

SPEECH

SPEECH: WHY ISLAMIC FINANCE?

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What do President Obasanjo of Nigeria, Nick the UK homebuyer, and Faisal the American college student all have in common? They're all trying to pay off loans that seem to increase every single day. What started off with a seemingly small interest rate ballooned into something completely unattainable. We'll look at each of their examples a little later.



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First, let's answer the big question on everyone's mind: How is Islamic finance different from conventional finance? It looks the same. The result is often the same. What's the difference?

Well, the best way to find out is with a simple, real-world comparison. Let's take \$10,000, for instance. And let's compare what a conventional bank can do with this \$10,000 and what an Islamic bank can do.

First, the conventional bank.

The conventional bank finds a credit worthy customer and lends at 5% interest. The bank is not particularly concerned about what happens to this money other than that it gets repaid. The customer, on the other hand, has already found a borrower willing to pay 7%. This borrower runs a small credit co-op for students and lends at 10%. One of these students is enterprising enough to lend to his unemployed brother at 15%. Who has just discovered the power of compounding interest and now lends to street vendors at 25%. We could go on. But you get the idea.

As we speak, there are poor people paying upwards of 40%...per month! Now obviously we can't blame conventional banks for everything that happens after they've made the initial loan. But we can blame the power of compounded interest."

Interest, and the fact that you don't need actual cash to lend money means that the original \$10,000 could keep passing hands until we pump out over \$100,000 of artificial wealth. Artificial is right. How much actual cash is there? Only \$10,000. With interest, we managed to turn \$10,000 into much more.

Now what happens if the street vendors go out of business? Or the unemployed brother doesn't find his job? Or the credit co-op goes bankrupt?

That's right. Loans don't get repaid. And if enough people can't repay their loans, lenders get into all sorts of trouble. This vicious cycle sets off a domino effect of defaults.

And imagine that instead of a \$10,000 personal loan, it's a million dollar business loan, or a billion dollar World Bank loan. Compounding interest grows so fast that borrowers are often unable to repay. People, economies, and the environment pay the price as we grow more desperate to meet rising debts.

So are we surprised when billions of dollars vanish into thin air?

Let's take the example of the Islamic bank. With this \$10,000 the Islamic bank only invests in actual assets and services. It might buy machinery, lease out a car, or invest in a small business. But, throughout, the transaction is always tied to a real asset or service.

And this is the central point: we can't simply "compound" assets and services like we can compound interest-based loans. An asset or service can only have one buyer and one seller at any given time. Interest, on the other hand, allows cash to circulate and grow into enormous sums.

That's the difference between Islamic finance and conventional finance: the difference between buying and selling something real and borrowing and lending something fleeting.

In recent years we've witnessed the most dramatic global financial downturn seen in decades. What began as a housing bubble soon became a sub-prime credit crisis. And what many thought would remain a credit crisis soon spread into a global financial meltdown. It devastated every corner of the world.

And while these events affected most of us negatively, there was one silver lining: people finally gave a serious look at alternative forms of finance. And many people stopped believing that interest could solve all problems.

Understanding what caused these events serves as our starting point for understanding Islamic finance, and how it differs from conventional finance.

What conventional finance enables is the ability to sell money when there is no money. To sell assets before there are any underlying assets. And to allow debts to grow unchecked while borrowers become more desperate.

Interest creates an artificial money supply that isn't backed by real assets. The result? Increased inflation, heightened volatility, richer rich, and poorer poor.

Let's look at 3 practical examples that show just how Islamic finance is different from, and better than, conventional finance. And while Islamic finance parts ways with conventional finance on more than just being interest-free, we'll focus on interest in this talk.

We'll look at 3 people in 3 very different, real-world situations: the first is the leader of a developing country: President Obasanjo of Nigeria; the second is Nick, a homebuyer in the UK, and the third is Faisal, an American college student.

Debt-Laden Country: Nigeria

We begin by quoting President Obasanjo who said these words after the G8 summit in Okinawa in 2000: "All that we had borrowed up to 1985 or 1986 was around \$5 billion and we have paid about \$16 billion yet we are still being told that we owe about \$28 billion. That \$28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what is the worst thing in the world, I will say it is compound interest."



