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HOW ISLAMIC FINANCE MITIGATE FINANCIAL CRISES

MOUSA AL MANASEER*

Banking and Finance Department, Mutah University, Alkarak, Jordan, Tel: 00962772328262;

Email: **mousa_almanaseer@yahoo.com**

Abstract

The worldwide monetary crisis that occurred in 2007 is the most exceedingly awful monetary emergency since the Great Depression in 1929. Manifestations of the crisis have begun through the tight liquidity in the banking system in the United States and the collapse of large financial institutions and falling stock and bond prices in addition to the failure of many of the major business companies. After that, the impacts of the monetary crisis spread to Europe and other countries. The effect of this crisis transferred quickly from the money related segment to the production sectors. This can be considered as a failure of the ideology of capitalism which concentrates on the interest-based finance. Since the beginning of the worldwide money related crisis, many of the studies and reports show that Islamic fund have not been adversely worldwide budgetary emergency, similar to the case in regular back, particularly in the principal time frame when the crisis emerged. The reason for this, according to these studies and reports that Islamic finance did not use interest (usury) and this is what gives it an advantage over the traditional finance, as Islamic fund concentrate on trading the origins of the material and this is what makes them immune toward the impacts of the worldwide money related crisis.

Keywords: **Economy; Global Economy; Globalization; Financial Institutions**

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INTRODUCTION

This research focuses on the dialog and investigation of the reasons for the worldwide money related emergency, which started in 2007, and in addition the suggestions and impacts of the emergency on worldwide monetary markets and the worldwide economy at a later stage. The research also focuses on the analysis of the Islamic financial system by giving an overview of the nature, functions and characteristics of this system, as well as the different aspects of this system from the traditional financial system. In conclusion, the research proposed a number of recommendations that could contribute to strengthening the process of financing methods to overcome the obstacles and difficulties faced by the financial crises.

The Importance of the Research

The importance of the study stems from finding a continuing answer for guarantee the soundness of monetary frameworks; toss fabricating another money related design that would consider the more productive working of budgetary intermediation inside national economies as well as crosswise over outskirts. Islamic back, with its accentuation on a solid linkage to gainful financial movement, its inbuilt check and adjusts and its abnormal state of divulgence and straightforwardness offers this prospect. Without a doubt, inborn in Islamic fund is the express components that address a few of the issues that have surfaced in the ordinary money related framework amid the present crisis.

THE AIMS OF THE RESEARCH

Discuss the causes of the worldwide monetary crisis.

Analyze the implications and effects of the crisis on global financial markets and the global economy.

Give an outline of the Islamic money related framework, and who it differ from the traditional financial system.

Propose suggestions that could add to reinforcing the way toward financing techniques of financing methods to overcome the obstacles and difficulties faced by the financial crises.

THE METHODOLOGY OF THE RESEARCH

This research uses descriptive and economic analysis in the theoretical discussion to reach conclusions and propose answers for the various aspects of the research questions.

The Worldwide Monetary Crises

There is almost a consensus among economists and policy makers in all over the world that the most important reason for the recent financial crisis is excessive monetary expansion and irresponsible, which resulted in a combination of activities that is characterized by the system based on the interest as a mechanism for investing money. This crisis, demonstrated once more, the disappointment of the worldwide money related engineering set up, which is primarily in light of the customary managing an accounting framework as a main consideration. The primary direct reasons for the worldwide monetary emergency can be crisis can be summarized by the following factors:

First, Cole and White [1] argue that the thrust of this crisis is that people are buying real estate all through to get loans from banks, and when increasing real estate prices, the owner gets new mortgage from the second division, and these mortgages are characterized by less quality and larger risk, especially if the value of real estate decreased. The other problem is that banks use derivatives to generate new sources of funding to expand their lending activities. When mortgages are used for the issuance of new securities (known as securitization) and the process continues this will generate more risk. This will prompt build the extent of the problem in what's to come. The combination of global credit and the ease flow of foreign money into the United States contributed to the creation of the so-called (housing bubble).

