In Your Interest

Is Islamic banking a viable alternative to interest-based conventional banking? Is it really any different from conventional finance? Does it offer a better way forward?

These and other questions face the next generation of Islamic bankers as they inherit an industry that, in just the last decade, grew from a niche market serving a largely Muslim population to a global phenomenon offered side-by-side its conventional counterpart. In the aftermath of the global financial crisis, it is now seen in a completely new light as not only an ethical form of finance, but also as a potentially superior one. First, however, we must understand what Islamic finance is and what it is not.

This article places special emphasis on equity-based Islamic finance because, while "good-enough" Shariah-compliant trade and lease based instruments currently predominate the market and manage to satisfy the letter of the law, stakeholders increasingly demand Shariah-based products that fulfill the original spirit of the law.

All banking is debt, equity, trade, or lease based. And all Islamic finance does is simply dispense with the debt. The same proven risk-oriented principles that benefited past generations of equity-based conventional bankers (more profitably than their interest-based counterparts) also ensures the success of future generations of Islamic financiers. The positive impact that Islamic-style equity has on both the profitability of a business and the well being of society contrasts sharply with the negative effects of interest-based instruments.

The demystification of Islamic banking requires an understanding of four basic points:
1) What is an Islamic bank?
2) How is an Islamic bank different from a conventional bank?
3) How is an Islamic bank similar to a conventional bank? and
4) How do the two compare in practice?

An Islamic bank is a financial intermediary that brings together the providers of capital with the users of capital in accordance with the principles of the Shariah (Islamic Sacred Law). Like conventional banks, a combination of products, services and customers loosely determines the type of banking the institution engages in: at a very basic level, investment bankers execute complex, investment-oriented transactions for large institutions; commercial bankers borrow, lease and lend; and retail bankers service consumer-oriented needs. Though increasingly there is considerable overlap across these industry specialties, with commercial banks offering investment banking expertise, investment banks providing retail operations, and retail banks evolving into full-service commercial banks, the burgeoning demand for Shariah compliant instruments at all levels of the banking value chain has Islamic banks repositioning themselves as one-stop financial shops rather than as specialist boutiques.

Islamic banks are unique in that their activities are regulated by rules derived from the Quran, sunna (Prophetic practice), and the traditional schools of scholarship. Certainly, there are banks that offer cosmetically-enhanced products that are Islamic in name only, but the increasing regulation of the industry, the improving sophistication of the customer base, and the genuine demand for authentic Shariah committees, limits the proliferation of these expedient, non-compliant banks.

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An Islamic bank is distinguishable from its conventional counterpart by some basic principles, each of which is derived from the Quran, sunna, or both. While thousands of fiqh (Islamic jurisprudence) rulings operationalize specific injunctions from the primary texts, four basic principles govern at least 80% of all Islamic transactions:

❖ **Riba-Free Transactions:** The Arabic word riba refers to "increase" or "addition", and in the commercial context refers to any incremental increase, however great or small, above the original lent or exchanged amount. While riba is of many types, the most common kind is ordinary commercial interest, where the borrower compensates the lender with an interest payment for the right to use a sum of capital over a period of time.

Often riba is translated as usury, and because in modern times usury normally refers to exorbitant rates of interest, Muslims often mistakenly regard seemingly benign commercial rates of interest as something other than riba. In reality, however, riba refers to any increment above the principal amount, whether it is a soft, development loan charged at 1% annually or a usurious consumption loan charged at 10% monthly. So riba includes both usury and commercial interest.

❖ **Risk Sharing:** The concept of risk sharing is common to all Islamic finance transactions, whether equity, trade, or lease based. A few additional conditions make Islamic finance transactions even more equitable in many cases; such as the ruling that silent partners receive profit no more than is proportionate to their investment, while they may receive less; and that working partners may enjoy more pre-agreed profit than is proportionate to their investment, reflecting an emphasis on reward for work rather than reward for merely possessing capital.