It seems unbelievable but, sadly, it's typical. Developing countries start off with relatively small loans and remain saddled with huge amounts of growing debt for generations. And remember, this could be Nigeria, or any other poor country. To give just one other example, during the years leading up to the 1997 Asian collapse, Indonesia's foreign debt as a percentage of GDP was over 60%. So Nigeria is certainly not an isolated example. There are countless more.

How did borrowing just \$5 billion end up in having to pay \$44 billion in total? Let's open up a spreadsheet and find out. For the sake of simplicity we'll just grow \$5 billion into \$44 billion between 1985 and 2000 and see what interest rate we get. It must've been a very high interest rate to get to \$44 billion in such a short period of time. So let's start off with 40% per annum. No that's not right.

Table 1: \$5 billion growing at 40%

Year	Debt
1985	5,000,000,000
1986	7,000,000,000
1987	9,800,000,000
-	-
1997	283,469,561,876
1998	396,857,386,627
1999	555,600,341,278
2000	777,840,477,789

Let's try 30%. That still gives us a very high number.

Table 2: \$5 billion growing at 30%

Year	Debt
1985	5,000,000,000
1986	6,500,000,000
1987	8,450,000,000
1988	10,985,000,000
-	-
1997	116,490,425,612
1998	151,437,553,296
1999	196,868,819,285
2000	255,929,465,070

It turns out that to grow \$5 billion into \$44 billion takes an interest rate of only 15.6%. Now on the face of it around 15% doesn't sound exorbitant. It doesn't seem unfair, and technically it isn't even illegal according to international law. In fact, we personally know of banks that charge high-risk credits upwards of 30% interest rates. But every day numerous countries find themselves in the same predicament as Nigeria.

UNICEF estimates that over half a million children under the age of five die each year around the world as a result of the debt crisis. But as we've seen, it's not the debt that's the problem. It's the compounding interest.

Now how would Islamic finance handle things differently?

Using the \$5 billion example, Islamic banks could provide \$5 billion of financing for infrastructure, literacy, healthcare, or sanitation programs, to name a few.

- An Islamic bank could have arranged for the \$4 billion construction of a natural gas pipeline and delivered it to Nigeria for \$5 billion using an Istisna.
- Or taken an equity stake in a highway project and shared in profits and losses using Musharakah or Mudarabah.
- Or purchased commodities and sold them at a premium using a Murabaha.
- Or structured a project financing using an Ijarah Sukuk.

These names may sound new to you, but as we explain them in our training modules, they're much like conventional equity, trade, and lease-based instruments already familiar to most bankers. Islamic finance, after all, permits legitimate profit.

We're not asking that everything be changed. Just the harmful parts, and eliminating interest would be the first step.

In all of these cases the bank could not have charged more than the initial financing premium. So if the Islamic bank was owed \$5 billion, that could never turn into \$44 billion or even \$6 billion. The debt would have to be fixed. Throughout our training modules we'll show you how these and other Islamic finance products operate.

Let's take another example of how Islamic finance is different from conventional finance. This time let's make it a little bit more relevant to our day-to-day lives.

Nick The Homebuyer

Nick has lost his job, his house, and all the money he had spent paying off his mortgage.

The property bubble that triggered the global financial meltdown could not have happened if the properties had been financed Islamically. Why? Because a conventional bank merely lends out cash. Legally, it can keep lending this cash over and over. Well above its actual cash reserves.

An Islamic bank, on the other hand, has to take direct ownership of an actual asset. Whether for a longer period in a lease or partnership, or a shorter period in a sale or trade, Islamic finance always limits the institution to an actual asset.

The next time anyone wonders whether Islamic banking is just dressed up conventional banking, ask them to show you a single major consumer bank that co-owns actual properties with their customers.

