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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

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INTEREST FREE BANKING: A POTENTIAL SUBSTITUTE TO CONVENTIONAL BANKING IN THE CONTEMPORARY GLOBAL FINANCIAL SCENARIO

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ABSTRACT

The current global economic recession that triggered in 2008-09 has yet again proved the failure of the prevailing financial architecture that is founded on the interest based conventional banking system. Prior to the present economic crisis, there have been numerous breakdown instances of the so called time tested world financial mechanism which interest is a key component of. The current global economic meltdown, as everyone knows, is the offshoot of the sub-prime mortgage crisis that emanated from the U S. The sub-standard housing loans that lacked the backing of adequate real value were repackaged and traded as derivatives. The unending transaction of such mortgages at highly inflated prices took the shape of a bubble that was sooner or later destined to burst. The crisis was no longer confined to the housing sector and the eventuality that occurred in September, 2008 shook the nerves of some most powerful economies of the world which were hitherto champions of the free market interest based economic system. The crisis that is often considered as the worst after the World War-II engulfed the whole world which is now highly globalized. Experts of interest free financial mechanism dub the crisis as the 'crisis of confidence' in the prevailing financial system and argue that there is a 'systemic flaw' inherent in the conventional banking. In the wake of continual global recessions over the last few decades including the latest one, some right thinking people have started focusing on the need for rationalizing and reforming the global financial architecture in a way that prevents the recurrent tremors in the global financial mechanism. Economists believe that the latest global financial crisis, that the world is still struggling to recover from, could have been evaded had there been interest free banking system in place of the conventional one. The present paper, therefore, takes a dig into the factors that lead to recurrent breakdowns of global financial system and explores the viability of PLS based (Profit-Loss Sharing) banking practices replacing the interest based banking system that is fast losing its relevance in the changing global financial milieu.

KEYWORDS
Banking, conventional, interest-free, financial, crisis.

INTRODUCTION

Interest free banking has the same scope and purpose as the conventional banking except that it operates on one comprehensive and distinguishing principle viz., profit and loss sharing (PLS) instead of accrual of interest. This distinguishing principle of interest free banking has essentially its roots in the Islamic mechanism of financial system based on the core Islamic rules of transactions known as *Fiqh al-Muamalat* which in turn is an important component of Islamic jurisprudence popularly called as *shariah.* It is in this backdrop that interest free banking originated from Islamic countries and as such is often termed as Islamic Banking. Numerous studies have in detail discussed the rationale behind the prohibition of interest (see, for example, Chapra, 2000) and the importance of PLS in Islamic Banking (see, for example, Dar and Presley, 2000). All such studies have in fact emphasized that all commercial transactions and contracts must be free from elements of *Riba (interest)*, *Gharar* (uncertainty), *Maysir* (gambling) and *non-Halal* (prohibited activities).

The contemporary financial economics differs from Islamic economics in many critical respects, of which the nature of money is one. Whilst both systems accept money as a store of value and a medium of exchange, the financial market based economic system treats money as any other commodity which can be traded for a profit. This profit on sale and purchase of money is nothing but interest. And it is this interest that is the precursor for the activity of money creation by the conventional banking system. A true interest free banking or Islamic banking abstains from the paying or receiving of interest (*riba*) as well as the artificial creation of money via the process of miniscule reserve. This circulation of artificial money (money not backed by real assets) paves, in fact, the way for ethical and unethical practices of earning money and amassing wealth. Greed, exploitation and abuses are the dominant factors in most financial transactions that take place under the conventional banking system. So long as commissions are received and interests paid, and the collaterals are in place, banks continue to lend. Reckless investors, on the other hand, knowing that the borrowed money is not theirs, borrow to the maximum. Depositors who care most about the high interest they receive, keep on depositing regardless of the portfolio and conduct of the bankers. This vicious circle continues until the bubble builds up and becomes a perfect recipe for a crisis, which all the parties viz., depositors, bankers and borrowers contribute to and all of them eventually suffer from.

