship are investors and traders, or buyer and seller based relationship. Other most important differences are for example emphasis given to project undertaken and the clients. Conventional bank gives extra importance to the client's credit worthiness while the Islamic bank gives greater importance to the viability of the project that to be invested. An Islamic bank also collects alms (Zakat) from the rich people and passes it to the poor people. One important difference between the CB an IB is that for conventional bank, borrowing from the money market is relatively easier while borrowing money for IB must be based on a Sharia approved underlying transaction . Also due to the importance given to the public interest by the IB, its aim is to ensure growth with equity while CB's own interest often becomes more important than growing with equity. One of the last and significant

differences between conventional and Islamic bank is that, conventional bank has to guarantee all its deposits. On the hand the Islamic bank guarantees only deposits for demand deposit account but the mudarabah (partnership) based account, bank and client share future profits or losses. We will deal the concept of mudarabaha and musharakaha (partnerships) concept in the coming subsections.

Table 1 illustrates the difference between conventional and Islamic bank

Conventional Banks	Islamic Banks
1. The functions and operating modes of conventional banks are based on fully man made principles.	1. The functions and operating modes of Islamic banks are based on the principles of Islamic <i>Sharia</i> .
2. The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
3. It aims at maximizing profit without any restriction.	3. It also aims at maximizing profit but subject to <i>Sharia</i> restrictions.
4. It does not deal with <i>Zakat</i> .	4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a <i>Zakat</i> Collection Centre and they also pay out their <i>Zakat</i> <sup>7</sup> .
5. Lending money and getting it back with compounding interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the Islamic banks. So we have to understand our customer's business very well.
6. It can charge additional money (penalty and compounded interest) in case of defaulters.	6. The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and

<sup>7</sup> Zakat means Alms or money or other gifts given to the poor people

	these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion.
7. Very often it results in the bank's own interest becoming prominent. It makes no effort to ensure growth with equity.	7. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
8. For interest-based commercial banks, borrowing from the money market is relatively easier.	8. For the Islamic banks, it must be based on a Sharia approved underlying transaction.
9. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	9. Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.
10. The conventional banks give greater emphasis on credit-worthiness of the clients.	10. The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
11. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.	11. The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller.
12. A conventional bank has to guarantee all its deposits.	12. Islamic bank can only guarantee deposits for deposit account, which is based on the principle of <i>al-wadiah</i> <sup>8</sup> , thus the depositors are guaranteed repayment of their funds, however if the account is based on the <i>mudarabaha</i> concept, client have to share in a loss position

Table 1. Difference between conventional and Islamic bank

<sup>8</sup> Al-waddiah is a current account with bank and bank is not liable to give any profit to al-waddiah clients

## **2.4 Basic techniques used by the Islamic banks.**

Having said that, Islamic bank is different from conventional bank by not dealing with interest the IB must be different from its conventional counterpart. Here I will put forward the differences forms of participation in trades and investment and techniques used by the Islamic bank in its operations. These modes of financing are numerous but some of the mostly used modes will be presented here.

### **2.4.1 Musharaka (Equity participation)**

In the musharaka participation, the bank is not the only who provides the funds but at least one or more partners contribute to the joint capital of investment. For example the bank enters into a partnership with a client and both contribute the equity capital. Both the bank and the client invest in varying proportion and they both have the rights to participate in the management of the project or the enterprise. From the perspective of corporate governance, the bank has the rights to exercise its voting rights and both the bank and partner also have their representatives in the board of directors. This kind of mode is different from the conventional banks' participation as it is based on profit/loss sharing arrangement. In this mode of participation, the bank and partner share the profit or losses according to their equity shareholdings.

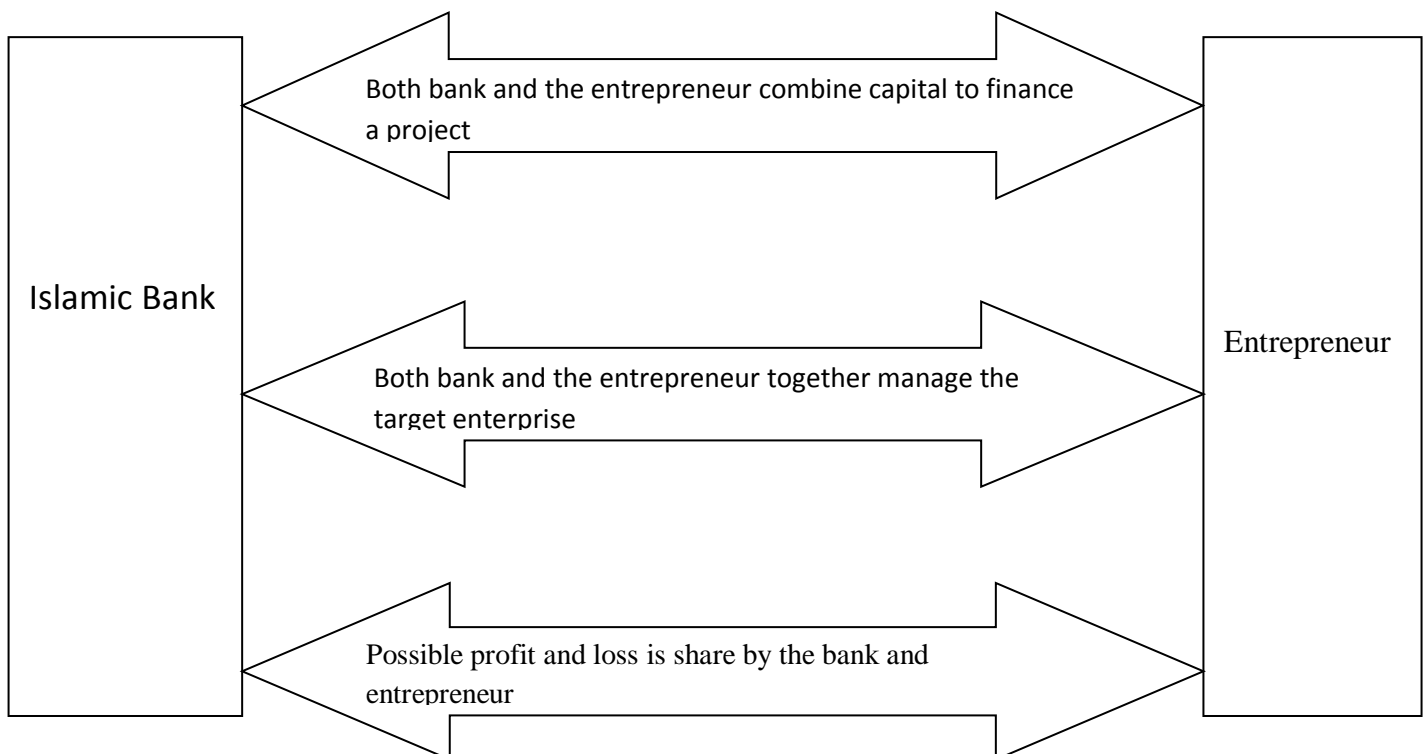
Musharaka can be used for different financing projects. According to Zineldin (1990), musharaka is also identical to the equity markets in which central bank and the government can acquire shares. Musharaka or equity participation contract is used usually for long-term projects (Luca & Mitra 1988). For practicality we take one important example that illustrates how musharaka financing mode works in practice.

It has been used mostly in house financing. The client wants to purchase a house for which he does not have adequate funds. He approaches the financier (IB) who agrees to participate with him in purchasing the required house 20% of the price is paid by the client and 80% of the price by the financier. Thus the IB owns 80% of the house while the client owns 20%. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the bank for using his/her share in the property. This means that he /she pays 80% of the rent to the bank because she/he owns 20% of the house. At the same time the share of financier is further divided in eight equal units, each unit representing 10% ownership of the house. The client promises to the IB that he/she will purchase one unit after three months. Accordingly, after the first term of three months he purchases one unit of the share of the financier by paying 1/10th of the price of the house. It reduces the share of the IB from 80% to 70%. Hence, the rent payable to the financier is also



reduced to that extent. At the end of the second term, he/she purchases another unit increasing his/her share in the property to 40% and reducing the share of the financier to 60% and consequentially reducing the rent to that proportion. This process goes on in the same fashion until after the end of two years, the client purchases the whole share of the financier reducing the share of the financier to 'zero' and increasing his own share to 100 % (Usmani 2002). This above example was taken directly from the book of Guide to Islamic banking (2002).

**Figure 3 illustrates musharaka profit and loss sharing**



**Figure 3. Musharaka profit and loss sharing**

### **2.4.2 Mudaraba or Trustee financing**

Mudaraba (Trustee financing) is also another form of financing mode in which the bank or the entrepreneur contributes the entire capital required for the investment project. The entrepreneur or the bank provides the expertise and labor. Profits and losses are shared between the bank and entrepreneur however; this is quite different from the musharaka contract in terms of losses. When a particular investment or venture is over, the entrepreneur returns the capital and pre-agreed share of the profit. The manager of the capital (Mudarib) keeps a proportion of the profit for compensation of his work and expertise. If the Islamic bank provides the capital for a specific project and partner manages the project and the project produces losses, the IB bears entire losses alone. The partner or the manager of the project losses only his/her reward as far as he/she is not a negligent, thus liability

of the entrepreneur is limited to his/effort (Zineldin1990). So it is now obvious that the bank receives profit only if a surplus exists. Luca & Mitra (1998) divide the mudaraba into unrestricted and restricted mudarabas. According to those authors, on the liability side of the balance sheet, the bank enters a contract with the depositors. It is called unrestricted because the depositors agree that their capital is used for limitless of profitable investments by the bank. These depositors share the profits with the bank according to an agreed percentage of the profit however; they do not have voting rights and cannot have their representatives in the board of directors. On the asset side of the balance sheet, the contract between the bank and the partner is called restricted mudaraba because the bank agrees to finance specific project carried out by the partner (Luca & Mitra 1988).

An Islamic bank for example lends money to a client to finance a factory. In return the bank receives pre-specified percentage of the factory's net profit every year. This share of the profits obtained from the entrepreneur provides for repayment of the principal and profit to pass to the depositors by the bank. However, there is some confusion about the issue. Those literatures that I have obtained mostly agreed that the capital provider bears the entire capital losses; however, according to Aramco World magazine (May-June 1987), profits and losses are to be shared by the bank and the entrepreneur. This Aramco writing is a minor issue because all these other academic literatures are in consensus about the issue and they agreed that the provider of capital has to bear any financial losses.

Figure 4 shows mudaraba profit sharing

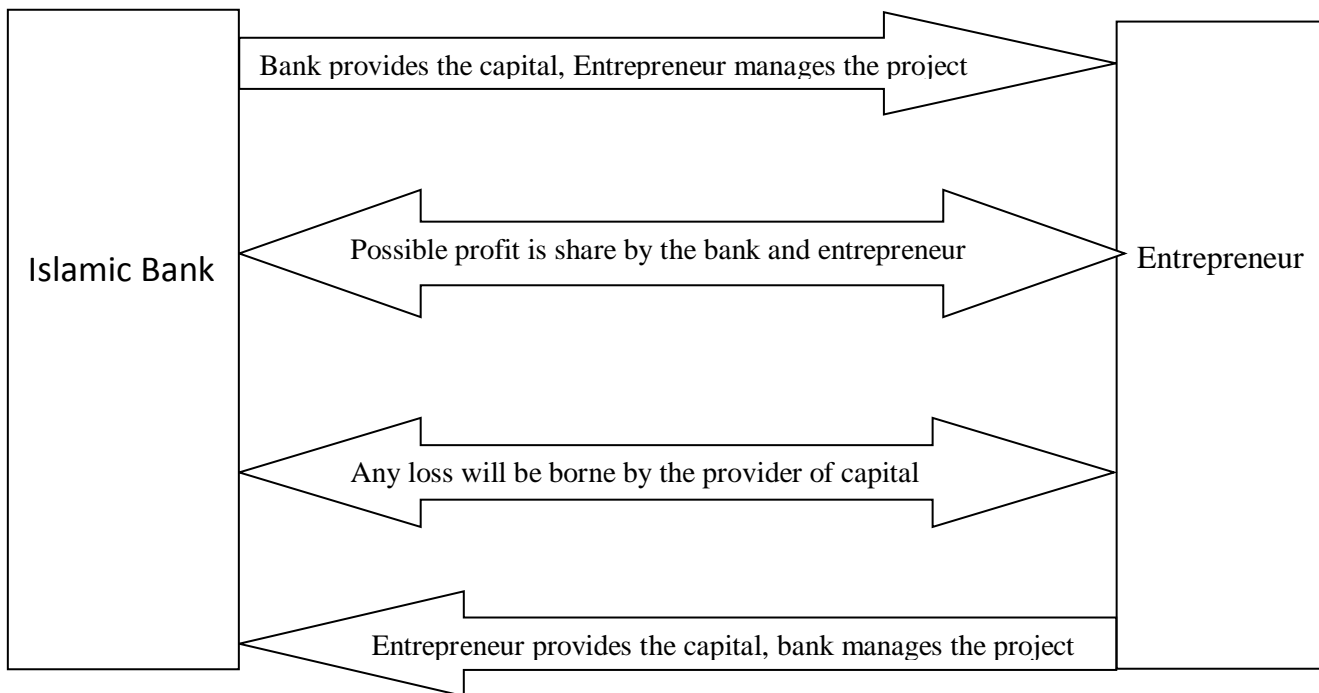


Figure 4. Mudaraba profit sharing

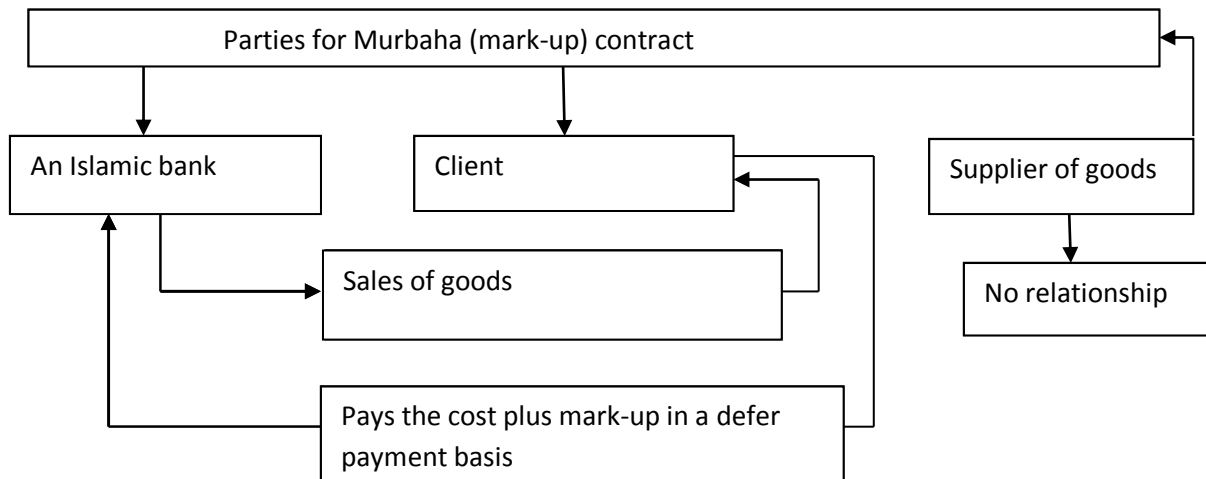
### 2.4.3 Murabaha (Mark-up)

Murabaha is another participating form used by the Islamic bank. In a murabaha contract, the seller informs the buyer the cost of the goods, services or producing a specified product. Parties negotiate a mark-up or profit margin and total cost is usually paid in installment. The murabaha is usually short-term contract. This mode of participation enables the Islamic bank to enter the trading cycle as a buyer of goods, raw materials and equipment or any assets. For example with murabaha contract, a client requests the bank to buy a certain asset at a specific price, and promises to buy it from the bank at agreed higher price at a set of time. This mode is criticized by some Muslim scholars (Siddiqi). They argued that murabaha is not legal financing mode under the Islamic law as the bank earns a profit without bearing a risk. The basic principle of sharia is that both the financier and the client should be subjected to both risk and returns. However, according to Zineldin (1990), these criticisms are baseless because the risk elements are there. The client is not obligated to buy the goods when they arrived and in this sense the bank should look for another buyer. On the other hand, the bank and the client know already the original purchase price and the rate of profit and in this sense if the bank does not tied the mark up to a time period and does not increase the price of the sale, the murabaha is considered as a legal under the Islamic legal trade.

Under the murabaha contract, for example an importer is interested in buying goods from abroad. The entrepreneur informs the bank and bank purchases the goods in its own name and sells to the

importer at an agreed mark-up. This form of murabaha is different from the conventional bank as conventional bank would simply lend the importer money and charge for fixed interest.

**Figure 5 parties involved in murabaha (mark up) contract**



**Figure 5. Parties involved in murabaha contract**

#### **2.4.4 Ijara( Lease)**

Lease is defined as “an agreement in which one party gains a long-term rental agreement, and the other party receives a form of secured long-term debt” ([www.investopedia.com](http://www.investopedia.com)). The lessee gains a long-term contract for the use of an asset, and the lessor is assured of regular payments for a specified number of years. Under the conventional leasing system, the lessee pays the specified rentals and a fixed interest rate over specified period of time for the use of specific assets. The conventional bank takes the risk of interest rate changes.

