

Visions for the Future of RF Banking

THE 2008 GLOBAL ECONOMIC AND FINANCIAL MELTDOWN

As I started writing this book, the world was experiencing the deepest economic and financial meltdown since the Great Depression of 1929. This meltdown has touched every citizen in the world because of the efficient communication systems that have successfully interconnected the world's financial and banking systems. It is unfortunate and sad to experience the laying off of many employees who had nothing to do with what happened, the loss of their homes through foreclosures, the decline in living standards not only in the developed world but also in the developing countries, and the increase in poverty worldwide.

The core reason for what happened has been a culture of “making” money on money by renting it with interest (*riba/ribit*) and speculating with it instead of working hard to earn it. The financial and banking system in the United States is well-designed and regulated, but unfortunately it has been abused by some who claimed that they could create money by using hedge funds, financial speculation, and gambling. The unfortunate thing is that many pension funds joined the party, because they were impressed by the high returns realized by these funds. These pension fund managers should have known better; they were entrusted with the future retirement funds of millions of Americans. Many of those who speculated and gambled with peoples' money and life savings did not abide fully by the regulations. They had the wrong idea about money and what money is all about. They believed that if you have a lot of money, you can make a lot more—not necessarily by investing in productive activities, but by using options, derivatives, and financial

gambling techniques that speculated on what the future holds. The 2008 melt-down proved that this was the wrong way to look at and invest money.

It is interesting to note that only 25 employees in the Financial Products division at AIG (AIGFP)—the huge international insurance company that employed 113,000 professionals worldwide—were responsible for bringing the whole company down. One of their tools was a product they designed to speculate on the movements in interest rates. For example, one of their bets would result in a profit or a loss of \$500 billion if interest rates changed by a small percent in either direction. This loss, realized by the company, is equivalent to paying for the loss and damage caused by 62 California-size earthquakes.¹ Unfortunately, AIG grew so big that even with the most sophisticated management and supervisory tools and techniques, no one could regulate the activities of this small group of employees.

What is most sad and disappointing is the fact that we all were warned many times about the outcome of such speculative activities in the market. Those who were in charge used a bandage approach to fix these problems temporarily. No one took the time or spent the effort needed to meticulously and permanently fix the root causes of the problem. Here is a list of some of the small earthquakes that introduced us to what was waiting in 2008:

- The Savings & Loans junk bond crisis (\$240 billion loss in 1989)
- The German commodity and metals company “Metallgesellschaft” (\$1 billion loss in 1993)
- Barings Bank (speculation by one of its traders in Asia cost more than \$ 410 million)
- Procter & Gamble Corp. (loss of \$160 million in 1994)
- Orange County, California (\$1.7 billion loss in 1995)
- Long-Term Capital Management Corporation (\$4 billion loss in 1998)
- Global Crossing Corp. (billions lost in 2001)
- Enron Corporation (billions lost in 2001)
- WorldCom Corp. (\$3 billion lost in 2002)
- Société General unauthorized trading (\$7 billion lost in 2007)

Analysts in most of these cases concluded that the main reasons for not avoiding these losses were management’s lack of clear and thorough understanding of the products and risks involved and the assumptions used in structuring these speculative financial products.

THE MEGA-BANKS AND FINANCIAL INSTITUTIONS

The primary reason for these mega-losses is believed to have been the lack of good and responsible judgment by those who were in charge. Many reasoned

that what happened was due to the lack of suitable government regulations. That may be partially true, especially in the cases of hedge funds and derivatives and associated financial products. The real fact of the matter is that the prevailing culture of renting money prompted many money managers to believe that money can reproduce and become productive if it is placed in speculative and “smart” products. As we detailed in this book, money is a tool, and it does not reproduce unless it is invested in a productive activity that adds value to the economy of the community and the country. There was an ill judgment, because speculation and its tools are a zero-sum game. Those who outsmarted other managers came away with huge profits at the expense of huge losses by others who made the opposite bet. As the hedge fund industry grew bigger, it dabbled in currency speculation, as happened in the 1997–1998 Asian Currency Crisis, which brought down the Asian economies. When the leaders of Asia complained bitterly about the need to stop these huge gambling activities and the way these activities were impoverishing their economies, they were lectured by the self-appointed and self-serving “free market” advocates and were marginalized. As the problem grew even bigger, these hedge funds did the unimaginable by bringing down the economies of the United States and the world in 2008.

No government can issue regulations that would guarantee good judgment. Good judgment has to do with a value system taught at home by the parents, by the values taught as families worship and become enriched spiritually, by the standards set by the school system, and by the university professors who teach finance. Judgment has to do with the prevailing culture, which is nurtured by the media that defines the norms of what is considered an acceptable behavior and lifestyle.