Of course, there's no excuse for Islamic banks that are Islamic in name only. But if the transaction complies with internationally recognized standards like AAOIFI, for instance, then there's no reason for it to have the many side effects associated with interest-based banking.

To provide just one example of how Islamic banks get directly involved in asset purchases, let's look at how a Diminishing Musharakah works. The word Musharakah refers to a partnership in Islamic finance.



And it's called a Diminishing Musharakah because the bank's equity keeps decreasing throughout the tenure of the financing, while the client's ownership keeps increasing through a series of equity purchases. Eventually, the client becomes the sole owner.

If Nick had lost his job with a Diminishing Musharakah, at the very least he would still have an equity stake in an actual property that he could monetize.

Pay close attention to this example because this is something you may want to suggest to your own local bank. There's no reason why they can't do it.

We've kept all the numbers and calculations very simple and straightforward for illustration purposes.

Let's take a \$220,000 house. And let's say the customer puts down \$20,000 and finances the remaining \$200,000 from the Islamic bank. Let's also say that the financing lasts 20 years and the bank sets a 5% profit rate. For the sake of simplicity, we'll make it 20 annual repayments.

In the first column (see Table 3) we have the year. In the second column we have the homebuyer's equity purchase, which is how much the buyer pays every year for buying the property's actual equity. It's his way of increasing his ownership in the property, while diminishing the bank's ownership, shown in the third column. The fourth column, called Rent, is what the homebuyer pays the bank for that portion of the property he doesn't yet own, a number that keeps decreasing as the bank's share also decreases. The final column shows what the homebuyer pays in total every year. Let's explain to you how we got these numbers, and how simple it is for most banks to put this together with just the will to take real ownership of an asset.

Let's go through each column one by one.

The homebuyer's equity purchase of \$10,000 is a simple straight line calculation of the \$200,000, divided by the number of years for the financing, 20 years. We subtract this \$10,000 each year from the bank's total balance, to get the next column, the bank's ownership, which, as we see, keeps going down each year until the bank owns none of the property.

Table 3: Nick's Diminishing Musharakah

Year	Homebuyer's Equity Purchase (\$)	Bank's Ownership (\$)	Rent (\$)	Homebuyer's Payment (\$)
1	10,000	190,000	10,000	20,000
2	10,000	180,000	9,500	19,500
3	10,000	170,000	9,000	19,000
4	10,000	160,000	8,500	18,500
5	-	-	-	-

Year	Homebuyer's Equity Purchase (\$)	Bank's Ownership (\$)	Rent (\$)	Homebuyer's Payment (\$)
6	-	-	-	-
7	-	-	-	-
16	10,000	40,000	2,500	12,500
17	10,000	30,000	2,000	12,000
18	10,000	20,000	1,500	11,500
19	10,000	10,000	1,000	11,000
20	10,000	-	500	10,500

Next, we calculate the homebuyer's rent. This is equal to the bank's ownership for that period multiplied by the bank's profit rate. This number also keeps declining each year, because as the bank's ownership declines, so does the homebuyer's rent.

Lastly, we calculate the homebuyer's total annual payment. This is simply the homebuyer's equity purchase plus his rent. This number also keeps declining each year until the homebuyer eventually becomes the homeowner.

At no time does the homebuyer pay any interest. And, certainly, at no time does any payment compound. The homebuyer just pays for two things: the house, in small payments, little by little. And the rent, for the portion of the house he doesn't yet own.

This simple structure is something that just about any conventional bank can offer today. It takes a leap of faith for banks accustomed to interest-based lending to suddenly become direct stakeholders in property. But as the growth of Islamic banking shows, these concerns are misplaced. Call it Islamic finance, ethical finance, or conventional finance, when a bank takes real ownership of an asset, economies don't fall apart like a house of cards.

Faisal The Student

Now our final example. Talking about indebted countries and property bubbles may seem removed from our immediate predicament.

What are we talking about? That's right: personal debt. In the US alone, credit card holders have amassed over \$1 trillion of personal debt. And that's just credit cards.

Let's take Faisal's student loan for example.