Ijara (Lease) is allowed under the Sharia but without interest (riba). Ijara or Lease is defined as a contract between Islamic bank (the lessor) and the client (the lessee) who is interested in using the asset and paying rent. Under the Sharia principle, Ijara (lease) is based on Profit Sharing agreement in which the Islamic bank buys the movable or unmovable assets to its clients for an agreed sum of money paid by the lessee in installment and for a limited period of time. It is different from the conventional leasing system in that Ijara (Islamic lease) is based on profit sharing system. The rent collected from the lessee is calculated on the bases of profitability of the asset rented not on the bases of bank’s capital involved (Zineldin1990).

On the other hand, risk involved to the lease is to be shared by both the lessor (bank) and the lessee (client). According to Zineldin (1990), the degree of risk is based on the profitability of the asset

and the future cash flow and thus it differs from the conventional leasing system in which the degree of risk is based on the market rate of the interest or the discounted future cash flow (Zineldin 1990).

These techniques mentioned above are the main basic financing modes used by the Islamic bank however, there are many more financing modes and they may come under these titles. Some of financing modes are for example, Takaful (Insurance) and muqarada which refers to Islamic bonds known as muqarada bond. Muqarada bond allows the bank to issue Islamic bond to finance specific projects. Investors who are interested in buying muqarada bonds are entitled to share the profits generated from the project with the bank but also share the losses. In this arrangement, the investor does not participate in the management of the project and has no voting rights (the investor acts as non-voting shareholder).

### **3. GLOBAL FINANCIAL CRISIS**

This chapter tries to investigate the questions on how global financial crisis affected Islamic banking system and what methods used to spare from the crisis from the perspective of the corporate governance. Because investment decisions and supervisions are tasks belong to the board of directors and thus decisions they may make have direct impact on the bank's performances. In this sense, corporate governance issues are essential when looking the causes of the global financial crisis.

#### **3.1 Causes of the global financial crisis**

As already mentioned in the introduction part, some of the most important triggers of the global financial crises were "Excessive and imprudent lending by banks over a long period, Housing bubble, Global financial Imbalances, Securitization problems, Lack of transparency and Rating Agencies. Subprime mortgage problem was the first trigger of the global financial crisis. Subprime credit refers to extension of credit facilities to borrowers who have deficient credit. The interest rate applicable in the subprime market credit is higher because of the higher risk involved in lending to people who do not show adequate creditworthiness.

According to Saraogi (2007), US government's lending standards were relaxed in 2000 to the point that many people were able to buy houses they could not afford. As a result when prices began to fall and loans started going bad, there was a severe shock to the financial system. In the pre-crisis, the interest rates were very low and house price was rising. The rationale behind taking an excessive mortgage was with home prices in secular uptrend. Borrowers were hoping that in a few years the market value of the mortgaged house would become greater than both principal and interest payment liabilities attached to it. Borrowers were hoping that they would sell their houses in the open market and excess of the market value of the mortgaged house over the liability towards the mortgage would be potential capital gain to borrowers. However, when the housing market started showing signs of weakness, no longer could borrowers think of selling their houses and paying off their mortgage liabilities as the price of their houses started to fall below the mortgage liability attached to it. Because huge lending occurred during this period of time, when borrowers defaulted, there were huge losses. According to Ravi (2007), more than \$20 billion investments were shut down because of the losses on account of investing in mortgage related securities.

Housing bubble was also one of the triggers of the last financial crisis. Investopedia defines housing bubble as "a run-up in housing prices fueled by demand, speculation and the belief that recent

history is an infallible forecast of the future. Housing bubbles usually start with an increase in demand (a shift to the right in the demand curve), in the face of limited supply, which takes a relatively long period of time to replenish (fill up) and increase. Speculators enter the market, believing that profits can be made through short-term buying and selling. This further drives demand. At some point, demand decreases (a shift to the left in the demand curve), or stagnates at the same time supply increases, resulting in a sharp drop in prices - and the bubble bursts”

According to Jickling (2009), “With its easy money policies, the Federal Reserve allowed housing prices to rise to unsustainable levels and this crisis was triggered by the bubble bursting as it was bound to it”

Securitization Problem was also one the causes of the global financial crisis. According to Jickling (2009), “securitization fostered the “originate-to distribute ”model<sup>9i</sup>, which he argued reduced lenders’ incentives to be prudent, especially in the face of vast investor demand for subprime loans packaged”. Ownership of mortgage-backed securities was widely dispersed, causing repercussions throughout the global system when subprime loans went bad in 2007. According to Chapra (2007), mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security. They had, therefore, less incentive to undertake careful underwriting. One of the causes of the global financial crisis was also lack of transparency. According to Jickling (2009), throughout the housing finance value chain, different participants contributed to the creation of bad mortgage and selling of bad security. According to this congressional report published after the crisis, those participants who create and sold the bad securities were apparently feeling secure they would not be held accountable for their negligence. As Jickling (2009), argues brokers, State agent, individuals in rating agencies and other market participants were maximizing their own gains and were passing the problem on down the line until the system itself collapsed. Maximizing own gains and moral hazard are then properly behind the collapse of the financial system in 2007.

Short-term Incentives for the bank managers is said to facilitate the financial crisis. Since managers and traders of numerous financial institutions receive a large part of their compensation in the form of annual bonus, they lack incentives to avoid risky strategies in the long- run. This short- term incentive and moral hazard are areas that would be analyzed in the next subchapters.

Excessive leverage is also mentioned as one of the causes of the crisis. According to Jickling (2009), in the post-2000 period of low interest rates and abundant capital, fixed income yields were

---

<sup>9</sup> An originate-to-distribute (OTD) model of lending, where the originator of a loan sells it to various third parties.

low. In order to compensate, many investors used borrowed funds to boost the return on their capital. Excessive leverage magnified the impact of the housing downturn, and deleveraging caused the interbank credit market to tighten. Other authors take the same position also. Bebchuk & Spamann (2010) argued that excessive risk-taking in the financial sectors has played an important role in the global financial crisis. As they argued, executive compensation arrangement may be contributed to excessive risk-taking. Those author's arguments are also in line with those of Jickling's arguments as they both related the excessive risk-taking to the short-term incentives available to the executives. One of the originators of the causes is said to relate to human frailty (weakness, ignorance and greed). According to Jickling (2009), behavioral finance suggests that, investors do not always make optimal choices as they suffer from bounded rationality and limit self-control. These above mentioned factors and many more are said to cause the financial crisis in 2007.

This research looks these problems from the perspective of the corporate governance and how it contributed to causes of the crisis. After this, the paper puts forward some arguments from the perspective of Islamic financing and how these problems avoided in the Islamic banks.

### **3.2 Corporate Governance**

Corporate governance is the set of processes, policies customs, institutions and laws affecting the way in which corporations are directed, administered or controlled (wikipedia.org). It includes the relationship among the many stakeholders involved and the goals for which the corporation is governed. It is also defined as “a framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with its all stakeholders (financiers, customers, management, employees, government, and the community)”. Simon & Rifaat (2009) defined corporate governance as “set of relationship between a company's management, its board of directors, its shareholders and other stakeholders”.

Corporate governance framework consists of explicit and implicit contracts between the corporation and the firms' stakeholders for distribution of responsibilities, rights, and rewards, procedures for reconciling the sometimes conflicting interests of stakeholders in accordance with their duties, privileges, and roles, and procedures for proper supervision, control, and information-flows to serve as a system of checks-and-balances (www.businessdictionary.com).

Given these definitions, corporate executives are expected to fulfill these promises including ensuring accountability, fairness and transparency and good administration of the capital entrusted



to them. Concerning the failure of the of the US financial system, these above mentioned practices were not present and this raises question of what went wrong and why?.

### **3.2.1 Moral Hazard**

Moral Hazard refers “to the risk that one part to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity or otherwise has an incentive to take unusual risk in desperate attempt to earn a profit”.

(www.investopedia.com). Moral Hazard is related to asymmetric information, which assumes that at least one party to the transaction has relevant information whereas the other part does not.

Bebchuk & Spamann (2010) identified key features of executive compensation arrangement that they said to have encouraged bank executives with excessive risk-taking incentives. According to these authors, “by enabling executives to cash a huge amount of equity- based and bones compensation before the long-term consequences of decisions are realized, pay arrangements have provided executive with incentives to focus excessively on short-term results and gave little weights to the consequences that risk taking would have for long-term on shareholders’ value”. These authors explained the excessive risk-taking “as taking actions that may either decrease or increase the value of the bank’s assets, but whose expected effect on the bank’s value is negative”.

On the other hand, if the executives or managers expect to capture a share of possible gains and bear a smaller share of possible losses, taking such risk will be attractive. On the other hand, those who provide equity capital have an incentive to take risk because they will capture the full upside but some downside will be borne by the government as insurer of deposits if the bank goes bankrupt (Bebchuk & Spamann 2010). An illustrative example put forward by these authors is a strategy in which the bank has assets of \$100 funded by capital of \$10 and \$90 of deposits. If the bank follows a strategy with 50% chance of decreasing the value of the bank assets by \$20 and a 50% chance of increasing it by X and X is less than \$20 which means that the risk strategy will have negative expected value, taking that strategy is the interest of the shareholders. This is the case because if bad strategies produce loss of \$20, the shareholders would not bear this loss fully. Because their capital in the bank is only \$10, their losses will be limited to this \$10. On the other hand, depositors will loss the remaining \$10 but the government, as guarantor of depositors will bear this loss of \$10. While shareholders bear loss that is limited to their capital funding in case of loss, they will capture the full benefit of increase of X in the value of the assets. According to these authors, shareholders will take the risk strategy as long as long as X is more than \$10 (Bebchuk & Spamann 2010). As these authors argued because depositors cannot be expected to prevent excessive risk-taking, by

banks and such risk-taking would lead to bank failure that would have bad effect on the government as insurer of deposits, government regulate and monitor bank's capital and activities. These authors argued that because of the limit information of the government as a regulator, such prudential regulation can constrain but cannot eliminate all excessive risk-taking by banks. This argument is in line with that of Chapra (2008). He argues that bankers and depositors have false sense of immunity from losses and this immunity impairs the ability of the market to impose the required discipline. However, Chapra advocates Islamic Sharia based investment while these other authors are arguing that short-term compensation policy is partly responsible for the current global financial crisis and the system should be reformed.

Another problem, which also related to this issue, is concerned about the capital and compensation structure. According to Bebchuk & Spamann (2010), capital of the banks is partly funded by debt instruments and holding firms that have an additional layer of debt funding holds the common equity of banks. Those authors presented another good example of this kind of problem in the compensation structure. They argued that if the bank's capital (\$10) in the previous example is financed by two ways; \$2 comes from note holders as debt and the remaining \$8 comes from common shareholders and the executive is holding common shares, he/she will be prevented from the effects of any increase in the level of loss beyond \$8. Those authors mentioned above also find another distortion that arises from the presence of an additional layer of debt financing at the level of the bank holding company. Because banks are usually subsidiaries of financial conglomerates and bank's decisions may be taken at the holding company level, problem arises because the incentives of the top executives are tied to the share price of the holding company.

As Bebchuk & Spamann (2010), argue the existence of the debt and risk asset at the holding level together with the holding's investments in the bank will alter the holding's incentives to manage the bank. One very important aspect of the distortion comes from the fact that "the bank holding company holds assets that are not in the traditional banking and if the non-bank assets of the holding company generates a loss, the value of the equity in the holding will be reduced, in effect leveraging the holding and therefore increasing the incentives for risk taking".

One very important and understandable contributor of excessive risk-taking is the bank's capital structure. Because deposits are the main source of financing, banks equity is very limit as banks have the rights to take deposits. Another illustrative example is put forward again by Bebchuk and Spamann. They have argued that if for example the bank's assets are \$100, which consists of \$90

deposits, \$2 bonds, and \$8 equity and as a result of loss, the bank's assets decrease from \$100 to \$96, then this decrease will reduce the book value of the common shares of the bank holding from \$8 to \$4. Now common shareholders can lose only \$4, if they take excessive risk, this will encourage excessive risk-taking (Bebchuk & Spamann 2010).

In conclusion, Bebchuk & Spamann (2010) find at least two distortions that encourage excessive risk-taking by the executives. The first distortion mentioned is the fact that executives were able to cash large amount of equity-based and bonus compensation before long-term consequences of decisions are realized. This means that short-term based compensation practices provided executives with incentives to focus excessively on short-term results and ignore the long-term consequences. They have also identified that executive compensation is tied to highly levered bets on the bank's asset. This practice has given executives little incentive to take into account the losses that risk-taking could impose on preferred shareholders, bondholders, depositors and taxpayers (Bebchuk & Spamann 2010). On the other hand, these authors identified another distortion that also enables shareholders to take excessive risk. Because bank's equity capital is very small and the amount that shareholders can lose is limited to that proportion of small amount, it is likely that common shareholders in banks will not have an incentive to take into account the losses that risks can impose on bondholders, preferred shareholders, depositors, taxpayers and the government as a guarantor of deposits.

While these above mentioned authors highlighted the causes from the perspective of the executive compensation, there are many arguments concerning the causes of the current global financial crisis. From perspectives of Muslim scholars, short-term incentives problems in the executive compensation system is one of the triggers but (e.g. Chapra 2008) argued that lack of profit and risk sharing arrangement and the mode of financing that conventional banks employed may contributed to the current global financial crisis.

So far, the causes of the global financial crisis were discussed from the perspective of executive compensation. Imprudent and excessive lending was first discussed and distortions in the executive compensation were identified. In the next subsection, the topic will be view from the Muslim scholar's point views and then how the crisis affected both conventional and Islamic banking will be followed.

### **3.2.2 Causes of the global financial crisis from the Muslim scholar's point views**

Muslim scholars share the view that imprudent and excessive lending and risk-taking partially caused the prevailing global financial crisis. However they presented three factors they argued made possible these practices to happen. First factor is the “inadequate market discipline in the financial system, which they argued is the result of profit and loss sharing absence. Second cause is said to be the expansion in the size of the derivatives, especially credit default swaps (CDSs). The third factor is “too-big to fail” concept which means that the government as a guarantor of deposits will bailout if the bank collapses. The last mentioned view is shared by most of the scholars both those who advocate Profit and Loss sharing (PLs) arrangement and those who either prefer to more regulation from the government or restructuring the incentives to bank executives.

#### **3.2.2.1 Profit and Loss sharing (PLs)**

One of the most important of profit and loss sharing arrangement is that, bank and client have to share the risk and rewards. According to Chapra (2008), one of the most important objectives of Islam is to realize justice in human society. As he argues justice needs a set of rules or moral values which everyone accept and faithfully complies with. Chapra argues that, justice is done if the financier and entrepreneur share the possible profits and losses. One of the basic principle of Islamic finance is related to the word “no risk, no gain”. As Chapra argues, these practices of (PLs) will help to introduce a greater discipline into financial system by motivating banks to evaluate more carefully the risks and effectively monitor the use of funds by the borrowers. On the other hand, the assessment of the risk involve will be undertaken by two sides namely the bank and the entrepreneur. This double assessment will provide a greater discipline into the financial system and will reduce the excessive lending (Chapra 2008). While Profit and Loss sharing (PLs) is argued to have the potential to eliminate excessive risk-taking or at least reduce, the Islamic bank also emphasizes the importance of equity financing. However, equity financing is ideal but not a must because financial needs of the institutions, individuals and government cannot amenable to PLs and Equity.

As already stated by Bebhuk and Spamann, when equity decreases to low level, there is an incentive to take excessive risk by the executive and common shareholders. So from the perspective of some Muslim scholars, the current crisis is related to the lack of Profit and Loss sharing and low level of equity financing by the financial institutions.

### 3.2.2.2 Vast expansion of the size of derivatives

One way to see the expansion of derivatives is to differentiate financial economy from the real economy. The economy in the Western countries is said to shift from the industry to services in the last 30 years (Hassan)<sup>10</sup>(<http://www.islamic-foundation.org.uk>). In US the service sector represents over 80 percent of the US economy. According to Hassan, participants in the financial industry gamble on what is going to happen in the real world, by betting on how businesses are performing and by betting on their profits. The real economy consists of housing, land, factories, cars and goods that can be traded. Financial economy consists of tradable paper with financial values that rise and fall based upon the value speculators give them usually with no real asset represented. Hassan argues that the financial economy is now valued more than the real economy. The size of the bond market is estimated at \$45 trillion, the stock market at \$51 trillion, and world derivatives markets is said to be around \$480 trillion and more than 12 times the size of the world economy. According to this arguments presented by the Hassan, investors are not seeking anymore to receive dividends, but rather to take advantage of the inflated price rises. This practice he said has led to speculation of extremely large proportions, including bets on the collapse economies.