THE CULTURE OF RENTING MONEY WITH RIBIT/RIBA

As we sort out and sift through the events that led to the financial earthquake of 2008, we conclude that there must be an optimum size for a company or a bank, beyond which the company becomes inefficient and difficult to manage and may become a great liability to the economy as a whole (as in the cases of AIG and Citigroup). The towns and cities of the United States were built by community building and loan societies, which gathered the community’s savings and invested them prudently back in these communities to finance the building of homes, cars, home mortgages, businesses, and other community needs. Many of these savings and loan local community banks were taken over by the big banks like Citibank. The progression of growth in the size of these banks tempted management to make more money by controlling more money. It was done first by becoming the large and certified banker of the government and then the preferred bank of the

large corporations, because they offered larger loans at lower interest rates and costs through their vast networks worldwide. Instead of large corporations supporting the local communities by using the services of their local community banks, savings and loans associations, and credit unions, they all migrated to the big banks.

As these big banks ran into no other areas for growth, they started to focus on the local communities and the small investors by essentially gobbling up most of the small community banks and savings and loan branches. They lured the gullible and simple law-abiding citizens to do business with them through slick advertising. For example, credit cards, which were designed to facilitate the day-to-day buying needs of the consumer, were changed into instruments to encourage small-size consumers to borrow money and consume more—without being told the truth about the high costs of borrowing via credit cards. University and high school students were offered credit cards. Many of them did not qualify on their own merit; they were sent credit cards by mail, because the companies knew that their parents would foot the bill. Many parents were surprised to receive their children's large credit card bills, which had to be paid to save their sons' and daughters' financial reputation and future credit.

Credit cards were also used to lure consumers by offering zero interest for six months. However, the card issuers did not make it clear to the consumer that after six months the interest rate would go to, say, 8 percent, and that if there were a delinquency, the rate would reach as high as 28 percent. All of these “unimportant” details were printed in tiny letters that could hardly be read, to “comply” with strict consumer compliance regulations. The only reason a credit card company would change interest rates arbitrarily and charge a lot of fees is that the company is in the business of renting money that borders on defrauding people, by seducing them to spend more so that the companies can make more money. It is surprising to observe that an average citizen with humble income and assets is allowed to own ten credit cards and accumulate a debt of more than \$100,000, as we experienced with the many decent fellow citizens who called us at LARIBA and the bank to help them sort out their personal financial problems.

Perhaps the saddest of all has been the way major banks handle overdrafts (non-sufficient funds checks written by customers who do not have enough money in their accounts). U.S. banks and credit unions are expected to make in 2009 an estimated \$38.5 billion in overdraft fees, 90 percent of which will be paid by 10 percent of customers, according to a Moeb's Services survey featured in the *Financial Times*.² The survey of more than 2,000 depository institutions found that the national median overdraft fee rose by one dollar to \$26 in 2009, with larger institutions charging a median of \$35 per overdraft. It also found that 44.5 percent of all institutions have overdraft income greater than net income. The

highest overdraft fees were charged by the largest banks, said Mr Moebs. At banks with assets greater than \$50 billion—a group including Citigroup, Bank of America, JPMorgan Chase, and Wells Fargo—the median overdraft fee is set at \$33. At BofA, a customer overdrawn by as little as \$6 could trigger a \$35 penalty. If the customer does not realize they have a negative balance and continues spending, they could incur that fee as many as 10 times in a single day, for a total of \$350. Failing to repay the overdraft within a few days results in an additional \$35 penalty. Conceptually, banks can be looked upon to be officially in the business of renting money (*riba/ribit*) and not in the real business they were created to do: investing in local communities.

As if that were not enough, a wonderful government program designed to help students who are in dire need to finance their education at low interest rates was also abused by those who love to rent money. The student loan program became an easy outlet for students to live it up, to spend more, and in some cases use the money as a down payment for a car or a house by also using the subprime home mortgage facilities. The daughter of a friend of mine, who is only 26 years old, graduated with a law degree from a prime university that cost her \$350,000. She financed this huge debt with a student loan. The sad part of the story is that she could not find a job. One can only wonder at how university graduates can start their careers and a family while owing these huge sums of money.

It must also be said that the student loan facility has helped inflate tuitions at universities and costs on campus. The culture of renting money and of spending today to pay later (with interest) has taken over American culture. The American lifestyle that once called for students to work hard while going to schools and colleges, taking part-time jobs as dishwashers, cleaning crews, waiters at restaurants, and tutors to help finance their education has largely gone by the wayside.

Perhaps the saddest part of this culture of renting money was accepting speculation and gambling techniques as a legitimate way of “making” money without having to work hard to “earn” it. These techniques were given fancy names and legitimate theories by distinguished professors at very prestigious universities. Investment bankers on Wall Street hired the brightest mathematicians from the best universities, such as, for example, CalTech (the California Institute of Technology, Pasadena, California, where Einstein was a visiting scientist), to work on these schemes and algorithms of gambling, using the same theories, algorithms, and solutions that are applied in the casino industry. These talented graduates were recruited to devise more sophisticated tools to outsmart others with money in order to win and “make” more money, instead of using their wonderful talents and education to design, for example, a better and more energy-efficient lifestyle and to teach the future generation.

