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Islamic Finance: Between Classical Law and Contemporary Practice

Thank you very much. I would like to take a few minutes and tell you what I think is a tragedy in the Islamic world. Martin Luther met a cobbler and the cobbler asked him: I am a new Christian, how do I serve god in my craft? And Luther told him: make a good shoe and sell it at a fair price. I often use the story to say that he didn't ask him to make a Christian shoe. In the same way, Islamic finance is just good finance, properly priced. And we don't have to hide behind Islamic label.

So let me tell you what Islamic finance is. Dr. Sultan told you yesterday that Islamic economics is not all about riba. It is a well accepted tradition that in the area of financial transactions, everything is permissible unless it falls in one of three categories: *riba*, *gharar* and the third is if the object of the transaction itself is forbidden, and it's called *mudhara-bah*. The reason people focuses on riba instead of gharar is that it creates arbitrage opportunities.

Here's how Islamic finance functions. Start with a problem, something to circumvent. Riba is forbidden. What is riba, people would argue. It can be understood as profitable trading in risk. The central version of course is lending with interest to make a profit.

Let's go back to the time when Muslim thinkers were rationalists, and I will take you to Ibn Rushd. When it comes to riba, he says the essence of the prohibition is to ensure justice in exchange. The reason that Islam prohibits some barter trade having increments (if I am trading gold for gold, dates for dates, it has to be in equal value) is because those things tend to be sufficiently homogeneous and that you can achieve equity through equality. And after all, people are not forced to do this barter. If I know that my dates are better, there is no reason I should trade the good dates for the bad dates without a differential in quantity. I could always sell my dates, and buy the other dates. So nobody is forced into the barter, and we need to make sure that we will ensure efficiency in exchange.

So here is where I think Islamic finance has a problem. Here is where I think Islamic economics has a problem. The focus on the contract form. Whenever you pick up any book on Islamic finance, all you re going to find is here is the Islamic way to do business. Mudharabah, murabaha, and so on;.all of which have perfect English terms: murabaha is cost-plus credit sales, mudarabah is just silent partnership. And when we come to the one word that doesn't have a good single word English translation, that is riba, we say interest. That's not what it is. Sometimes it is interest, sometimes it's not. Any compensation for the time value we call it interest without even redefining economic terms. So they focus on contract: this is how you do business in the Islamic world. I think it's not really about contract forms. It's really about the institutions.

If you’re regulating markets, you regulate markets by making sure contracts are in the right form. If you regulate institutions, you don’t regulate only the instruments used by institutions. You regulate institutions themselves. You think of FDIC, they don’t regulate the banks transactions, they regulate the banks. There is a big difference.

So there are a few reasons to call 24:50 bribe what I call Sharia arbitrage, the way to make millions of dollars by selling …

The first is the statutory profit margin. The bankers can figure that if they capture the market, they can charge a high price. And if they charge a high price, they can make millions of dollars.

The second component is the risk in security. Even if it doesn’t make sense, these people can hire “sharia scholars” to support their financial products. The “scholars” just cite a verse from the Koran that said these are the one who are insane because they say there is no difference between trade and riba. But Allah has forbidden riba and has allowed trade. You don’t have to understand. You’ll pay more even if it doesn’t make sense to you.

So let’s take the simple mortgage example. The intermediary sells credit, it doesn’t sell houses. They are in the business of buying and selling houses. They are in the business of extending credit. They only reason they buy the house is to sell it. Indeed the FDC in London is advocating that not pay tax people that buy houses to sell it to make money on the interest.

So let’s look at the financing interest that the person pays, that’s what it is. The typical financing interest is the cost of funds to the financial provider, Islamic or otherwise. They are operational costs. That has to be the person who checks my credit history. And then the Islamic “version” is a lawyer fee, the arbitrage cost. They have to write the contract in such a way that it satisfies the religious scholars. That’s the name of the game: How to make it look different to different people. And there are jurist fees (I call it the indulgence prices). Somebody needs to put a certification price. It has to have the right address, and it has to put a certification price that says this is Islamic, and I put my own hereafter on the line. It’s my responsibility now. In the hereafter, I will be the one who has to pay the price if I was wrong.

And then there are bankers saying they are trying to help people, and then making supernormal profits on those people who are the most underprivileged, who have the highest infant mortality rate, the highest illiteracy rate, the highest malnutrition rate, etc.

So here’s what riba means. It’s not in the contract form but in customer is getting the exact same thing for having to pay more for it. The term riba virtually means increase. Not all increases are riba. The forbidden riba is the increase that is not justified: the customer doesn’t get any economic value for what he pays. I didn’t say 3, 4 and 5 are riba. I would say that Islamic finance is actually perpetuating riba.

You don't have to reinvent the wheels. It worked ….If you want to avoid dealing with predatory lenders, you mutualize. You go to your credit union. To every student we teach, we say you get your first job, you want to finance a car don't go with the bank; go to your credit union, because the credit union is not there to make a profit. It is there to help the community. It is there to extend credit to those who need it. The higher finance bankers will still make their money; you don't have to worry about it.

In most of the Islamic world, people don't know about credit unions. In most of the Muslim world, they don't know what these mutuals are. What I am suggesting is that every mosque needs to teach its people that you have to save, and invest in other people's business. You need to have some object for mutual credit and mutual insurance. What is prohibited is profitable trading in credit, profitable trading in risk. These things can easily be mispriced to disappoint people. If people want to rise out of poverty, they have to do by their own bootstrap. Credit unions are non-profit and thereby will reduce the scope of sharia arbitrage.

Islamic economists said instead of depositors receiving interest, we're going to have shareholders. What we have is depositors, but they are not getting to the principles. They are neither depositors receiving interests, nor are they shareholders. They are never in the board of directors. It's simply exploitation of people in the name of religion telling them this is their way to salvation. Indulgence.

If you read the Wall Street Journal last month, bankers are trying very hard to hurt the credit unions. Banks are making record profits year after year, quarter after quarter, but credit unions are cutting their share of the profits and banks are worrying about it. We need to embrace credit unions. We don't need sharia arbitrageurs to charge indulgences any more. Care for justice is not unique to Islam, care for our community is not unique to Islam and we don't need to reinvent the wheels.