The same view is present also by Chapra (2008). He argues that in the Sharia based financial economy, debt selling is not allowed and the risk associated with the debt must be borne by the lender him/herself. He argues that this restriction will not only motivate the creditor to be more careful in assessing the credit risk but also will prevent the debt from rising far above the size of the real economy and at the same time release a huge volume of financial resources for the real sector and thus enabling expand employment and production. According to Jicklig (2009), financial innovation and complexity of the financial system played a role in the current global financial crisis. Jickling (2009) argues that new instruments in structured finance developed so rapidly that market infrastructure came under stress.

On the other hand financial complexity has played significant role because investors were not able to make independent judgment on the merits of their investment. “Standard economy theory assumes that investors act rationally in their own self-interest which implies that they should take risks they understand” (Jickling 2009).

---

<sup>10</sup> Dr. Abul Hassan is Coordinator of the Islamic Economics Unit, The Islamic Foundation, UK.

<sup>10</sup> Managing director, International Institute of Islamic finance Inc, Amenie Business Solutions, Kuala Lumpur, Malaysia

So in conclusion it is now clear that the size of the derivatives, financial innovation that developed so rapidly and complexity of the financial assets that prevented from investors to make a good judgments, distortions in the executive compensation, and lack of profit and loss sharing practices are the main factors that is put forward by different researchers.

Analyzing the causes of the prevailing global financial crisis was important because it enables us to see how banks were armed themselves from these problems and techniques used by different banks to spare the crisis. Next we investigate how Islamic bank spared from the current global financial crisis.

### **3.3 Islamic bank and the effects of the financial crisis**

When looking to find the impact of the global financial crisis on Islamic and conventional banking, it is maybe important to look from three different perspectives: bank supervision, modes of transactions that banks use, and bank's performance during and after the crisis. In looking the modes of transactions, we will be able to identify those modes that mainly contributed to the crisis because losses incurred by the banks are attributable to specific mode of financing used or policies invested by the banks. On the other hand, banks supervision and compensation policy are important factors as they relate control and bank's risk-taking that lead to bank failure or success.

#### **3.3.1 Modes of transactions of the IBs**

As already stated Islamic bank is different from the conventional bank as Islamic bank operates according to Sharia principle. By following these principles, Islamic bank cannot invest in assets that Islamic law prohibits. Thus types of products and services that conventional and Islamic banks invest are different. Also another way to look the differences between conventional and Islamic bank is the way banks deal with risk-taking, sources and use of funds.

While depositors transfer risk to conventional bank and receive guaranteed and pre-specified rate of return for their investments, the Islamic bank uses profit and loss sharing arrangement where Profit Sharing Investment Account (PSIA) holders share the profit and risk. The returns for the investors under the Profit and Loss sharing arrangement are not guaranteed and will be dependent on the bank's performances. On the other hand, in conventional banking, borrowers are required to pay interest that is independent on the returns of their investment. Thus conventional banks transfer risk through credit default swaps or securitization and main source of financing is debt based financing. In an Islamic bank, the main use of sources are Musharaka (Equity participation) where both bank and entrepreneur contribute capital to undertake a project and both manage the target firm and share

possible profit or loss according to their shareholding capital, while in Mudaraba (Trustee finance) based arrangement, an Islamic bank provides the capital required for a certain project and the other partner contributes expertise and labor and manages the firm. Profit generated by the project invested are shared by the bank and investor however in this form of contract the bank bears all the losses and the investor loses his/his reward, unless a negligence is identified (Dridi 2010).

An Islamic bank is said to be better armed against global financial crisis because of the transaction modes they use. According to Dakar<sup>ii</sup> (2010), “money is not commodity and has not intrinsic value itself even when it is lent out”. The only advantage for money is to convert its monetary function into economic function through either trading or investment. Thus Islamic bank as a follower of Sharia principle cannot invest in any product that they required. The Sharia based investment is identical to the ethical investment from the Western perspective. Many researchers present the main factors that were enabling Islamic bank to spare from the financial crisis. First of all, the Islamic bank does not sell debt because debt selling is prohibited in the Sharia. According to the Sharia principle “Man can sell only what he owns”. Mortgage backed securities and credit default swaps are said to contribute the financial crisis. On the other hand, Islamic bank does not invest in toxic assets and mortgage backed securities. Muslim scholars such Chepra (2008) and others argued that debt selling and derivatives were the source of the global financial crisis. On the other hand, Islamic bank financing modes are said to assist the Islamic banks to spare from the financial crisis. These contract modes are mentioned above and are for example Musharaka (Equity partnership) and Mudarabah (Trustee finance), Ijara (Lease). These financial contracts are all based on profit and loss sharing principle which enabled Islamic bank to finance its operations in equity. As already mentioned, when shareholders equity is very small compared to the deposits and bonds, there is an incentive for the common shareholders and company executives to take excessive risk as their liabilities are limited to their shareholding.

### **3.3.2 Bank's performance during and after the financial crisis**

Number of comparative studies conducted by different researchers investigated the performances of Islamic and conventional banks. Dridi (2010) has analyzed the performances of 120 conventional and Islamic banks after the crisis and investigated the global financial crisis's effect on these banks. One-fourth of these banks were Islamic banks while the rest were conventional banks. According to this report, the study covered 80 percent of the Islamic banks globally and all banks were operating in Islamic countries. This report which conducted on behalf of the International Monetary Fund (IMF) in September 2010 looked into a number of factors such as the change in profitability, bank lending, bank assets and bank rating. The study finds that, IB was more profitable than conventional

bank prior to the crisis. During the crisis from 2007 to 2008 both Islamic and conventional banks profitability declined. However, IB profitability decreased less than 10% while CB profitability decline more than 30%. According to this study, all Islamic banks over performed on their conventional counterparts except only three banks in 2008. However, the study finds that Islamic banks were affected by the crisis as the impact of the crisis moved to the real economy and IBs losses were significant after crisis compared to the their conventional banks. According to this IMF report, factors that enabled the IB to perform better than CB could be related to lower leverage and strict adherence to Sharia principle.

As Maher & Jemma (2010) argued, Islamic banks were having higher average return on average assets and higher average return on average equity prior to the global financial crisis, and thus, it was expected that a larger decline in profitability for IBs if the higher profitability was due to greater risk taking. The study finds that, change in profitability was larger for the IB during 2009 because global financial crisis moved to the real economy and thus affected the performance of the Islamic banks. During this time, the decline in profitability was for the IB around 50% while the CB profitability declined less than 15%. However the average returns on average assets and average equity of the two groups during years 2008 and 2009 were close on average. According to this report this was due to bad risk management employed by the Islamic banks.

From the perspective of the bank lending, the study finds that, IBs maintained stronger credit growth compared to the conventional banks and this suggests that the market share of IBs continued to grow and these authors argued that in general, Islamic banks' credit growth was less affected by the crisis. As Jemme (2010) argued, on average, Islamic banks' credit growth was twice that of conventional banks during 2007 and 2009.

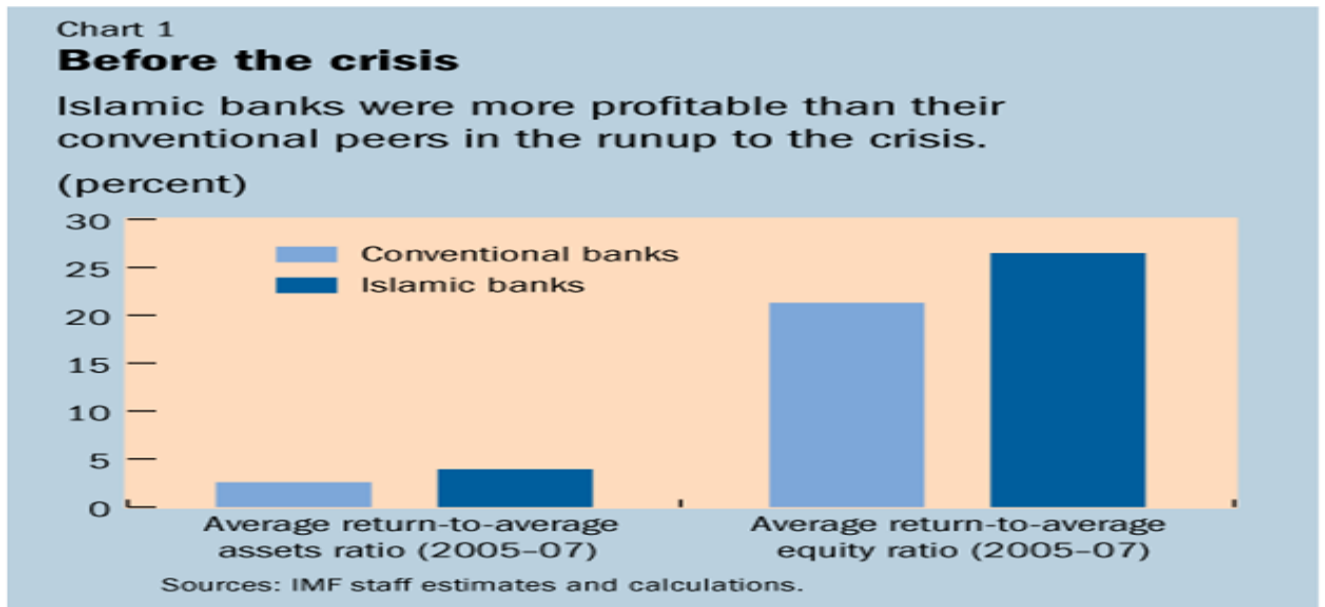
Maher and Jemma's report also compared the asset growth of the both banks. Their finding of the asset growth is similar to that of credit growth as asset growth of IBs was also significant compared to CB. They have argued that Islamic banks' assets growth was more than twice that of conventional banks and this indicated stronger market share increase for the Islamic bank.

On the other hand, these authors investigated the change in rating for the two banks. Their argument about the change in rating is similar to those of profitability changes, credit and asset growth. According to these authors, changes in rating were calculated based on the ratings of foreign long-term debt by three external rating agencies (Moody, Fitch and S &P). The study then compared the results to pre-crisis rating of the banks and finds that; change in rating was more favorable to the Islamic bank or similar, except only for one country. Next are three charts that illustrate how



Islamic and conventional banks are affected by the crisis before, during, and after the global financial crisis.

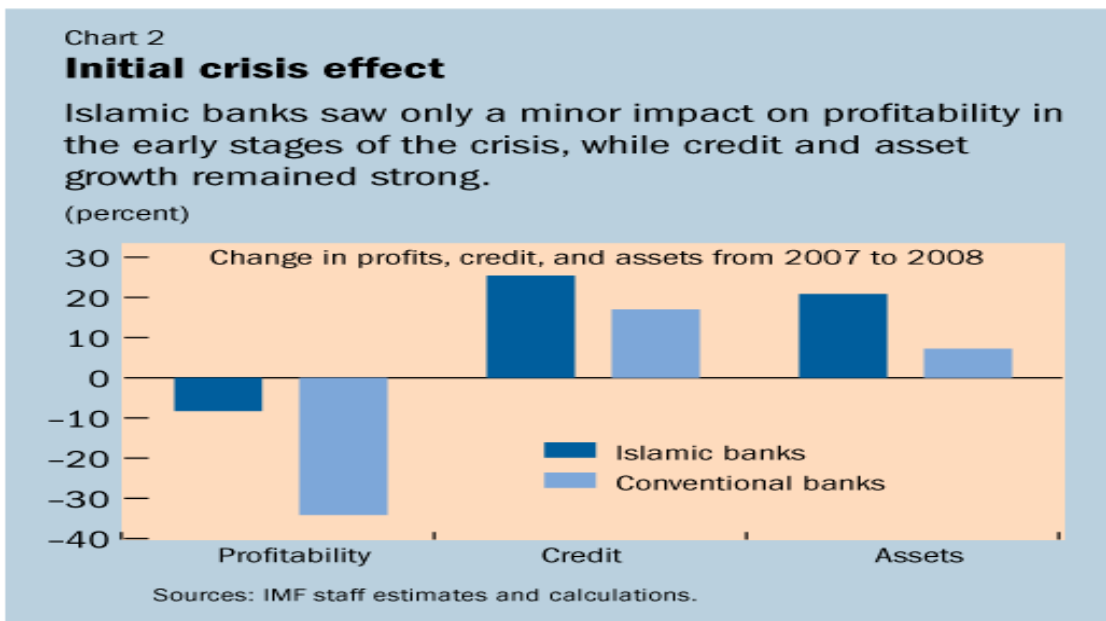
**Chart 1 shows Islamic and conventional bank's profitability before the crisis**



Source: [www.imf.org/external/pubs/ft/survey/so/2010/res100410a.htm](http://www.imf.org/external/pubs/ft/survey/so/2010/res100410a.htm)

As can be seen here in chart 1 in the pre-crisis, the Islamic bank was more profitable than its counterpart when evaluated on their average returns-to average assets ratio and to average equity ratios.

Chart 2 depicts the profitability of the banks during the crisis

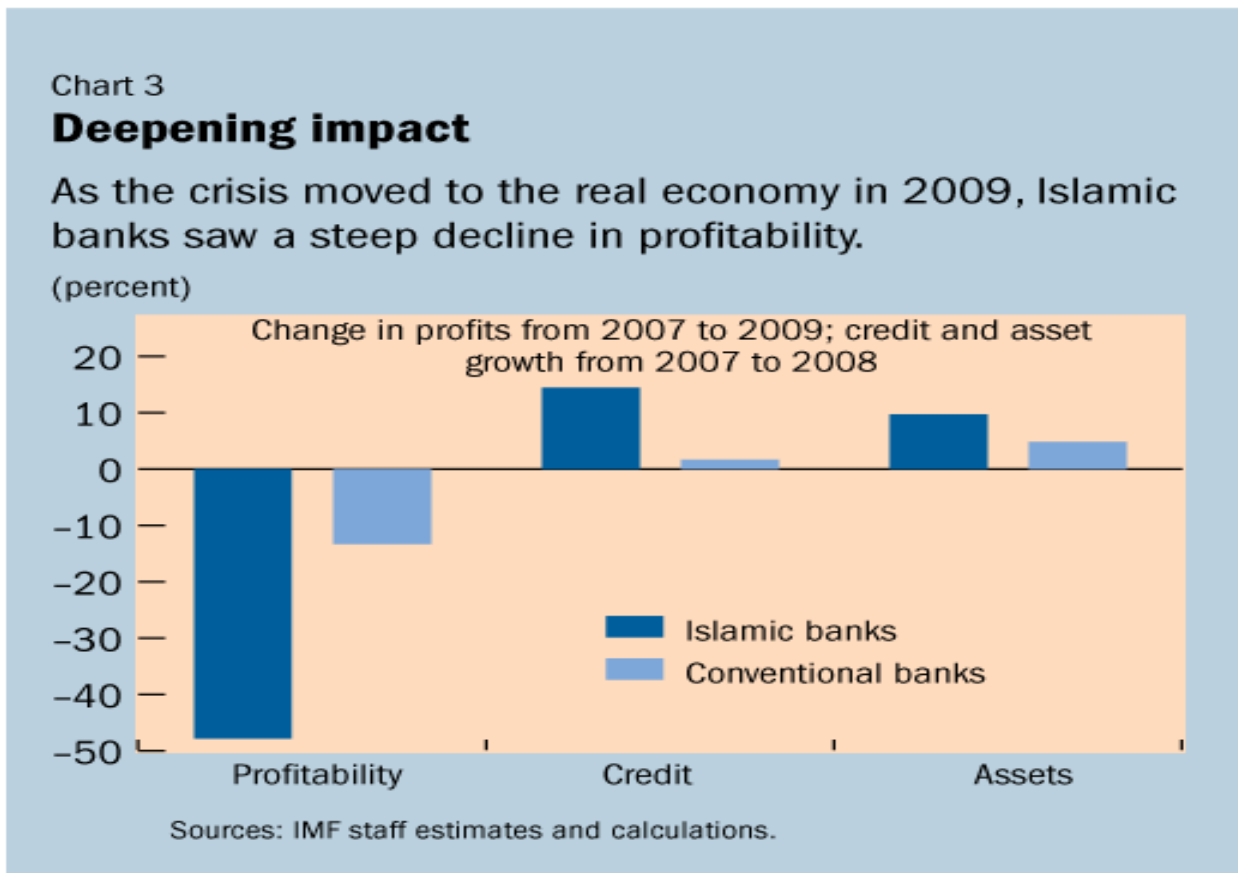


Source: [www.imf.org/external/pubs/ft/so/2010/res100410a.htm](http://www.imf.org/external/pubs/ft/so/2010/res100410a.htm)

As can be seen from chart 2 above, the effects of the global financial crisis were minor during 2007 and 2008.

But as the crisis moved to the real economy, the Islamic bank tested a bitter decline in profitability compared to conventional bank but its credit and asset growth remained still stronger

Chart 3 compares the after the crisis impact on both Islamic and conventional banks



Source: [www.imf.org/external/pubs/ft/surveys/so/2010/res100410a.htm](http://www.imf.org/external/pubs/ft/surveys/so/2010/res100410a.htm)

This study conducted by IMF is very interesting and sheds lights on the Islamic banks' performance. Also the same argument is put forward by Eagle, co-founder of the Edcomm Group Banker's Academy. She argued, "Islamic finance remained steady in the tough global economy primarily due to the nature of the industry. According to Sharia law, she argued, "buying or selling of debt is strictly prohibited, as well as insurance and investment gains and excessive risk-taking. In other words, Sharia-law does not allow individuals or companies to borrow money that does not exist – it must be invested into productive enterprises. It is this more cautious attitude towards money that has kept Islamic banks relatively safer from the effects of the global financial crisis today compared to their conventional banking counterparts" (Eagle 2010).

