

The Boom & Bust Cycle and Islamic Finance

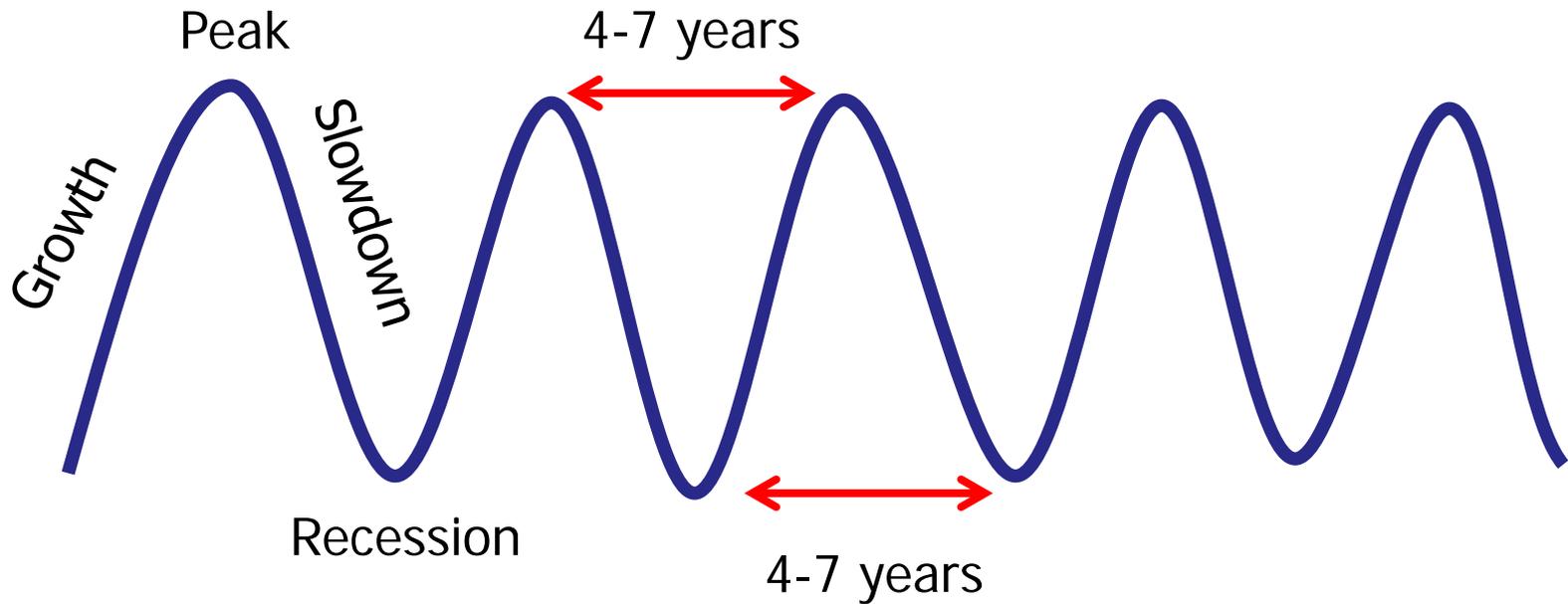
Presented by Tariq Alrifai

May 25, 2015

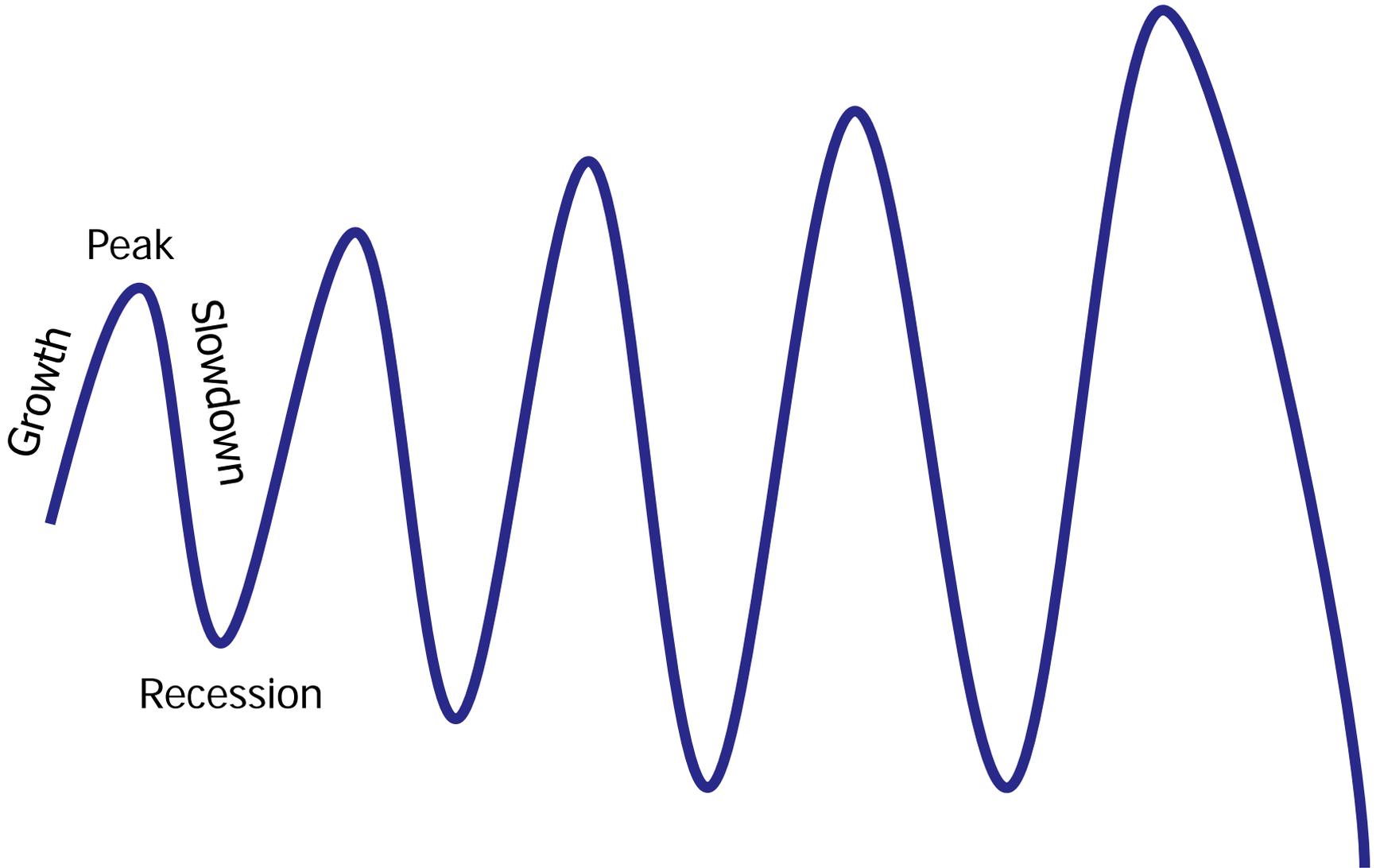
Overview

- What's going on with financial crises?
- Why are we headed for another crisis?
- Won't central banks be able to save us again?
- What does this all mean?
- What are the solutions?

The Economic Cycle



The Economic Cycle



The financial crisis cycle and its increasing severity

2015 ???

2008 Global Financial Crisis

2001 Dotcom Bubble

1997 Asian Financial Crisis

1994 Mexican Peso Crisis & Bond Crisis (Tequila Crisis)

1987 Black Monday (Global Stock Crash)

1980 2nd Oil Shock (Iranian Revolution / Iran-Iraq War)

1973 1st Oil Shock (OPEC embargo)

Why are financial crises
increasing in severity?

What were the problems cited for causing the financial crisis and were they fixed?

1. Easy credit and subprime borrowers
2. Too-big-to-fail banks
3. Too much debt
4. Complex derivatives

1. Easy credit and subprime borrowers

“Emerging debt sales hit surprise record in 2013, outlook upbeat”

Reuters, December 4, 2013 .

“Warning signs flash for junk-bond investors”

USA Today, May 18, 2014 .

“Special Report: How the Fed fueled an explosion in subprime auto loans”

Reuters, April 3, 2013 .

“Auto loan delinquencies rise as subprime lending gains steam”

Fortune, August 20, 2014 .

