

Islamic Finance *forum*

Are we likely to witness consolidation within the Islamic banking industry as we have seen with the conventional banks?



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Consolidation is an inevitable consequence of the over-riding imperative within Western enterprise models to “cut costs” and “maximize shareholder value”. In the case of the Islamic banking industry certain bottlenecks strengthen this trend, principally a shortage of Western-based legal expertise and of Islamic scholars both versed in modern financial techniques and sophisticated enough to bridge the fundamental divide between an asset-based economy and a deficit-based financial system.

The foci of Islamic banking consolidation appear likely to be the developing “Centres of excellence” in London and Dubai. The source of funds will be the sea of petrodollars which - unlike after the first oil shock - are not destined for US assets, but probably rather for investment in the developing economies of the Middle East, India and China.

However, I believe that a tsunami is about to overwhelm any wave of consolidation, embodied in the trend towards disintermediation and decentralization of the financial system inherent in the pervasive spread of the Internet: i.e. the “Napsterization” of financial markets.

We already see in the emergence of a direct “peer to peer” connection between lender and borrower without credit intermediation by banks. Alternatively, new partnership-based “Clearing Unions” offer bilateral interest-free credit, subject to a multilateral guarantee.

In the future banks will no longer create credit – the unquestioned but deeply questionable “Deficit-based” financing at the heart of monetary markets as currently practiced – but may instead manage the creation of credit and introduce investors to investments possibly using new trust and partnership legal “wrappers”.

Central Banks will cease to issue deficit-based money and instead become monetary authorities managing the issue of “asset-based” money by national treasuries.

Timescale? At most five years, precipitated by a dollar crisis itself founded upon peaking en-

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Can any transaction be structured Islamically assuming the appropriate Shariah advisory board is in place?
If so what does this mean for Islamic Finance going forward?



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If the answer to the first question is "Yes", then Islam could find itself in an analogous position to the Catholic Church at the time of the Reformation when sinners were able to purchase "Indulgences" from a complacent priesthood.

What we see today are essentially "halal windows into a haram palace" - or an Islamic veneer upon an un-Islamic reality. This applies equally to monetary and capital markets.

The reality of our current "Deficit-based" monetary system is that virtually all (>97% in the UK) money in circulation comes into existence as credit created by banks as a multiple of their capital base - so-called "fractional reserve banking". As J K Galbraith said, this financial legerdemain is "so simple the mind is repelled".

In respect of capital, there is a blindness among Islamic scholars and Shariah Boards to the inequitable nature of "investment" through the customary Western vehicle - the "Joint Stock Limited Liability Company". I confess that I find it difficult to see in what respect the sharing of risk and reward in this legal structure is ethically superior to the "haram" debtcontract.

I believe that transactions may now be structured Islamically without the need for Shariah advisory boards simply by utilising an ethical enterprise model - ie legal and financial structure - consistent with Islamic principles.

The vehicle for this is a "Corporate Partnership" of which the new UK Limited Liability Partnership is the first example, but for which many jurisdictions have close analogies, such as the US LLC.

One may then arrive at simple new "asset-based" finance vehicles for investment in productive assets through "Co-ownership" between Asset Financier and Asset User - Musharakah in other words: and in respect of a Corporate Partnership-based credit model we see bilateral interest-free credit with a multilateral guarantee - ie Takaful.

Are financial structures commonly used in Malaysia, such as Murabahah bonds and Bai Bithaman Ajil bonds sufficiently acceptable to Middle Eastern investors? If not, do you think this has contributed to the lower than anticipated levels of investment in Malaysia by Middle Eastern funds, and if so what needs to change?



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There are probably two factors at work here.

Firstly, a LIBOR-based rate of return is very clearly a ""Deficit-based" but "Asset-backed" return - in other words obviously based upon bank-created credit secured by a claim over assets.

I suspect that only a minority of Middle Eastern investors are prepared to suspend their critical faculties in order to accept such a return, rather than a return based upon the actual market value in use ("usufruct") of the asset.

The second factor may be a residual suspicion on the part of investors in relation to Malaysia's robust attitude in respect of capital flight exemplified by her implementation of exchange control measures in 1997/8.

"Asset-based" solutions (based upon actual ownership of productive assets and associated revenues) allow us to transcend the first problem of course, as I point out elsewhere.

The second issue comes under the heading of "political risk" and will continue to be taken into account by investors - the question being whether Dr Mahathir's successors would take the same (in my view, absolutely correct) view he did or subscribe to neo-Liberal orthodoxy.

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Is it the case that Islamic banks have yet to introduce a sufficient range of financial products to cater to a wide investor and client base? If so, what steps do these organizations need to take in order to attract new clients and investors?



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Regrettably Islamic banks are up against human nature. So it is difficult to market a financial product – such as an Islamic mortgage – which addresses the relative minority who are prepared to make (perceived) financial sacrifices in following their faith by sharing a perceived likely increase in property values with a financial institution or investors.

Some lateral thinking is therefore required. Do Islamic banks and investment institutions not realize that they have in their hands a “non-toxic” mechanism for “equity release”? And that in the UK alone, for instance, it is estimated that in excess of £1 trillion worth of property is owned free of mortgage by individuals aged over 65 most of whom would in fact be only too pleased to release some of their equity via an (Islamically sound) investment in their property since this would give superior results to the existing alternatives.

I have been working with a team of professionals on developing just such a product for the last 18 months, and would be pleased to work with any Islamic investment institutions which may be interested in such UK property-based revenue streams.

The world’s Islamic banks continue to report record profits, often outperforming the most optimistic of forecasts. Are these likely to continue and what sort of message does this send out to the global investor community?