McNamara, the co-founder of Yasaar mMediar, expresses the same argument. "Sharia principle prevented Islamic banks from engaging in excessive speculative activities and because all transactions must be backed by physical assets, the use of derivative collateralized instruments is not permitted. This has shielded the Islamic bank from direct exposure to the toxic assets that have caused the major losses to be incurred throughout the global financial crisis banking industry". He

argues that Islamic bank also is not immune entirely of the effect of the financial crisis. Because the interconnectedness of the international financial system, no country has direct immunity from the crisis and thus Islamic financial system is affected by the crisis of the confidence amongst investors (McNamara 2009).

Middle East financial experts have also expressed similar arguments. An interview conducted by Asharq-al-Awsat in the middle of the financial crisis in 2008 and involved by leading financial experts concluded that, because Islamic banking is distinguished by the fact that it is prohibited from buying debts under the Islamic Sharia law, Islamic banks are safe from the effects of the global financial crisis. However, they agreed that Islamic banks will be affected to a certain degree as they are part of the wider global financial system and consequently will be affected by all global financial dealings, even if only in an indirect manner (<http://www.asharq-e.com>)

In addition to these factors mentioned above, the risk and profit sharing arrangement which is fundamental to Sharia compliance finance, introduces discipline to the Islamic banks and encourages the adoption of prudent risk management practices.

### **3.3.3 Incentives compatible with PLs contracts**

This subsection introduces the moral hazard inherent in the Profit-Loss sharing Islamic model and later will present the incentives used for the PLs contracts.

As mentioned in the previous chapters, Islamic banks use Profit and Loss sharing contracts (PLs) in their operations. It was also argued that PLs financing modes would help the IB to introduce a greater discipline into financial system by motivating banks to evaluate more carefully the risks and effectively monitor the use of funds by the borrowers. However, PLs model has its problems as other conventional contract models. It was argued (Al Hallaq's comments, 2002) that internal supervision such a religious, social and ethical value would play a role in fulfilling the contracts between the agent (entrepreneur) and Principle (bank). However, as Habib (2002) argues, there are also moral hazard problems inherent in profit and loss sharing financing modes.

As Habib argues, it was believed that Islamic banking would take the form of "two-tier mudarabah model"<sup>11</sup> however banks' experience has shifted these beliefs and showed that, there is some

---

<sup>11</sup> The first tier Mudaraba between depositors and the Islamic has those depositors acting as Rabbul-mal and the bank acting as the Mudarib. and the second tier Mudaraba between the Islamic bank

inherent problem in applying of profit sharing model in financing *mudarabah* and *musharakah*. As Habib argues, the Mark-up (*Murabaha*) financing model became common in Islamic bank financing. The underlying reasons are moral hazard problems in profit-sharing model of financing.

As Khan (1985) argues, moral hazard problem arises from underreporting profit by the entrepreneur. Moral hazard problem does not exist from the depositor's side. Depositors choose their bank because of the shared value, which means in this regard sharia principle, however moral hazard problem comes from the investors who are after profits and will likely press their interests. Khan (1985) suggested that the problem of underreporting by the entrepreneur might be reduced by the implicit penalty in the form of monitoring. However, as Habib (2002) suggests, this may not solve the problem because the entrepreneur is aware of the monitoring of the bank and put forward an incentive compatible with the profit sharing model. Ahmed proposed to use the assets of the entrepreneur as collateral to punish the entrepreneur if he/she underreports profits to minimize the problem. Ahmed's model will be presented in the later part of this chapter.

Early, Berger and Udell (1998) pointed out that "source of finance depend on the company's size, its age and the information available to it" Iqbal & Llewlynn (2002) insist, when the firm is new, it starts out as small enterprise and do not have any track record or acceptable physical collateral to find funds from the institutional sources. On the other hand big and medium size companies have already long track record and also have the possibilities to provide physical collateral and thus can obtain long-term and short-term credits. As these authors argued, the "underlying theoretical explanation for this phenomenon lies in the traditional problem of asymmetric information in the financial intermediation" (Iqbal& Llewlynn 2002). According to these authors, the problem of adverse selection is higher when enterprise is small and this is due to the higher costs related to the assessments.

As Iqbal & Llewlynn (2002) argue, small and riskier firms with a little or few assets would choose the profit sharing modes of financing to spread their risks while larger firms with substantial assets and more experience with managing risks will prefer a fixed mark-up mode of financing.

On the other hand, banks prefer to finance larger firms on *musharaka* (equity participation) and smaller and riskier firms with *murabaha* (mark-up mode of financing mode). By using these

---

and those receiving financing has the bank acting as *Rabu-ulmal* and the customers acting as *Mudarib*

techniques, bank's policy is to distinguish the low risk investors from high risks ones. To illustrate a little bit more, riskier firms would prefer to enter profit sharing contract while less risky firms are interested in entering mark-up contracts. As can be seen above, the Islamic bank will target the medium and large size investors for a profit sharing mode of financing (Iqbal & Llewlynn 2002). However, the moral hazard problem in profit-sharing model is said to have limited the use of the concept in the Islamic banking.

As already mentioned, the moral hazard occurs when the investor's conduct changes after the firm receives the fund from the banks. The agent-principal problem arises when the agent (entrepreneur) acts against the principal's (bank) interest and conducts the business according to his/her own selfish interest. This kind of problem exists because of the asymmetric information. As Mishkin (1995) argues, moral hazard arises if "the agent misuses the funds, slack about the management of the company and is not honest". Iqbal & Llewlynn believe that the Principal-Agent problem can be resolved if the principal (bank) could obtain sufficient information from the agent (entrepreneur), however, obtaining such information is costly to the principal. Thus incentives that can align the interest of the bank and the entrepreneur must be introduced.

In Islamic finance, the problem of asymmetric information can be divided into two stages: pre-investment and post-investment stages. In the first stage, moral hazard problem is very high. When the bank's representatives and entrepreneurs meet to decide undertake a project, knowledge between them creates asymmetric information. In general, entrepreneurs know better their own industriousness, collaterals, moral character and success of the business they want to finance than the bank. On the other hand, Islamic bank has incomplete information and would be benefited from knowing the true characteristics of the entrepreneur and quality of their proposed venture. On the other hand, moral hazard may also occur after the project is launched because of the hidden agenda motivated early by the self-interest of the entrepreneur that was not known by banks at the first stage. In the post investment stage, information concerning the true characteristics of the entrepreneur may be concealed from the IB (Arsim 2010). In the musharaka (equity participation) contract, the bank manages the project with the entrepreneur and thus moral hazard can be reduces but cannot eliminated because of the adverse selection.

Ahmed<sup>12</sup> (2002) introduced incentives that he argues is compatible with profit sharing model.

Ahmed (2002) argues that “reward/punishment function” would suit the profit sharing model; however his model was not new itself. Townsend, Gelle & Hellwig introduced a similar model early in 1979 and 1985. Reward/punishment will depend on the actual profit found in the audit relative to the reported profit by the firm. These are contained three factors and they consist of wrong reporting, true reporting and false reporting. Habib’s model is based on auditing and he argues that auditing costs can be used for reward in case of honest and penalty for dishonest. Because the auditing occurs in ex post and it depends on the bank’s decision to undertake the auditing or not, if for example dishonest is observed the entrepreneur may pay the auditing cost plus other penalty costs. On the other hand if he/she reports honestly, on her/his profit and auditors proved that he/she gets a reward from their honest reporting.

On the other hand Rifki (2009) investigated the moral hazard inherent in murabaha (mark-up) contract. He argues that, moral hazard appears in murabaha contracts in a different ways. One significant problem is the entrepreneur’s dishonest behavior to gain monetary benefits by pretending to be defaulted and terminating the contract before the end of the agreement. A fluctuation of price is a kind of signs observed in some murabaha contracts.

This argument that Rifkin presents raises some questions about the validity of the argument presented by ahmed (2002). Auditing based reward/punishment may work neither in murabaha (mark-up), nor in musharakah financing modes. This happens because auditing is conducted ex post and entrepreneur may pretend to default ex ante. On the other, this model would not solve the moral hazard inherent in musharaka contract because of the adverse selection, which occurs ex ante.

Finally, some Muslim scholars also argued that, bank’s strict adherence to the sharia principle and Sharia board of directors employed by the IB also assisted the Islamic bank to avoid the Short-term Incentive problems and thus spared from the current global financial crisis. First argument, which is related to the ethical conduct, is that the Muslims moral code may prevent Muslims from behaving in ways, which are ethically unsounded. On the other hand, Sharia board of directors that an Islamic bank to have in addition to traditional board of directors is very important at least for one reason. Those clients who use Islamic products require assurance that the Islamic bank follows the Sharia principles. If the Sharia audit committee reports that, the bank is violating the Sharia principles, the

---

<sup>12</sup> Habib Ahmed is Economist, Islamic Research and Training Institute in Islamic Development bank in Jeddah, Saudi Arabia.

IB may lose the confidence of the clients. Thus Sharia audit board's existence may assist the bank's managers to behave ethically and for this reason moral hazard problems may be reduced.

### **3.4 Conclusions from the chapter**

In this chapter, I have analyzed the causes of the global financial crisis from different perspectives namely from western and Muslim scholar's perspectives. Excessive risk-taking and imprudent lending were mentioned as the main source of the current global financial crisis. Some scholars argued that these practices are the result of the Short-term incentive problems that are available for the executives. Lack of equity financing and excessive debt was also mentioned as some of the causes of crisis. On the other hand, Muslim scholar's point of view, speculation and excessive risk-taking are there because bankers and depositors have false sense of immunity from losses and this immunity impairs the ability of the market to impose the required discipline. These scholars argued that profit & loss sharing financing modes might eliminate or reduce the excessive risk taking. Some scholars also mentioned vast expansion of the financial economy compared to real economy. These Muslim scholars also argued, in order to avoid speculation (gharar), transactions must be backed by physical assets.

The chapter also presented the evidence of how Islamic banks spared from the current global financial crisis by putting forward the study conducted by IMF. The Study investigated the asset, credit and profitability growth for the two banks prior and after the global financial crisis and concluded that Islamic banks were affected less compared to conventional banks. Then the chapter looked briefly moral hazard inherent in the Islamic banking and presented some argument concerning the incentives that are compatible with the profit & loss sharing financing modes.



## 4. RESEARCH METHODOLOGY

In this chapter research method, data collection and validity of the empirical research are presented. First, research method is presented and the reason why this method was chosen is mentioned. In the second subchapter, data collection and how it was carried out will be put forward. In the second subchapter the process of the data collection will be outlined and this is about preparation, searching the contacts, designing the questionnaire and delivering the questionnaire and conducting the interview. The third subchapter covers briefly reliability and validity of the research.

### 4.1 Research method

The method used in this research is qualitative and descriptive in nature and investigates how things are rather than suggesting how things should be. Shank (2002) defines qualitative research as “a form of systematic empirical inquiry into meaning” By systematic means “planned, ordered and public”, following rules agreed upon by members of the qualitative research community. By *empirical*, he means that, this type of inquiry is grounded in the world of experience. Inquiry into meaning says researchers try to understand how others make sense of their experience.

According to Denzin & Lincoln (2000) qualitative researchers study things in their natural settings, attempting to make sense of, or to interpret phenomena in terms of the meanings people bring to them”

Qualitative research has some advantages as it provides complex textual descriptions of how people experience a given research issue. Qualitative method is more flexible as it allows greater spontaneity and adaptation of the interaction between the researcher and the interviewee. Another advantage of qualitative methods in exploratory research is that it uses open-ended probing questions and gives the participants the opportunity to respond in their own words, rather than forcing them to choose from fixed responses.

This research can be categorized as a descriptive and explanatory research as it describes and explains how Islamic bank spared from the current global financial crisis from two different perspectives, from existing literature, scientific journals and from the Islamic bank managers point views.

## 4.2 Data collection

The empirical research was conducted at four banks in Kenya from which two of them are fully Sharia compliant banks and other two are conventional bank's Islamic windows. The study was conducted between August and October 2011 in Kenya. The empirical data for the study consists of 6 open-ended questionnaires complemented with semi-structured interviews. (See the appendix at the end of the paper). In addition, bank's financial statements were used as sources. This means that first, research questionnaire forms were sent to these managers for filling and after they filled the questionnaires, another round of semi-structured interviews was conducted to have more comprehensive knowledge from the interviewees.

This was due to the guidelines given to the managers not to give recorded-interviews. The interviewees represented different levels of the banks and included senior, middle and low level managements. Two of them are senior managers, three are middle managers and one of them is senior business customer advisor.

First, some of the interviewees were contacted through email and others by visiting personally. Altogether 8 managers were contacted of which 6 of them responded. Three of the interviewees are fully Sharia compliant bank managers while other three managers are from conventional bank's Islamic windows. Five of the six managers are corporate level managers while one of them is a branch level manager. This was due to the guidelines given to the branch level managers because corporate level managers control communication tasks with researchers or people from outside. Thus almost all branches directed me to the corporate level managers who were located in bank's headquarters.

These managers were asked to answer pre-prepared semi-structure recordable questionnaires. There was also strict guideline in the bank's corporate level. These managers were hesitant to accept recorded-interviews but they accepted answering as questionnaire modes. After a discussion it was agreed that first, managers would fill as questionnaire modes but promised to sit with the researcher after their completion of the questionnaires to allow the researcher to take more notes to enhance the reliability of the research. After this, a questionnaire papers were sent or handed over to the managers for filling.

After a week, every manager was contact by visiting personally his/her office or was sent an e-mail to arrange a meeting. Five of these managers agreed to sit with the researcher and to discuss about unclear points and answer further questions. Because the questionnaire research has its limitations such as misinterpreting the questions by the participants or even sometimes not to answering some

of the questions at all because lack of understanding, face-to-face meetings with the managers was important and this actually resolved some problems. These meetings lasted on average 30 minutes and the researcher was able to take more notes and to clarify some unclear questions to the managers and ask further questions. After this, results of the questionnaires were grouped and then results of the notes taken during interviews and questionnaire results were grouped together for analysis. Both results of the questionnaires and interviews notes were then analyzed and then compared to the theories, thus this research was implemented by using open-ended questionnaire complemented with semi-structured interviews.

### **4.3 Reliability and validity of the research**

Reliability refers to the consistency and repeatability of the result of the research and validity means whether the researcher is studying the phenomena he/she is supposed to be studying (McKinnon 1988). According to Golden-Biddle and Locke (1993) in the qualitative research, validity and reliability are related to sense of convincing such as reliability and plausibility. McKinnon (1988) lists four factors that could endanger the reliability and validity of the research. These are observer biases; observer caused threat, limitations and complexities of the human mind and finally the data access limitations. On the other hand, Chapman and Ahrens (2006) insisted that the definition above is not appropriate and that reliability and validity may be changed to plausibility.

To address these above-mentioned factors, the questionnaire answers were complemented with semi-structured interviews to enhance the reliability and the validity of the study. Mixing both questionnaire and face- to-face interviews may limit the possibility of lack of reliability and validity problems mentioned above. On the other hand by comparing the empirical evidence to the theories we may better understand whether there is a plausibility problem. However there is at least one problem, which is concerned about the reliability. Because Kenya's Islamic bank were established during or after the global financial crisis, they are not comparable to those of other Islamic banks such those IBs in Saudi Arabia and in Malaysia.

## **5. EMPIRICAL EVIDENCE OF THE GLOBAL FINANCIAL CRISIS IMPACTS ON ISLAMIC BANKING.**

This chapter covers the empirical part of the research and it is composed of seven subchapters. First subchapter looks into the Kenya's Islamic banking and a brief history of Islamic banking system in Kenya. Second subchapter covers Islamic bank's corporate governance and how it differs from the conventional bank's corporate governance. The subchapter present also Moral hazard inherent in Islamic banking and it gives a clue how Islamic bank deals if such behaviour occurs.

Third Subchapter tries to present reasons behind the current global financial crisis from the perspective of Islamic bank's managers. The fourth subchapter lists some of the main risks that banks encounters during their operations and fifth subchapter presents main factors that enabled Islamic banking to shield from the current global financial crisis and what techniques are used? In the sixth and seventh subchapters, future directions of IBs and how IB's senior managers see will be discussed and at the end, we will examine whether the Islamic banks have anything to offer to conventional banks.

### **5.1 Overview of Kenya's Islamic banking**

There has been a Muslim presence in Kenya since 8th century. Muslim Arabs who were mainly traders and Muslim immigrant working the east of Africa brought Islamic faith to Kenya. Muslim communities located mainly in coastal area of Kenya. First Muslims were Arab traders however – Ugandans and Asian Muslims arrived in Kenya in the 1970s. Muslim population was doubled after 1991 because of the civil war in Somalia.

Muslim population in Kenya is estimated 12% - 30% of Kenya's population. The reason of the huge difference of the percentage is because there are no reliable estimates to confirm the exact number of Muslim population in Kenya. ([www.ummaheconomics.org](http://www.ummaheconomics.org)).