His education cost him about \$30,000 a year for four years. That's \$120,000. And Faisal had no savings to start off with. He got an interest rate of 10%, which is fairly typical for many students, and he began borrowing \$30,000 at the beginning of each year. Three years after graduation he began paying off his student loans at the rate of \$20,000 per year.

Can you guess how long it took Faisal to pay off his entire loan?

That's right. It'll take him over 25 years to pay off his loan.

And in the end he spends over \$400,000 to pay for his \$120,000 education. And that's assuming Faisal keeps his well-paying job. If he's unemployed, the debt just gets bigger.

An Islamic bank, on the other hand, could structure a service-based Ijarah to lease out the university's credit hours. Faisal ends up paying about 20% or 30% more; but with the interest-based loan, he pays about 400% more.

Islamic finance never can, and never will be able to grow Faisal's debt once it's fixed.

Principles of Islamic Finance

Let's now step back for a moment and ask: so how *does* Islamic finance make any money?

Let's take a moment to compare banking in general with Islamic finance.

All banking products can largely be divided into the following 4 categories:

1. Equity
2. Trading
3. Leasing, and
4. Debt

Equity refers to direct ownership, trading refers to buying and selling, leasing refers to giving an asset or service out on rent, and debt refers to providing an interest-based loan.

Simply put, Islamic finance permits equity, trade, and lease-based transactions, but forbids debt.

And in many ways we're already familiar with these kinds of transactions. Here's most of Islamic finance in a nutshell:

- Mudarabah, Musharakah, and Sukuk are all equity based



- Murabaha, Salam, and Istisna are trade based
- And Ijarahs are lease based

Let's look at some of the basic principles that guide Islamic banks.

These are that transactions must:

1. Be interest free
2. Have risk sharing and asset and service backing
3. Have contractual certainty
4. And that all the elements of the transaction must, in and of themselves, be ethical

Let's look at each of these 4 guiding principles.

First, the transaction must be **free of interest**.

The Islamic ban on interest is not new. For centuries banned by Christians and Jews, the Shariah, or Islamic Law, prohibits paying or earning interest, irrespective of whether it is a soft, development loan or a monthly consumption loan.

In fact the Vatican itself has said, "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."

The examples we've seen clearly show the harms of interest, not only to banks and governments but also to individuals. Islam is concerned with the well-being of society, sometimes at the immediate expense of the individual. A single interest-based loan may *seem* harmless, but an entire economy based on interest can have devastating consequences.

The second principle that governs Islamic finance transactions is the element of **risk sharing and asset and service backing**.

The central juristic principle in the Shariah that informs our concept of risk-sharing states: "al ghum bil ghum," meaning "there is no return without risk."

Bankers know that the concept of risk sharing is common to all equity-based transactions. Islamic finance is no different, where profit and loss distribution is commensurate with investment proportions.

Lending cash on interest is not the kind of risk sharing we're talking about. In a conventional loan the bank doesn't directly involve itself in how the cash is spent. Here's the cash. See you in a few months with some extra cash. That's all. Even with a secured loan, in which the bank takes security and gets more involved, there is still no direct equity position. The bank still doesn't own anything. An Islamic bank, on the other hand, actually takes a direct equity position, or buys a particular asset

and charges a premium through a trade or a lease. It uses risk mitigants, but not without first taking ownership risk.

There must also be **contractual certainty**.

Contracts play a central role in Islam. And the uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah.

Contractual uncertainty happens when the basic prerequisite or integral of a contract is absent, such as the existence of the subject matter, the fixing of a delivery date, or the agreement on a price. Conventional insurance, interest, futures and options all contain an element of contractual uncertainty and are thus prohibited.

And lastly, Islamic finance transactions must be **ethical**, which means that there is no buying, selling, or trading in anything that is, in and of itself, impermissible according to the Shariah. Examples include dealing in conventional banking and insurance, alcohol, and tobacco.

With these basic principles in mind, we invite you to try our introductory training modules before progressing onto more advanced topics. At Ethica Institute you learn at your own pace. Play, pause, stop. Anytime, anywhere.

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