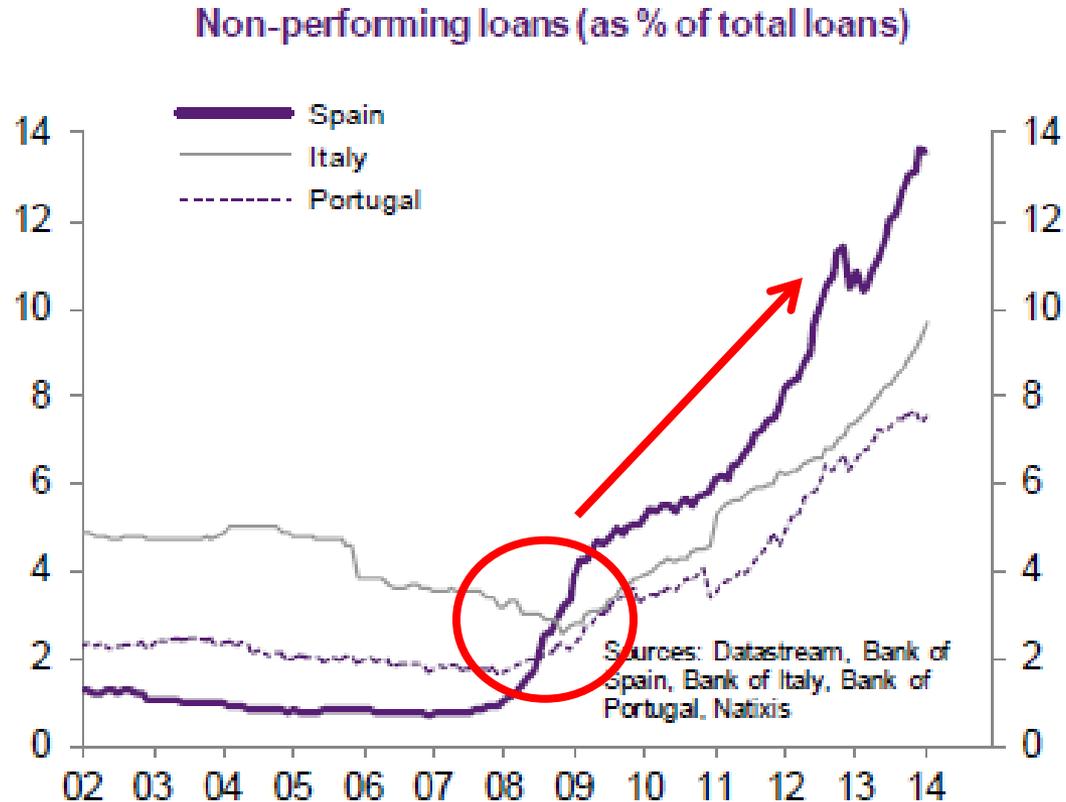
“US Student Debt Reaches \$1.1 Trillion, Surpasses Credit Card Debt And Auto Loans”

International Business Times, May 13, 2014 .

“The Next Big Bailout: Student Loans”

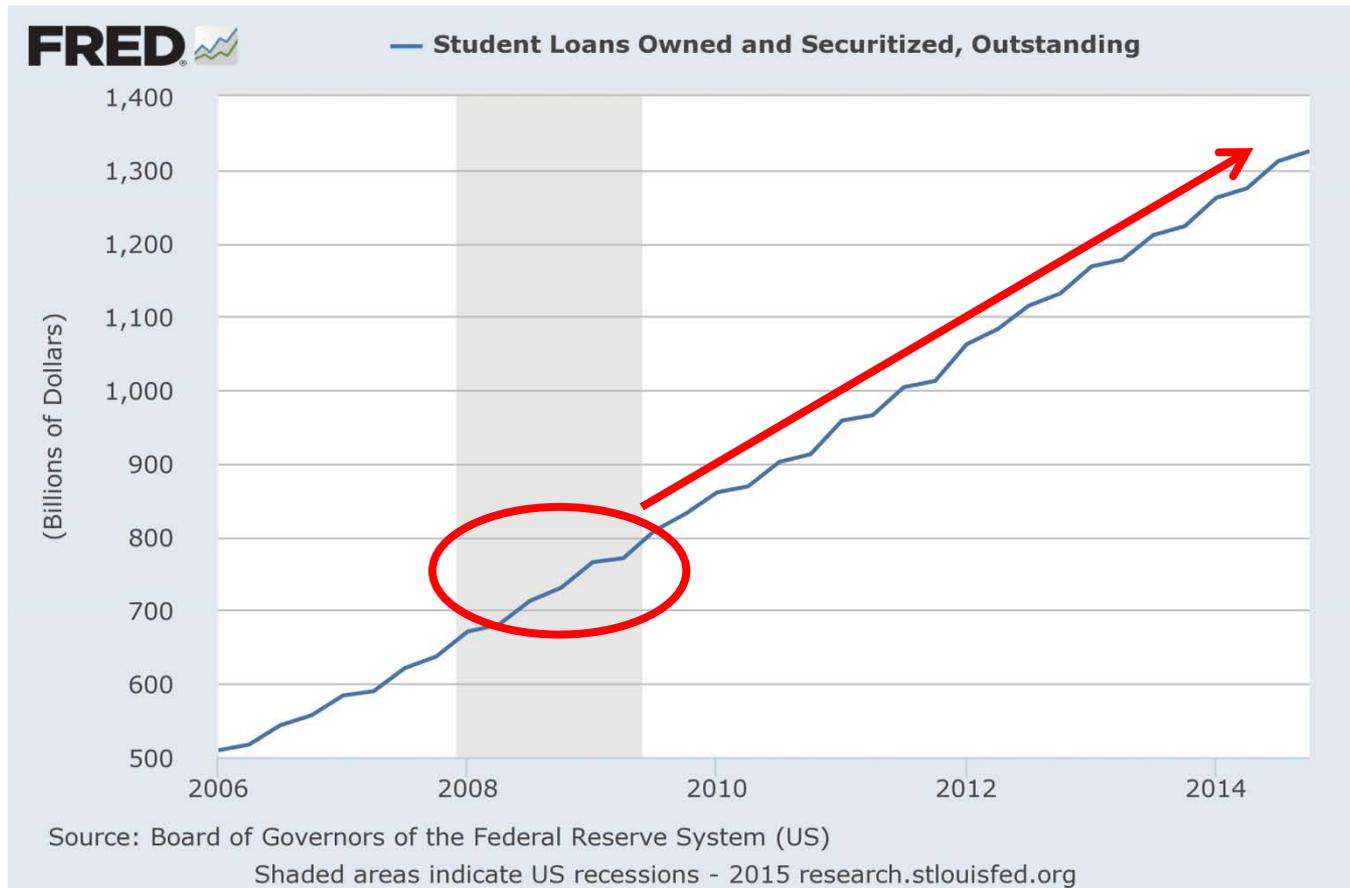
Fox Business, June 3, 2014 .

