IDB Group Forum 2008
“Impact of the Global Financial Crisis and Islamic Finance”

Iqbal Khan
CEO - Fajr Capital
The global elite is underperforming

“Seven major crises in 20 years ... that is not good enough.”

(Larry Summers, Former US Secretary of the Treasury)
Major financial crises since 1980

1. Latin American Debt Crisis - Beginning in Mexico (1980s)

Timeline:
- 1980: 1
- 1990: 2 3 4 5
- 2000: 6 7 8
- 2008: 9
Current crisis is illustrated by milestone events (I)

Collapse/rescue of major financial institutions

Unprecedented intervention by global regulators

- Direct government capital infusions
- Increased guarantee of bank deposit accounts
- Taxpayers becoming shareholders in banks

Source: BBCnews.com (6 Oct 2008)
Current crisis is illustrated by milestone events (II)

**Volatility in markets**

Global equity markets tumble
- MSCI World Index -19.60% (3m)

1Y performance:
- Dow: -37%
- MSCI: -41%
- FTSE 100: -39%
- DJ Eurostoxx 50: -52%
- Hang Seng: -53%
- Nikkei 300: -43%

- Oil falls from July peak of $147 to around $70 p.b.
- Gold fluctuated from $750 to $900 in 30 days

**Corporate liquidity crisis**

- Access to credit has shutdown
- Impact on corporate operations
- Impact on earnings starting to show

Source: Bloomberg, FT
I and others who believed that “lending institutions would do a good job of protecting their shareholders are in a ‘state of shocked disbelief’. ”

(Alan Greenspan, Former Chairman - U.S. Federal Reserve)
Root causes are unsustainable pattern of behaviour

Excessive lending

- **Extremely overleveraged banks**: 
  - EU average of 35-1 (Deutsche 50-1) 
  - US average of 20-1 (Lehman 30-1)
- **Consumer attitudes**: 
  - “Buy-now-pay-later” 
  - US sub-prime are 20% of mortgage write-downs
- **Household debt**: 
  - UK 165% of disposable income 
  - US 138%

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**Opaque financial securities**

- Misleading ratings:
  AAA ratings on sub-prime MBS which are difficult to price and value
- Derivatives disaster\(^4\):
  - $600 trillion industry
  - CDS - $55 trillion
  - (World GDP $66 t)


A multitude of factors, with long term systemic changes needed
### Root causes are unsustainable pattern of behaviour

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**Failings in governance**
- **Misaligned incentives**:
  - Generous bonuses while shareholders suffer
- **Sleepy supervision**: Fractured set-up with piecemeal regulation
- **Regulatory lapses**:
  - Buildup of $10 trillion shadow banking industry; low credit approval screens, leverage ratio

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**A multitude of factors, with long term systemic changes needed**
Impact of current crisis is sweeping

1. Financial Institutions
2. Global Markets
3. Real Economy
4. Policy Implications

Systemic impact
# Financial institutions hardest hit

Largest banking writedowns and capital raising to date (USD billion – 13 October 2008)

<table>
<thead>
<tr>
<th></th>
<th>Writedown</th>
<th>Capital Raising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wachovia</td>
<td>96.7</td>
<td>11.0</td>
</tr>
<tr>
<td>Citi</td>
<td>61.0</td>
<td>49.0</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>52.2</td>
<td>29.9</td>
</tr>
<tr>
<td>Washington Mutual</td>
<td>45.6</td>
<td>12.1</td>
</tr>
<tr>
<td>UBS</td>
<td>44.2</td>
<td>27.1</td>
</tr>
<tr>
<td>HSBC</td>
<td>27.4</td>
<td>5.1</td>
</tr>
<tr>
<td>Bank of America</td>
<td>27.4</td>
<td>30.7</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>18.8</td>
<td>19.7</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>15.7</td>
<td>14.6</td>
</tr>
<tr>
<td>IKB</td>
<td>14.0</td>
<td>11.5</td>
</tr>
<tr>
<td>Lehman</td>
<td>13.8</td>
<td>13.9</td>
</tr>
<tr>
<td>RBS</td>
<td>13.3</td>
<td>22.0</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>10.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>10.0</td>
<td>5.8</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>9.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Fortis</td>
<td>8.8</td>
<td>21.5</td>
</tr>
<tr>
<td>Credit Agricole</td>
<td>8.2</td>
<td>7.9</td>
</tr>
<tr>
<td>Other</td>
<td>158.4</td>
<td>129.0</td>
</tr>
<tr>
<td>Total</td>
<td>635.3</td>
<td>419.7</td>
</tr>
</tbody>
</table>

Source: Bloomberg.