The popularity of debt-style, interest-free instruments like Murabaha (mark-up financing) reflects the infancy of the Islamic banking industry and the tendency to gravitate towards something that mimics interest. But even in Murabaha transactions, where the bank intermediates a purchase by buying the good and charging a mark-up in advance, the condition imposed by the Shariah, and absent in a conventional loan agreement, is that the Islamic bank assumes some of the risk as well by holding the good for a period of time. Few conventional banks will choose to own anything, even if only for a short period.

This distribution of risk is itself an equity-based principle. Such seemingly insignificant conditions are often lost in contractual minutiae, and often confuse the layman into thinking that there is no difference between a given Islamic product and its conventional counterpart, but when things go wrong, the details in an Islamic contract place particular emphasis on the equitable distribution of risk.

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❖ Asset and Service Backing: Because Islam restricts the treatment of money as a commodity by declaring unlawful any profit earned from the exchange of like currencies, regardless of the time value of money, transactions are backed by an asset or a service. Asset and service backing ensures that real assets and inventories are created, rather than pyramidic money-lending schemes where money simply creates money and market volatility increases unchecked. Even monetary losses due to inflation are overcome by denominating the exchange of money into an asset with intrinsic utility, such as gold.

Because Islamic banking relies on asset and service backing rather than interest payments, conventional bankers often point to Islamic banking's inability to service demand for short-term loans. This is less true now than ever before. Islamic banks have now gained the expertise and scale necessary to conduct a broader set of activities. Across the world, Islamic bankers now provide car and home loans, fund short-term working capital requirements, and offer a range of shelf-like instruments.

❖ Contractual Certainty: Contracts play a central role in Islam. The uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah and creates gharar (ambiguity or uncertainty leading to dispute). Conventional insurance, interest, futures and options all contain an element of contractual uncertainty. This is distinct from commercial uncertainty, such as whether a business will be profitable or not, which is acceptable because there is an asset (such as property, plant and equipment) or a service (such as labor) underpinning the risk.

Some of the above mentioned differences between Islamic and conventional banking seem inconsequential, even trivial to some, but these ostensibly insignificant conditions spell the difference between financial dynamism and financial disaster, as will be shown later.

The similarities between Islamic banking and conventional banking far outnumber the dissimilarities, because the basic principles of finance remain the same. Companies still only raise cash in one of two ways, with the first method conforming to Islamic principles: 1) by issuing equity, or stocks, done by selling shares in a company, where the rise and fall of the share's value reflects the holder's share in profits and losses; and 2) by raising debt, or large IOUs called bonds, which obligate the company to repay the holder some fixed-income at some given maturity. Like conventional banking, Islamic banking enables the profit-motive, fosters a spirit of transparency and corporate responsibility, and ultimately seeks to promote shareholder value, all within the guidelines of the Shariah. Capitalism, if you will, without the after-taste.

So how do equity-based Islamic banking and interest-based commercial banking compare in practice? The question should be answered on three levels: 1) the profit impact; 2) the economic impact; and 3) the social impact. It is worth emphasizing that in the longer term these levels are inter-related. No company profits unfairly, or suffers adversely, without having a negative residual impact on the economy. And no economy suffers without some concomitant social cost:

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❖ **Profit Impact:** Comparing the profitability of equity and debt, history is quite telling. Between 1926 and 1999 in the United States:

$1 invested in small stocks would now be worth $5,117;

$1 in large stocks, $2,351;

$1 in corporate bonds, $61;

$1 in government bonds, $44; and,

$1 invested in an extremely safe Treasury bill would now be worth $15.

Out of 54 possible 20-year periods between 1926 and 1999, stocks outperformed bonds all 54 times. For the risk averse among us (i.e. bondholders), in bad times the highest returning bonds still managed worse than the lowest returning stocks. In the worst 20-year period for large stocks, $1 grew to $3.11, and for intermediate government bonds, $1 grew to $1.58 (Ibbotson Associates, 1999). We have to rethink our concept of risk. The perceived long-term safety of bond investing is as illusory as its profitability is real. Equity is not only historically more profitable but, as these numbers convincingly show, the safer long-term choice. Even risk-adjusted returns are higher for equity than they are for debt.