Second, the mismatch problem or the disparity between banks deposits and long haul resources prompted the powerlessness of banks to recharge here and now obligation which they used to fund long haul interests in home loan securities. The over utilizing of budgetary foundations have driven some eminent monetary establishments into liquidations and conveyed others to the edge of fall. Although Central Bank (Federal Reserve) controls commercial banks, investment banks in the United States are not subject to supervision by the central bank and this expanded some banks' lending to more than sixty times the size of their capital. Globalization has appropriately assumed a key part in empowering rushed exchange of systemic hazard inside and crosswise over national limits [2].

Third, lack of control and supervision especially in relation to the investment banks, brokers mortgages, oversight of financial derivatives and oversight of financial institutions that issue credit worthiness certificates and thus encourage investors to turn on the securities. In addition to the foregoing, the expansion and the proliferation of hedge funds that have led to the creation of huge cash flow and achieve quick gains [3]. These funds are not open to all people, but for the rich only, and all fund absorbs about 500 investors, and funds mentioned unregistered and not subject to control and operate this fund to borrow from financial institutions at low interest rates and then invest the money in exchange for higher benefits and thus make a profit from differences and this so-called financial leverage, which include an investment in the securities or credit derivatives [4]. The process of converting various loans (such as mortgage loan and other) to bonds which can be traded in financial markets increased the debt volume. Therefore, the weak oversight and supervision is the other factor that encouraged the

expansion of the debt.

Finally, the immoral behavior of managers and shareholders can be considered as an important cause of monetary crises. If we look at the reality of these two classes it become clear that, their return is controlled by the span of loans provided by the money related foundation, on account of non-payment or bankruptcy, the risks of these loans beard by creditors or governments that rescue the financial institution if it get in troubled later. The return to shareholders is a return on assets multiplied by the ratio of assets to capital, and the compensation for managers are linked to the size of loans also, which means that the yield increases with increasing lending categories. However, this increase in irresponsible lending that benefits the shareholders and their managers were the cause, of the fragility of the financial institutions and the lack of stability of the financial system. The shared view held by money related researchers and masters are that the worldwide money related emergency in all actuality is an emergency of fizzled morals [5].

Consequences of the Monetary Crisis

The global financial crisis resulted in loss of money related foundations one after the other, which resulted in falling in the real estate prices and stock prices in the United States, Europe, Asia and other countries [6]. At a later stage, the impacts of the budgetary crisis moved into economic activity, as expanded unemployment, recession and decreased on the oil prices. The results of the monetary crises become clear from the following:

Sharp decrease in worldwide value markets this is clear from the setback of factual indicators of NASDAQ, Dow Jones, NIKKE and many other European and Asian markets which affected by the severity of the crisis [7]. The disappointment or fall of various worldwide money related organizations, for example, Lehman Brothers Holdings Inc. in September 2008 [8,9]. This can be viewed as one of the biggest liquidations in the real estate history. Its resources alone were esteemed at $43 billion. Moreover, The US government has raced to the release and proclaimed its target to purchase dangerous bank resources esteem in abundance of US$1 trillion, to keep the crumple of vexed monetary organizations. Furthermore, when the American International Group insurance conglomerate filled in troubles the US government paid$180 billion to rescue it and this was this was sufficiently bad to free it from its inconveniences. Therefore, the governments of various industrialized countries assigned more than $7 trillion bailout and liquidity injections to recover their economies. Assets of the largest 1,000 banks in the world grew by 6.8% in the 2008/2009 financial year to a recordUS$96.4 trillion while profits declined by 85% to US$115 billion. Growth in assets in adverse market conditions was largely a result of recapitalization.

Ware and oil costs achieved record highs took after by a droop. Politicians, budgetary specialists and financial analysts, don't foresee a close end to the emergency and alert of stretched out tough circumstances to come as the world's primary economies are heading towards recessions. The guess is that instability and doubt in worldwide monetary markets are likely to bring about additional unemployment and a decrease in

development [10]. Therefore, central banks loan fees in composed endeavors to build liquidity and maintain a strategic distance from subsidence and to bring back a few (certainty) in the monetary markets.

