# SECTOR REPORT

## 21st Century Islamic Finance

### *By Chris Cook*

## Introduction

**There is a dawning realization that the global economy has reached a "tipping point" at which continuing economic growth in Brazil, India and China in particular will outstrip the availability of energy supplies, leading to geopolitical crisis.**

Furthermore, while climate change is now widely accepted as a fact, it is not generally appreciated that climate change is merely the effect, and that the exponential economic growth mandated by the "deficit-based" structure of the global financial system is the cause. As we will see, due to the inexorable mathematics of compound interest upon the money supply, our existing financial market infrastructure is simply unsustainable.

By "asset-based" finance is meant investment through "ownership" of assets within a "legal wrapper" such as a company, a trust or other entity. By "deficit-based" finance is meant credit – which may be either:

- interest-free "trade" credit – or "time to pay" granted by a seller to a buyer;
- interest-bearing credit created as a debt by a credit institution as lender to a borrower, and which may be either "asset-backed" ("secured") or "unsecured."

This "western" capital market structure – and the inherent conflicting legal claims of investors (ie asset-based financiers) and secured lenders (ie deficit-based financiers) over the same assets and revenues – is so ingrained upon our consciousness that it comes as a shock to realize that there may be alternatives.

These emerging "alternatives" are not new, but based upon ways of conducting commerce which are thousands of years old and are at the heart of Islamic business practice.

## The problem

The UK regulator, the Financial Services Authority, no longer distinguishes banks and building societies as such, but classifies them together as "credit institutions" who are permitted to create credit as a multiple of their capital base in accordance with the capital requirements set out by the Bank of International Settlements in the 1988 Basel Accord.

This institutional credit has been "monetised" to give us the money we are accustomed to using. For the most part (>97% in the UK) this money exists in the form of bank accounting records/databases and electronic messages passing between them within the bank "clearing" system. The residual notes and coins in circulation in the UK is the only credit now issued directly as money by the Bank of England.

Over 70% of the money currently in circulation in the UK arose from loans secured by mortgages over residential property, ie it is "deficit-based" but "asset-backed."

When credit institutions "lend" money into circulation by creating credit, they are not providing something of value in exchange, as occurs in trade credit. A credit institution's function as an intermediary is to provide a guarantee in respect of the borrower's performance and to manage the risk in respect of that guarantee. The provision of a guarantee, and the service of record-keeping and risk management which accompanies it, is the "value" which credit institutions provide.

A bank's role as a credit intermediary is well illustrated by the emergence of new internet services such as www.zopa.com, which bring together individuals wishing to borrow money directly with individuals willing to lend – without the credit intermediation of a bank – but with the possibility that a bank could provide to Zopa members services such as credit assessment, risk management and a guarantee.

The basis of the rate of return – ie interest – on bank lending is mandated by Central Banks and is typically at a rate which allows banks to obtain "super-profits" through an excessive "spread" between the rate paid to depositors and that charged to borrowers. Any such excess return received by banks constitutes an inherently inflationary driver of global economic growth.

By way of example, when a bank lends £100,000 to buy a house, some £200,000 will be repaid over the life of the loan. However, the additional £100,000 does not exist at the outset, but must, in turn, be created by the banking system as money over the term of the loan and acquired by the borrower in order to repay his obligation.

The exponential growth of a deficit-based monetary system drives "economic growth" through the need for the creation of economic value by investing in productive assets.

Historically such investment has generally been made by exchanging this deficit-based money for shares ("equity") in a Joint Stock Limited Liability Company ("Corporation"), which are issued and traded on the global stock markets.

This legal structure is flawed in two ways:

- the general conflict between the interests of investor shareholders and all other stakeholders; and in particular
- the "principal/agency" conflict between the interests of the investor shareholders and the directors/management.

Both the contract of debt and the corporation are flawed as investment mechanisms in that risks and rewards are shared imperfectly between the investor and the user of the investment. In the case of debt, the lender is entitled to the return of his principal regardless of the borrower's ability to pay. While in the case of equity, the investors cannot lose more than the money they invest, but in return have an absolute and permanent right to the assets and net profits after the costs of the business have been deducted.

