

La Trobe University Islamic Banking and Finance
Symposium

Would Islamic Finance have prevented
the global financial crisis?

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Overview

Preamble

Global financial crisis - effects

Global financial crisis – causes?

Introduction to Islamic Finance

Would Islamic Finance have prevented the global financial crisis?

Preamble

Disclaimers

About Mohammed Amin

Disclaimers

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- Any forward looking statements should not be relied on for any purpose and do not constitute investment advice.
- The presentation is made for educational purposes only. No responsibility is accepted to anyone who acts or refrains from acting based on any statements made.
- The speaker may have a personal shareholding in any companies that may be mentioned.

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Mohammed Amin is a tax partner at PricewaterhouseCoopers LLP and leads their Islamic Finance practice in the UK.

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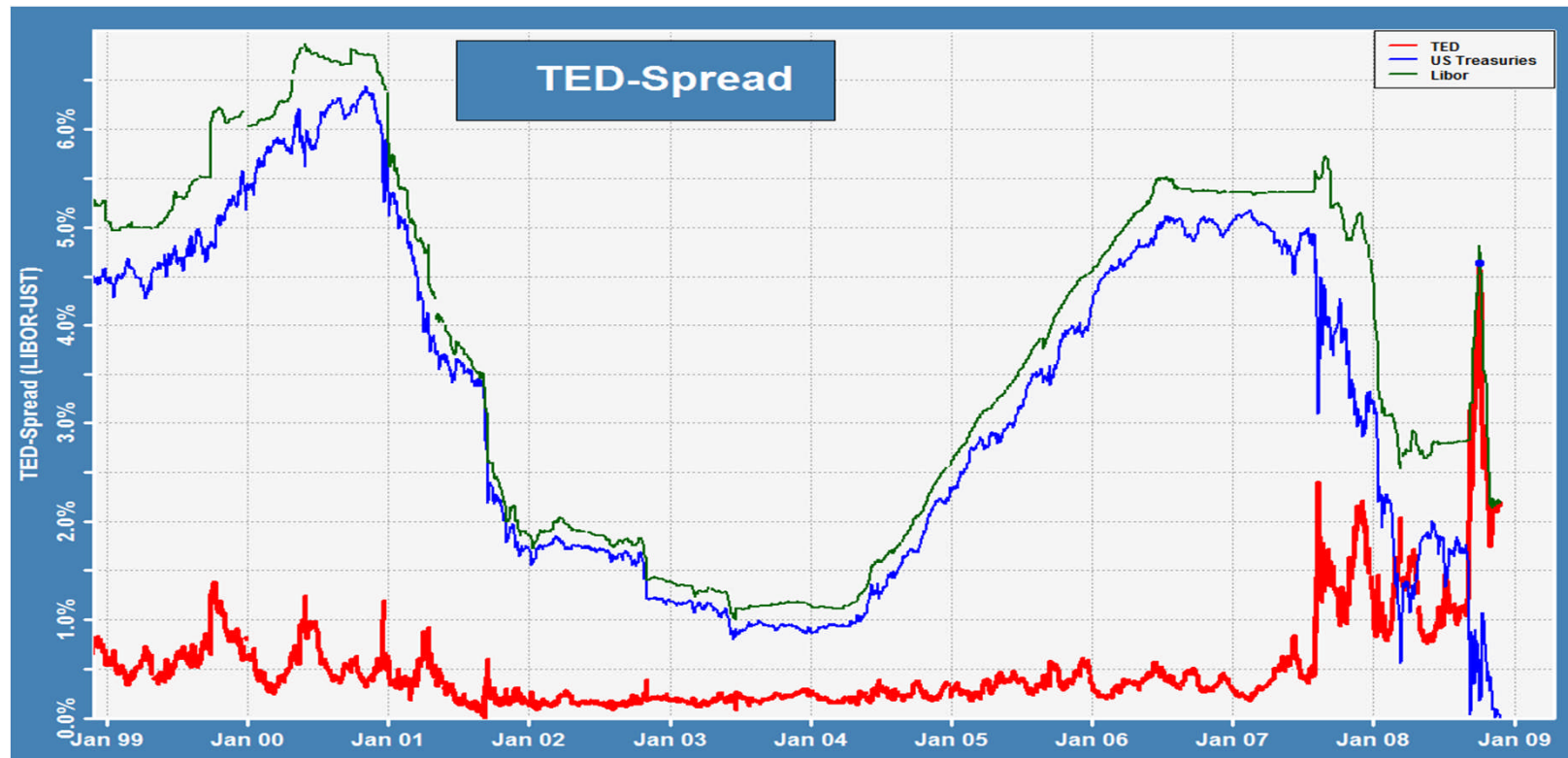
- a member of HM Treasury's Islamic Finance Experts Group, set up to advise the Government on Islamic finance strategy
- chairman of the Business & Economics Committee of the Muslim Council of Britain
- a Council member of the Chartered Institute of Taxation
- a member of the Policy & Technical Committee of the Association of Corporate Treasurers

Many of Amin's previous articles and presentations on Islamic Finance can be found on his Islamic Finance blog at:

pwc.blogs.com/islamicfinance

Global financial crisis - effects

The US Treasuries / Eurodollar Libor (TED) spread



IMF Global Financial Stability Report April 2009 estimated bank writedowns 2007-2010

Writedowns on assets	\$US billion	% of total assets
US banks	1,049	8.8
UK banks	316	5.0
European banks ex UK	1,109	4.6
Asian banks	337	3.5
Total	2,810	5.4

Falls in bank share prices

	1 or 2 Jan 2007	Lowest price	Date
Citigroup	\$56.28	\$0.97	2/3/2009
Bank of America	\$54.18	\$2.53	16/2/2009
Royal Bank of Scotland	582.51p	10.3p	20/1/2009
Lloyds TSB	577.35	42p	6/3/2009

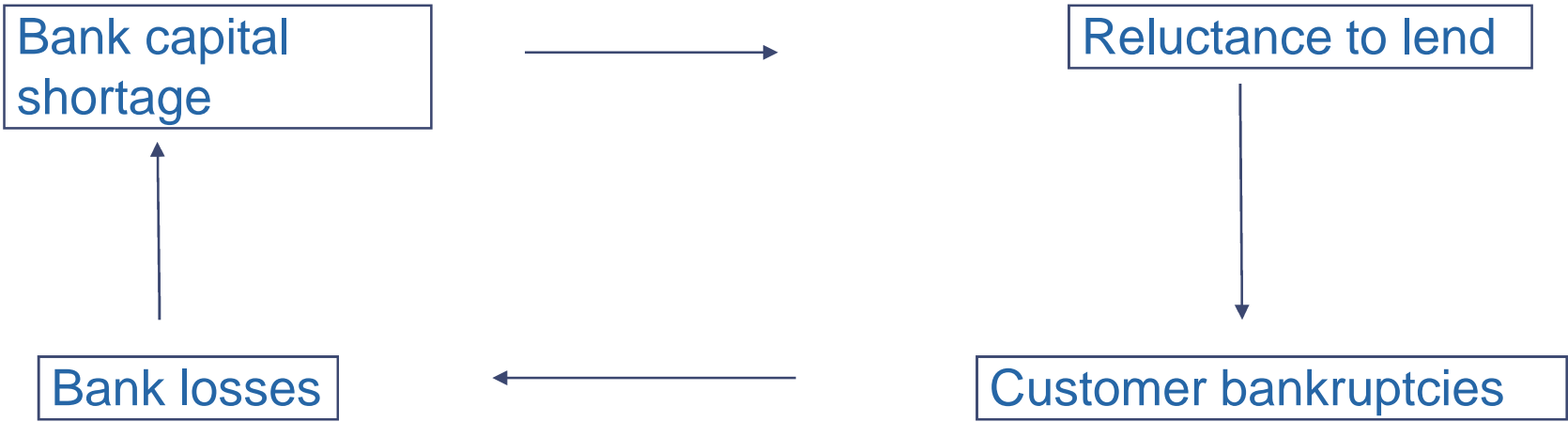
Why bank share prices matter

Ability to remain in business

Lehman Brothers

Temporary restrictions on short selling financial shares

The downward spiral



Global financial crisis – causes?