Islamic Finance

In the previous sections, we highlight the most important causes and results of the worldwide money related crisis in this part we will try to show how Islamic finance can treat the imbalances which caused this crisis. We will focus here on the most important principles underlying Islamic finance, Islamic investment instruments and the treatment of imbalances in the global financial system, which has already talked about. The most important pillars of Islamic finance, which has direct link to the subject of this paper, are what can be termed the three contraband in economic activity, which are: prohibition of interest (Riba), Uncertainty (Gharar) and gambling in addition to risk sharing mechanism [11].

Riba has the exacting significance of “an excess and is characterized as an expansion or overabundance, which accumulates to the proprietor in a trade or offer of a ware, or, by excellence of an advance game plan, without giving proportionate incentive to the next gathering. Another identification of riba explained by Khan [12] as a predetermined return on the use of money, he says " in the past there has been dispute about whether Riba refers to interest or usury, but there is now a consensus amongst Muslim scholars that the term covers all forms of interest" [12]. Although the term Riba is wider than the interest rate on which the modern economic system is based on, but we confine ourselves here to the interest that deal with contemporary commercial banks rate, which is religiously prohibited. The prohibition of interest as a mechanism to rotate funds from savers to investors through banks means in short that money in Islam cannot be transformed into a commodity bought and sold, but rather is a means to facilitate the activity, real economic and therefore the movement of money should tie to the movement of merchandise and enterprises [13].

Uncertainty (Gharar) is characterized as exercises that have components of instability, equivocalness or trickery. In a business exchange, it alludes to the uncertainty relating to either the goods or the cost of goods. A component of gharar is viewed as a typical wonder in the market on the off chance that it is not unreasonable in the agreements, and where the impact on the economy and society is viewed as insignificant. This is accepted by Shari'ah as it would be for all intents and purposes difficult to kill this component totally from the market. An extensive component of gharar in a business exchange, then again, is restricted by shari'ah as it might influence the legitimateness of a transaction. Investment in future contracts is considered a sort of gharar, which is null and void [14]. The prohibition of the future contract is mainly due to the uncertainty and changing of interest of both parties in the contract when it falls due.

Betting is alluded to as qimar or maisir in Arabic, which implies any movement that includes a plan between at least two gatherings, each of whom attempts the danger of a misfortune where a misfortune for one means a pick up for alternate, as is natural in betting exercises. The pickup collecting such exercises is unlawful in Islam, as it

redirects the individual's consideration from gainful occupation, and towards storing up riches without exertion. Inclusion in action to make a benefit to the detriment of another gathering is viewed as a corrupt prompting in Islam [15].

Risk Sharing

Under conventional banking, the investor is assured of a predetermined rate of interest. By contrast, the most important element of Islamic managing an account is that it promotes risk sharing between the supplier of funds (financier) and the operator of funds (entrepreneur). Since the nature of this world is uncertain, the results of any project are not known with certainty in advance. Therefore, there is constantly some hazard included. In customary saving money, this hazard is borne by entrepreneur. Whether the project succeeds and produces a profit or fails and produces a loss, the owner of capital gets a fixed return [16].

Islamic Financing Instruments

Murabaha is a form of trade transaction often used to finance the purchase of goods and then sell them to the customer at a higher price on deferred payment [17]. Here, the interest that is usually paid by the client in the traditional loan is replaced by the profit which is the difference between the purchase price and the selling price. The offering value covers the price tag and the conveyance costs notwithstanding a benefit to the bank [18].

Mudarabah (capital financing with profit sharing): is a course of action between a capital provider and an entrepreneur, whereby the entrepreneur can mobilize funds for a business activity. The total return of the project shall be divided according to an agreed ratio. However, in case of loss, the capital provider bears all of the residual losses if the entrepreneur fails. Profit-sharing continues until the capital is repaid [19].