1. Easy credit and subprime borrowers



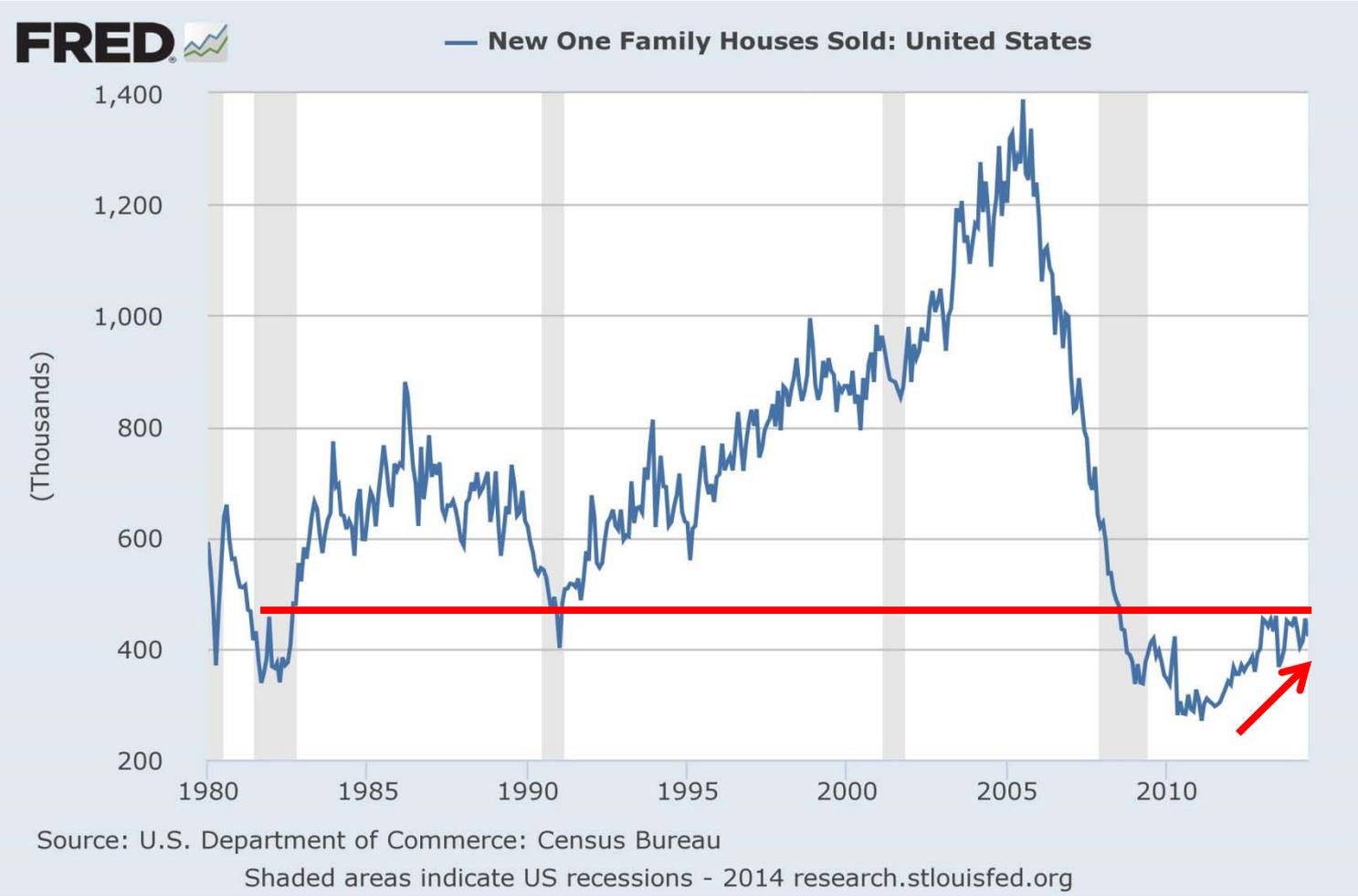
Source: Datastream, Bank of Spain, Bank of Italy, Bank of Portugal, Natixis

1. Easy credit and subprime borrowers



Source: Federal Reserve Bank of St. Louis.

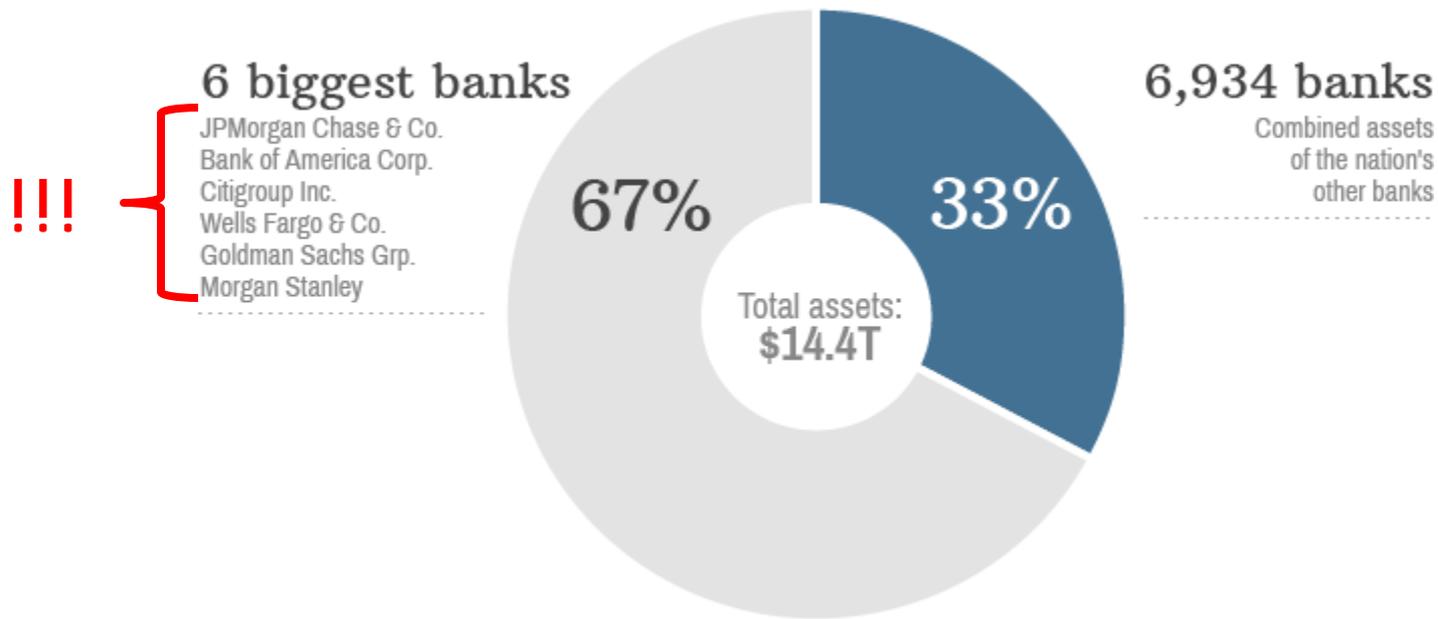
1. Easy credit and subprime borrowers



Source: Federal Reserve Bank of St. Louis.

2. Too-big-to-fail banks

Top US bank holding companies by assets



NOTE: TOTAL BANKING ASSETS INCLUDES TOTAL ASSETS OF ALL COMMERCIAL BANKS, SAVINGS BANKS, SAVINGS INSTITUTIONS. THIS DOES NOT REPRESENT TOTAL BANK HOLDING COMPANY ASSETS. AS OF JUNE 30; SOURCE: SNL FINANCIAL

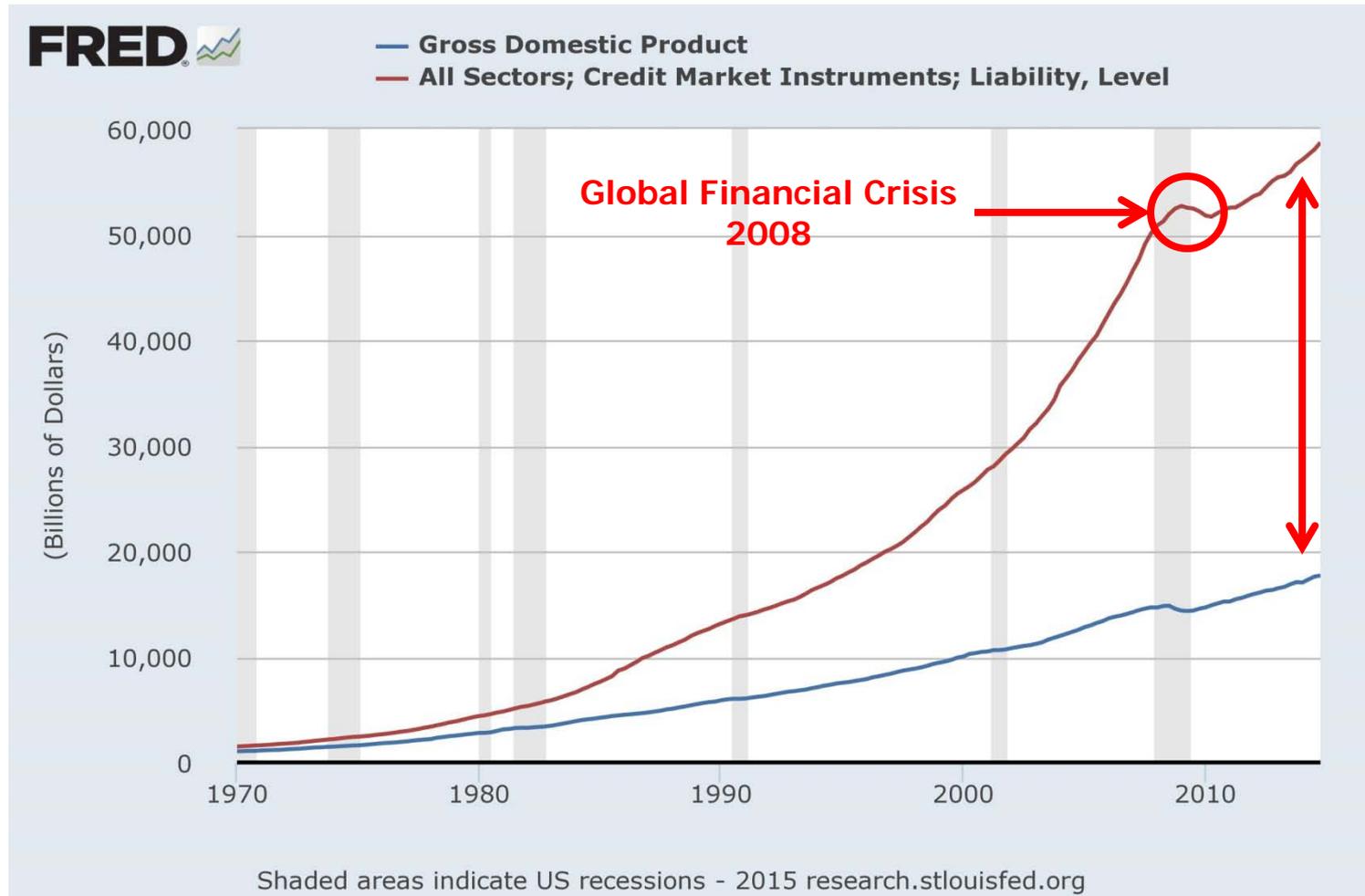
Source: CNN Money, September 2013

2. Too-big-to-fail banks

Scandals and Fraud:

