Islamic Finance Project
Harvard Law School
Islamic Legal Studies Program

LSE-Harvard Public Lecture on Islamic Finance
London School of Economics, London, UK - February 24, 2010

Global Perspectives On Islamic Finance : A short Report

On February 24, 2010, London School of Economics and Harvard Law School held a joint public lecture on Islamic Finance, the fourth annual lecture in a series aimed to expand dialogue and understanding of contemporary issues in the field. The lecture was entitled "Global Perspectives on Islamic Finance" and discussed the role of faith-based finance in shaping global markets, particularly after the recent financial crises.

The lecture began with a brief introduction by the Pro-director at LSE and chair of the event, Sarah Worthington. Worthington introduced the topic of the lecture and keynote speakers Stephen Green and Umer Chapra.

Stephen Green, Group Chairman of HSBC Holdings, organized his talk around three important lessons from the recession and how they reflect the growing importance of Islamic Finance in avoiding future crises. The first lesson gleaned from the recession, he began, is that there is no alternative to market-based development; without it, unemployment, illiteracy and poverty would plague the developing world. He noted various socioeconomic barriers to development that are especially relevant to the Muslim World, including: high levels of income inequality, as in Egypt and UAE; soaring rates of population growth which will pose a number of challenges as the population ages; and the lack of breadth and depth in financial markets, noting that only 14% of Muslims around the world have a bank account.

The second lesson he drew was that the world's economic center of gravity is moving east and south which make it all the more imperative that the world work together and build common ground in response to globalization. He noted the increasing trade flows between emerging markets as they become less dependent on exports to Western consumer nations and the unprecedented level of cooperation during the financial crisis which demonstrated the possibility of inclusiveness in businesses, positing that emerging markets will drive recovery and lead global growth in the generation ahead. Reflecting on the ways in which the Islamic Finance market is also becoming broader and more diverse, Green noted geography—how Islamic Finance products are now available in 48 countries, with London as the leading hub in the western world—and the more diverse products, including sukuks and takaful. He asserted how important it is that products are standardized, as the lengthy process of obtaining approval on whether a product is Shari'a-compliant brings not only high transaction and regulation costs, but also stifles the development of innovative products and hence future growth in the sector.

In line with this point, the third lesson of the financial crisis, he explained, is the need for products that meet genuine customer needs in a sustainable way instead of illusory profits. Drawing on the example of how HSBC applies ethical principles of Islamic Finance to its operations, Green argued that it is both possible and necessary to have an ethical approach to banking. Only then, he concluded, can we begin to contribute responsibly to the social and economic development of society.

Following Green's lecture, Umer Chapra, Advisor with the Islamic Development Bank of Jeddah, discussed another important lesson from the financial crisis: the importance of adequate market discipline in the financial system. Discipline, he argued, gets injected through incentives and deterrents or profit and loss. The absence of profit and loss sharing in the financial system hurts discipline and leads to excessive and imprudent lending, high leverage, speculation and debt crises, creating an inherent instability in the financial system. For instance, the recent subprime mortgage crisis was a standard example of excessive and imprudent lending resulting from the absence of profit loss sharing and a false sense of assurance against losses. His paper "The Global Financial Crisis: Some Suggestions for Reform of the Global Financial Architecture in the Light of Islamic Finance" discussed various sources of this false sense of assurance, including collateral, securitization which switched the "originate-to-hold" model to the "originate-to-distribute" model of financing, the spread of derivatives like credit default swaps which made it possible for lenders to insure themselves against the risk of default, and banks' "too big to fail" self-concept. Depositors, in turn, do not demand more discipline from their financial institutions because the guarantee of interest assures them of the repayment to their deposits. Thus, he argued, the false sense of immunity in bankers as well as depositors impairs the ability of the market to impose the required discipline.

However, the financial system can be injected with greater discipline and stability through the incorporation of Islamic Finance principles. In particular, the profit and risk sharing model and prohibition of interest in Islamic Finance would help motivate financial institutions to assess risks more carefully and monitor the use of funds by borrowers more meticulously, reducing excessive lending; depositors, in turn, would play a more active role in the enforcement of this discipline if they also share in the profit and loss. Islamic Finance also ensures that credit expansion is consistent with the growth of the real economy and minimizes speculation by allowing credit primarily for the purchase of real goods and services that the seller owns and possesses.

Chapra also recognized how incorporating more discipline in the financial system may still deprive subprime borrowers from credit even in the Islamic Finance system. To truly ensure that justice is upheld and the poor have access to credit, innovation must be introduced to the system. Thus, he proposed two possible measures to reduce both the costs and risks of subprime financing. The first is the use of zakah and awqaf resources to make interest-free loans available to the very poor who are unable to get it in the conventional system. This, in line with the zakah objective of enabling the poor to become more financially independent, can partially offset the extra costs of evaluation, with governments also bearing part of the cost with subsidies and commercial banks as part of social responsibility. For those who are eligible for zakah and are unable to repay their loans because of a genuine problem, zakah may be used to offset the losses from default as is consistent with another objective of zakah—forgiving the debt of those who are unable to pay because of strained circumstances. For those who are not eligible for zakah, Chapra recommends that the banks resort to the purchase of CDSs to minimize their risk. Chapra's second proposal was to integrate commercial banks with their vast network of resources into the microfinance system to ensure that there are adequate resources to enable credit access to the poor. In this way, Muslim countries can take greater strides towards reducing income inequality and poverty, while any conventional financial system can also benefit from adopting elements of Islamic Finance to introduce greater discipline into the system and hence stability and protection from future financial crises.

Following their lectures, a lively question and answer session ensued. The audience raised a number of interesting topics for discussion such as morality, the role of the government in confronting financial problems, and a potential inconsistency between profit maximization and ethical banking. The program concluded with final comments by speakers Stephen Green and Umer Chapra, who emphasized the universality of values espoused in Islamic Finance.