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As defined by the UK’s Financial Services Authority, banks are not actually “banks” but rather “credit institutions” which exist to create credit, backed by their capital base in line with capital requirements set out in the Basel Agreement.

Such credit creation/intermediation is a very profitable business to be in, since any return in excess of the costs of providing the service and of borrower defaults is pure profit.

Islamic banks are able to create such credit, repackage it into Islamic finance/quasi-investment and then move it off their balance sheet by selling it to investment institutions. In this way, the risk of default – itself already relatively low due to the ethical quality of the customer base – disappears, leaving a handsome profit margin.

Global investors should be queuing up to invest in Islamic banks – since to reapply the famous description once made of the UK’s then extraordinarily profitable Granada TV – they truly have a “license to print money”.

We continue to witness extraordinarily large profits from many of the world’s Islamic banks, many of which are relatively small and recently established financial institutions. Do such levels of profitability indicate a high and opaque fee structure within these organizations?



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Banks, whether Islamic or not, are not banks as far as the UK’s Financial Services Authority is concerned, but “Credit Institutions.”

In other words, they create credit on the basis of a regulatory “Capital base” as set out by the 1988 Basel Accord. Any return from the differential (the “bid/offer spread”) between what they pay to depositors/“investors,” and what they charge to borrowers/“customers” in excess of the cost of providing the system and of defaults by borrowers/customers is pure profit.

Banking is therefore a remarkably profitable business.

The arbitrary rates of return (ie interest) set by Central Banks have nothing whatever to do with these underlying costs, and in fact, therefore, may often be one of the root causes of inflation, rather than a cure, as conventional economic wisdom has it.

The source of Islamic banks’ credit is the same as any other banks – ie pure credit creation with a click of a mouse – it is merely the risk profile between the bank and its counterparties that is different from conventional banking.

I must confess that I find it difficult to understand how any Islamic scholar who understands the process may approve of any credit creation in excess of banks’ capital: “Islamic Banking” involving such credit creation is arguably, therefore, a contradiction in terms.

Putting that subject to one side, in essence the answer to the question is that Islamic banks are particularly profitable for two principal reasons: the default experience is better and the bid/offer spread is greater – probably because of complexity and opacity in charging.

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How important a role does Takaful play in the development of a liquid and efficient Islamic capital market?



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The future of Islamic capital markets lies in distinguishing between investment on the one hand and credit on the other, ie between asset-based and deficit-based finance.

The former is concerned with revenue sharing and new asset-based financing tools such as the “capital partnership,” as opposed to the inequitable limited liability company. A “capital partnership” is essentially Musharakah achieved within a new partnership-based corporate legal “wrapper.”

The latter is concerned with the sharing of risk and essentially comprises a mutual guarantee of bilateral “trade” credit (ie “time to pay”) between a seller and a buyer. Such a “guarantee society or “clearing union” is essentially “Takaful” again within a partnership legal wrapper. There is no place for credit creation by banks, which are disintermediated.

The role of banks changes to:

- (a) appraising investments and providing liquidity by bringing investors together with investments or “making a market;”
- (b) maintaining an accounting system and risk management in respect the mutual guarantee of credit creation.

Are Islamic real estate investments more attractive than their conventional equivalents?



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In order to answer this question we have to examine what “conventional” real estate investments are and the nature of the returns to which they give rise. There are essentially two types of conventional investment in real estate:

- (a) “Deficit-based” but “asset-backed” securities, which are essentially fixed or variable (by reference to base rate) rate loans secured against properties.
- (b) “Asset-based” investments in real estate vehicles which own portfolios of property.

The former – Mortgage-Backed Securities – are growing rapidly in popularity as credit institutions bundle mortgage portfolios and sell them off to investors interested in a certain return with limited exposure to capital loss.

However, this class may be absolutely excluded as halal, leaving the latter, which are again divided between investment in property companies and other new types of vehicle – such as Real Estate Investment Trusts (REITs) – which becoming increasingly popular. Both allow participation in the capital gain which we have come to expect from real estate investment over time, but the latter are more advantageous in terms of the inherent cost structures and particularly tax transparency.

The almost totally unappreciated truth of the matter is that the greater part of the gain in real estate values derives from the fact that land prices are driven up by the availability of “deficit-based” credit created by the current “fractional reserve” banking system. This leads to unearned capital gains to those lucky enough to “own” land.

In a more equitable system a “Commons” such as land would be held in trust on behalf of the community, with those having exclusive private use of this Commons compensating the community through a “land rental” payment.

This is, of course, the basis of the Islamic belief that land and other “commons” (such as “fire” = energy and water) can be absolutely “owned” only by God; that we are merely stewards, and it is arguable that “zakat” in respect of such ownership may be characterized as compensation to the community.

It is an interesting question for debate what the Prophet (s.a.w.) would have made of the “privatization” of water and the relatively modern concept of exclusive “ownership” of knowledge, i.e. the concept of “intellectual property.”

The value of land in fact derives from its rental value, and this is a function of the capital investment made in the land by the “owner,” as well as investment made by the community in infrastructure such as transport access and utilities, which give rise to a “location value.”

“Asset-based” investment vehicles simply package both “ownership” and the streams of property rentals which combine both the value of the land and the capital invested in the land. It is my thesis that the closer such vehicles approach the revenue-sharing principles of Islamic investment, then the more efficient and effective they become.

If my thesis is correct and it is the case that an Islamic enterprise model is optimal, then it follows that the answer to the question posed will be that Islamic investment in real estate is more attractive than conventional investment using defective and conflicted legal forms such as companies and “trusts.”