RECURRENT FAILURES OF CONVENTIONAL BANKING SYSTEM

By creating money out of thin air and putting it into circulation, central and commercial banks almost all over the world have together caused a succession of speculative bubbles that can be traced back to more than 300 years in the Western world. As such, the current crisis is not an unusual phenomenon and therefore is not the first one and does not seem to be the last one either, given the structure of the present global financial architecture. As Stiglitz (2003) emphasized, "….international financial crises or near-crises have become regular events….It is becoming rarer for a country not to have a crisis than to have one and, by some reckonings, there have been 100 such crises in the past 35 years". Thus, there have been intermittent economic tremors during the last many decades. However, the only difference, if at all there is one, is that of the severity. Experts feel that the present crisis is the worst after the World War-II and even more severe than the Great Depression of 1930s. The present crisis engulfed the whole world which is now extremely globalized and shook the very foundations of the global financial structure. Though the repackaging and trading of sub-prime housing mortgages as derivatives, CDOs and CDSs, that lacked the backing of adequate real value, triggered the economic downturn in the US, the crisis was no longer confined to the housing sector and the phenomenon snowballed into a full blown recession that brought the whole world to the virtual economic standstill within a matter of days.

There are many similarities of the current crisis with the previous ones that have occurred since 1930s. The analysis shows that there is a host of specific factors inherent within capitalism and the free-market economy that trigger the recurrence of economic crises. Like in the case of previous financial crises, many voices have been raised against the conventional banking practices for being at root of the current crisis. Great panic in fear of the collapse of the world financial system has led to the search of rescue plans for banks and hence bailout packages worth billions of dollars for banks and financial institutions by the governments which were hitherto champions of the free market and survival of the fittest economic model. It has taken more than three trillion dollars of bailout and liquidity injections by a number of industrial countries to somewhat ease the intensity of the crisis. Experts of interest free financial mechanism dub the crisis as the *'crisis of confidence'* in the prevailing financial system and argue that there is a *'systemic flaw'* inherent in the conventional banking (SESRIC Monthly Report, June 2009).

Islamic economists and advocates of interest free banking like Siddiqui (2009); Chapra (2009 and Bagsiraj (2009) refer to the continual global economic crises in general and the latest one in particular as a result of interest and its rate structure. Huge budgetary imbalances, excessive monetary expansion, large balance of payments deficits and inadequate international cooperation can all be related to flaws in the theory of interest, which, according to experts, is at the root of the crisis. Moreover, there are fears that present crisis may have exposed the world economy to a prolonged period of slowdown. In the above backdrop, there have been voices which call for rethinking of some alternative financial systems and search for a new architecture that could help minimize the frequency and severity of such a crisis in the future (Camdessus, 2000; Stiglitz, 2007; Baily *et al,* 2008).

ANATOMY OF THE CURRENT CRISIS & RATIONALE FOR DESIGNING A NEW FINANCIAL STRUCTURE
It is illogical even to think of designing a new financial architecture without first determining the primary cause of the economic crises that have sporadically plagued the world over the past some decades. The generally recognized most important cause of almost all crises has been excessive and imprudent lending by banks (BIS, Annual Report, June 2008). This raises a serious question of what makes it possible for banks to resort to such an unhealthy practice that not only hurts their own long-run interest but destabilizes the international financial system as a whole. There are a number of factors that make this possible.

One of the most important of these is the inadequate market discipline in the financial system (Chapra, 2009). What is it that makes it possible for the financial system to have unwarranted discipline when this is considered to be a precursor for the global financial mess? In the simplest terms, the market is able to impose discipline only when it is able to reward efficiency and prudence and punish inefficiency and recklessness. In other words, there would be a check on excessive lending only if the banks were afraid that it would lead to losses, impact their reputation, and even cause bankruptcy. However, excessive lending is a predominant feature in a system where profit-and-loss sharing (PLS) does not exist, rather the repayment of loans with interest is generally assured, and '*the too big to fail*' concept ensures a fictitious sense of survival. This false sense of immunity from losses and possible collapse, in fact, introduces a fault line into the system and consequently, the banks do not undertake a careful evaluation of loan applications. Besides disproportionate increase in sub-prime mortgages, this leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, unsustainable increase in speculative investment and the resultant rise in asset prices. If allowed to prolong, such a phenomenon, later on, gives rise to a steep decline in asset prices, and to financial fragility and debt crises. The consequences are catastrophic in case it is accompanied by overindulgence in short sales, inadequate market regulations and less state intervention. Inadequate discipline, thus, promotes excessive lending and high leverage, and leads first to a bubble and then to a debt crisis (see for example, Fisher, 1992; Minsky, 1975). This phenomenon has been endorsed by the G-20 Summit held on 15 November 2008 which opined that excessive leverage was one of the root causes of "vulnerabilities in the system" (G-20, 2008). Historically studying the intermittent global financial meltdown, Galbraith (1990) concludes that there has been a decisive role of debt and leverage in the speculative booms of the last three centuries.