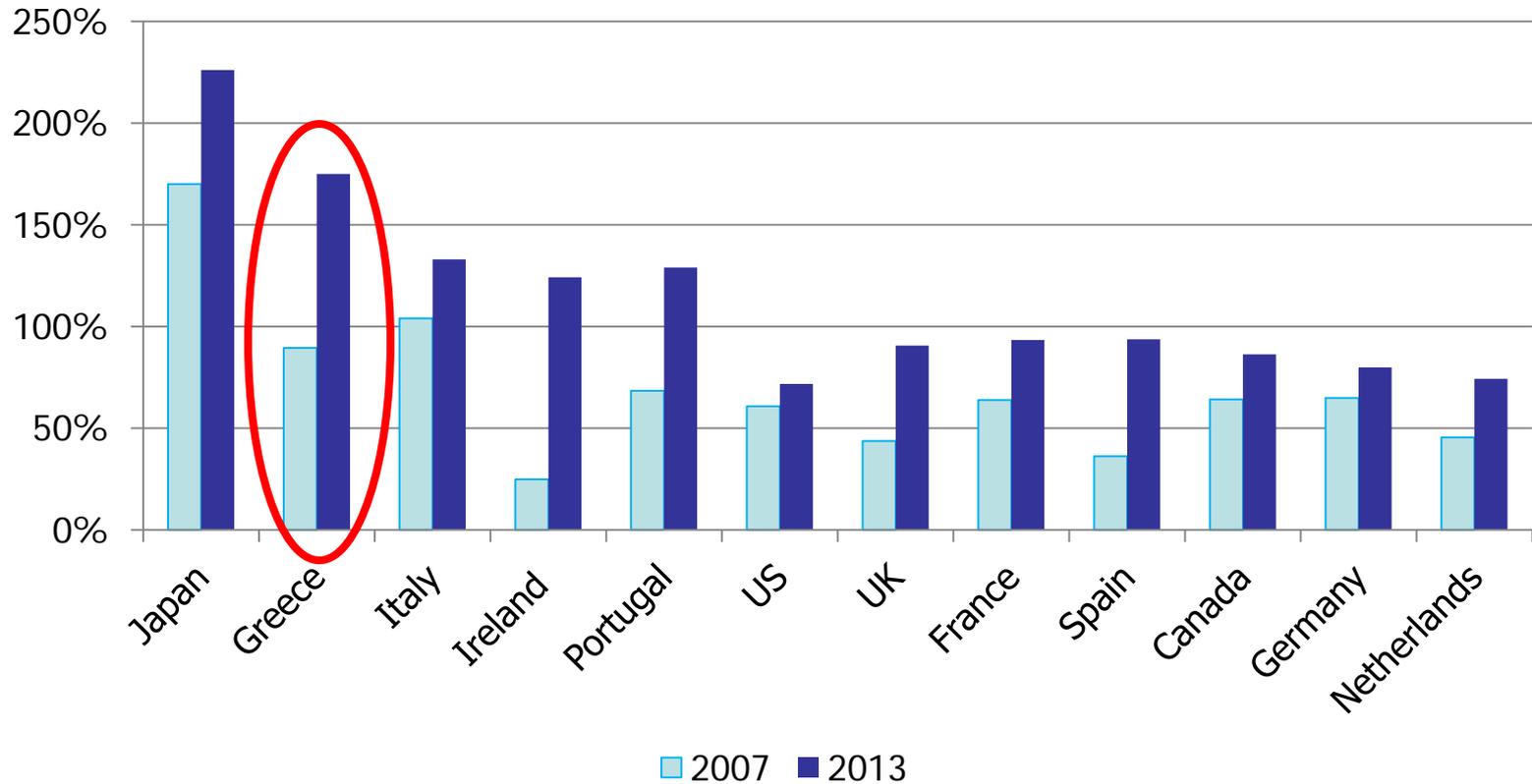
1. Misleading investors in subprime debt
2. Money laundering
3. LIBOR scandal
4. Forex scandal
5. Gold manipulation scandal

3. Too much debt



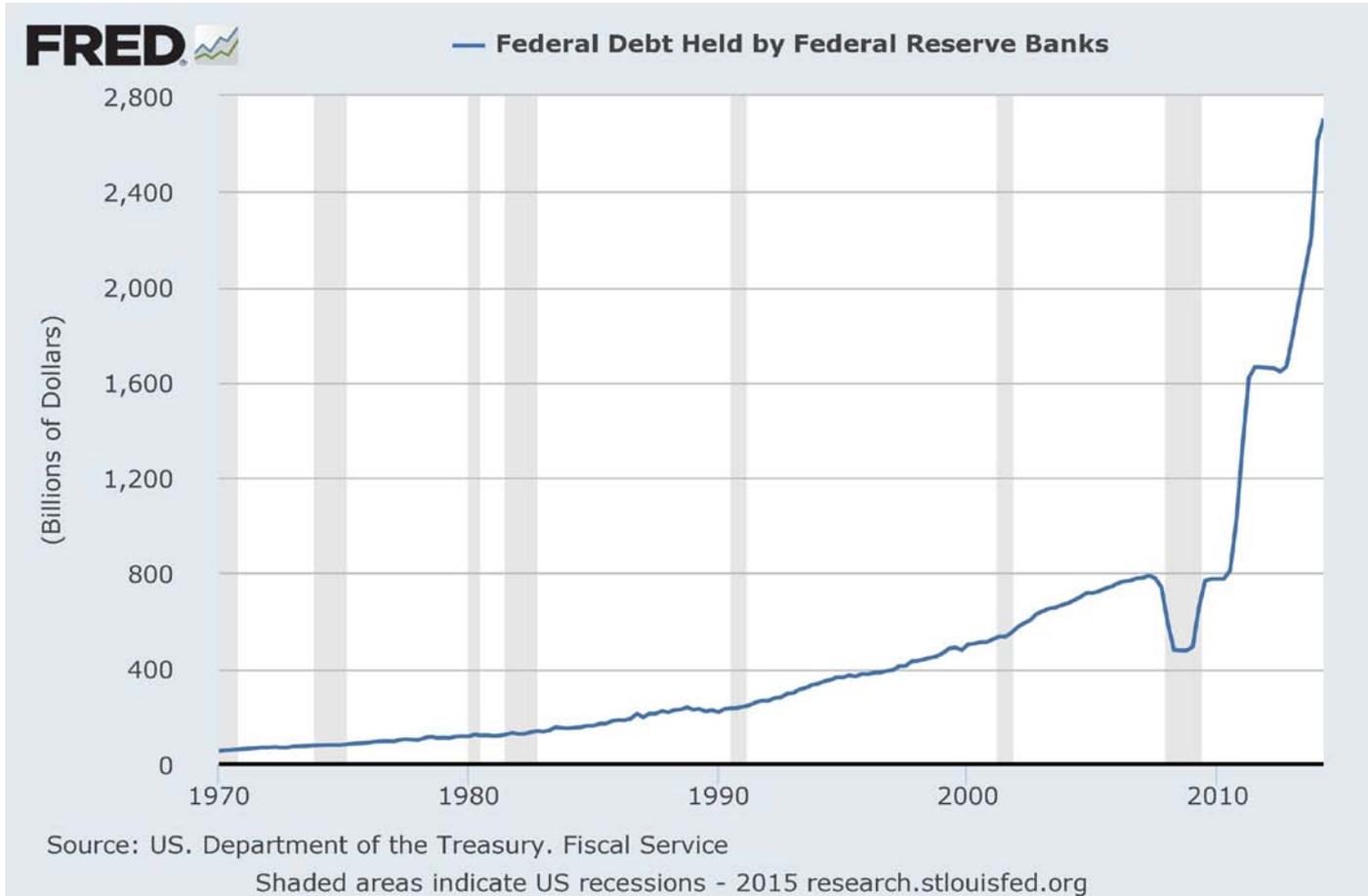
Source: Federal Reserve Bank of St. Louis.