Sub-prime mortgages

Incentive effects of securitisation

Co-mingling in CDOs

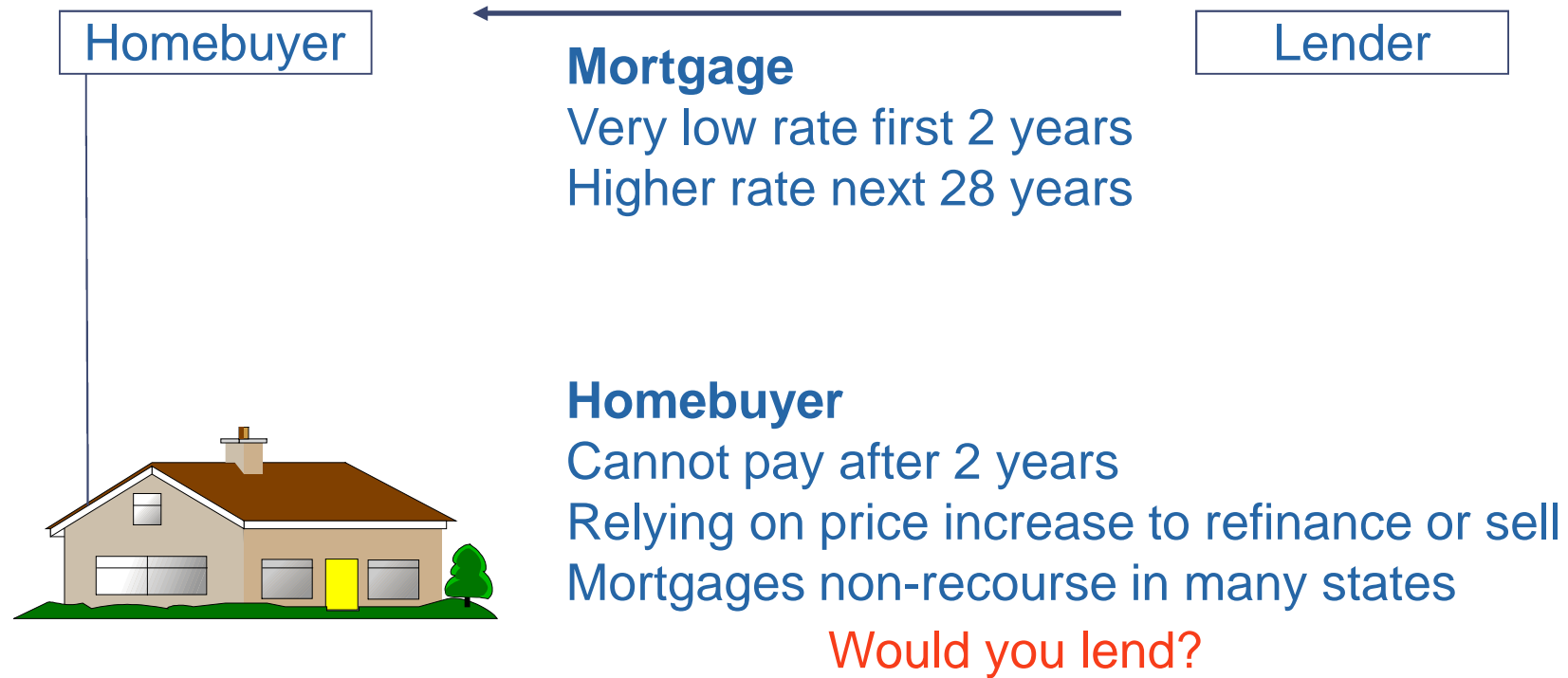
Monoline insurers

Insurers selling credit default swaps

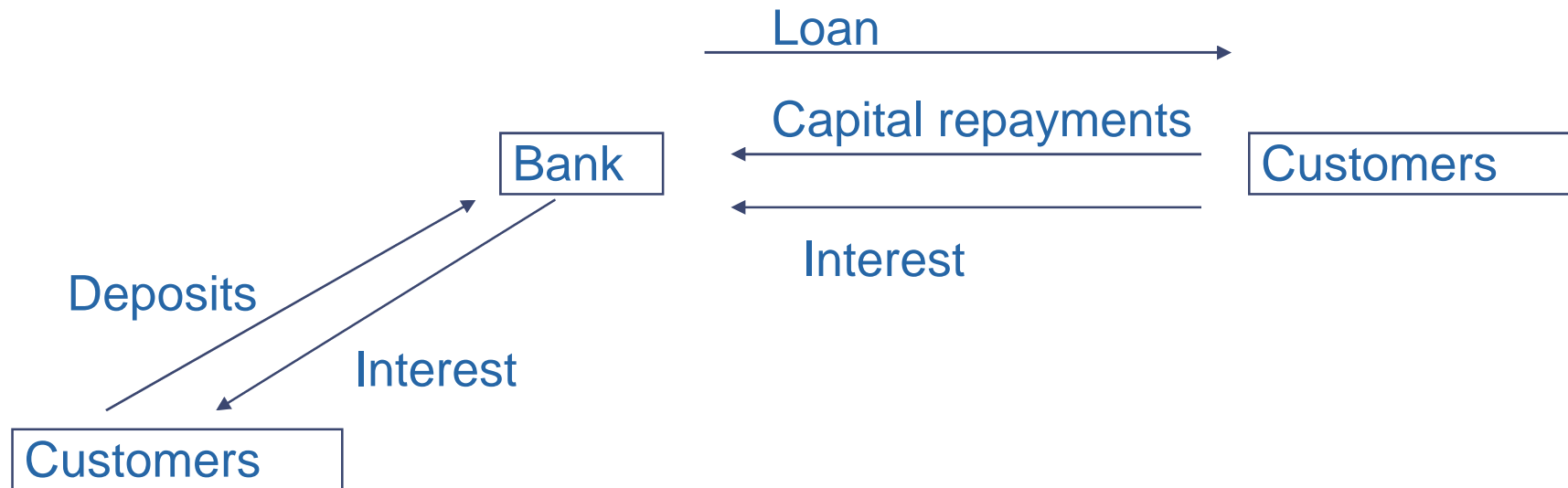
US government sponsored enterprises

Over leveraging generally

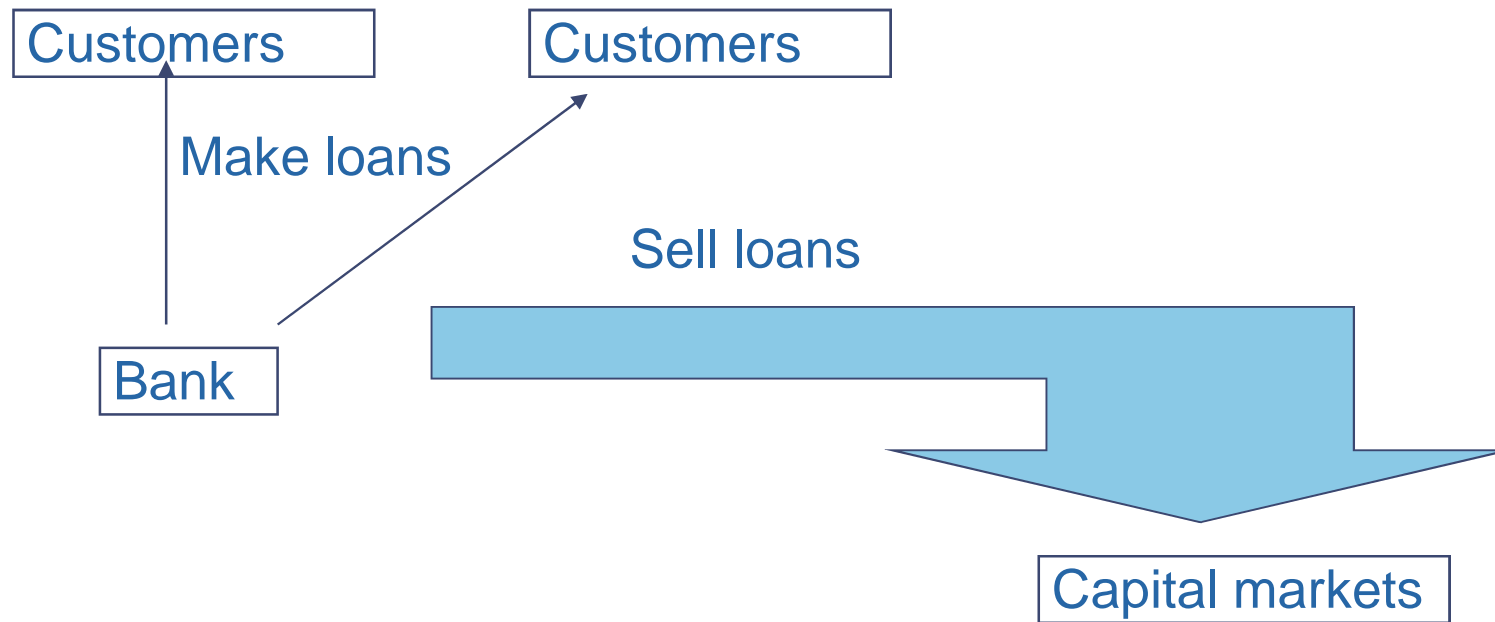
Sub-prime mortgages



Banking the old fashioned way



New banking - “originate and sell”