The second reason of the crisis, which in fact is the precursor for imprudent lending, is the quality and valuation of collateral. Collateral is, of course, indispensable for managing the risk of default. However, this purpose is served only in case the collateral is of good quality. Nevertheless, collateral is prone to a valuation risk and its value is influenced by the same factors that diminish the borrower's ability to repay. If there is no risk-sharing and the return is so called guaranteed, the banks will have little incentive to undertake a careful evaluation of the collateral and will extend financing for any purpose including speculation and gambling. The collateral can, therefore, by itself hardly be a substitute for a more careful evaluation of the project financed (Summers, 2008).

Another factor that provides protection against losses is securitization which is a paradigm shift from *'originate-to-hold'* model to the *'originate-to-distribute'* model of financing. This enables the lenders to sell the debt, transfer the risk of default to the purchasers, and use the proceeds to make more loans and hence, increase their profits.

One problem which the reckless bankers confronted while securitization was that while prudent and rational purchasers would be willing to buy the prime debt, they would be reluctant to buy the subprime debt. This problem was solved by the creation of collateralized debt obligations (CDOs). Under this arrangement, prime and subprime debts were mixed and securitized by putting them into different groups with varying degrees of risk and maturity. For an average buyer, the CDOs were difficult to understand as complex models were used for this purpose. This made the purchasers primarily rely on rating agencies. The rating agencies, in turn, also used complex computer models to predict the likelihood of default. Independent judgment of the risk involved, therefore, became difficult (Baily, *et al*, 2008). Still there would have been no problem in this had the rating agencies not suffered from conflict of interests and provided accurate ratings. However, since they were paid by banks and hedge funds which organized and sold these structured securities, they had no incentive to be more ethical and professional in their business. The rating agencies, therefore, issued ratings on the basis of information that was provided to them without much analysis. The high ratings plus the relatively higher yields on these CDOs, made it easier for mortgage originators to pass the risk of default to the ultimate purchasers. Loan volume accordingly gained greater priority over loan quality and the amount of lending to subprime borrowers and speculators increased steeply (Mian and Sufi, 2008; Keys, *et al*., 2008).

An important factor that further impacted the underwriting standards is the spread of derivatives like credit default swaps (CDSs) which made it possible for lenders to insure themselves against the risk of default. The buyer of the swap (creditor) paid a premium to the seller (a hedge fund) for the compensation he would receive in case the debtor defaults. Even though this innovation would have resulted in further reducing underwriting standards, it may not have caused much harm had the hedge funds also performed some scrutiny and sold the swaps to just the actual lending banks. They, however, sold them also to a large number of other institutions and individuals who were willing to bet on the default of the debtor. These swap-holders, in turn, resold the swaps to others and the whole process continued several times. While a genuine insurance contract indemnifies only the insured party against losses actually suffered, in the case of CDSs the hedge funds and insurers had to compensate several other swap-holders who had not suffered any loss from default. In addition to this betting on debt default, there was also betting in the case of interest rates and exchange rates far in excess of the genuine need for hedging. As a result of all this, risk became excessively accentuated and made it impossible for the hedge funds and banks to honour their commitments.

The notional amount of all outstanding derivatives was estimated at $683.7 trillion in June, 2008 (BIS, November 2008), more than 12 times the world GDP of $54.3 trillion in 2007 (World Bank, 2008). Of even greater risk was the fact that a large proportion of derivative contracts became concentrated in the hands of relatively few dealers who were interlinked to one another through different credit instruments. As a result, the default of even one could quickly destabilize all others and lead to a financial crisis. It is in this backdrop that George Soros described derivatives as *'hydrogen bombs'*, and Warren Buffett called them *'financial weapons of mass destruction'*.