3. Too much debt



Government debt to GDP ratios
Source: Bloomberg

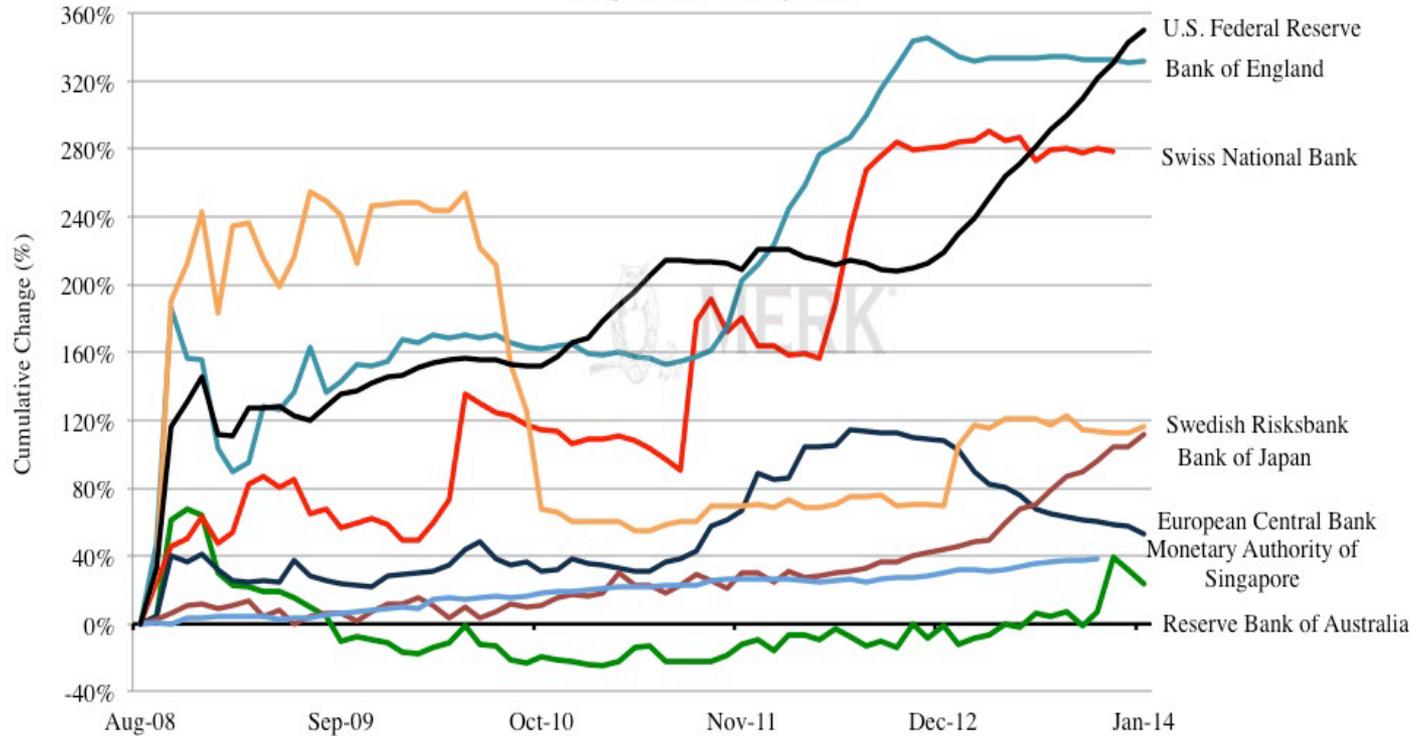
3. Too much debt



Source: Federal Reserve Bank of St. Louis.

3. Too much debt

Cumulative Change in Central Bank Balance Sheets
(August 2008 - January 2014)



Source: Merk Investments, U.S. Fed, ECB, BOE, BOJ, MAS, SNB, RBA, Riksbank

© Merk Investments LLC

Source: Merk Investments LLC

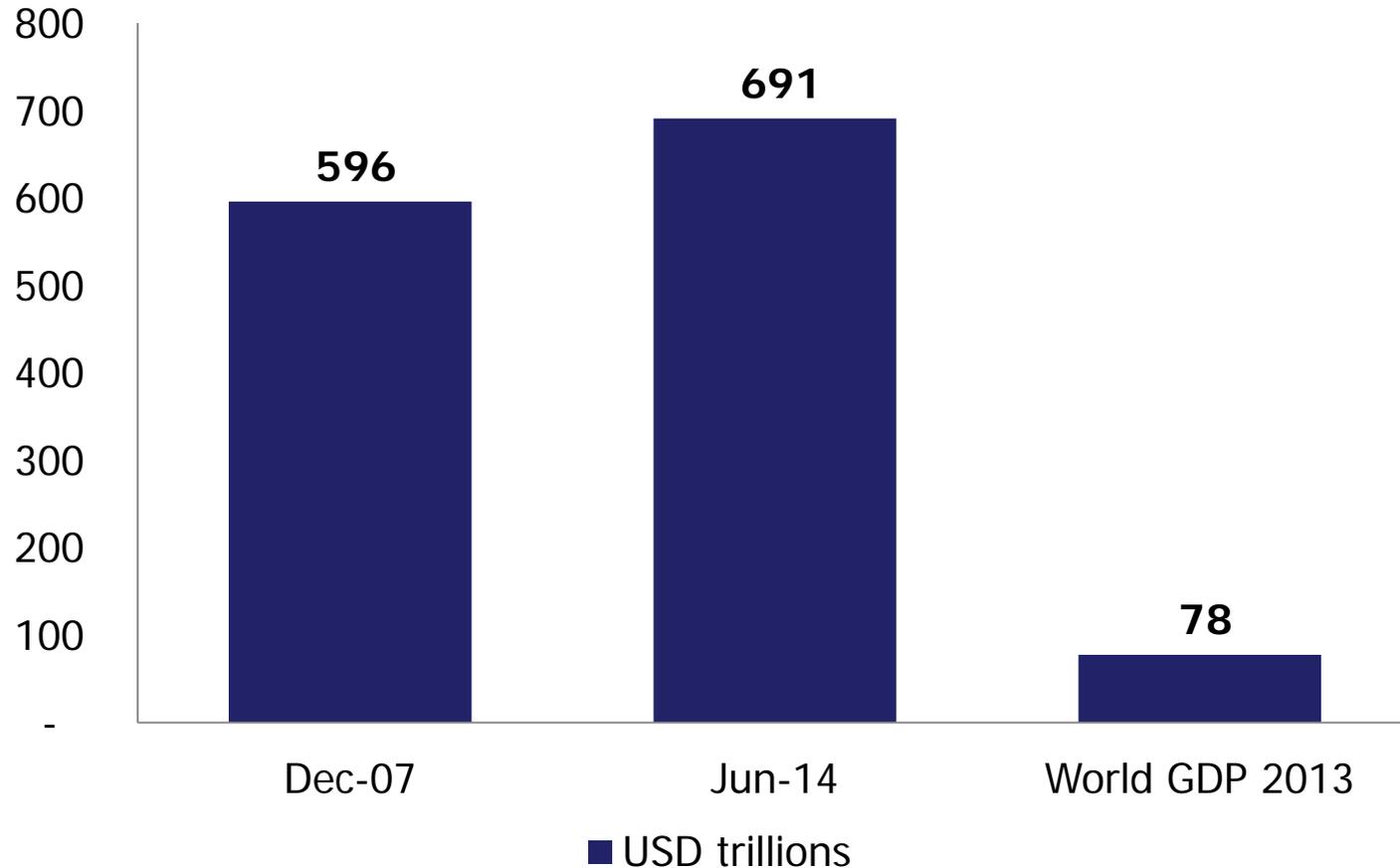
4. Complex derivatives

Definition:

"A derivative, put simply, is a contract between two parties whose value is determined by changes in the value of an underlying asset. Those assets could be bonds, equities, commodities or currencies. The majority of contracts are traded over the counter, where details about pricing, risk measurement and collateral, if any, are not available to the public."

- New York Institute of Finance.