Regardless of these estimates, Islamic and conventional banks have seen a window of opportunity in assisting to finance business catering to the Islamic market such as hotels, food stores houses, cars and restaurants. In addition to these services, these banks developed Sharia compliant wealth management and investment products to target some of the Somali wealthy immigrants. For confidentiality B, C, F, and G are used for the names of the banks.

First bank that has explored the Kenya's Islamic Market was bank B. It established what the bank called an Islamic window in 2005. Conventional bank's Islamic window is a branch which offers Islamic product and services. For the present day, there are eight financial institutions that offer

sharia compliant products in Kenya. Bank B has two Islamic windows branch in Kenya however it offers sharia compliant products in other branches.

One of the most significant banks that offer Islamic product in Kenya is also bank C. Bank C is privately owned incorporated in Kenya and it was established in 1995. The bank is conventional but offers a wide range of Islamic products and services. Its offering consists of personal, business, diaspora and Iman banking. Iman banking is composed of Iman Current account, Iman saving Account and Iman asset facilities that offers financial for corporates and individuals such as mortgage (diminishing Musharakah financing), Iman financing for telecommunication (Iman Mteja product), Motor vehicle financing (Murabaha/Ijara), Letter of Credit (Murabaha), Working capital financing (Murabaha) and bank guarantees (kafaalah). Bank C has 14 branches in Kenya in 2011.

There are two fully Islamic Sharia compliance banks across Kenya. Those are Bank F and bank G. Bank F was established in 2007 at the same time when global financial crisis was shaking the world's financial institutions. The bank has 18 branches across Kenya.

Bank G is another full Sharia compliant bank in Kenya. Middle East investors who saw the needs of the clients in Kenya set up the bank in 2005 but started its business in 2008. Bank G has total assets of USD 105 and reported 74 million Kenyan Shillings profit for financial year of 2010 and its income growth was 50% while total assets increased 24% during 2010. The bank has 14 branches in Kenya.

Both bank F and bank G controlled one percent of Kenya's banking assets (<http://www.newhorizon-islamicbanking.com>).

Those four banks are the most significant banks in Kenya that offers Islamic product and services to their clients that are not dependent on religion as all faiths used their services and this research collects data from these four banks and any conclusions will be drowned from the data collected from the four financial institutions.

## **5.2 Islamic bank's Corporate Governance**

In this section the differences between Islamic and conventional bank's corporate governance is analysed from the perspective of Islamic bank's senior managers. Advantages of having two boards of directors will be also investigated. In the second section, moral hazard problem inherent in Islamic banking will be discussed and how IB manages see these problems will be put forward.

### 5.2.1 Differences between CB and IB's corporate governance

As already mentioned in subchapter 3.2, corporate governance was defined, as a “set of relationship between a company’s management, its board of directors, its shareholders and other stakeholders”. In the theoretical part differences between conventional and Islamic bank’s corporate governance was not made explicit. However, at least there are known differences. As conventional banks employ one board of directors, Islamic bank has an extra Sharia board of directors.

For confidentiality, these alphabetical are used instead of the bank’s name as bank IB and CBIW. So CBIW denotes to conventional bank’s Islamic window and IB to fully sharia compliant bank.

Explaining the difference in corporate governances between the two banks, one Sharia audit manager describes as follows:

*“Nexus of Corporate Governance is the Allah the creator i.e. the principles are divine whereas conventional corporate governance Men is at the center where shareholders’ interests are paramount” (Sharia audit Manager, IB).*

In this regard, divine principles refer to sharia compliant where the emphasis is not given only to the profitability of the bank but bank should also keep in mind the need of the society as a whole.

Another manager talks the differences between IB and CB bank’s corporate governance:

*“Islamic banks have to empower an extra sharia experts who ensure that, IB runs its operations in accordance with sharia” (Communication & Corporate affairs, IB).*

According to this manager, main purpose of the Sharia board is to make sure that the bank is conducting its operations according to the principals of Sharia and this is what differentiate Islamic bank from its conventional bank.

A member of Sharia audit committee member puts the differences as follows:

*“Corporate governance is driven by ethics and Sharia financial principles i.e. avoidance of riba (interest), speculation (gharar), maysir (gambling) etc.” (Sharia audit member at corporate level,IB)*

This manager relates the differences the prohibition of riba (Interest), Gharar (Speculation) and Masir (gambling).

As one manager explains, the difference relates to the ethical issue.

*“They are similar in all aspects except that in IB corporate governance there is greater awareness and obligation to observe ethical issues beyond the ordinary call of duty etc. it’s not just conducting business but doing business with ‘a human face’ – in order to maximize benefits that accrues to the whole society. This emanates from the fact that for the majority of Muslim it’s not just a choice but also a religious call. IB also does not support the so called ‘sin’ industries (alcoholic drinks, arms, casino, pornography etc.)” (Assistant Business Development manager, CBIW).*

Another manager explains the differences of IB and CB’s corporate governance and expresses as follows:

*“Islamic banks are audited by competent Sharia board while Conventional banks are audited by any auditor” (La Riba Business Development Manager, CBIW).*

So in conclusion, the most significant differences between the two corporate governance of the banks is that, they perform similar tasks but in addition, Sharia committee has to advise and certify in the form of legal opinion that the products and services offer by IB are Islamic and the society as whole benefits from the banks.

According to these managers, there are numerous benefits of having two boards of directors. One manager describes that two boards of directors are important in order to satisfy the ethically driven customers. Legitimate profits means that the bank conducts its operations according to the Sharia principle. One manager explains these benefits:

*” This an additional corporate governance mechanism which provides a balance; whereas the board of directors pushes management for profits the Sharia Board ensures that the profits are legitimate” (Manager at Corporate level, IB).*

As one manager explains, Sharia and traditional boards perform different tasks that are important. One important role perform by Sharia board is to create communication channel between communities and the bank. This is important tasks as it generates confidence among publics and increases the IB,’s products/service acceptance.

*“Sharia board provides oversight & advisory role in relation to sharia compliance issues. Benefits provided include stewardship role, vetting of new products, liaison role between communities/public & Banks, instill confidence in the public hence increase product acceptance. Traditional board play strategy development role & check on issues of corporate governance. They represent the interest of all stakeholders & also mediate on the same, therefore are critical in long-term viability & sustainability of the institutions they represent” (Assistant Business development manager, CBIW).*

Another Manager divides these benefits gained from two boards of directors in to two and states as follows:

*“This is an added level of screening prudent investment decision and it ensures that society and community avoid from harmful activities with capital” (Sharia audit manager at corporate level, IB).*

Another Manager insists that the benefits are related to sense of caring and feeling of the clients and profiting through satisfactions of the clients. Because Muslims clients do not use such products that Sharia prohibits, the Sharia audit committee ensures that banks invest in only products and services that Sharia permits.

*“It give sense to all Muslims that the products offered are Islamic in this case it give Muslim community sense of caring” (La Riba branch and Business Development Manager, CBIW).*

Another Senior Customer advisor expresses the important of both boards of directors sharing ideas and skills that enhance the decision making process and increasing the reputation of the bank:

*“Both boards share ideas & skills which will benefit the organization; in its reputation and ethical operations” (Senior Business advisor, CBIW).*

Sharing ideas and skills is important and it is absolutely beneficial for the bank as these two boards share ideas and double check the investment decisions and this technique increases the reputation of the bank. While the traditional Board members have business educational background, Sharia Board members have both business and Islamic jurisprudence educational background. Thus they may combine their skills and share ideas.



## 5.2.2 Moral Hazard and Islamic banking

Moral Hazard inherent in Islamic banking is a bit different than that of the conventional banking. Clients or partners do not always enter the contract in good faith with the IB and there is possibility that they will behave differently after the contract is signed. However from the bankers and senior managers of the bank are monitor by both conventional board of directors and Sharia board. Because speculation (gharar) is not allowed in the Islamic bank, this prevents managers to manipulate. On the other hand, Islamic bank deals only with physical assets not with cash; this may assist IB reduced managers possible wrong doing.

As one Manager admits, moral hazard occurs in the Islamic bank and comes from the direction of entrepreneurs who are motivated by high profits and thus find easier to mislead the bank and distorts the financial statement by declaring less profit than the real actual profit.

*“Yes, in equity participating modes of financing, customer does necessarily find sufficient motivation to declare actual profits in order to make more returns” (Sharia audit Manager, IB).*

Whenever the bank detects such behaviour, certain penalties are imposed on the client. According to this manager, the bank informs the client its minimum profit expectation and client has to fulfil that expectation.

*“The bank imposes on the client of its minimum profit expectation” (Sharia audit Manager, IB).*

As another senior manager explains that some entrepreneurs pretend to default in order to gain some monetary value while in real cases, some entrepreneurs default in reality. In both of these cases, there are moral hazards involved. One entrepreneur may default but has the capacity to pay back the bank while another one defaults but has not the capacity to pay his liabilities. In both cases the bank deals with client differently as the manager states below.

*“May be in the cases of default, of which they are dealt with differently, he who can pay and has refused to pay is penalized. But he who does not have the capacity to pay is given time to reorganize him/herself” (Sharia audit member at corporate level, IB).*

For all Islamic banks, moral hazard was not significant problem and even some of them insist that they were not encountered.

As one senior manager states the problem is just minor for his bank.

*“We have been on the market since 2005 but we have just encountered one incident in which the customer was not able to pay back and this was due to special case because the client passed away and his successor was not able to pay back loans. The bank sold the collateral and received the initial value” (Senior Business advisor, CBIW).*

### **5.3 Reasons for the global financial crisis, IB's view**

For the Islamic bank manager's point view, debt selling, speculation, the size of the derivatives and lack of equity financing were the main triggers of the current financial crisis. However, as some scholars argued in the theoretical part of this paper, the size of the derivatives was not such big issue but it plays a role in the banking failure. On the other hand short-term incentives problem inherent in conventional banking system were not detected in Islamic bank.

One manager puts the reason behind the global financial crisis as follows:

*“The size of the financial (derivatives etc.) was not partially responsible but certainly it forms a big chunk of the reason of the crisis, Speculation (gharar) is the basis for the financial economy which is prohibited in Islam” (manager of Communication & Corporate affairs, IB).*

However, another manager agrees that the size of the financial economy compared to the real economy was part of the causes of the global financial crisis. He explains the problem below:

*“Yes, the assets were not worth the papers they were print on. This primarily is what caused the financial crisis, which was compounded by rating and collateralization onward sale. When Default occurred – as they were to – the domino-effect(chain reaction) spiraled to the whole industry mortgage takers saw more economic sense in defaulting than continue serving their mortgages while these collateralized debt had no asset to fall back to” (Sharia audit Manager, IB).*

Third manager agrees that the size of the derivatives play a role because of the oversupply of credit.

*“Yes because overly supply of credit caused ‘too much money’ chasing few economic activities with accompanying effect of investors throwing caution to the wind hence overly engaging in very risky transaction (sometimes bogus investment). With the accompanying hugeness & interconnectedness of the financial systems, isolated problems quickly spread to rest of the world hence the global financial crisis. Simply put it – global financial system had outgrown the real economy” (assistant Business Development manager CBIW).*

As another manager states, short-term incentive that encourage excessive risk-taking is related to speculation and that is not a problem in Islamic banking because speculation is not allowed in Islamic jurisprudence. She puts the issue as next:

*“This aspect does not arise in IB as excessive risk-taking (gharar in IB terms) is prohibited in Islamic jurisprudence” (Communication & Corporate affairs manager, IB).*

Another manager agrees that his bank does not have short-term incentive problems, as ethical and moral issues are central in IB decision-making.

*” I think IB is not facing Short-term incentive problems, moreover the whole concept is underpinned on ethical & moral issues that take a center, which by extension diminishes the need for excessive risk taking by individual bankers with the aim of huge bonuses. Therefore incentives are properly aligned and the emphasis is to give the public options where they access financial solution, which is consistent with their faith/personal belief & conviction. Hence compensation is properly aligned to this bigger & lofty objective” (assistant Business Development manager bank CBIW).*

Another manager states that because Islamic law gives more emphasis to socio-economics aspects, it is only this, what differentiate Islamic banks from conventional banks.

*“Unless IB practitioners maintain the socio-economic objectives of principles of Islamic laws of commercial transactions, the different between Islamic & conventional banks will be difficult to discern” (Sharia audit Manager, IB).*

In conclusion, speculation (gharar), size of the derivatives, overly supplied credit and excessive risk-taking are factors that IB managers perceived as the causes of the global financial crisis. On the other hand, they believed that because short-term incentive problems inherent in CB are related to speculations, IB did not encounter such problem because speculation is prohibited in Islamic jurisprudence. On the other hand Islamic bank maintains the socio-economic objectives; this differentiates them from the conventional banking. This means that CB maximizes the profits without restrictions and for this reason it may take excessive risks while the IB has to follow the Sharia principle that prohibits speculation.

#### **5.4 Main risks that bank face**

In this subchapter I will investigate main risks banks face in their operations and how banks manage these risks. Banking risk management is a complex and comprehensive process, which includes

creating an appropriate environment, maintaining an efficient risk measurement structure, monitoring and mitigating risk-taking activities and establishing an adequate framework of internal controls (Casu, Giradone & Molyneux 2006). For privately owned bank, management's objective is to maximize shareholder's value. Because there is a pressure on management to improve the shareholder's returns, banks have to assume higher risks and at the same time manage these risks to avoid losses (Casu, Giradone & Molyneux 2006). The aim of risk management in banking is to ensure that, the individuals who take or manage risks clearly understand it; the bank's risk exposure is within the limits established by board of directors; risk-taking decisions are in line with the business strategy and the objectives of the bank and risk-taking decisions are explicit and clear. Because these risks are so numerous, some of the main risks will be put forward. After analyzing the main risks in brief, some specific risks for IB will be put forward.

#### Market risk

Market risk refers to a risk resulting from the movement in market price, changes in interest rates and equity and commodity prices. General or systematic market risk is caused by a movement in the price of all market instruments due to macro factors. Banks use Risk-Adjusted Return on Capital (RAROC) to reduce the market risk. According to Casu, Giradone and Molyneux (2006), RAROC measures the risk inherent in each banking activity, and the risk is computed taking into account the asset price volatility, calculated on historical data. Value-at-Risk (VAR) is also another tool for market risk management and it estimates the potential loss on the current portfolio from adverse market movements (Casu, Giradone and Molyneux 2006).

#### Country risk

Country risk refers to a collection of risks associated with investing in foreign country. Political, exchange rate, economic, sovereign and transfer risks are included in country risks. It is a potential risk that a country will be unable to repay debts to foreign lenders in time (Raghavan 2003). Casu, Giradone and Molyneux (2006) list at least six techniques for managing country risk. These are effective oversight by senior managers; appropriate risk management policies and procedures; an accurate system for reporting change in country risk and potential exposures; an effective for analyzing country risk; country risk rating system and regular monitoring of country conditions.

#### Credit risk

Basle Committee defines credit risk as "the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms" (Casu, Giradone & Molyneux (2006). Generally credit risk is associated with the traditional lending activity of the banks and is described

as the risk of loan not being repaid in part or in full. There is always possibility for the borrower to be defaulted from his/her commitment but credit risk can arise also from the decline in the credit-standing of the counterparty. This means that, the probability of default increases and as result the cost of borrowing increases. The objective of credit risk management is to minimize the risk and maximize bank's risk adjusted rate of return by maintaining the credit exposure within the acceptable parameters (Raghavan 2003). Banks monitor credit risk through number of standards procedures, such as ceilings placed on the amount lent to a single client (Casu, Giradone & Molyneux 2006). Basle Committee for Banking Supervision (2000) lists four areas that banks have to address. These are establishing an appropriate credit risk environment; operating under a sound credit-granting process; maintaining an appropriate credit administration; measurement and monitoring process and ensuring adequate controls over credit risk.

Banks also use credit checking and credit scoring when evaluating client's credit worthiness. Credit checking is a technique that enables the bank to check the applicant's credit history. On the other hand, credit scoring is a qualitative approach, which involves asking the applicant a number of questions to determined his/her ability to pay back her/his obligation (Casu, Giradone & Molyneux 2006).

#### Interest rate risk

An interest rate is the price that a borrower pays in order to be able to consume resources at the present time rather than at a point in the futures. Interest rate risk refers to a risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in other interest rate relationship. It derives from mismatching the maturities of assets and liabilities as part of bank asset transformation function. Management of interest rate aims at capturing the risk arising from the maturity and re-pricing mismatches and is measured both from the earnings and economic value perspective. (Raghavan 2003). To manage the interest rate risk, bank use two techniques and these are "Gap and Duration analysis" (Casu, Giradone & Molyneux 2006). Gap refers to the difference between interest rate sensitive assets and interest rate sensitive liabilities over a specific time-horizon. according to Casu, Giradone and Molyneux, "if the interest rate sensitive liabilities are greater than the interest rate sensitive assets, then an increase in interest rates will reduce the bank's profit and vice versa".

Duration refers to average life of an asset's or liability's cash flow. Duration analysis takes into account the average life of an asset or liability rather than its maturity (Casu, Giradone & Molyneux 2006).