The role of securitisation

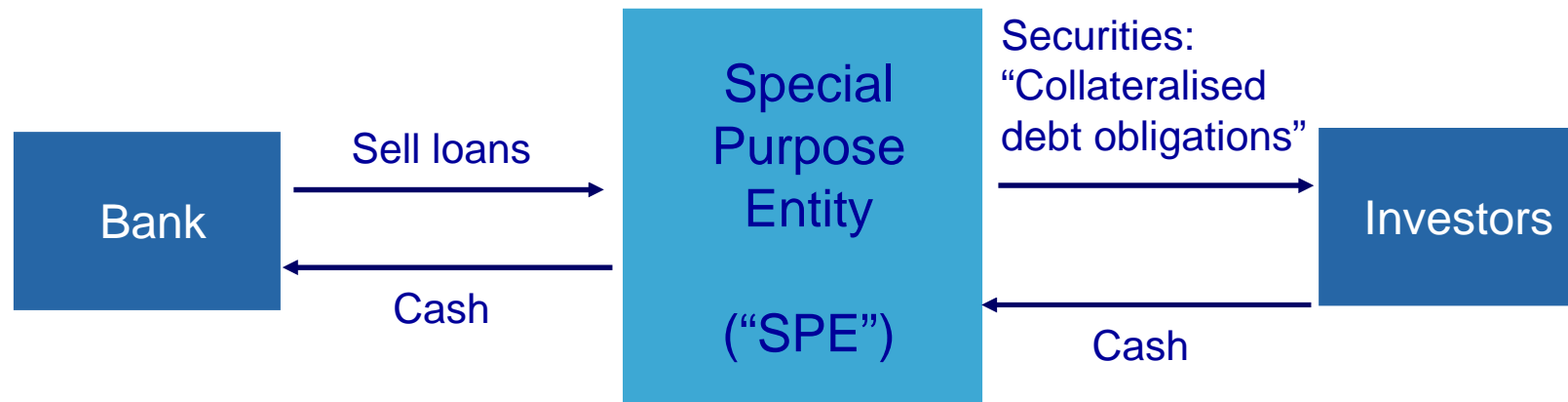
Basic securitisation

Collateralised debt obligations

CDO squared

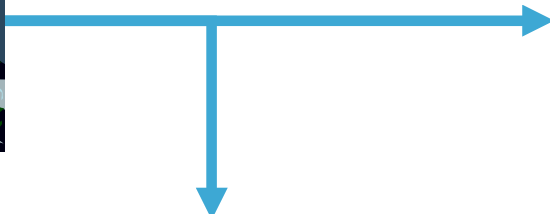
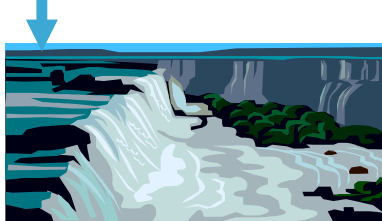
Government sponsored enterprises

Collateralised debt obligations

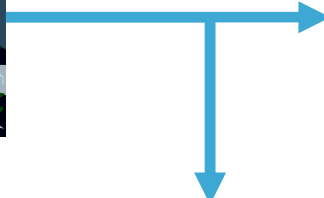


Tranching and “waterfall”

Cash in



Senior Debt 20%
AAA (3% return)