Financial capital – in its two forms of debt and equity – gives rise to conflicting legal claims between the interests of the "owners" and the "financiers" which are irreconcilable: in other words, the "western" model of financial capital is and always has been "broken."

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# SECTOR REPORT

## 21st Century Islamic Finance (continued)

### A Halal window on a Haram palace – deficit-based Islamic finance

Islamic banking as currently practised is an Islamic veneer on an un-Islamic reality. While Islamic banks may fully utilize Islamic principles in their sharing of risk and reward with their customers, there remain two issues:

- Islamic banks fund these "investments" using the same "fractional reserve" banking model as other banks, ie they create the investment as a multiple of their capital base in accordance with the 1988 Basel Accord;
- the money created through this process is, therefore, either an electronic deficit-based money, or notes and coins issued as necessary by the Central Bank (if there is a Central Bank – in some jurisdictions banks issue under the auspices of a Monetary Authority both electronic money and paper "IOUs" as well).

This reality is at best not made clear by Islamic banks and is at worst deliberately obscured. For instance, we are encouraged to believe that Islamic banks are akin to credit unions which do not operate on a fractional reserve basis, but truly accept deposits and then lend these deposits to borrowers.

However, that is extremely unlikely to be the case: credit to a multiple of the Islamic bank's capital base is created and the recipient of this freshly minted money then either deposits it back into the banking system for later use or pays it to someone else who does so.

It is a matter of sequence:

- *pre-existing* "wealth" is *first* deposited in credit unions and *then* lent to borrowers;
- claims over customers' *future* wealth are *first* created by banks and the resulting money created is *then* deposited into the system.

Many commentators have over the years questioned the ethics of fractional reserve banking and it is difficult to understand how it is that deficit-based money created as credit by a banking system in this way is Islamically acceptable.

### Partnership finance

There is an alternative financial infrastructure which is already emerging due to the ability of the Internet to link individuals directly, thereby making redundant middlemen/ intermediaries such as banks.

This alternative is based upon the risk and revenue sharing principles at the heart of Islamic finance and arises out of a simple new partnership-based "enterprise model," or "legal and financial structure," which achieves:

- revenue-sharing through "co-ownership" in a "capital partnership;"
- risk-sharing through a "guarantee society" or "clearing union."

The former gives rise to forms of debt-free "asset-based finance" and the latter to a form of mutual interest-free "deficit-based finance" or credit: students of Islamic finance will observe that the former is to all intents and purposes "Musharakah" and the latter "Takaful."

It is a recent (introduced on the 6th April 2001) legal entity which allows us to encapsulate Islamic values in this way – the UK Limited Liability Partnership ("LLP"). Putting to one side the dubious nature of limitation of liability free of any obligation, the strange fact is that legally the LLP is *not* a partnership, but *is* a corporate body, ie it has a continuing legal existence independent of its members and may, therefore, own property and enter into contracts in its own name.

Furthermore, the LLP agreement between members is infinitely flexible and may be whatever they agree. Most importantly, the members have no responsibility for each others' actions individually (ie the "several" liability of a partnership), but rather have a "joint" or collective responsibility bounded by the LLP agreement.

In simple terms, the outcome is of a new and totally open legal "wrapper" for assets, revenues and risks: an "open" or "Islamic" corporate entity providing a unique synthesis of collective and individual rights and obligations.

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## Capital partnerships

When this "open corporate" is applied to the financing of productive assets through a "capital partnership," we see the potential for entirely new asset classes of shares in the revenues of productive assets. Moreover, these "shares" need not be restricted to a purely monetary return, but may be in "money's worth" such as energy, or the use of property.

A capital partnership has at least two members:

- the capital member – who invests money or money's worth;
- the Capital User – who uses the capital invested;

and gives rise to simple but radical financing options. First, since there is no obligation to return this capital, it is essentially "equity" and for an indefinite period – as long as the capital is used – the members share revenues in agreed proportions.