Musharakah (Active Partnership): Musharakah is widely used for joint venture investments. It is also used by Islamic banks for the purchase of real estate, equivalent to a traditional bank mortgage but instead of interest, the Islamic bank receives a share of the rent of the property. It is a partnership between the two parties every one of them provides part of the capital. The profit will be divided between the two parties by the ratio they agreed in when they sign the contract, but the losses are divided based on participation in the ownership percentage [20]. These can be administered by the partnership of the bank or the client or both or a third party.

Istisna'a: It serves as a purchase contract between the bank and the client where the client identifying goods to be manufactured. Under this contract, the bank undertakes to complete the depicted product during a pre-determined period, while the client requesting the product is obliged to pay the price if it complies with the conditions and description of the depicted product. This contract has a popular use in the construction sector, where the client seeks financing for his construction project. Istisna'a contract is suitable for the financing of aircraft manufacturing, equipment for factories and constructions [14].

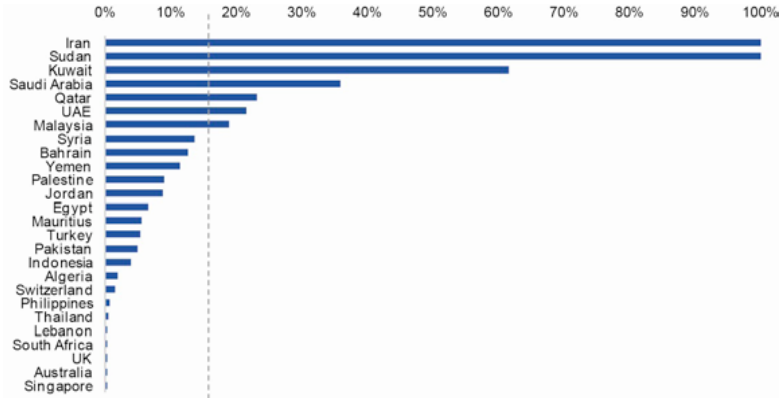
Salamis a deal contract in which the purchase price is paid in full by the bank in advance, while the receipt of goods will be delayed to specified date in the future [21]. Salam can be used to finance agricultural sector transactions where the farmer can receive money in advance to prepare his land for production by selling certain amounts of the crops and after harvesting the crops, he will deliver the quantity sold to the bank.

Leasing (Ijarah): It is a contract whereby the bank leases equipment or specific assets to the customer at a concurred rental over a particular period. Toward the finish of the agreement the client can buy the asset at an agreed price or take it as a gift from the bank, and the periodic rental paid here contained the price of the assets. The owner of the leased assets retains some of the risks and rewards associated with the leased assets. Al-Jarhi and Iqbal [22] argue that leasing is a popular Islamic instrument and it is most widely used in corporate financing.

Islamic Treatment of Imbalances in the Worldwide Monetary Framework

The flexibility of the Islamic monetary foundations amid this emergency exemplifies the characteristic qualities installed in Islamic back that are supported by strengths of the Sharia standards. This emerges from two basic prerequisites of Islamic fund right off the bat; the monetary exchange must be joined by a basic profitable financial movement that will create honest to goodness salary and riches, accordingly setting up a nearby connection between the budgetary exchanges and gainful streams. Along these lines, in the Islamic fund plan of action, financing or value investment must be reached out to exercises in the genuine part that have monetary qualities. Subsequently, Islamic money related resources are required to develop couple with the development of hidden financial exercises. By 2009, there were over US$822 billion resources being overseen in more than 300 banks and 250 common subsidizes the world over agreeing to Islamic standards [4] and starting at 2014 aggregate resources of around $2 trillion were sharia-consistent. As per Ernst and Young, Islamic managing an account resource developed at a yearly rate of 17.6% in the vicinity of 2009 and 2013 and will develop by a normal of 19.7% a year to 2018.

Figure 1: Islamic Banking Market Share by Jurisdiction (2012E).



Source: Islamic Financial Service Industry Stability Report, 2013.

We noticed that Islamic monetary resources are engaged in the Middle East and Asia and remain vigorously packed in Islamic banks. Apart from Sudan and Iran, which have fully Islamic compliant financial system, GCC countries and Malaysia have the biggest Islamic market share at the end 2012, as illustrated in Figure 1.