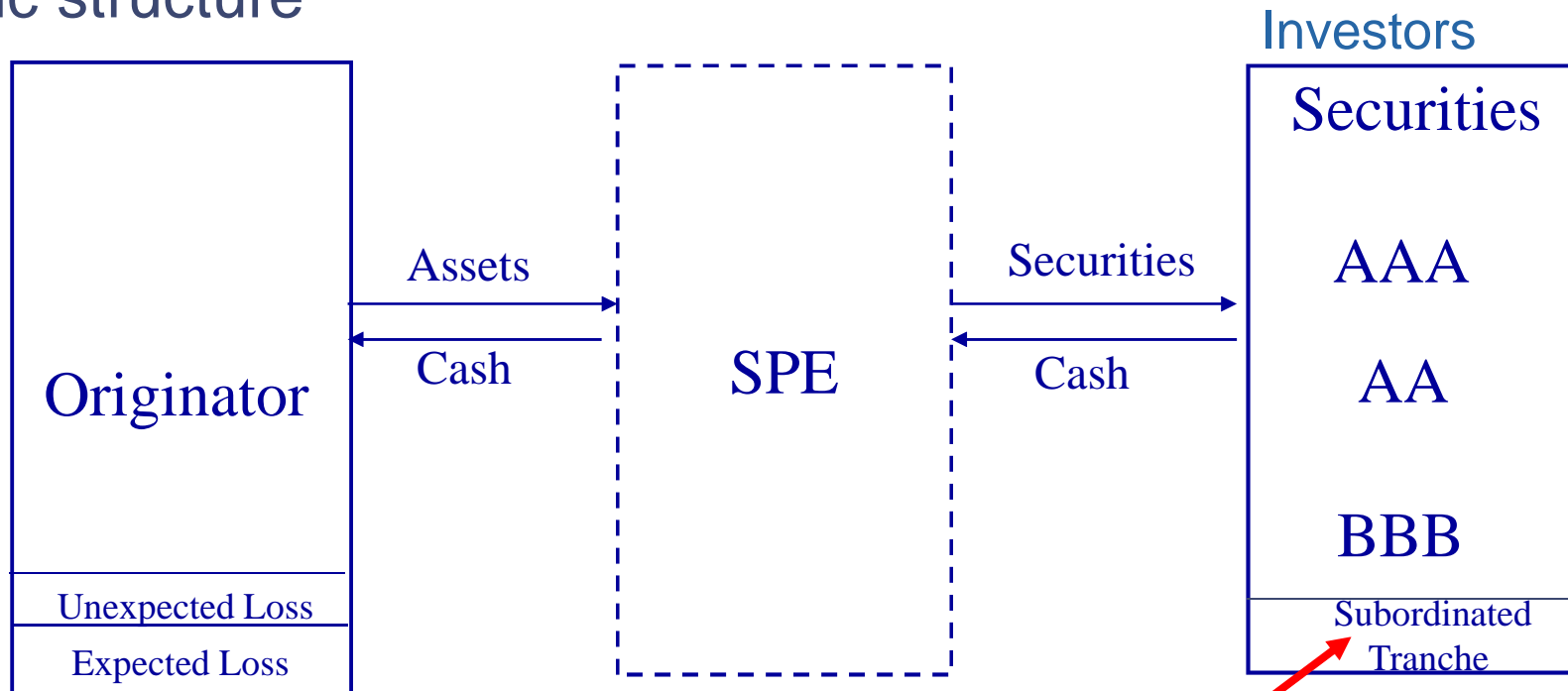


Investment Grade 60%
(4% return)



Subordinated 20%
(8% return)

Asset sale securitisation Basic structure



May be held
by originator

Why regulated entities securitise

Capital requirement for pool of bank loans:	
Pool of bank loans	
<u>£100</u>	
Bank capital required	<u>£ 8</u>

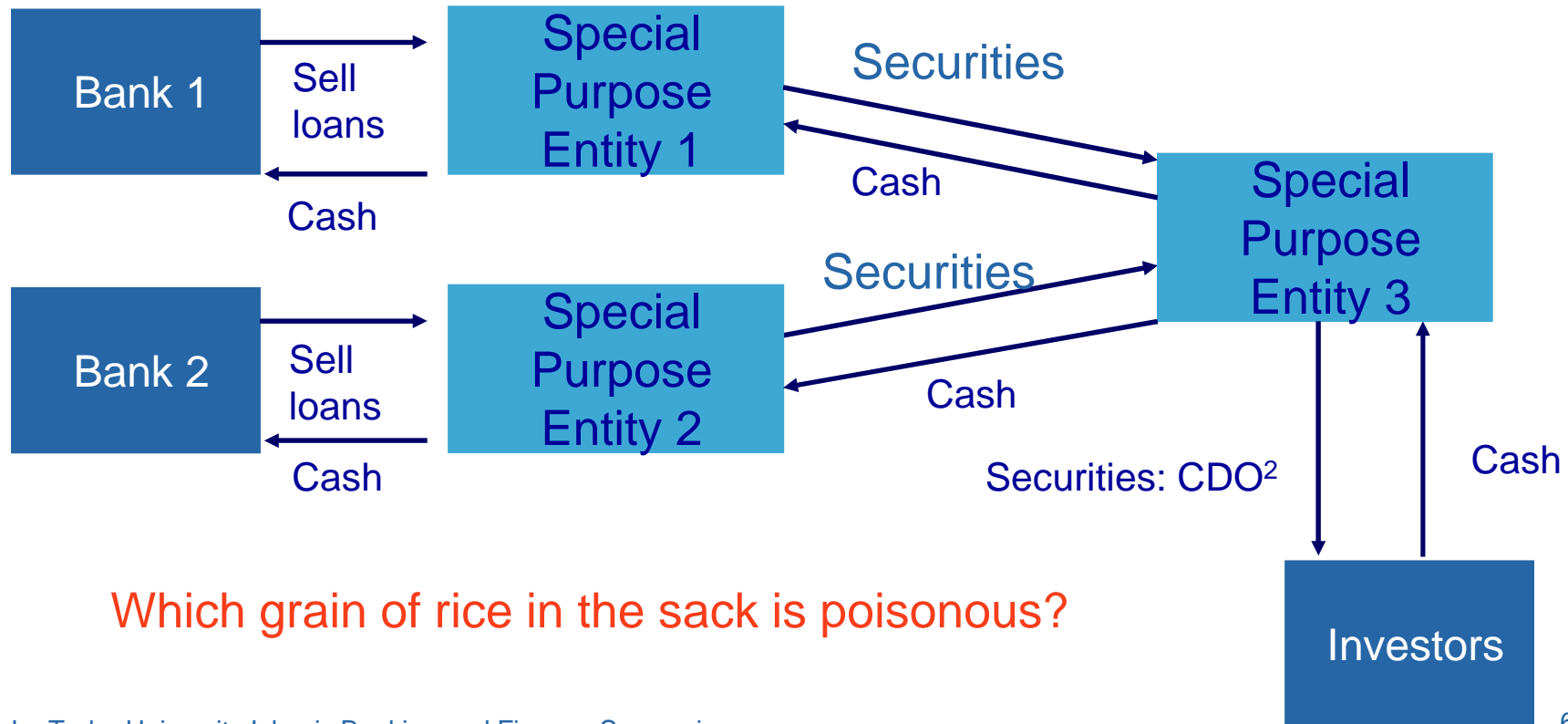
Capital requirement for credit underpinning to SPE:	
Pool of bank loans	
<u>£100</u>	
Financed by:	
Securities	£
98	
Subordinated debt	
<u>£ 2</u>	

Can a bank let its SPE's fail?