Derivatives are making the system more unstable



Source: Bank for International Settlements and the IMF

Example: Deutsche Bank derivatives exposure

Deutsche Bank
Financial Report 2014

1 – Management Report
Risk Report
Credit Exposure

111

Notional amounts and gross market values of derivative transactions

Dec 31, 2014

Notional amount maturity distribution

in € m.	Within 1 year	> 1 and ≤ 5 years	After 5 years	Total	Positive market value	Negative market value	Net market value
Interest rate related:							
OTC	16,193,068	13,319,460	8,081,916	37,594,443	439,519	413,696	25,823
Exchange-traded	3,253,648	841,043	714	4,095,406	152	152	(1)
Total Interest rate related	19,446,716	14,160,503	8,082,630	41,689,849	439,671	413,849	25,822
Currency related:							
OTC	4,783,759	1,307,251	609,549	6,700,559	130,775	134,567	(3,792)
Exchange-traded	12,428	103	0	12,531	55	106	(51)
Total Currency related	4,796,187	1,307,354	609,549	6,713,090	130,829	134,673	(3,844)
Equity/index related:							

Source: Deutsche Bank 2014 Annual Report

Example: Deutsche Bank derivatives exposure

Notional amounts and gross market values of derivative transactions				
Dec 31, 2014		Notional amount maturity distribution		
in € m.	Within 1 year	> 1 and ≤ 5 years	After 5 years	Total
Interest rate related:				
OTC	16,193,068	13,319,460	8,081,916	37,594,443
Exchange-traded	3,253,648	841,043	714	4,095,406
Total Interest rate related	19,446,716	14,160,503	8,082,630	41,689,849
Currency related:				
OTC	4,783,759	1,307,251	609,549	6,700,559
Exchange-traded	12,428	103	0	12,531
Total Currency related	4,796,187	1,307,354	609,549	6,713,090
Equity/index related:				
OTC	1,203,958	203,328	35,678	1,442,964
Exchange-traded	499,899	71,213	4,240	575,353
Total Equity/index related	1,703,857	274,542	39,919	2,018,317
Credit derivatives	337,245	935,967	119,549	1,392,760
Commodity related:				
OTC	13,708	2,549	7,115	23,371
Exchange-traded	89,656	22,218	66	111,939
Total Commodity related	103,364	24,766	7,181	135,311
Other:				
OTC	34,340	8,945	0	43,285
Exchange-traded	9,186	1,037	0	10,223
Total Other	43,526	9,982	0	53,509
Total OTC business	22,566,078	15,777,500	8,853,806	47,197,384
Total exchange-traded business	3,864,818	935,614	5,021	4,805,453
Total	26,430,896	16,713,114	8,858,826	52,002,836
Positive market values after netting and cash collateral received				

52,002,836

€ millions

Source: Deutsche Bank 2014 Annual Report

Example: Deutsche Bank derivatives exposure

Balance Sheet

Assets in € m.	Dec 31, 2014	Dec 31, 2013
Cash and due from banks	20,055	17,155
Interest-earning deposits with banks	63,518	77,984
Central bank funds sold and securities purchased under resale agreements	17,796	27,363
Securities borrowed	25,834	20,870
Financial assets at fair value through profit or loss		
Trading assets	195,681	210,070
Positive market values from derivative financial instruments	629,958	504,590
Financial assets designated at fair value through profit or loss	117,285	184,597
Total financial assets at fair value through profit or loss	942,924	899,257
Financial assets available for sale	64,297	48,326
Equity method investments	4,143	3,581
Loans	405,612	376,582
Property and equipment	2,909	4,420
Goodwill and other intangible assets	14,951	13,932
Other assets	137,980	112,539
Assets for current tax	1,819	2,322
Deferred tax assets	6,865	7,071
Total assets	1,708,703	1,611,400

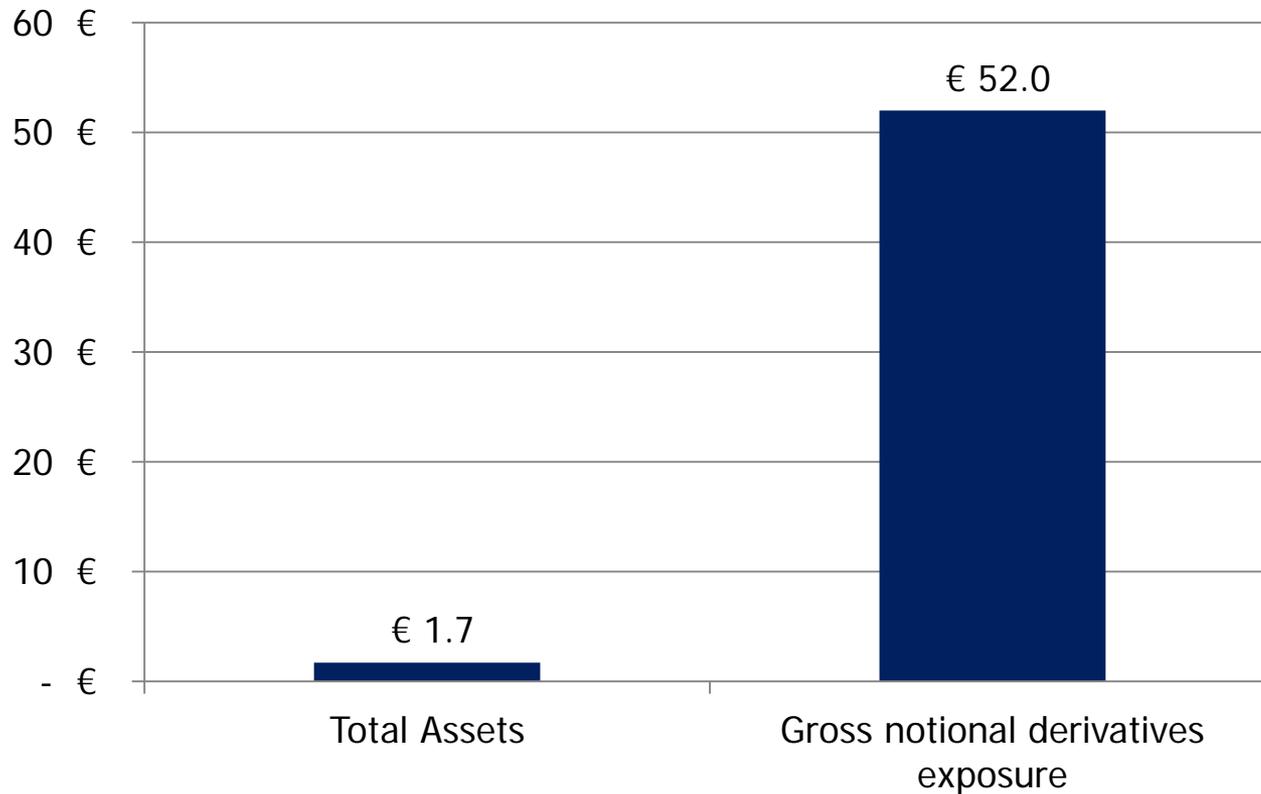
1,708,703

€ millions

1,708,703

Source: Deutsche Bank 2014 Annual Report

Example: Deutsche Bank derivatives exposure



Amounts are in trillions of Euros

Source: Deutsche Bank 2014 Annual Report

The problems of the 2008 financial crisis and how they are in 2015

1. Easy credit and subprime borrowers (**BIGGER**)
2. Too-big-to-fail banks (**BIGGER**)
3. Too much debt (**BIGGER**)
4. Complex derivatives (**BIGGER**)

Central Banks to the rescue?