- **Cause of writedowns:** Banking exposure to mortgage backed debt and derivative products
- **Capital shortfall:**
  - Small capital bases and reliance on short-term funding have led to solvency fears and liquidity crunch
  - Capital raising has not offset writedowns to date
Global banks too large for home regulators to save

- Credit driven: Loan books grew inflating assets
- As big as countries: 11 banks are bigger than their country
- Systematic risk: Size of banks increases cost of collapse – and a case for separation of payments system

Source: Citigroup Research
Markets have reacted to liquidity shortfalls and recession fears

MSCI World Index (1Y) -41%

Brent Crude Oil (1Y) -24%

Dow Jones Industrial Average (1Y) -38%

DJ-AIG Commodities Index (1Y) -27%

Margin calls and unwinding of positions exacerbating the contraction

Source: FT (23 Oct 2008)
Crisis in banking directly impacts economic activity

- Bank insolvency
- Crisis of confidence
- Lack of short-term lending
- Disruption of payments
- Corporate liquidity crisis
- Inability to meet financial obligations

Instability in the banking system can destroy otherwise healthy economies
Economic crisis puts most vulnerable stakeholders at risk

| **Small and Medium-sized Enterprises (SME)** | • Employment impact: SMEs are the economy’s employment generation base |
| **Beneficiaries of public aid** | • Public welfare project strains: Government capital injections will draw from other budget items |
| **Beneficiaries of international aid** | • Humanitarian relief impact: Benevolent aid packages will be effected as low priority budget allocations |
| **Food insecure** | • Economic downturn: Bottom-of-the-pyramid will be the most socially vulnerable group as disposable income is threatened |

Shari’a-compliant solutions needed to ensure the flow of aid
Crisis is recasting basic regulatory model

<table>
<thead>
<tr>
<th>Lending practices</th>
<th>• How did sub-prime mortgages reach 20% of U.S. mortgage market?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial securities market</td>
<td>• Reform of derivatives market regulation (in particular CDS and CDO) is required</td>
</tr>
<tr>
<td>Accountability</td>
<td>• Need for global co-ordination in supervision activities, with lender-of-last-resort empowered with greater authority</td>
</tr>
<tr>
<td>The case for “narrow banking”</td>
<td>• Fundamental distinction between guaranteed deposit-takers (bank payment system) and investment managers (risk-bearing accounts) is increasingly essential</td>
</tr>
</tbody>
</table>
Crisis underscores need for Shari’a-based approach

Impact points

1. Financial Institutions
   - Need for savings and investment orientation to replace consumption and credit culture

2. Global Markets
   - Dangers of opaque sale of debt now shown to be evident

3. Real Economy
   - Stronger links needed between banking and real economy investment

4. Policy Implications
   - Differentiation between deposit-taking institutions and investment managers

Material crisis requires moral solutions
Is Islamic finance the key to solving the current crisis?

In theory, Islamic principles would avoid the crisis...

- *Ribā*-based and creditary lending
- The unrestricted sale of debt
- *Gharar* and lack of transparency in financial securities
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In theory, Islamic principles would avoid the crisis...

- Riba-based and creditary lending
- The unrestricted sale of debt
- Gharar and lack of transparency in financial securities

... but in reality, the Islamic finance sector has a long way to go

- Need to shift from debt-based to savings-orientation
- Need deeper capital markets to make system viable
- Real economy impact remains limited

The Shari’a offers answers, but a robust system is not yet present
Closing thoughts

- Crisis brings opportunity for fundamental re-thinking
- Holistic, multi-disciplinary approach is required
- Diverse stakeholders must be involved
- Pivotal time for Shari’a-based thought leadership
- Corporate Social Responsibility (CSR) needed as urgently as ever, in innovative and creative ways

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