Banks bringing structured investment vehicles (SIVs) back onto balance sheet

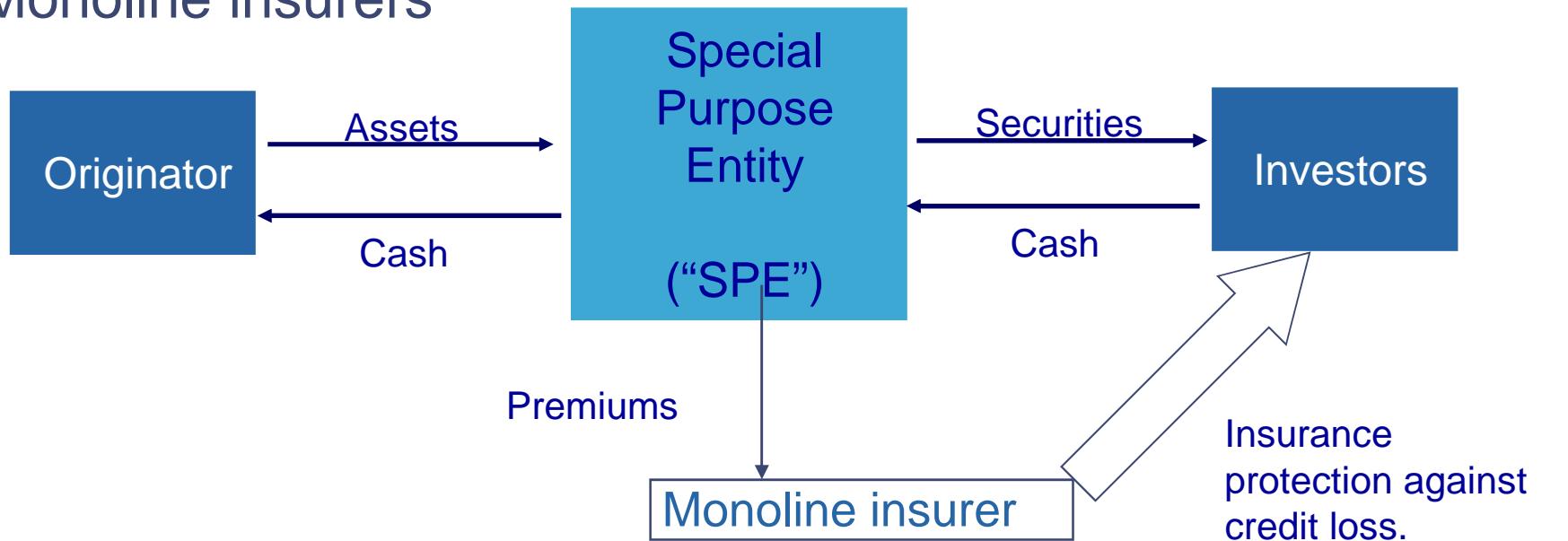
Impact on capital ratios

CDO squared



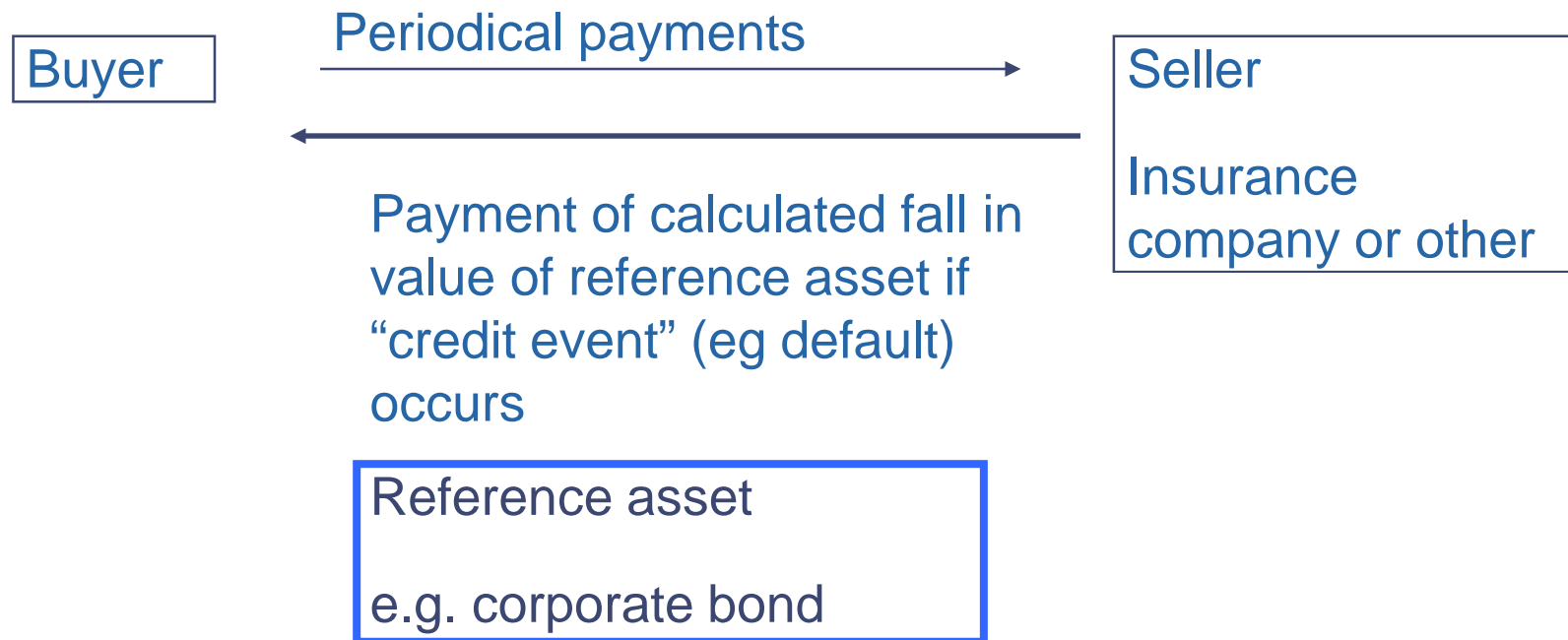
Which grain of rice in the sack is poisonous?

Monoline insurers



What happens if the monoline loses its credit rating?

Insurance companies selling credit default swaps - “CDS”



NB: Buyer need not own the reference asset

Government sponsored enterprises



Federal National Mortgage Association (Fannie Mae) total assets \$919 bn at 31 March 2009

Federal Home Loan Mortgage Corporation (Freddie Mac) \$947 bn at 31 March 2009

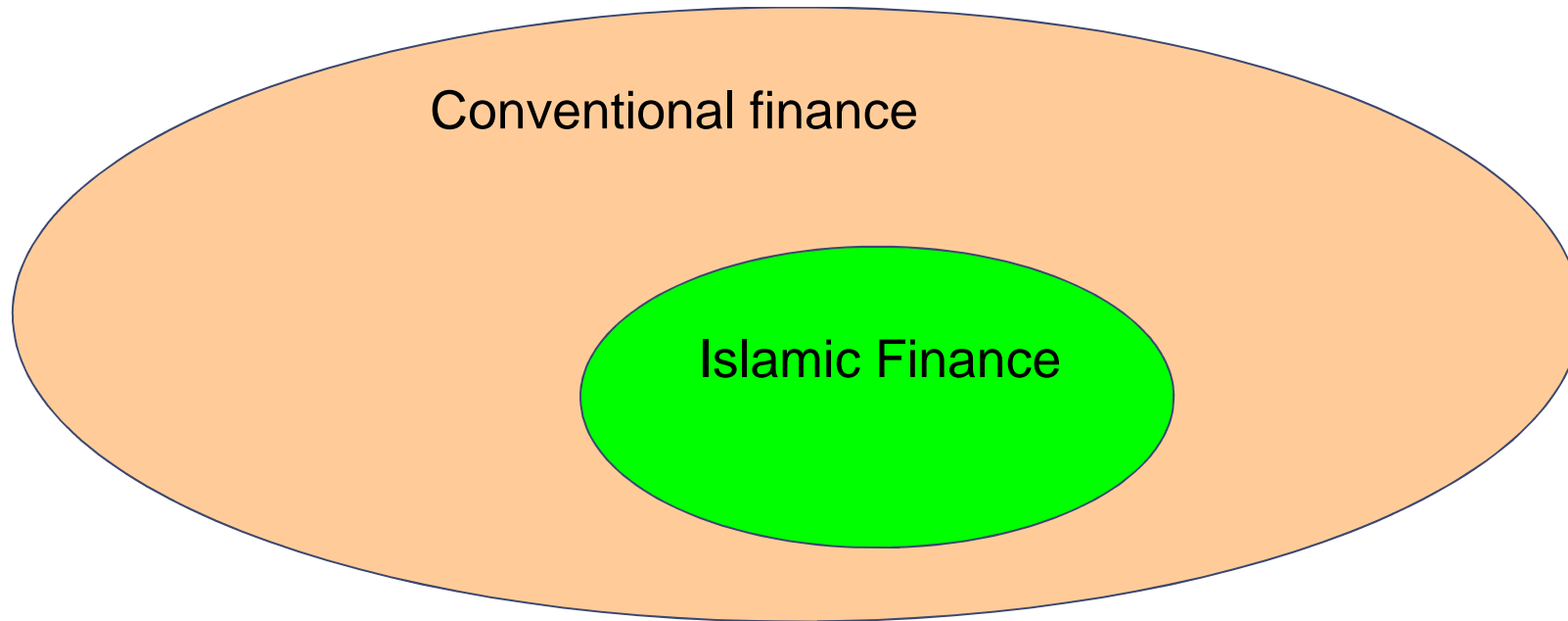
IMF forecasts \$250 billion of losses in US GSEs