Example 1

- *A property purchased for £100,000, of which £80,000 is financed: the occupier/investor receives 20 shares and the financier/investor 80 shares at a value of £1k each. (or 200/800: 2000/8000 etc – it is the 20%/80% proportions which matter, there being no par or nominal value to these shares).*
- *A rent of £6,000 pa is agreed for two years for the above property: the occupier pays net £4,800 pa; the investor receives net £4,800 pa.*
- *After two years, the occupier wishes to invest £12k in the property: at £120k valuation he purchases a further 10%: at £96k valuation he purchases 12.5% and so on.*

Secondly, it is possible to return capital in the form of the output of the productive asset.

Example 2

- *A wind turbine produces 1 MegaWatt and costs £1m to build. An investor of £10k receives no return on his investment but instead is repaid his capital over 20 years in the form of energy at today's price of £50 per mw/hr, ie he has purchased 200 mw/hrs at this price, deliverable at the rate of 10 mw/hrs per year for 20 years.*
- *The effect for the community developing the turbine is that it has sold perhaps 30–40% of their production forward for 20 years, and in return have financed the turbine interest-free.*
- *Investors have purchased energy at today's price and may either consume it over 20 years or sell at the prevailing price to other investors, ie a simple new direct investment in energy backed by "co-ownership" of the turbine.*

These two possibilities open up entirely new asset classes for investors which are capable of revolutionising capital markets.

### *Guarantee societies/ clearing unions*

A guarantee society provides a mutual/collective guarantee of transactions carried out bilaterally between its members. Businesses may extend credit (or "time to pay") to each other and to customers, which is backed by a "default fund" into which guarantee users pay an agreed provision for as long as they use the guarantee.

Example 3

> *Bloggs Computers is a member of the Tower Hamlets Guarantee Society and sells a computer to Mr Dell for £1,000, giving him 60 days to pay. Mr Dell pays 0.5% per month into the default fund for the use of the guarantee. Unfortunately Mr Dell breaks his leg and is able to pay only £500 on the due date: Bloggs Computers obtains the balance of £500 from the society, which allows Mr Dell to repay the balance in four payments of £100 and a credit of £100 to Mr Dell in return for 10 hours of work in the community.*

Members of a guarantee society may agree to accept settlement of their obligations in "money's worth" rather than money. The result is to incorporate into the guarantee society a "barter network" with interest-free credit, similar to that of the Australian company Bartercard and the Swiss WIR business barter network.

## 21st century finance

We are already seeing the emergence of "asset-based" finance in Canada, where investors may buy units in "income trusts" and "royalty trusts" which own part or all of the revenues from productive assets such as an oil-field. Equally, we may observe that the Australian Macquarie Bank is making fortunes acquiring productive assets with deficit-based finance and repackaging these assets through "asset-based" finance using "trusts" whose shares or units are sold to pension investors.

However, the "open corporate" LLP now emerging in the UK demonstrates new possibilities for asset-based finance which do not have the flaws and restrictions of either company or trust legal wrappers. Furthermore, we also see a simple new mechanism for mutual deficit-based finance which is interest-free but shares operating costs and defaults between its members.

The flow of revenues from "capital partnerships" comprises "debt-free" value: while the provision of mutual credit within guarantee societies gives rise to a form of "interest-free" value. The monetary system of the 21st century will be a generic, decentralised exchange network and "transaction engine" where these debt-free and interest-free forms of "value" are exchanged by reference to a "value unit."

This network, and the partnership tools described above, are emerging quite simply because those enterprises, whether public or private, which do not use them are at a disadvantage to those who do. The fact is that such an "optimal" policy is also a policy entirely consistent with the values underpinning Islam.

> *"Behind it all is surely an idea so simple, so beautiful, that when we grasp it – in a decade, a century or a millennium – we will all say to each other, how could it have been otherwise? How could we have been so stupid for so long?"*
> (John A Wheeler)

*Note: The author is a former Director of the International Petroleum Exchange (IPE) and a member of the Wimpole consortium.*

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