A fourth factor that tended to provide a false sense of security is the *'too big to fail'* concept which provided an assurance to 'big' banks that the central bank would come to their assistance and bail them out. Obviously, banks which carried such a safety net have incentives to take greater risk than what they otherwise would (Miskhin, 1997).

Yet another important factor for the intermittent global financial crises in general and that of the current one in particular is that many countries, especially the Western economies have shifted their focus from industry to services. Consequently, the services sector now represents over 80 percent of the US economy, with the financial sector being the largest one. Rather than contributing in physical terms, the players in the financial industry gamble on what is going to happen in the real world, by speculating the performance of businesses and betting on their profits. This financial sector is a parallel economy which exists alongside the real economy and produces nothing real and tangible. On the other hand, the real economy consists of housing, production, manufacture and other tangible goods which can be traded, leased, and bought and sold. In other words, these are physical goods that are produced by people who are employed to make them. But the financial economy consists of tradable paper with financial values that rise and fall based upon the value people assign them, often representing no real asset.

The size of financial economy worldwide is now enormous and its estimated value is far more than the real economy. The size of the worldwide bond market is estimated at $50 trillion. The size of the world's stock markets is estimated at $55 trillion. The world derivatives market has been estimated at $500 trillion, more than 30 times the size of the US economy and 12 times the size of the entire world economy. In fact, the financial markets have now become so divorced from the real economy that investors are no longer interested in dividend income. They are rather eying to make profits out of rising prices. This has led to speculation of gigantic proportions, including bets on the rise and fall of economies.

Given that banks lend excessively to maximize their profit, why is it that the depositors do not impose a discipline on the banks? They can do this in several different ways, for example, by demanding better governance, greater transparency, and more efficient risk management. If this does not work, they can always punish the banks by withdrawing their deposits. They do not, however, do so in the conventional financial system because they are assured of the repayment of their deposits with interest (Mishkin, 1997). This makes them complacent and they do not take as much interest in the affairs of their financial institution as they would if they expected to suffer losses. 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. This, along with the easy monetary policy pursued by the central banks, led to an unhealthy expansion in the overall volume of credit, to excessive leverage, to subprime debt, and to living beyond means. This tendency of the system got further reinforced by two other factors. One of these was the excessive use of complex computer models which few people understood. These models took the place of human judgment and left little incentive for bank management to use their own knowledge and skills to assess the actual risk of the underlying assets. The second factor was the bias of the tax system in favour of debt financing; dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense. The result is that a number of banks have either failed or have had to be bailed out or nationalized by the governments in the US, the UK, Europe and a number of other countries. This generated fear and uncertainty in the market and led to a credit crunch, which has made it hard for even healthy banks and firms to find financing. There is a lurking fear that this might be only the tip of the iceberg and a lot more may follow if the crisis causes a prolonged recession and leads to defaults on the part of credit card institutions, corporations, and derivatives dealers.

INTEREST FREE BANKING: A POTENTIAL ALTERNATIVE TO CONVENTIONAL BANKING

In the backdrop of the anatomical facts of the latest global financial crisis given in the preceding paragraphs, there have been voices for rethinking of some alternative financial systems and search for a new architecture that could help minimize the frequency and severity of such a crisis in future (Camdessus, 2000; Stiglitz, 2007; Baily *et al,* 2008). Among these alternatives, the Islamic finance and interest free banking is the largely debated one in the developed and developing countries in general and Islamic countries in particular. Experts believe that the recurrent global economic downturns including the latest one could have been avoided had there been interest free banking in place of conventional banking (see for example, Chapra, 2009; Hassan, 2009). The arguments they put forward in support of their view seem to be logically founded.