Over leveraging generally

Interest tax deductible

- Private equity
- Commercial companies generally: “efficient balance sheets”

Introduction to Islamic Finance



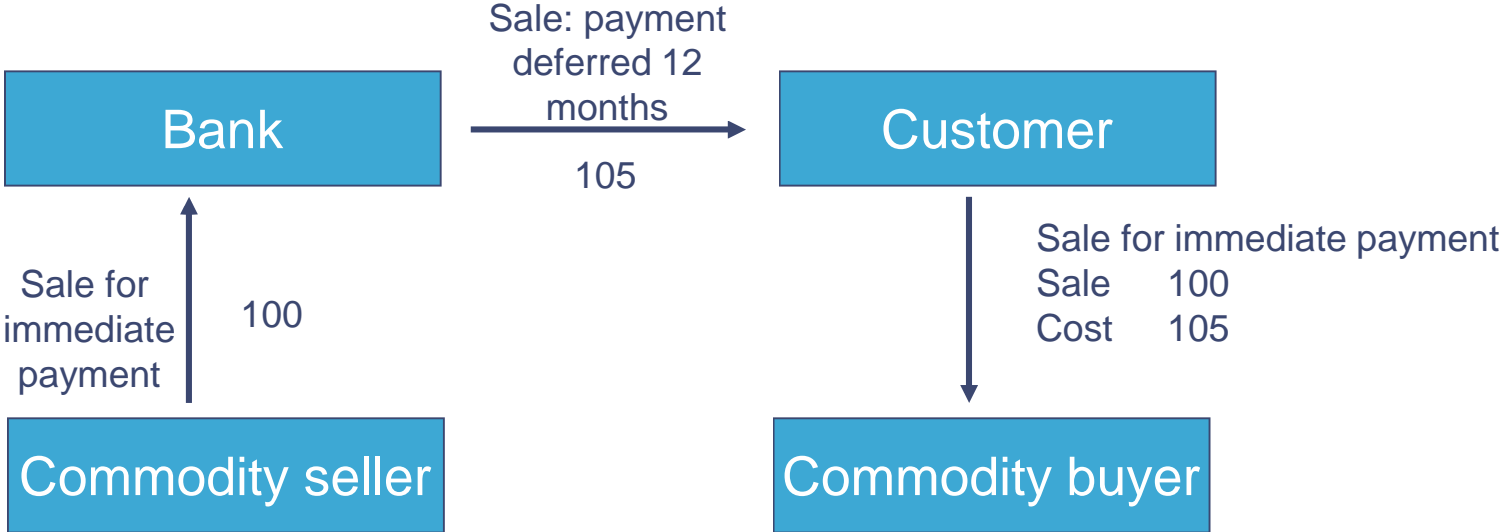
Islamic contracts with “conventional” economics