Secondly, that it depends on benefit partaking in which there is a common hazard sharing. Islamic fund, in this manner, induces the Islamic money related establishments to embrace the proper due ingenuity on the reasonability of business proposition and by upholding the prerequisite for straightforwardness and exposure. The part of the Sharia board in guaranteeing that all parts of business operation of Islamic money related foundations are as per the Sharia standards, includes another level of oversight which intrinsically defends against reckless practices. Grasped completely, these in-constructed measurements of administration and hazard administration expected to adds to defending Islamic back from the potential dangers of budgetary anxiety emerging from intemperate use or theoretical exercises [23].

Budgetary development additionally should be bolstered by powerful hazard administration and solid administration rehearses. It is perceived that modern and complex monetary structures regularly result in the disappointment of buyers, financial specialists and even controllers to comprehend the dangers and use installed in the instruments which thus brings about the absence of straightforwardness and insufficient hazard administration. In Islamic back, an essential under the hazard sharing game plans is having the important data to comprehend the dangers that are to be borne by Islamic monetary establishments. The express hazard sharing component between the lender and client in Islamic fund commits its members to assess chance profile of the item or venture suggestion, the fundamental patterns in profit and money streams, and its pay delivering potential. This procedure additionally permits the estimating of assets to be balanced in like manner.

Similarly imperative is the hazard administration ability of the Islamic budgetary organization to deal with the dangers that are impossible to miss to Islamic money related exchanges. Extra capital is for instance required to pad the stock dangers of hidden resources and value positions that are installed in association contracts, in this way conveying the capital necessities nearer to the genuine monetary dangers in arrangement of the money related organizations. To deal with investors' desires and maintaining market certainty, Islamic banks are likewise allowed to set aside a bit of salary got from resources supported under Mudarabah contracts, as benefit evening out stores (PER), as a component to address the effect of master cyclicality of their profits. This is strengthened by a mix of more grounded administration and improved straightforwardness to address the trust-based connections which is a central sign of Islamic back.

CONCLUSIONS AND RECOMMENDATIONS

The most important reasons for the recent monetary crisis is excessive use of the real estate loans, using derivatives to generate sources of funding to expand banks' lending,

the disparity between banks deposits and their long haul resources which led failure of banks to reestablish here and now obligation they used to back long haul interests in home loan securities. Furthermore, the excessive use of leverage and weak oversight and supervision are other factor that encouraged the expansion of the debt which results in recent financial crises. Finally, the immoral behavior of managers and shareholders can be considered as an important cause of financial crises. The worldwide monetary crisis resulted in sharp decrease in worldwide value market, disappointment or fall of various worldwide monetary organizations, such as Lehman Brothers. In addition, this crisis expanded unemployment, recession, fluctuations in commodity and oil prices that reached high record took after by a droop.

Other than the recognition of the restriction of Riba, Gharar and Maysir, the most habitually cited particular element of Islamic saving money is the substitution of premium term by benefit sharing instrument. Amid the worldwide money related emergency period, in spite of the turmoil crosswise over budgetary markets, Islamic banks remained moderately powerful, and develop at a generous speed contrasted with their traditional companions because of the way that interest for monetary items had been basically household driven, which was encouraged by banks' high capitalization and adequate liquidity that provided a moderately higher level of certainty to counterparties. In addition, financing in Islamic saving money depends on the idea of benefit sponsorship, where land is utilized to ensure these ventures. The role of the Sharia board in ensuring that all aspects of business operation of Islamic budgetary establishments per the Sharia standards adds another level of oversight which inherently safeguards against irresponsible practices.

In summary, the study recommends: avoiding the speculations in the financial transactions. Search for instruments that help hazard and liquidity administration to prevent systemic crises and to stabilize the monetary framework. . Modify the existing structure for Islamic banks to be able to provide the best products and outstanding service within the scope of Islamic laws. Connect the Islamic finance to social and economic goals to achieve financing purposes. More grounded administration and improved straightforwardness to address the trust-based connections which is a central sign of Islamic and conventional finance.

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