#### Liquidity risk

Liquidity risk refers lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. A bank might face liquidity risk because of lack of confidence or unexpected need for cash. If withdrawals are higher than normal, the bank may not be able to meet its obligations. Sound liquidity management can reduce the probability of serious problems. Liquidity risk arises from both sides of the balance sheet. On the liability side, up-normal cash withdrawal can cause the liquidity problems. On the asset side, unexpected high loan defaults can cause liquidity problems. The purpose of liquidity risk management is to avoid a situation of negative net liquid assets. (Casu, Giradone & Molyneux 2006). To manage the liquidity risk, banks can hold sufficient liquids however holding increased liquid assets have their problems. According to Case, Giradone and Molyneux (2006), "instead of holding liquid funds, a bank could make more profitable loans". The Asset Liability Management (ALM) is a part of the overall risk management in banking (Raghavan 2003). Banks use also Liquidity Gap analysis to manage the liquidity risk. The liquidity gap is defined as "the difference between net liquid assets and volatile liabilities".

#### Operational risk

Operation risk is defined as "a risk associated with the potential for system failure in a given market, usually resulting from inadequate internal processes and strategies, people, system or from external events. It can be summarized as a human error. Operational risk refers to breakdown in internal controls and corporate governance leading to error, fraud, performance failures that results in financial loss (Raghavan 2003). There no single approach for managing operational risk however the Basle II proposes three basic approaches for managing operational risk. These are the basic, the standard and the internal measure approaches (Casu, Giradone and Molyneux (2006). According to these authors, in the basic approach, the bank "allocates capital using a single indicator (Gross income) as a proxy for bank's overall operational risk exposure". In the standard approach, a bank's activities are divided into number of standardized business units and lines. The internal measurement approach enables the bank to use internal loss data.

In addition to these risks, banks face foreign exchange and off-balance sheet risks.

## Sharia compliance risk

In addition to these risk types, an Islamic bank faces Sharia risk. Sharia risk is associated with not implementing Islamic investment and finance products in accordance with the *Sharia* principles and is divided into four categories.

First category is Sharia compliant risk and is about avoiding interest, gambling, uncertainty and excessive risk taking. In addition to these, Sharia compliance requires abstaining from investing some products that are considered as non-Islamic. These are for example alcohol, pork, pornographic films, and gambling industries. These above mentioned are what differentiate Islamic banking from conventional banking. Failure to comply with these requirements with minimum parameters of Sharia requirements could have irreversible impact on Islamic bank as it damages the reputation of the bank and could lead to dissolution of the invested entity. To avoid such thing to happened, the Sharia board checks and ensures the details of the investment and declares it legitimate before the investors are committed to undertake the proposed investment ([www.qfinance.com](http://www.qfinance.com)).

One Manager expresses the risk that IB faces:

*“The most significant risk that IB faces is the Sharia risk which encompasses reputational risks as well as financial risk” (manager for Communication & Corporate affairs, IB).*

The second category risk is related to implementation mechanism and process of the finance investment products. When enterprise presents financial products to the Sharia board and Sharia board investigates first the legality of the product such as types of contracts, fees charges and other details necessary for the Sharia compliance and gives advices, enterprise finalizes the product as Sharia board advised. After this process Sharia board approves the products and gives permission to market.

The second category of compliance risk then arises if after the product enters the market fails to conform to the directives given by the Sharia board. It could be failing to follow step-by-step guidelines. For example second step cannot start before the first step. (Money cannot invest before acceptance of the offer is signed etc.). So both financial risk and reputational risk could occur if the enterprise fails to follow the directives given by the Sharia board.

The third category of compliance risk is related to the different opinion of the Muslim scholars or

different regulatory body declared investment void. Muslim scholars follow different school of thoughts (etc. Shafia & Hambalia etc.), one group of scholars may introduce Fatwa<sup>13</sup> agreeing the product as a legal while other group of school of thoughts declares void. This is because the Fatwa is derived from Ijtihad (Making legal decision that is based on independent interpretation of the legal sources of the scholars).

As one manager explains in case the Sharia board's guidelines are not implemented as advised, IB will encounter a reputational risk from the public. According to this manager, the different opinion of Sharia board in different countries also poses a risk to the IB.

*“Reputational risks – in the event that principles of sharia issues are overlooked, IB will face greater backlash from the public. Performance risks – IBs are too few isolated and far apart in geographical presence. This present challenge in developing vibrant financial systems & curtails necessary cooperation hence growth & development will be isolated to few areas. Market risks- it is not well understood concept therefore will continue to face challenges in acceptance even from mainstream Muslim communities. The situation in even made worse by the variation in practice in different countries due to opinion differences on treatment of different transaction hence adding more confusion to little understand & complex subject. Globally there is tendency to benchmark IB against conventional banks which has a different set of traditional values and objectives; hence IB will continue to exist as a shadow of mainstream conventional systems for a while longer”*  
(Assistant Business Development manager, CBIW).

The fourth category of Sharia compliance risk is concerned with the processes. If the process of structured product presented to sharia board is not followed as advised by Sharia board, the Sharia board may add some additions or deletions, which are of its own. For example if the developers of the products include the process information that was not initially presented to the Sharia board.

While IB shares those risks with conventional bank, there are some unique characteristics for IB. Because IB is not part of the global financial industry, it must hold more liquidity than its conventional banks. Another manager puts the Liquidity risk that IB faces as follows:

*“IB faces “Liquidity risk”. Islamic banks held more liquidity than conventional banks due to the lack of investor money of capital markets”* (Sharia audit Manager, IB).

---

<sup>13</sup> A legal opinion or ruling issued by Muslim scholars



Besides these risks, IB also faces other risks that are unique for the IB. Because Islamic bank shares the profit with its clients, the client may declare less profit than he/she actually gains from the project. One manager stresses the problem of declaring the actual profit by the entrepreneurs.

*“Real declaration of profits is an issue, especially when the client wants to avoid paying the profits for the investor (rabu al maal)” (Sharia audit member, IB).*

The following table lists some main risk that both conventional and Islamic banks face in their operations. These banks share almost all these risks except that IB does not face interest rate risk but in addition to these risks it faces sharia compliance risk.

Table 2 depicts risks that Islamic and conventional bank face in their operations

Type of risk	Explanation
Market risk	Risk resulting from the movement in market price, changes in interest rates and equity and commodity prices. However Islamic bank does not face interest rate risk.
Country risks	A risk that economic, social and political conditions of a foreign country will adversely affect a bank’s commercial and financial interests. Sovereign risk is also part of the country risk and can result in the re-scheduling and renegotiation of the debt, with considerable losses for the lending banks.
Off-balance sheet (OBS) risk	Relates to the risks incurred by a bank in dealing with non-traditional banking activities such as financial derivative products (e.g. futures and options), guarantees and letters of credits.
Credit risk	The potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.
Interest rate risk	The risk that an investment’s value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in other interest rate relationship.

Operational risk	Risk associated with the potential for system failure in a given market, usually resulting from inadequate internal processes and strategies, people, system or from external events
Foreign exchange risk	A risk that exchange rate fluctuations affect the value of a bank's assets, liabilities and off-balance sheet activities denominated in foreign currency.
Compliance risk	Risks associated with the potential for systems failure in a given market; usually resulting from inadequate internal processes and strategies, people, and systems, this includes legal and Sharia compliance risk.
Liquidity risk	Risk resulting from lack of marketability of an investment that cannot bought or sold quickly enough to prevent or minimize a loss. Because IBs are not part of the global financial industry they must hold more liquidity than the conventional banks.

Table 2. Some risk types inherent in CB and IB.

### 5.5 Factors that enabled IB to to spare from global financial crisis

The most important factors that assisted Islamic bank to survive from the current global crisis can be divided in five factors. These are: avoiding Excessive risk-taking, Uncertainty, Speculation, investing in Toxic assets and Derivatives. In addition IB's financing modes may be assisted to shield from the current global crisis. Financing modes are asset backed financing and Profit and loss sharing etc. Additional Sharia board also assist the IB as some managers believed.

Explaining the important of using asset backed financing, one manager states as follows:

*“Islamic banks don't finance on the basis of giving cash, they only lend to purchase assets; this happens through asset-based financing modes of Murabaha and Musharaka, Ijara and Istisna. This financing mode eliminates the possibility of excessive risk-taking involved in credit-creation practiced by the conventional banks” (Communication & Corporate affair's Manager, IB).*

As one manager argues IB is better equipped than its counterpart because of the faith involve in their operation.

*“Better equipped only in two ways; they are more insulated from crisis because they were holding less ‘toxic assets’ in their books) that culminated the global financial crisis. Secondly, due to religious or ethical conducts practiced by the IB, these institutions have greater chance to wither difficult times compared conventional banks” (Assistant Business Development Manager, CBIW).*

Another Manager lists four aspects that he believes assisted the IB to spare from the financial crisis:

*“The fact that IB do not sell debt, products are either asset backed or asset based, Islamic banks are not fully integrated to conventional banking industry and Islamic banks had not financed or their portfolios were not dependent on the subprime mortgage market” (Sharia auditor Manager, IB).*

One manager agrees these above-mentioned issues but adds that because Islamic banks are still in their earlier stages, they may encounter similar problems when they developed and undertake complicated products and services :

*“IB was spared from the crisis basically because of how they conduct their operations, which is in line with sharia precept namely avoidance of riba (interest) based transactions, speculation (gharar) & uncertainty. In addition IBs are still in infancy hence were not engaged in a complicated financial instruments although these might change specially seeing the innovation that is taking place in the industry by the day where products/instruments that boarder conventional products are rolled-out. In some quarters, these practices have been heavily criticized arguing it aims to sanctify conventional products under sharia compliant products with similar end results” (Assistant Business development manager, CBIW).*

On the other hand as another manager insists, profit sharing arrangement that IB employs is one of factor that enabled IB to shield from the current financial crisis.

*“The profit and loss sharing mechanisms that are applied by the banks” (Sharia audit member at corporate level, IB).*

As one assistant manager agrees, that profit sharing mechanism helped IB to shield from the global financial crisis but admits that IB is part of wider global financial sectors so it was not immune from the global financial crisis. This argument is quite different than those other managers; because conventional bank’s Islamic windows are part of the global financial system as their parent

companies are conventional thus it is true that they were affected by the global financial crisis. On the other hand, IBs are not completely dependent on global financial system.

*“Yes to some extent because profit sharing is after process event (i.e. once actual returns have been realized from a given actual transaction) hence there is reduced uncertainty & reduced speculative engagement. This means IB cannot engage in overly risky financial instruments i.e. CDO but all the same IB cannot be totally shielded from global financial crisis because they are part of the whole financial arrangement and their success will be determined by the general world economic status & vibrancies” (Assistant Business development manager, CBIW).*

## **5.6. Banks performances during and after crisis**

Investigating the Islamic bank's performance in Kenya has its problems. One of the problems is related to Kenya's Islamic banking short-term existence. Three of the four banks that offer Islamic products in Kenya were established during the financial crisis. Thus it is not possible to investigate how they were performing prior to the crisis. However, there are certain indicators that can be look to find their performance during the crisis. Asset and profitability growth are some factors that could indicate directions where IB is heading. On the other hand Islamic bank managers views are something that could assist us to conclude if the IB is more resilient in the face of global financial crisis. Because only two banks are fully Sharia compliant in Kenya, we investigate those two bank's asset, and profit growth. Other two banks have Islamic windows and it is not possible to find separately conventional bank's IB Windows's asset and profit and growth. However, manager's view might assist us to infer how they're progressing.

As one manager explains, it is not possible to compare the two banks (CB and IB) as the Islamic banks in Kenya were established in just few years back.

*“Our bank is three years old therefore we can't compare” (Sharia audit Manager, IB).*

Another manager admits that even if the bank is very young and was established in 2007, it is already performing better than conventional banks.

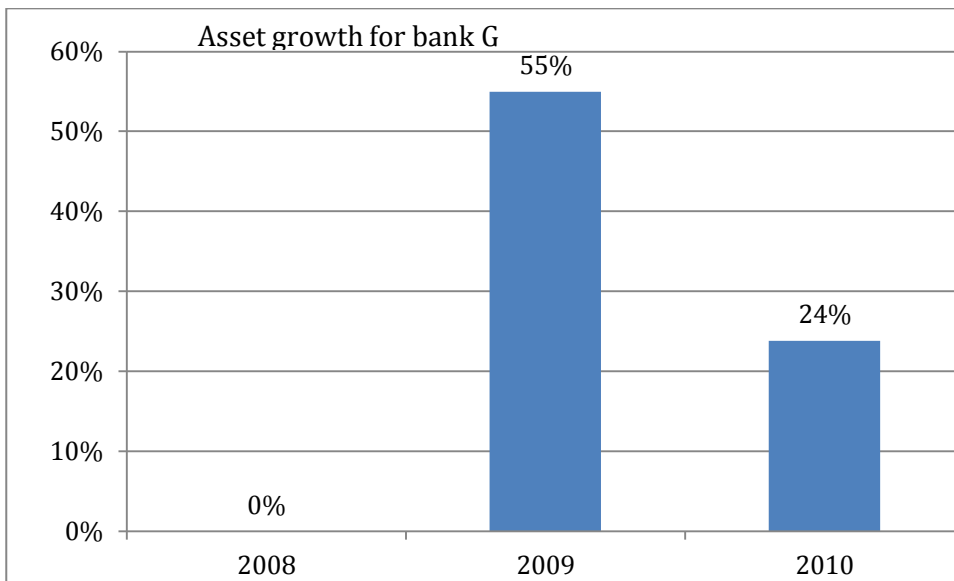
*“The IBs performed better especially considering none of the major IBs felt the adverse effects of the financial crisis” (Communication & Corporate affairs, IB).*

Another manager agrees even if his bank was small and opened for business after the global financial crisis started it is performing fairly.

*“It is a small bank and it began after the financial crisis and I believe that it is fairing on well”*  
(Sharia audit member at corporate level, IB).

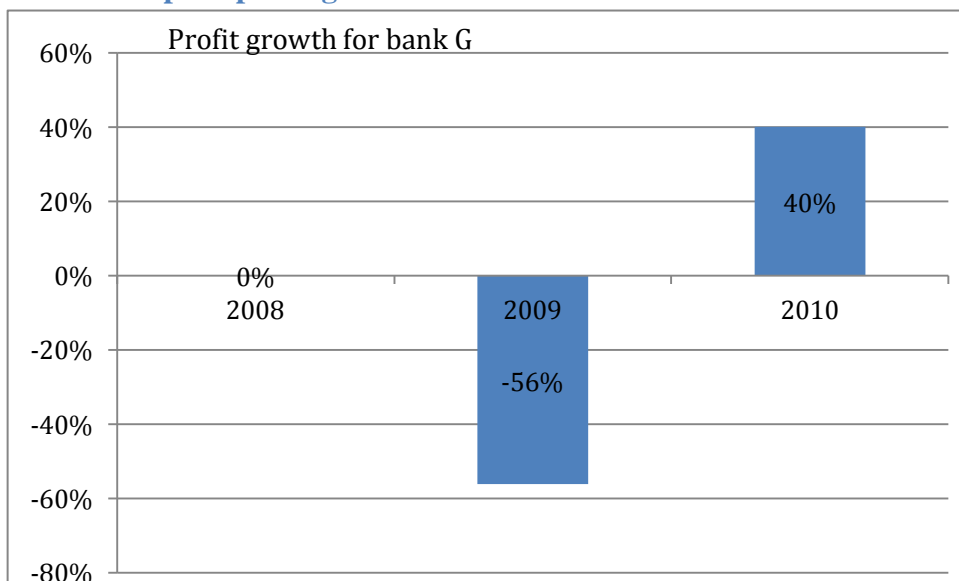
Next four charts depict the profit and asset growth of these two fully sharia compliant banks however these banks started their operations during or after the global financial and reported their first profits just 2010. However their total assets continued to grow during these years.

**Chart 4 shows asset growth for bank G**



**Source: bank G financial statement**

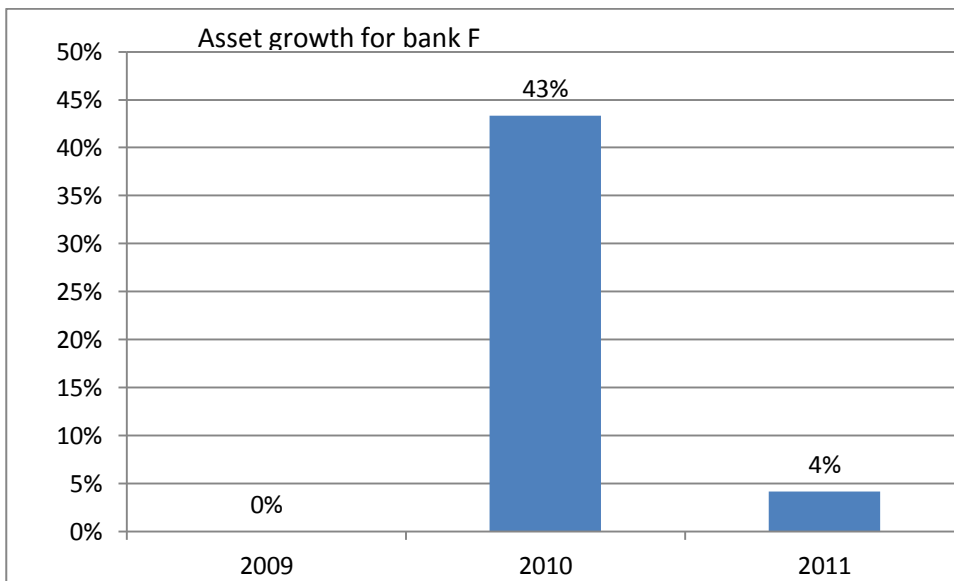
**Chart 5 depicts profit growth for bank G**



**Source: bank G financial statement**

Also next two charts explain the asset and profit growth of bank F.