Murabaha

Ijara

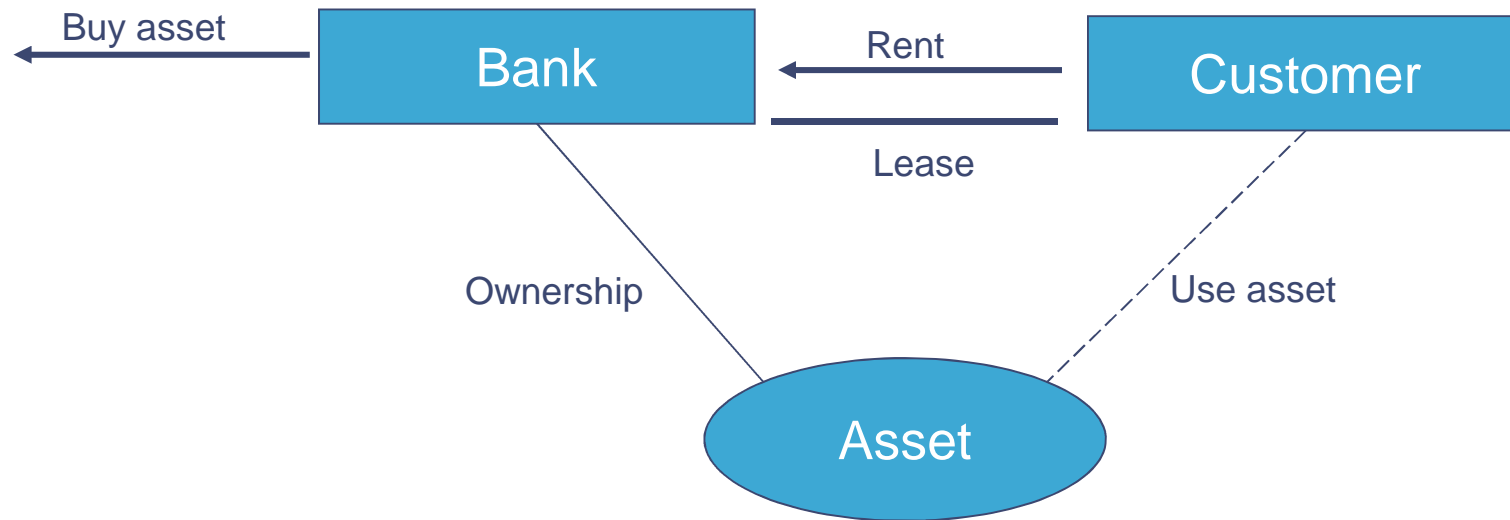
Synthesising debt

Commodity murabaha or tawarruq



Equivalent to 5% interest bearing loan by Bank to Customer

Ijara

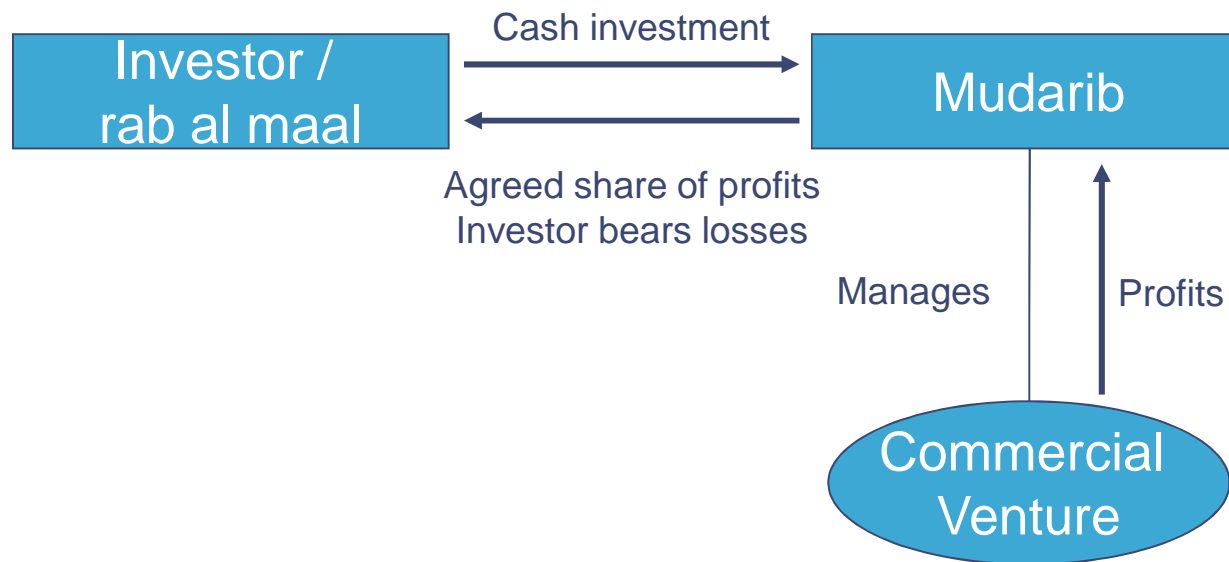


Islamic contracts with financier risk sharing

Mudaraba

Some sukuk

Mudaraba – partnership with one capital provider



Islamic bank's liabilities

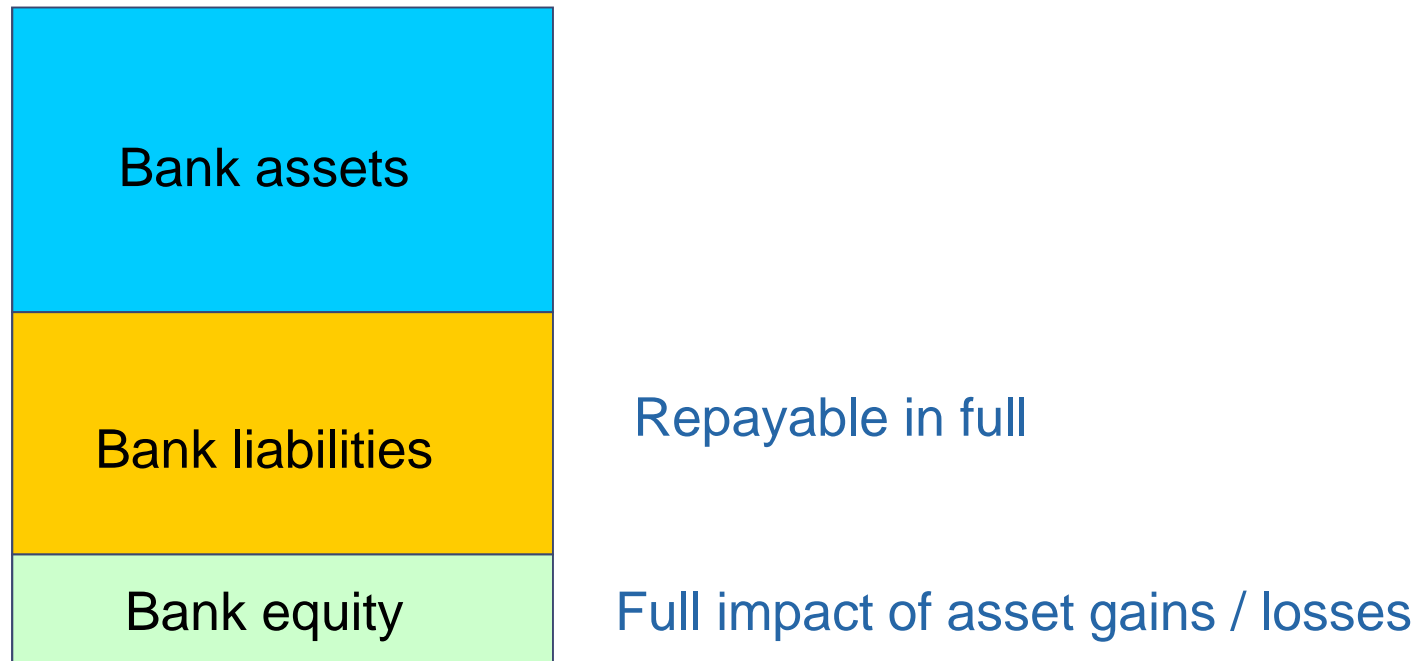
Current account

- Interest free deposit
- No return

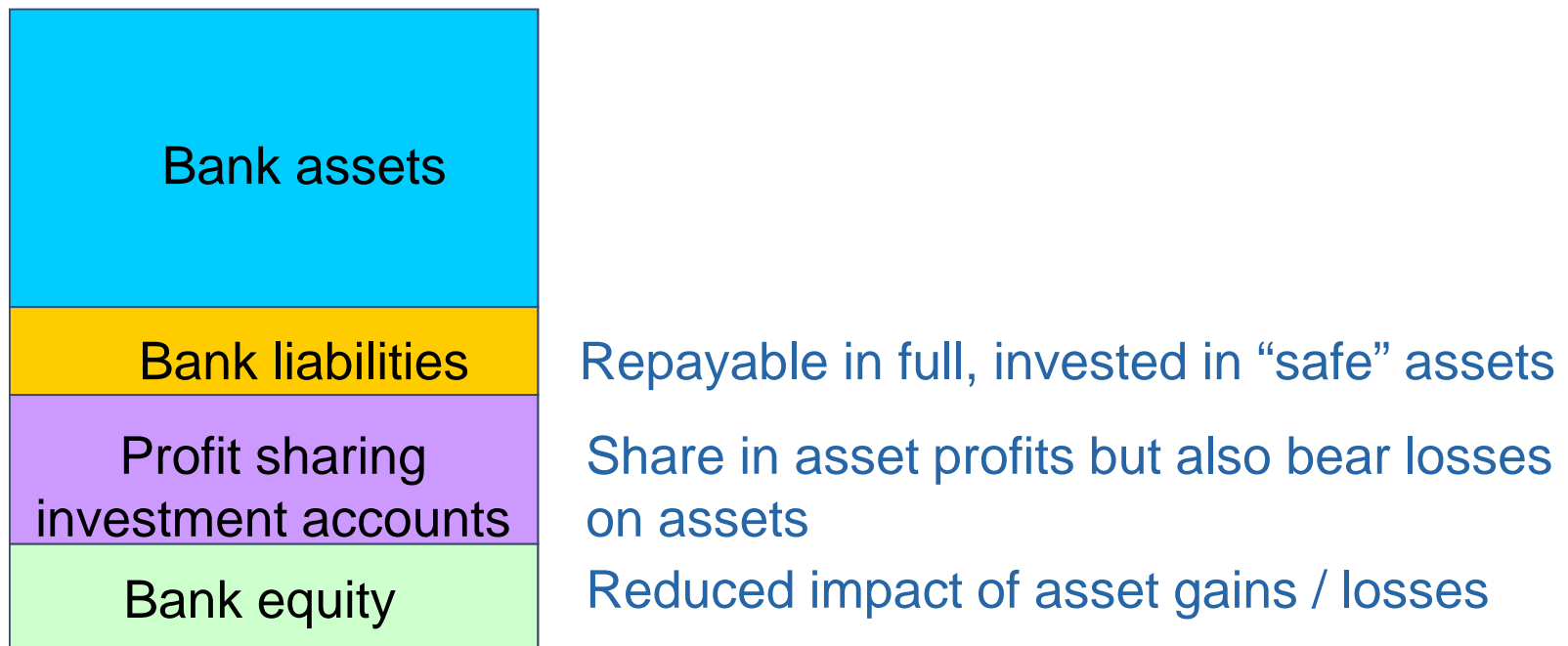
Deposit account

- Profit and loss sharing investment account (mudaraba)