The world's leading central banks have established zero interest rate and inflation targets with the stated objectives of:

1. Stimulating trade and economic growth
2. Reducing the cost of debt and the debt burden
3. Discourage savings and encourage spending

Stated inflation targets:

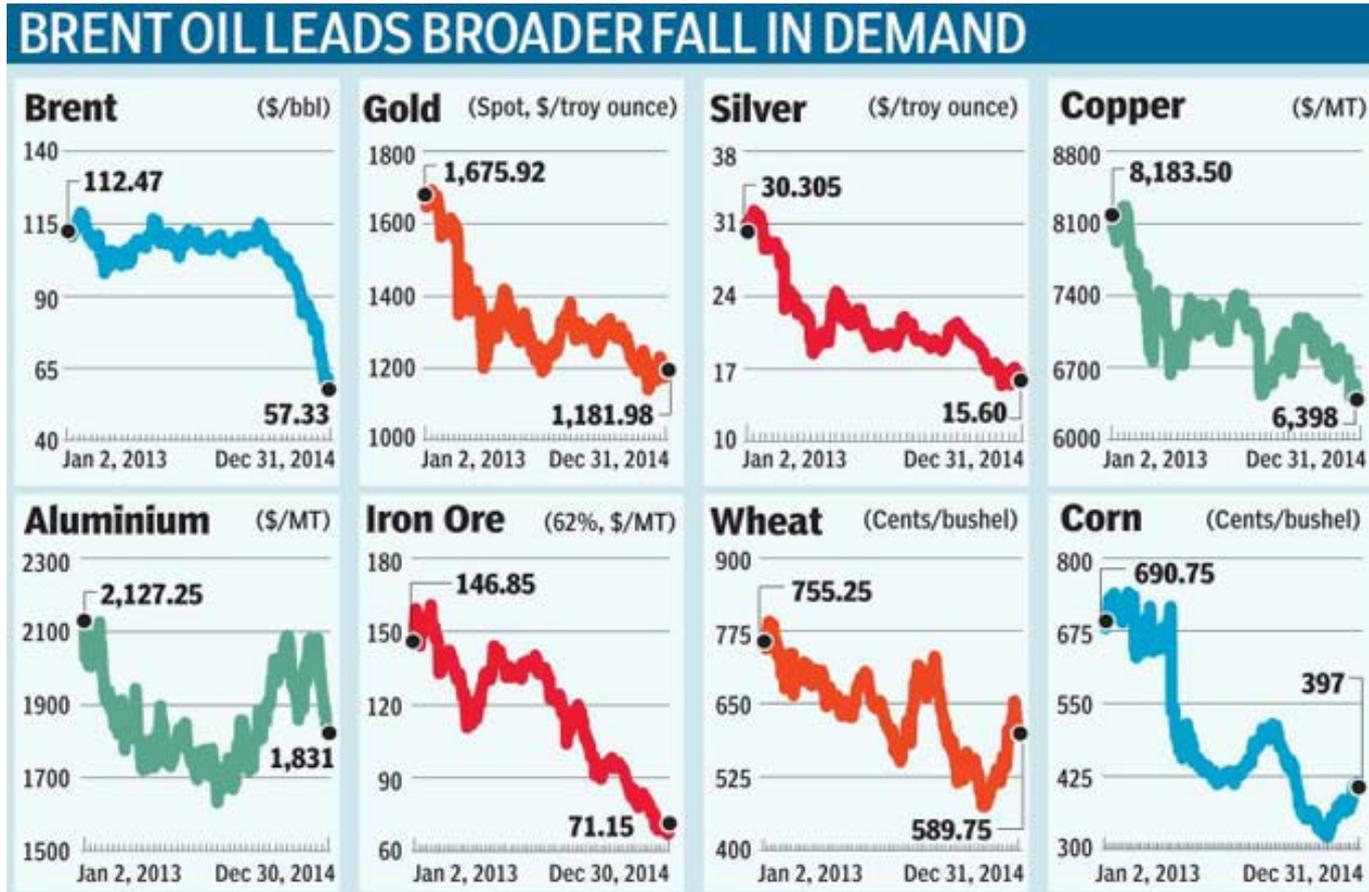
- U.S. Federal Reserve (Fed): 2%
- European Central Bank (ECB): Close to but below 2%
- Bank of Japan (BOJ): 2% by April 2015

Central Banks to the rescue?



Source: Zerohedge

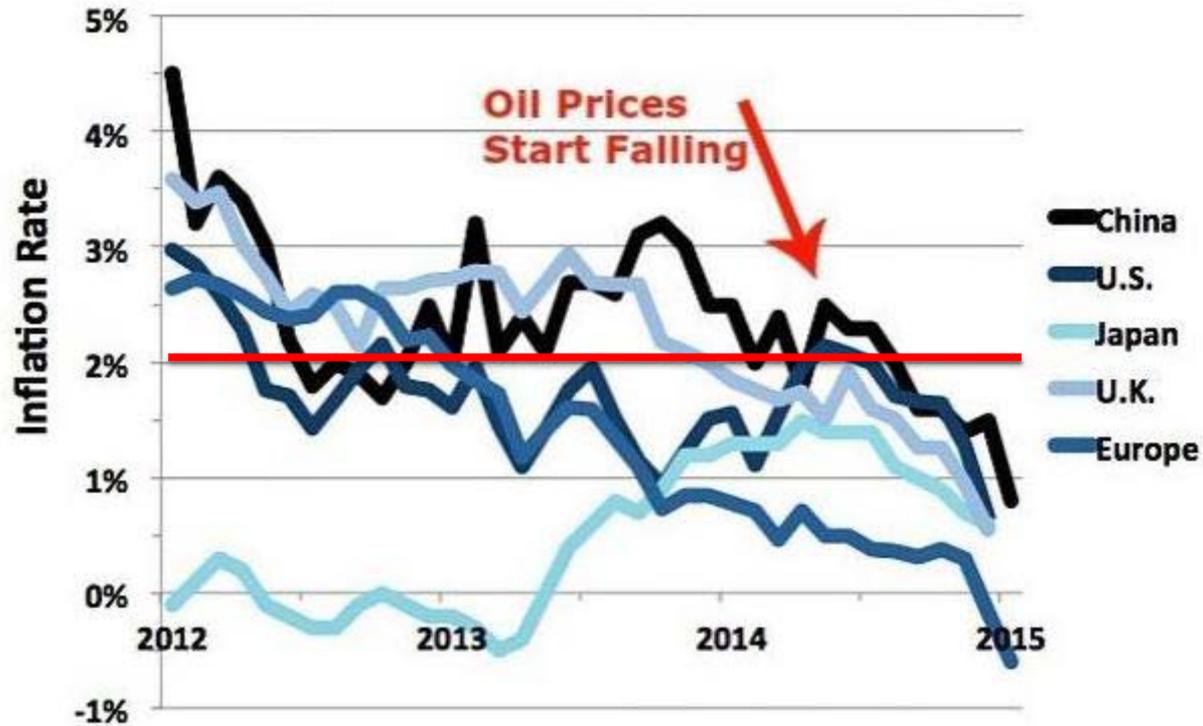
Central Banks to the rescue?



Source: Wall Street Journal

Central Banks to the rescue?

Inflation Is Dead: It's Below 1% Everywhere



Source: Federal Reserve, National Bureau of Statistics of China, Statistics Bureau of Japan

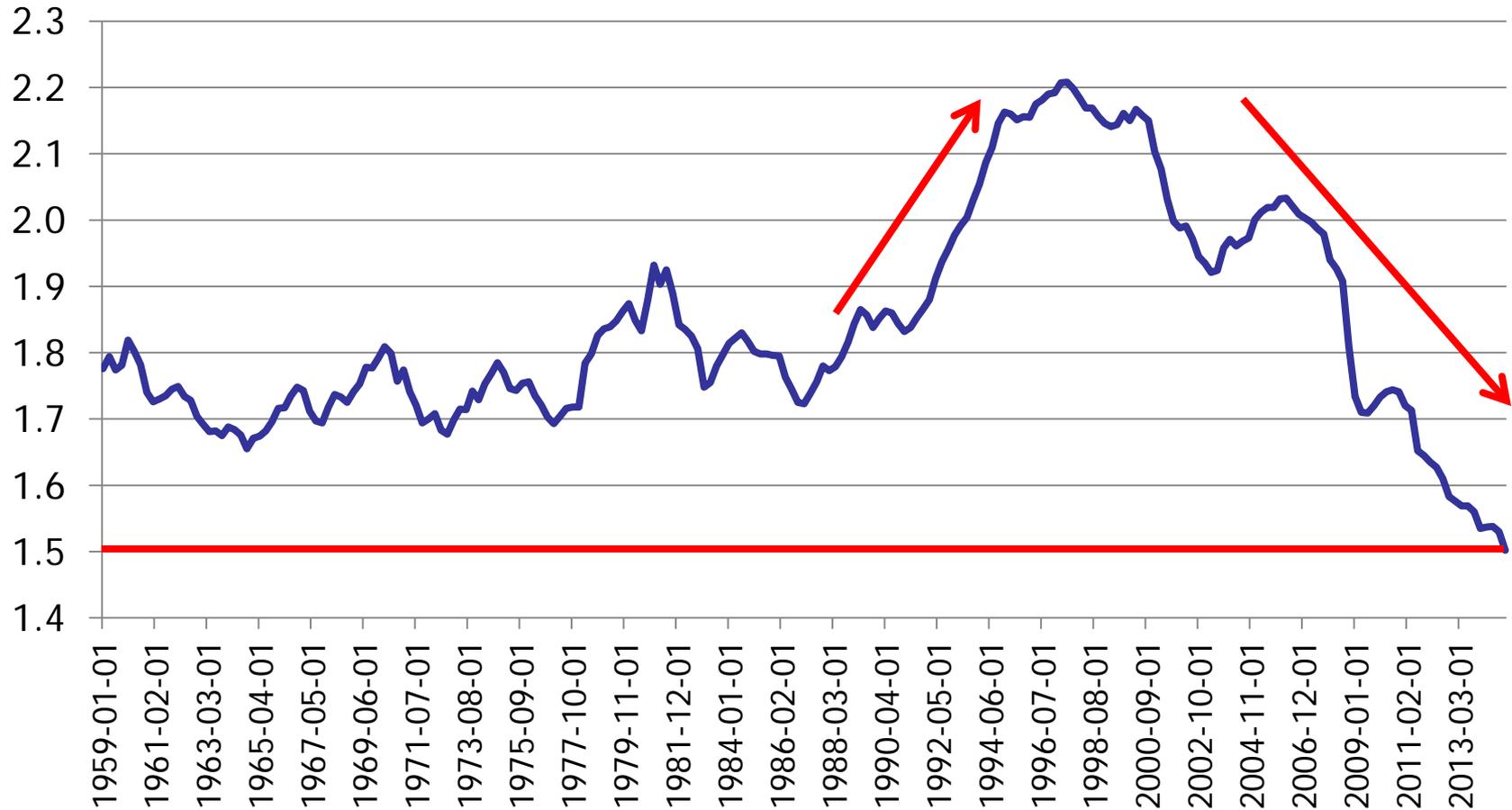
Central Banks to the rescue?