The current global financial crisis affected a number of most successful institutions operating in the international financial arena including some of those which were hitherto considered as well established and 'too big to fail'. Islamic banks and financial institutions, operating on non-interest mechanism, on the other hand proved comparatively cushioned from the crisis. Given the scenario where Islamic banking and finance proved resilient to the global financial slump, many experts and analysts, particularly in the developing economies intensified their argument that conventional banking is highly vulnerable and that there is a need to think of potential alternatives and most of them assert that Islamic banking and *shariah* based finance is a potential and feasible substitute.

In the conventional banking, the process of lending is subject to asymmetric information, moral hazard and greed. In an attempt to borrow more and divert funds in speculative investments, borrowers most of the times misinform lenders who do not exercise adequate care while lending as they eye on the so called assured but illusionary returns (interest). Such a self-centered outlook poses as unimaginable risk on all the parties including the depositors whose money the banks actually lend. Thus, the assured and guaranteed returns or interest, a cardinal element of conventional banking, which is essentially highly uncertain and never so guaranteed, is at the root of the failure of the conventional banking practices.

Interest free banking and Islamic finance is devoid of the fundamental flaws that serve as avenues of immoral indulgence and human greed and cause the breakdown of the conventional banking system. Islamic finance requires that all financial transactions must be free from *riba* (interest or usury), *gharar* (uncertainty), *maysir* (gambling) and other *haram* (prohibited) activities. Besides, financial dealings in islamic banking and finance are guided by the ultimate objective of achieving the ideals of equity and equitable justice where priority is given to equity-based financing rather than leveraging and debt-based financing (Kassim and Majid, 2009).

Being at the core of islamic finance and banking, the principle of equity and justice in the society requires that financial transactions must be based on profit and loss sharing rather than interest. This ensures sharing of risk of loss by all the parties viz., the depositor, lender and borrower and not just confining it to either of them (Chapra, 2008). Such an arrangement paves the way for a prudent behaviour on the part of the parties and a better market discipline. Not only the lenders evaluate the loan applications of prospective borrowers more cautiously and subsequently more effectively monitor the use of funds by them but also the depositors, whose hard earned money bankers actually lend, scrupulously evaluate the investment alternatives before taking a final decision. The borrowers, in turn, exercise restraint from indulging in non-real asset investments and unscrupulous business ventures.

Islamic financial system and interest free banking does not allow the creation of debt through either lending or borrowing. It rather requires creation of debt through the sale or lease of real assets via various modes and instruments of *shariah* compliant financing such as *murabahah*, *istisna*, *sukuk* etc. The objective is to enable the needy borrowers to buy urgently needed real goods and services at present considering their ability to pay at a later time. Such an arrangement prevents the falsely created rat race and deters the unnecessary expansion of debt. Experts of interest free financial system suggest certain conditions for the unwarranted debt expansion and money creation, which according to them is the root cause of almost all major financial breakdowns. Chapra (2008) summarizes these conditions as under:

- the asset which is being sold or leased must be real and not imaginary or notional,
- the seller must own and possess the goods being sold or leased,
- the transaction must be a genuine trade transaction with the intention of giving and taking the delivery, and
- since the debt cannot be sold and the risk associated with it cannot be transferred, it has to be borne by the creditor himself.

Under the above conditions, the debts cannot be traded and the financial markets cannot be stretched beyond what the real economy can bear. Hence, the derivatives and their trading, which is essentially speculative in nature and do not add any value to the real economy, is eliminated from the market mechanism, the phenomenon that was at the core of the recent financial global meltdown. Since the above conditions fall within the framework of islamic finance, many economists and macro financial experts and analysts have come to support the interest free banking and islamic financial system.

In the backdrop of the current financial breakdown and above principles of islamic finance, many banks and financial institutions across the world are building up their islamic units and tapping in the emerging industry which is now estimated at a whopping $ 1 trillion in assert size and growing annually at 15-20% (Reuters, 2009). Presently, interest free investments and islamic financial instruments are acceptable in a vast number of countries, both islamic and others, including the UK, US, Japan, Malaysia, China, Indonesia etc. and continue to expand to many other countries as an alternative or, at least, complementary to the existing banking and finance system. As Wilson (2009) asserts, "the spread of islamic finance to Western markets demonstrates that it is now being treated seriously by regulators and finance ministries because islamic banking is less prone to cyclical fluctuations and provides a viable alternative to conventional banking".

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