❖ **Economic Impact:** The primary objective of most commercial banks is to increase profit by extending loans to creditworthy individuals at the highest possible rate while undertaking the least amount of risk. But this objective focuses both borrower and lender on repayment, not profit. Typically, the lender has little active interest in the borrower's business; only an interest in the borrower's ability to repay, often at all costs, including the well being of the business and the borrower. Equity focuses on profit (and loss).

If the principal (lender) has an equity share in the business, he will have an almost exclusive focus on the profitability of the business. Knowing that a loss is possible, the principal will make every effort that the agent (borrower) succeeds.

In a debt transaction the borrower loses everything if the business fails, and is still left to repay. While in an equity transaction, the agent loses nothing if the business fails, besides time and effort, and has nothing to repay. Further, debt inhibits innovation by putting undue focus on repayment schedules while equity promotes innovation by focusing on the business itself. Small, growing businesses need to invest time and money to innovate before becoming profitable, a task made difficult by even the most lenient repayment schedules. Early repayment by the borrower precludes reinvestment into innovating the business, while delayed repayment increases subsequent payment sizes.

Too, the confrontational nature of interest-based lending debilitates business. In a debt transaction, the lender and borrower work in conflict, having to negotiate and renegotiate repayment schedules and lending rates. In an equity transaction, the principal and the agent work in concord to make more money.

From a distributive justice perspective, debt tends to centralize capital into larger corporations that are more able to match stable cash flows with repayment schedules. Equity, on the other hand, is more distributive in that it favors smaller companies that provide a greater profit potential. Speculative debt-based borrowing, including borrowing to finance equity purchases, triggered almost every major financial disaster in the modern capital market era. The negative effects are not merely money-deep; debt affects the collective consciousness of the business community, creating a demeaning and disempowered "borrower culture" rather than a vibrant and productive "investment culture."

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❖ **Social Impact:** As the Quran mentions in relation to wine and gambling, "In them is great sin, and some profit for men; but the sin is greater than the profit." (2:219) So too, interest has its share of convenient, short-term advantages, but like other evils, comes at the price of a broader social impact.

Real world examples are illustrative. The IMF and the World Bank aggressively disbursed loans for decades in the name of economic rehabilitation and poverty alleviation. Now recipients of their soft loans and structural adjustment programs are deeper in debt than ever before. Their non-usurious, low-interest loans compounded over time to create a situation where interest payments now exceed original principal amounts often by several orders of magnitude. The world's poor now pay several times more in interest payments than they do in all social services combined, leaving us with damning evidence that the debt-based sincerity of the IMF and the World Bank only served to spread world poverty.

At a commercial level, interest-based lending centralizes capital into fewer hands. The common man puts a higher proportion of his wealth into interest-based instruments than the wealthy man because he lacks the capital to make long-term investments and requires a ready source of liquidity, like a bank deposit, which returns a low rate. At the same time, the common man's lower disposable income requires him to continuously borrow capital for consumption purposes, like financing a car, a home or an education. For this, the same man earns a low interest rate and is charged a high borrowing rate.

The owners of capital, on the other hand, include high-worth, decision-making stakeholders of society, like banks, corporations, the government, institutional investors and wealthy individuals. By charging interest, they access the borrowers' and depositors' capital at relatively low rates and allocate them with other owners of capital (often in the form of equity-based investments) for significantly higher profits, which serve only to centralize capital among owners. This is neither conspiracy nor collusion. This is the nature of interest. The lines between borrower, depositor and owner are rarely well defined, but one fact remains: the nature of interest-based lending is such that the lower one's income, the higher one's borrowing rate and the lower one's return on deposits. Equity, on the other hand, levels the playing field, so that large and small investors share identical returns.

With global trends headed in the direction of equity (evidenced by the dramatic emergence in recent decades of the individual investor; the success of the mutual fund; the proliferation of new stock exchanges and equity indices; and an increase in global privatizations) there seems to be a collective acknowledgement that equity is the investment of choice. Debt continues to be a corporate mainstay as the cheaper source of financing, particularly among large, stable borrowers able to reduce their cost of capital by matching expected cash flows with future debt repayments. But to choose debt over equity has severe implications, not just for the business itself but also for society as a whole. Leaving Islamic banking as not only a viable and profitable choice, but also a responsible one.