Conventional bank balance sheet



Islamic bank balance sheet

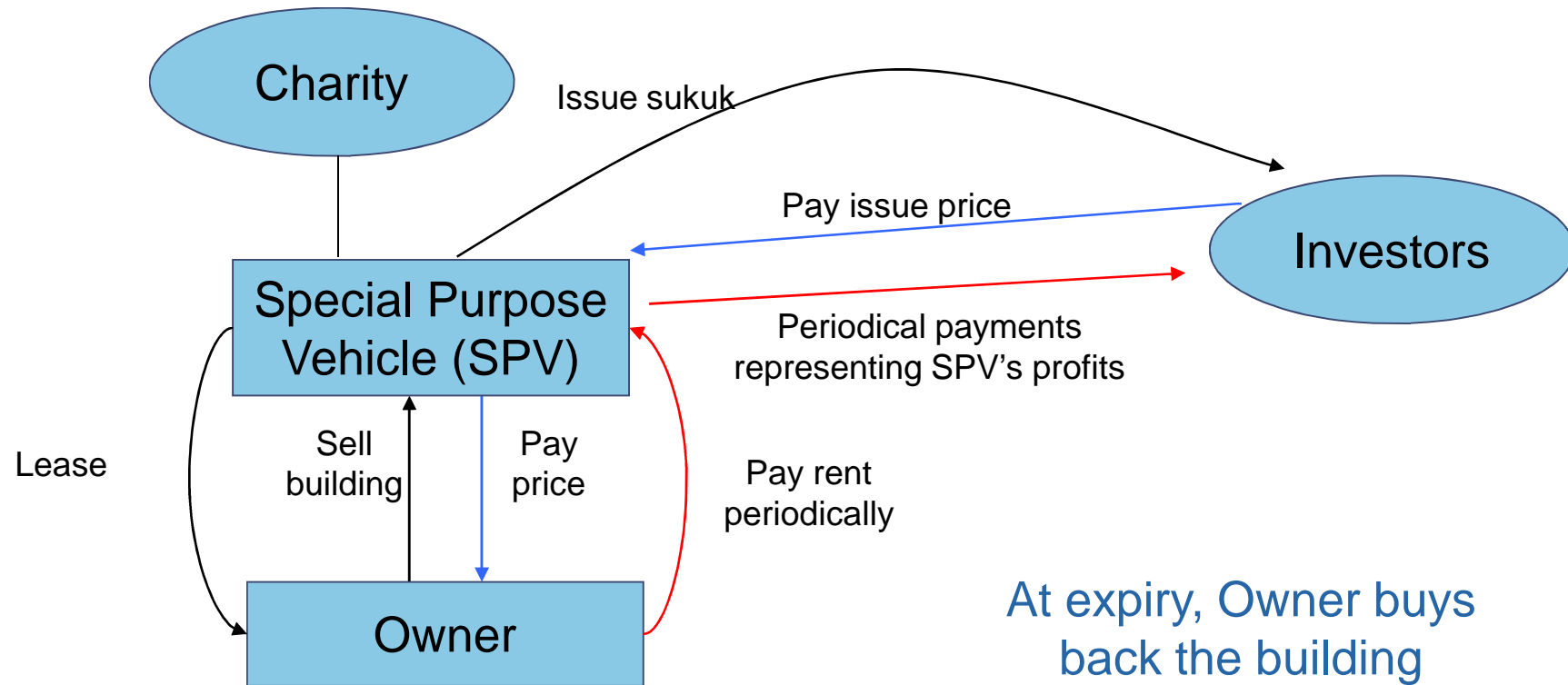


Sukuk

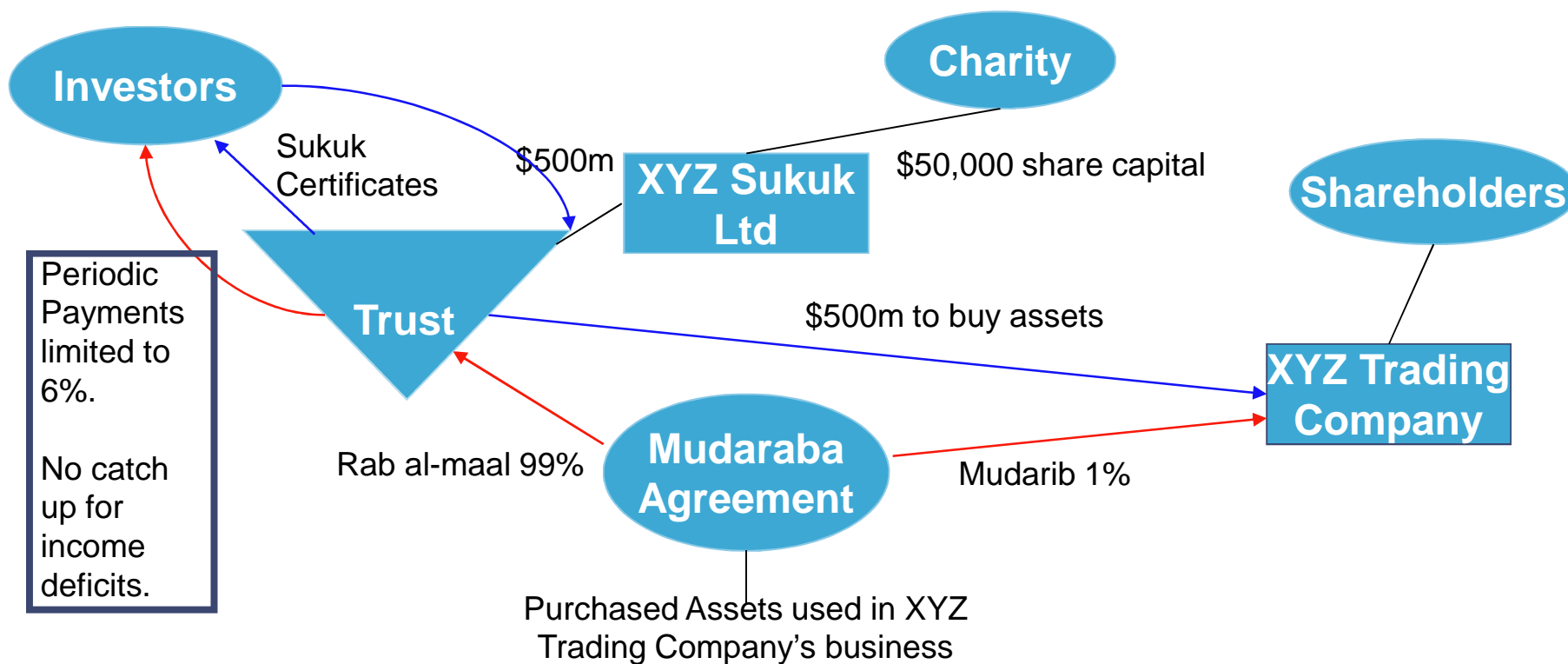
The Islamic equivalent of bonds

- Goal – replicate characteristics of conventional bonds without infringing the rules of Shariah
- No legal debt involved
- Can be bought and sold between holders of the instrument without affecting the company
- Provides finance for a fixed period of time (typically 3–5 years)
- Provides investors with a flow of regular payments without involving interest
- Usually written under New York or English law

Ijara sukuk – conventional economics



Mudaraba sukuk – risk sharing economics



What's different about Islamic finance?

Caveat emptor v requirement for ethical dealing

- Don't lend if customer should not borrow

Prohibition of debt trading

Prohibition of gharar (CDO², derivatives)

Risk sharing by PSIA holders

Risk sharing by some sukuk holders

Concluding comment

Islamic Finance distributes risk differently from conventional finance.

Many of its features would have made the global financial crisis much less likely.

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