Source: Wall Street Journal

Central Banks to the rescue?

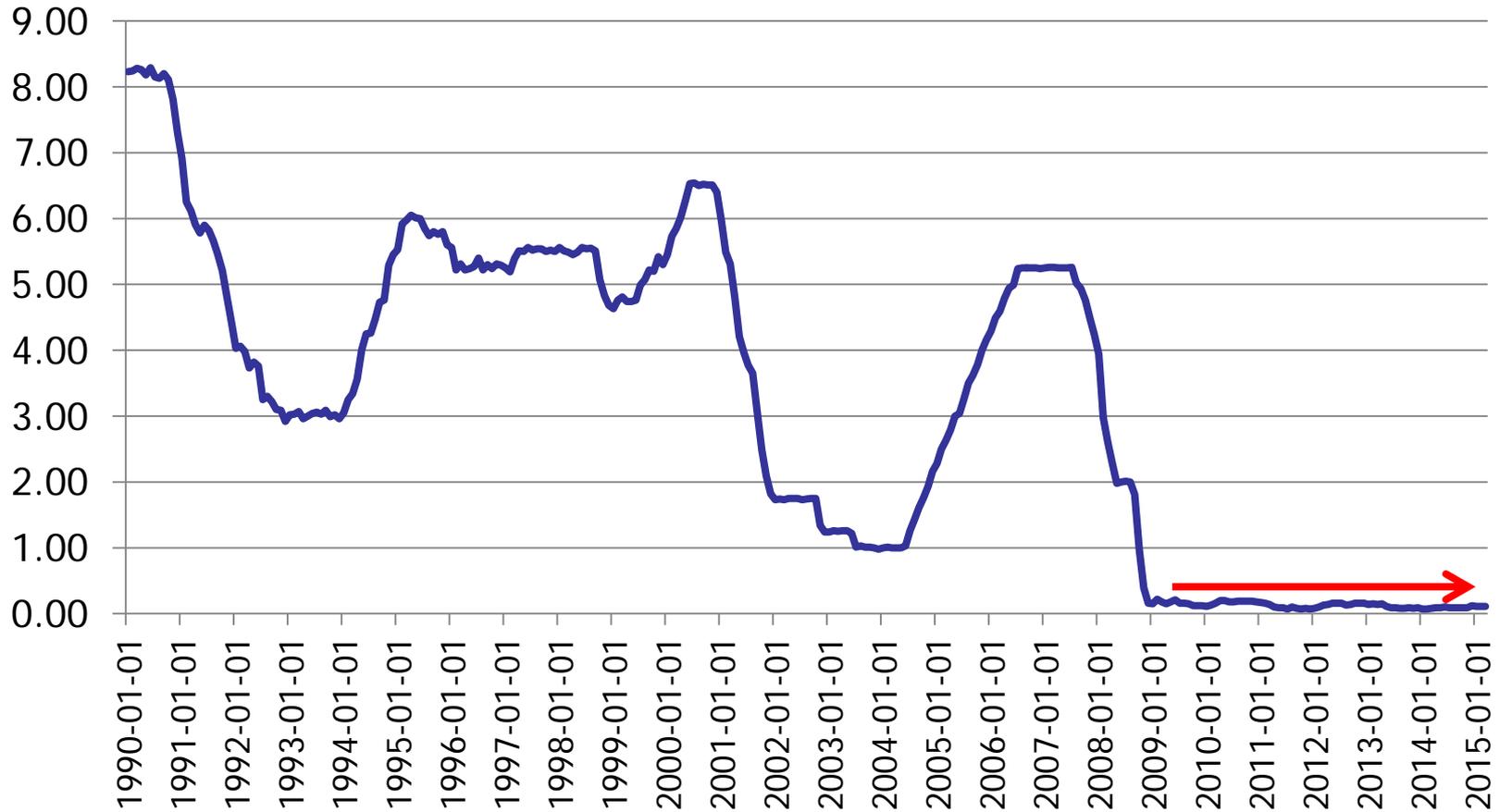
U.S. Velocity of Money M2



Source: Federal Reserve Bank of St. Louis

Central Banks to the rescue?

U.S. Federal Funds Rate



Source: Federal Reserve Bank of St. Louis

Central Banks to the rescue?

Central banks' solutions:

- Buy even more debt
- Keep interest rates as low as possible
- Punish depositors and savers

Results:

- Equity markets are hitting highs thanks to cheap debt
- Bonds are going further into negative territory
- GDP growth is stalling and starting to decline
- Deflation is firmly setting in which should drive down commodities, such as oil, even further and accelerate debt defaults
- Gap between rich and poor is accelerating

What does this all mean?

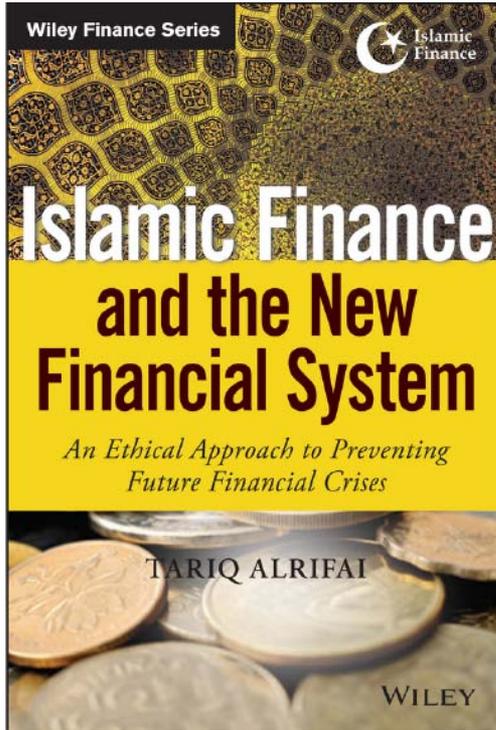
- Our financial system runs on a boom and bust cycle
- Financial crises occur frequently and are becoming more severe
- Governments and central banks are not solving the problem
- The core of the problem is an ever increasing mountain of debt combined with a derivatives market nearing 1 quadrillion in size
- The next financial crisis is just around the corner and will be more severe than the crisis of 2008
- Do not expect governments or central banks to be able to save the system at that point
- Expect large cases of debt default (both corporate and sovereign) along with falling asset prices across the board as deflation sets in (a phenomenon central banks said would never happen)

Is there any good news?!

What are the solutions?

The sad truth is that it will take a crisis to fix the problems of the current system. Expect the new financial system to:

- Bring back ethics and moral standards into the financial system (principals of equality, shared risk, eliminate moral hazard)
- Return to sound money principals (new gold standard or other constraints on reckless government)
- Redefine money as a medium of exchange and not a commodity
- Remove the casino from the financial system (derivatives)
- Find solutions to a debt-based financial system (equity)



Available at:

- Amazon.com
- Barnesandnoble.com
- Wiley.com

Questions or comments?

You can reach me on tariq@failaka.com