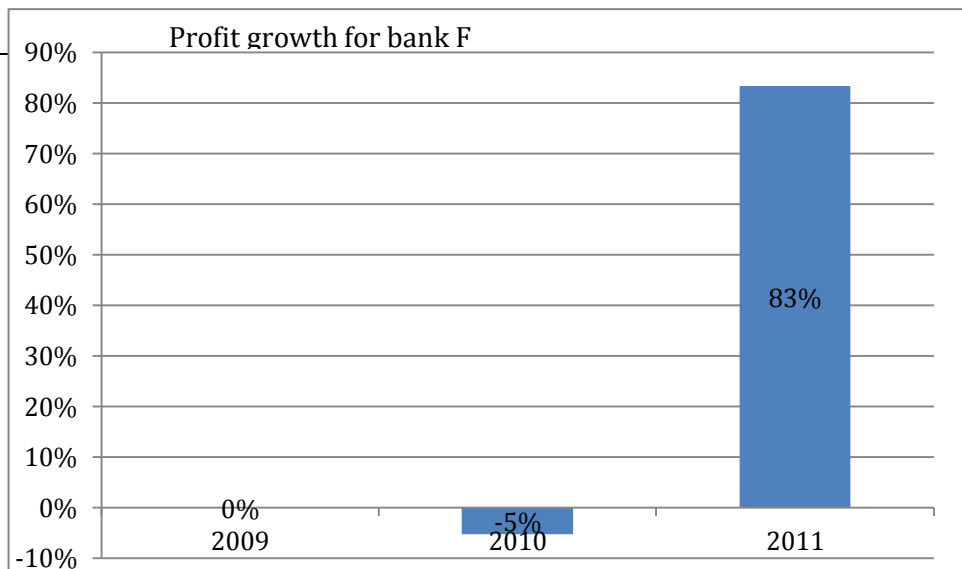
**Chart 6 shows asset growth for bank F**



**Source: bank F financial statement**

Because bank F started its operations in 2007, it reported its first profit in 2010

**Chart 7 depicts profit growth for bank F**



**Source: bank F financial statement**

Taking into account the ages of these banks and timing of their establishments (2007 – 2009), these above-mentioned charts show the growth of assets and profitability of these banks and this shows that these banks are not affected as other conventional banks.

As one manager insists, there are no reliable estimates and banks in Kenya are not internationally known, but he thinks they are less affected by the crisis and thus better performed. However all these charts showed that those bank's assets and profits grew during this limit period they were existed.

*“There is no discernible data measuring these aspects and also no one is certain how the crisis affected banks in Kenya because most Banks are not internationalized. But with expert reports indicating that IB have been affected less by the crisis elsewhere, it has generated interest in public wanting to know how IB exactly operate hence facilitated in un-packaging the concept & demystifying the same” (Assistance Business Development Manager, CBIW).*

A manager of another bank that was operating prior to global financial crisis explains how he sees bank's performance.

*“Islamic banking is better performed - reason is that all the finances given by Islamic banks to its customers are secured, thus the risk of default is low compared to the conventional banks where the risk is very high due to the default and financing is not secured, particularly cash. Therefore Islamic banks are very profitable as it takes back its assets in case the client is unable to pay back” (La Riba Business Development Manager, CBIW).*

A senior business customer advisor at the same bank agrees as follows:

*“Islamic banks in Kenya are still at initial stages, but so far so good, in credit, asset and liability growth is phenomena and surpassed the growth projection” (Senior Business advisor, CBIW).*  
*In conclusion, most Islamic banks in Kenya were established during the global financial and thus it is not possible to compare to the conventional banks but when consider such time of period they were operating we can conclude that these banks revealed their strengths. On the other hand, the time period these banks were in the market was the time, in which the global financial crisis was in its worse and thus it is clear that these banks are better equipped than the conventional banks.*

## **5.7 Future of IBs**

When looking the future of Islamic banks and how they may expand, it is may be important to look three important aspects. From the perspective of the bank managers, acceptances they have already received and how they are spreading to the global market. The last 5 years, Islamic financial Institutions were taking root in many part of the world. Conventional banks were also on the move to penetrate the Islamic markets and traditional Islamic banks that were operating in

dominant Islamic countries banks were also investing to non-Islamic countries. Some examples can be found by looking the origins of those banks that are already operating in Kenya. Some of these investors are from the Gulf of Arab countries. On the other hand Islamic banks invest in Turkey alone more than 1.4 billion in just 18 months period ([www.hurriyetdailynews.com](http://www.hurriyetdailynews.com)). There are similar examples in UK and France where the population of the Muslims is significant. On the other hand conventional banks are finding more interest in investing in Islamic products. In Kenya there are both local and western banks that have opened Islamic banking windows and others are on the process to obtain the license. As one manager explains, because of the high profits gained last few years by IB banks, more banks are entering the sector and are obtaining the license.

One manager explains future of the interest-free products:

*“That assumption is not far-fetched considering that even the Vatican admitted, interest-free banking (IB) is the solution for these perennial booms and deposit economies” (Communication & Corporate affairs, IB).*

Another manager agrees the above argument but adds that IBs growth is possible if they press the Socio-Economic objectives.

*“Yes to some extent. Islamic banks have proved more resilient to financial crisis of nature and size experienced but there have been lessons even for IB. If indeed IBs remain true to the socio-economic objectives and stop mimicking CB, yes they will definitely expand to other regions and find acceptance” (Sharia audit Manager, IB).*

One manager explains the future of IB and basis his view on the relationship between financial economy and real economy growth and acceptance already gained by the IB in non-Islamic countries.

*“Definitely in many aspects, now there is greater awareness of the intimate relation between financial growth & real economic growth, more emphasis on how to measure & screen risk, curtailing excessive risk taking through alignment of incentives for staff & CEO, stringent disclosure etc. There is greater acceptance of IB in even non-traditional Islamic country etc. Britain & Malaysia are cooperating on advancing the concept of IB further through research, best practice sharing” (Assistant Business Development Manager, CBIW).*



Another manager bases his view on the product offering for both Muslims and non-Muslims and how the different communities accepted the IB already.

*” There will be continue growth in the Islamic bank as all the product that are offered by IB are given to all people of different religion and they see it as the best product every offered.*

*Conventional banks never thought of taking care about Muslim community. The Islamic sector has the potential in a growth of any business. For instance the start of Islamic bank led to the growth of many sectors i.e. mortgage and vehicles which increased the profit for many entrepreneurs as a result, reducing the poverty in the community and increasing employments”*  
*(La Riba Business Development Manager, CBIW).*

## 6. KEY FINDING

This chapter will analyse the result of the empirical part of this paper and will also investigate if the empirical evidences are in line with the finding of the theoretical part. The main purpose of this paper was to investigate how Islamic banking spared from the current global financial crisis and this was looked from two different perspectives. In the theoretical part of this paper analysis was made from the existing literature and scientific journals. In the theoretical part of this paper Islamic bank's manager point views are central.

### Impact of the global financial crisis on IB

In looking how global financial crisis affected the IB, there are certain aspects that can be investigated from the empirical part. First, IB's performance during and after the crisis. This can be divided into two. By looking the IB manager's point views and by looking the asset and profitability growth by the IB and then comparing the evidence to the theoretical part of this paper.

From the managers point views, IB was not affected by the crisis and certain reasons were given. There are at least eight factors that either Islamic bank avoided compared to CB or undertaken to spare from the global financial crisis. Four of those that IB avoided are: speculation, investing in toxic asset, debt selling and buying and short-term incentive problems in the management compensation system. Those above mentioned and other factors were argued as the main triggers of the current financial crisis. There are also four other characteristics that were found from the IB operations. These are what might be helped the IB to avoid the current global financial crisis. These are asset-backed financing, modes of transactions such as profit and loss sharing, ethical aspects involve in the decision-making and IBs independent on subprime mortgage, which was the source of the current global financial crisis.

### Speculation

Speculation (Gharar) means an act whose outcome is unknown, uncertain or not disclosed and it has been prohibited in an Islamic law. It is considered a form of gambling that takes place in trade rather than traditional gambling. As some of these IB managers stated, speculation (gharar) was contributed to the global financial crisis and by avoiding, IB was able to spare one aspect of the triggers of the global financial crisis.

*“When I was young, people called me a gambler. As the scale of my operations increased I became known as a speculator. Now I am called a banker. But I have been doing the same thing all the time.” (Sir Ernest Cassell, banker to Edward VII<sup>14</sup>)*

Table 3 combines factors that trigger global financial crisis and methods used by IB.

Factors	CB	IB	Description
Speculation	Yes	No	One of triggers of the global financial crisis
Invest in toxic assets	Yes	No	One of the triggers of the global financial crisis
Fully asset-backed financing	No	Yes	Assisted to shield from global financial crisis
Use of profit & loss sharing	No	Yes	assisted to shield from global financial crisis
Debt selling & buying	Yes	No	One of the triggers of global financial crisis
Dependent on Subprime mortgages	Yes	No	Subprime mortgages triggered global financial crisis
Faith involved in investing	No	Yes	Argued to assist the IB to shield from the crisis global financial crisis
Short-term incentive problems	Yes	No	Argued as one of the triggers of the global financial crisis

Table 3. Some factors that triggered the global financial crisis and methods used by the IB.

#### Avoiding investing in toxic assets

Toxic asset is defined as financial assets whose value has fallen significantly and for which there is no longer a functioning market, so that such assets cannot be sold at a price satisfactory to the holder. (en.wikipedia.org). It was argued that investing in toxic assets was one of the triggers of the global financial crisis. Because Islamic bank gives more emphasis on success on the projects it

<sup>14</sup> Edward (2000) *Devil Take The Hindmost: A History of Financial Speculation*, A Plume Book. New York.

invests projects whose demand are still significant. This is because IB partners itself with the client; it does not give cash rather it invests products or services for which there is still demand and this is proved because the client him/herself is the consumer.

#### Debt-financing and excessive leverage

Excessive leverage was one of the main triggers of the global financial crisis and is the basis for sovereign debt crisis currently shaking Greece and Italy. Excessive leverage was argued to contribute to the current global financial crisis. Because Islamic bank is either asset backed or asset based using Musharaka or Murabaha modes, it does not sell or buy debt thus, IB avoids debt financing and excessive leveraging. IB managers interviewed in this paper argued that, this was part of the reason why IB was not affected by crisis.

IB was not fully dependent on subprime mortgage. Subprime mortgage was one source of the global financial and it refers to extension of credit facilities to borrowers who have deficient credit.

Islamic banks were not fully integrated to the Subprime mortgage industry and this might help them to avoid the effect of the current crisis tested by the conventional banks. Those IB managers gave some different opinion about the dependent of the IB to the global financial industry. Those four banks consisted of two conventional bank's Islamic windows and two fully Sharia compliant banks and those conventional bank's Islamic windows admitted that IB was affected afterwards by the crisis because of the financial institutions interdependent. This is understandable because their holding banks were conventional and these holding banks are part of the global financial system. On the other hand those fully Sharia compliant banks were not dependent to the global financial industry and they were not affected by the crisis like other conventional bank's Islamic windows.

#### Profit & Loss sharing financing modes

As Chapra argued in the theoretical part of this paper, profit and loss sharing modes will help the IB to introduce a greater discipline into financial system by motivating banks to evaluate more carefully the risks and effectively monitor the use of funds by the borrowers. Profit and loss sharing financing modes has some benefits. First, in case of loss bank and client have to share losses. Second, there is double screening investment decision and this could enhance the decision making and helps the project to succeed. According to these managers, profit and loss sharing financial modes supported by double screening decision making enable the IB to reduce uncertainty and speculation and thus helped them to spare from global financial crisis.

### Ethical investment

Sharia board is an additional level of decision-making body. It has certain benefits for the IB. First, traditional board and Sharia board have to double assess the project that is to be invested. This is beneficial because they may combine skills and share ideas which were not possible for one board of directors. Second, Sharia board consists of Muslim scholars who are usually trusted clerics and if they audit the project operations and monitor the activities of the traditional board managers, this gives huge confidence to the public and investors of the project. If for example Sharia audit body reports some misconduct by the managers, it will have serious effect on IB's operations. The IB gains from Sharia board from two other important benefits. First, if greedy managers try to manipulate and Sharia audit discovers, it will have serious impact on the IB and thus it is likely that managers will behave in good manner. Second, because of the reputation gained from the Sharia board, bank's clients may increase thus generating more profits through customer satisfaction.

### Short-term incentive problem

Jickling (2009) argued that excessive risk-taking by financial Institutions played a significant role in the global financial crisis. Similar argument was also presented by Bebchuk & Spamann (2010). As they argued, excessive risk taking was encouraged by the existing executive compensation arrangement system. They both related the excessive risk-taking to short-term incentive problem inherent in the executive compensation system. In Islamic banking, short-term incentive problem is related to the speculation (gharar), which is not allowed in Islamic Jurisprudence. All these interviewed managers were in consensus about the issue and argued that there are no incentive problems in Islamic banking compensation system. This can be understood from two different aspects. First, Islamic Jurisprudent forbids speculation and this is may be reason why these managers are not engaged in speculation. Second, if the Sharia Supervisory board that monitor the bank manager's activities detect such activities, it could have serious effect on the Islamic bank as Sharia audit body has to report these activities to the public.

### Asset-backed financing

Asset backed financing is the opposite debt financing and it was briefly mentioned above. The Islamic modes of financing are different from the conventional banking modes of financing. In conventional banking system when applying an asset-based loan, the client has to pledge assets to secure the loan from the bank. This is called collateral loan or secured loan and in case the client defaults, bank has the right to sell the collateral to recover the losses. In conventional banking

system, banks pay money to the client to buy the assets and thus client owns the assets. In Islamic banking system, there is always a physical assets involved in the transaction. In Islamic banking system, the bank buys the assets and sells to the client but the ownership remains with the bank until the client completes the payments. This means that, the IB does not pay money to the client; it allows the use of the asset until the ownership of the bank diminishes and this happens through musharaka, murabaha and mudarabaha etc. modes of financing.

As mentioned above, Islamic products are either asset backed or asset based and according to the IB managers interviewed in this study, asset based financing modes helped IB to avoid the effect of the global financial crisis.

These above mentioned techniques are factors that were enabled Islamic bank to spare from the current financial crisis as these managers argued in the interview.

## **7. DISCUSSION**

This chapter examines and overlooks the entire thesis and summarizes the research. Chapter also concludes the research, will discuss the limitations and will suggest for further research.

### **7.1 Summary of the research**

This research examined the global financial crisis impact on Islamic banking and how IB avoided the worst financial crisis. It also put forward how Sharia compliant financial Institutions work and what financial transaction modes they use. The research problem or main question of the paper was “What are the impacts of the global financial crisis on the Islamic banking system and how Islamic bank spared from the crisis?” This was further divided into four sub questions as next:

- What are the differences between Islamic banking model and conventional banking model?
- What financing transaction modes an Islamic bank uses compared to conventional banks?
- What are the differences between the Islamic bank’s corporate governance and Conventional bank’s corporate governance?
- How interest-free banking system (Sharia principle based) work compared to the interest based banking system

The research is descriptive in nature and investigates how things are rather than suggesting how things should be. The research first looked into the existing theories about Islamic banking systems and it used the literature and scientific journals. In the empirical part, data was collected from four banks of which two are fully Sharia compliance banks and two are conventional bank’s Islamic windows. In the next subchapter theoretical findings are compared to the empirical part and conclusion will be made.

### **7.2 Conclusions of the paper**

The aim of the research was to investigate how Islamic banking system spared from the current global financial crisis and investigate the main factors that were enabling the Islamic bank to spare from the crisis. The theoretic part of the research investigated the existing literature and scientific journals to understand how IB avoided the worst financial crisis. In the theoretical part, concept was defined and then justification for banking was put forward. Sharia concept was also analyzed from different point of views and then the paper investigated differences between Islamic and conventional banking systems. Because Islamic banking is different from conventional banking system it was important to put forward basic techniques used by the IB. These were financial transaction modes employed by IB.

The research then looked into the causes and of the global financial crisis from two different perspectives. General views of both Western and Islamic thinkers were analyzed and it was concluded that imprudent and excessive lending, Short-term incentives for the bank managers and distortions in the executive compensation were the main causes of the global financial crisis. Excessive leverage was also mentioned as one of the causes of the crisis. After these above mentioned factors, Islamic scholars point views of the causes were also investigated. These scholars mentioned above, agreed factors presented but added three other more factors that they argued were part of the causes of the global financial problem. First factor is the “inadequate market discipline in the financial system, which they argued is the result of profit and loss sharing absence (financing modes). Inadequate market discipline refers to the responsibility of the banks and financial institutions to conduct business while considering the risks to their shareholders. Second cause is said to be the expansion in the size of the derivatives, especially credit default swaps (CDSs) and third factors mentioned by Muslim scholars is “Too-big- to-fail” concept which means that the government as a guarantor of deposits will bailout if the bank collapses because these banks are too large and financial institutions are interconnected and this will affect the whole economy. All scholars share this last factor. In the last part of the theoretic part, the paper investigated if Islamic bank spared from the current global financial crisis. It presented evidence from different sources.

The study conducted by IMF looked in to the conventional and Islamic bank’s performance prior, during and after financial crisis. It looked into asset, credit and profitability of these two banks. It concluded that, Islamic banks were not affected or were affected less than the conventional banks and this was the result of the decline of the global economy and occurred in ex post. On the other hand, surveys conducted by number of leading journals in the Middle East concluded that Islamic bank was unaffected by the crisis. These scientific journals and other Muslim scholars presented some factors that they argued to enable by IB to spare from the current global financial crisis and they are listed below:

- Buying or selling of debt is prohibited in Sharia law
- Engaging in excessive speculative (Gharar) activities is not allowed in Islamic jurisprudence
- Sharia-law does not allow individuals or companies to borrow money that does not exist – it must be invested into productive enterprises
- All transactions must be backed by physical assets
- Use of derivative and collateralized debt instruments are not permitted



- Profit & Loss sharing financing modes which is fundamental to Sharia compliance finance introduces discipline to the Islamic banks and encourages the adoption of prudent risk management practices.
- In addition to the traditional board of directors, Sharia boards of directors monitor the activities of the bankers and this limits excessive risk-taking and speculations.

These above mentioned factors were the main factors that were put forward by different studies and number of scientific journals.

The result of the empirical part of the paper is based on the interviews and open-ended questionnaire from senior managers of two fully Sharia compliant and two conventional bank's Islamic windows.

IB managers see the causes of the global financial crisis as follows and this is in line with theoretical finding. First, these managers were asked their opinion about the causes of the global financial crisis. The finding of the empirical part of the study is summarized below.

- Debt selling and buying
- Speculation (Gharar)
- The size of the derivatives
- Lack of equity financing
- The size of the financial economy compared to real economy.
- Lack of profit & loss financing modes.

Factors that Islamic bank managers considered to enable the IB to spare from the global financial crisis are listed next:

- Islamic banks don't finance on the basis of giving cash.
- Religious or ethical considerations
- The fact that IBs do not sell debt.
- IB products are either asset backed or asset based.
- Islamic banks are not fully integrated to the global financial institutions.
- Islamic banks had not financed or their portfolios were not dependent on the subprime mortgage market.

- They have been involved in less in risky transactions (they were holding less ‘toxic assets’ in their books).
- Avoiding speculation (gharar) & uncertainty and
- The profit Loss sharing mechanisms that are applied by the banks.

Based on these factors presented here in the empirical part of this research it is easier to conclude that Islamic banks spared from the current global financial crisis. On the other hand we can also conclude that this finding supports the theories presented early in this paper and is fully in line with the argument presented by IMF and other different scholars.

To remind us what were the arguments, next are some main arguments presented early in the paper. Saraogi (2007) related the causes to the Subprime mortgage problem and government lending policy. On the other hand Jickling (2009) and Chapra (2008) argued that excessive and imprudent lending by banks over a long period of time were some of the causes of the global financial crisis. According to Chapra (2008) and others, expansion in the size of the derivatives, especially credit default swaps (CDSs) were to blame for the current global financial crisis. Chapra (2008) and Bebchuk & Spamann(2010), argued that short-term incentive problem and lack of equity financing were some of the causes of the crisis. Hassan (<http://www.islamic-foundation.org.uk>) related the causes to the size of the financial economy compare to the real economy. Comparing these arguments to the managers point views, we can conclude that the empirical finding supports the theory.

However, there is one argument that this finding does not support. According to Bebchuk and Spamann (2010), short-term incentive problem in the executive compensation system was also one of the triggers of the global financial crisis. These authors investigated the short-term incentive problem in the executive compensation system within the conventional banking and not Islamic banking and this paper concentrated on to Islamic banking thus, the differences may be due to the fact that IB and CB are quite differences in their corporate governance and their financing modes.

Based on this finding, short-term incentive problems were not detected in IBs compensation system. As these managers argued, short-term problem is related to speculation (gharar) and this does not arise in Islamic banking because speculation is prohibited in Islamic jurisprudence.

On the other hand, this finding supports theoretical argument that suggested that moral hazard problem is inherent in IB financing modes. Habib (2002) argues, the Profit & Loss sharing (PLs) is also subject to moral hazard problems. According to Khan (1985), the problem of moral hazard

arises because the entrepreneur may underreport the profits he/she gains from the project financed by the bank and the entrepreneur him/herself. Moral hazard problem does not exist from the depositor's side. The empirical finding supports this argument. According to this empirical finding, in equity participating modes of financing, customers do not necessarily find sufficient motivation to declare actual profits in order to make more returns.

To sum up, this study investigated how Islamic banking was spared from the global financial crisis. The conclusion is that most of Kenya's Islamic banks were established during the global financial crisis and thus, it is not possible to compare to other Islamic banks such those of Saudi Arabia and Malaysia that were in the market prior to the global financial crisis. However the successes of these banks in such a short time of period that they were in the market shows these banks are not affected by the crisis. The study supports the theoretical evidence that argues Islamic financial institutions were unaffected by the global financial crisis. Asset and profit growth for these IB such in short period of time shows that these Islamic banks are more resilient than conventional banks. Also the growth rate of Islamic banks which is 10% to 20% shows that IB is better equipped than its counterpart in the face of the global financial crisis.

While IMF study conducted in 2010 analysed the the impact of the global financial crisis on Islamic financial systems, we argued in the introduction part of this paper that there was limit research on the subject. I also mentioned the less attention given to the financing modes of Islamic banking compared to conventional banking system. Lack of sufficient empirical evidence on how Islamic banks spare from the global financial crisis was also mentioned in the introduction part of this research. The empirical finding of this research also supports the previous studies such that of International Monetary Fund (IMF) that concluded that IBs are better equipped than CBs in the face of the global financial crisis. It also complements the IMF study as it presents the financing modes used by the IB and further discusses briefly the short-term incentive problems inherent in Islamic banking's executive compensations system.

This study contributes to understand why Islamic banking spared from the current global financial crisis, what methods are used by the IB, and in general how Sharia compliant banks work in practice. To understand how Islamic bank spared from the current global financial crisis, the study looked into the differences between Islamic and conventional banking systems. It also put forward the financing modes used by the IB to find out if these methods are the factors that enabled the IB to spare from the crisis. These were musharaka, mudaraba, murabaha and ijara modes of financing. By looking the causes of the global financial crisis, we were also able to understand how IBs spare

from the crisis. The study contributes also to understand how Islamic banks avoid short-term incentive problems in the executive compensation system.

Weakness of the research and the need for further.

This paper investigated how Islamic bank avoided current global financial and what factors used to spare the crisis. Open-ended questionnaire complemented with field interviews were used to discover if these banks were spare from the crisis. However there are some problems related to this study. Because most of Kenya's Islamic banks were established during the global financial crisis, they are not comparable to those Islamic banks that were in the market prior to the global financial crisis such as those banks in Southeast Asia such as Malaysia or in gulf countries such as Saudi Arabia and others.

Due to these factors mentioned above this finding might not generalizable. At least there is one important aspect that is not comparable to other advanced banking systems and that is executive compensation system. As argued early by the IB managers, short-term incentive problem was not detected in Islamic banks executives' compensation system and that was due the Sharia restrictions on speculation (gharar).

While it is possible that this argument is true, it is may be paramount to investigate in more depth how these other advanced Islamic banks perceive the issue of short-term incentive problems in their executive compensations system.

## REFERENCES

- Abul, H. (2009). The Global Financial Crisis and Islamic Banking  
(<http://www.iefpedia.com/english/wp-content/uploads/2009/10/The-Global-Financial-Crisis-and-Islamic-Banking.pdf>)
- Bebchuk, A., Spammann, H. (2010). Regulating Bankers PAY, Georgetwon Law Journal, Discussion Paper No. 641
- Casu, Girardone & Moluneux (2006). Introduction to banking: Prentice Hall Financial Times, Harlow , England
- Central Bank of Kenya (2009, 2010). Banking Supervision Annual Reports
- Chapra, M. (2008). The Global Financial Crisis: Can Islamic Finance help?  
([http://www.isdbforum.org/presentation Papers/5-M\\_Umer\\_Chapra.pdf](http://www.isdbforum.org/presentation%20Papers/5-M_Umer_Chapra.pdf))
- Chibli, M. (1988). Islam and Finance: Graham & Trotman, cop. London, England
- Denzin & Lincoln, Y. (2000). Handbook of Qualitative Research, London: Sage Publication Inc.
- Dick, K. Nanto (2009). The Global Financial Crisis: Foreign and Trade Policy Effects: Congressional research (<http://www.fas.org/sgp/crs/misc/R40496.pdf>)
- Hassan, A., Yusuf, H. (2010). Investment Risk in Islamic Finance  
(<http://www.qfinance.com/financial-risk-management-best-practice/investment-risk-in-islamic-finance?full>)
- Humayon, A., Dar & Johm, R. (1999). Islamic Finance: A western Perspective, International Journal of Islamic Financial Services, Vol. 1 No.1
- Islamic Financial Service Board (2010). Islamic Finance and Global Stability  
(<http://www.ifsb.org/docs/IFSB-IRTI-IDB2010.pdf>)
- Jickling, M. (2010). Causes of the Financial Crisis: Congressional Research Service (www.crs.gov:)
- Khalifa, Y. (2006). Speculative Capital: An Islamic View  
([http://islamiccenter.kau.edu.sa/7iecon/Ahdath/Con06/\\_pdf/Vol2/32%20Yousif%20Khalifa%20Speculative%20Capital.pdf](http://islamiccenter.kau.edu.sa/7iecon/Ahdath/Con06/_pdf/Vol2/32%20Yousif%20Khalifa%20Speculative%20Capital.pdf))

- Lews, K. (2010). Accentuating the Positive, governance of Islam investment funds, Journal of Islamic Accounting and Business Research, vol.1 No.1
- Maher, H., Dridi J. (2010). The Effects of the global financial crisis on Islamic Banking and Conventional Banks, A Comparative Study, Journal of International Monetary Fund, September
- Mahmoud, El.Gamal (2001). An Economic Explication of the Prohibition of Riba in Classical Islamic Jurisprudence (<http://instituteofhalalinvesting.org/content/el-gamal/gharar.pdf>)
- McKinnon, J. (1988). Reliability and Validity in Field Research: Some Strategies and Tactics", Accounting, Auditing & Accountability Journal, Vol. 1 Iss: 1, pp.34 – 54
- Mehboob, H. (2005). An Explanation of Rationale behind Prohibition of Riba in the Doctrine of three Religions; with special reference to Islam ([http://www.econ.nagoya-cu.ac.jp/~oikono/oikono/vol47\\_34/pdf/vol42\\_2/mehboob.pdf](http://www.econ.nagoya-cu.ac.jp/~oikono/oikono/vol47_34/pdf/vol42_2/mehboob.pdf))
- Naim, A. (2010). The issue of moral hazard and adverse selection in musharakah contracts and proposal for risk mitigation (<http://arzim.blogspot.com/2010/02/issue-of-moral-hazard-and-adverse.html>)
- Rifki, I. (2009). Assessing - Moral Hazard Problem in Murabahah Financing: Journal of Islamic Economics, Banking and Finance, Volume 5, number 2, May – August
- Shaikh, S. Jalbani (2008). Amanat Risk Management in Islamic and Conventional Banks: A Differential Analysis, Journal of Independent Studies & Research, Szabist, Karachi,
- Simon, A. Rifaat, A. (2009). Profit Sharing Investment Account in Islamic banks: Regulatory problems and possible solutions, Journal of Banking Regulation, 2009, 10, 300-306
- Simon, A., Rifaat, A. (2007). Islamic finance: The Regulatory Challenge: Wile, Singapore
- Sonia, O. (2004). Qualitative Research  
([http://wagner.nyu.edu/leadership/publications/files/Qualitative\\_Research.pdf](http://wagner.nyu.edu/leadership/publications/files/Qualitative_Research.pdf))
- Usmani, A. (2002). A guide to Islamic banking: Daru - Ishaat Urdu Bazar Karachi-1 Pakistan
- Zaharuddin & Abd-Rahman (2007). Differences-between-islamic-bank-and-conventional (<http://mohdhafez.wordpress.com/2007/03/03/differences-between-islamic-bank-and-conventional>)

Zineldin, M. (1990). *The Economic of Money and Banking*: Almqvist & Wiksell, Stockholm, Sweden

<http://arzim.blogspot.com/2010/02/issue-of-moral-hazard-and-adverse.html>

[http://en.wikipedia.org/wiki/Riba#Prohibition\\_of\\_Riba](http://en.wikipedia.org/wiki/Riba#Prohibition_of_Riba)

<http://en.wikipedia.org/wiki/Sharia>

<http://fpc.state.gov/documents/organization/122298.pdf>

<http://mohdhafez.wordpress.com/2007/03/03/differences-between-islamic-bank-and-conventional/>

[http://mpra.ub.uni-muenchen.de/7571/1/MPRA\\_paper\\_7571.pdf](http://mpra.ub.uni-muenchen.de/7571/1/MPRA_paper_7571.pdf)

<http://www.asharq-e.com/news.asp?section=6&id=14245>

[http://www.bankersacademy.com/pdf/Global\\_Islamic\\_Finance\\_Ask\\_The\\_Experts.pdf](http://www.bankersacademy.com/pdf/Global_Islamic_Finance_Ask_The_Experts.pdf)

<http://www.businessdictionary.com/definition/corporate-governance.html>

<http://www.centralbank.go.ke/downloads/bsd/annualreports/bsd2010.pdf>

<http://www.emeraldinsight.com/journals.htm?articleid=1858422&show=html>

[http://www.ibtra.com/pdf/journal/v5\\_n2\\_article5.pdf](http://www.ibtra.com/pdf/journal/v5_n2_article5.pdf)

[http://www.ica.org/resource\\_file/11490p841-851.pdf](http://www.ica.org/resource_file/11490p841-851.pdf)

<http://www.ifsb.org/docs/IFSB-IRTI-IDB2010.pdf>

<http://www.investopedia.com/terms/m/moralhazard.asp#axzz1eSFeqXab>

<http://www.islamic-foundation.org.uk/IslamicEconomicsPDF/Hassan-financialcrisis-if.pdf>

<http://www.ruf.rice.edu/~elgamal/files/riba.pdf>

[http://www.ummaheconomics.org/index.php?option=com\\_content&view=article&id=144&Itemid=146](http://www.ummaheconomics.org/index.php?option=com_content&view=article&id=144&Itemid=146)

[http://yasaarmedia.com/Yasaar\\_Media\\_Islamic\\_Investment\\_Banking\\_2009.pdf](http://yasaarmedia.com/Yasaar_Media_Islamic_Investment_Banking_2009.pdf)

[www.qfinance.com/financial-risk-management-best-practice/investment-risk-in-islamic-finance](http://www.qfinance.com/financial-risk-management-best-practice/investment-risk-in-islamic-finance)

## APPENDIX

Q1. What benefits Islamic banks gained from having two different board of directors, Sharia and traditional board of directors?

Q2. Is there a moral hazard problem in Islamic banking, which of the transaction party behaves immorally? And how IB manages these problems?

Q3. Islamic bank uses Profit sharing arrangement; do you think this practice assist the IB to shield the Global financial crisis? How?

Q4. How you see the size of the financial economy (e.g. derivatives), do you believe that the hugeness of the financial economy compared to the real economy is partially responsible for the global financial crisis?

Q5. What are the main risks Islamic banks faces in their operations compared to Conventional banks?

Q6. Can you comment on the argument that says Islamic banks are better equipped than conventional banks in the face of the global financial crisis?

Q7. Global financial crisis started from the Subprime mortgage in US and spread to the world and affected immediately conventional banks but according to some reports Islamic bank was affected afterwards, can you comment on this arguments?

Q8. What factors do you think enabled Islamic bank to spare from the current global financial crisis, would you mention some of the most important factors?

Q9. What are the differences between Conventional and Islamic bank's corporate governance?

Q10. Short term incentives for bankers that encourages excessive risk-taking is said to contribute to the global financial crisis, are Islamic banks detected such short-term incentive problems in their compensation systems?



Q11. When you compare Islamic banks (your bank) to the Conventional bank, which group do you think better performed (profit, asset and credit growth) during and after the global financial crisis?

Q12. How do you see the future of the IB, do you think the global financial crisis revealed the strength of the IB and this would assist them to expand outside of the Islamic world in the future?

Q13. What Conventional banks can learn from Islamic banks?

---