The son of a friend of mine is a gifted mathematician. He was offered a multimillion dollar per year job at a major investment bank in New York to work on these mathematical models. As he explained it, one can only wonder at the way the stock market and the bond market were turned into a large gambling casino. It is puzzling that an investment bank could justify this large salary for a young university graduate who did not even have to assume any risk! This culture proliferated throughout the economy. Medical doctors have to charge their patients and insurance providers a lot of money, which they turn around and pay back to (possibly) the same insurance company, to protect them and their families against malpractice law suits.

Probably the saddest part of all is the mirage of wealth that many thought they had on paper for years, only to discover that it was just paper wealth. Unfortunately, that discovery came a bit late for the majority of the baby boomer investors, who were preparing to retire just as the bubble burst.

THE LIFESTYLE OF THE JUDEO-CHRISTIAN-ISLAMIC VALUE SYSTEM

As was stressed throughout this book, the Judeo-Christian-Islamic value system prohibits us from participating in the culture of renting money. Perhaps one of the most important prohibitions in the Jewish Bible (*Exodus: Chapter 22, verses 24–26*), the Christian Bible (*Exodus 22:25, Leviticus 25:35–37, Deuteronomy 23:19–20, Nehemiah 5:1–13, Psalm 15, Proverbs 28:8, Ezekiel 18:5–18, Habakkuk 2:6–7, Luke 6:27–36*) and the Qur'aan (*Chapter II—Al-Baqarah 275-278, Chapter III—Alee Imraan—The Family of Mary & Jesus (the family of Imraan):3:130, Chapter IV—An-Nissa'aa (Women):4:161, Chapter XXX—Ar-Rum (The Romans) 30:39*) is the prohibition of *Ribit* (Old Testament) or *Riba* (the Qur'aan).

As explained in Chapter 2, we know from the original Jewish teachings that a person of the Jewish faith who participates in ribit cannot stand as a witness in a Jewish court; the old Catholic teachings (before 1100 C.E.) hold that a person who deals in ribit is denied a Catholic burial. In the Qur'aan, charging of ribit/riba is one of the most severe offenses against God.

As discussed in great detail throughout the book, ribit/riba, according to Judaic, Christian, and Muslim teachings (which this book has pioneered calling Judeo-Christian-Islamic values) can be defined as the act of renting money at a price called *interest*. In the old days, the word *usury* was derived from the act of paying a price (interest) for the use of money. We also know that today's money is a thing, a manmade currency. It is fungible, just as an apple is. One cannot rent an apple from another, and the same applies to money. The minute money is handed over to another person, it becomes

that person's responsibility to invest it prudently, and it is the responsibility of those who give it in trust (the bankers) to users (the borrowers) to handle it prudently.

That is why today's culture, which emphasizes spending as much as you can today by renting money with interest from banks, by using credit cards, and by using the family's home as a credit card (home equity line of credit and loans), is frowned upon and prohibited by all faiths, especially those in the Judeo-Christian-Islamic value system. Money is a measuring device that quantifies the success or failure of an investment. It is not for hire or rent to the highest bidder (at the highest interest rate). If we had evaluated the purchase of each item, based on its utility as measured by its actual market rent (rent of a car, a house, or a business, according to the *mark-to-market* and *commodity indexation* rules discussed in the book), we would have been saved from speculation and from the deep holes of debt many of our community members and our beloved country and the world are suffering from. That is why Jesus (pp) took it upon himself to drive the money-changers out of the temple.

It is believed that one of the important elements in solving the unfortunate financial meltdown is to simply reverse the trend of mergers and acquisitions that caused the financial institution to grow so large that it became difficult to manage and regulate. It is sincerely believed that it is the responsibility of the government regulators, through their periodic examinations, to decide whether an institution has outgrown its ability to manage risk. Time and again we were taught—by the hard school of loss of peoples' money and assets—that the investment banking culture is completely different from that of the commercial banker. Based on my own experience while working with Smith-Barney and Citigroup, it is evident that investment bankers and commercial bankers have two different temperaments, risk tolerances, and purposes. It was proven that the two cannot be merged or mixed. Bank of America tried it with Charles Schwab and failed; Citibank and Smith Barney tried and failed; and now Bank of America, after merging with Merrill Lynch, is once again finding out that what we learned in the late 1970s and early 1980s still holds true. Perhaps we should respect the experience that led to the *Glass-Steagall Act*, which installed a thick wall between the two activities after the Great Depression.

SOME ADVICE FOR THE NEWCOMERS TO THE RF LIFESTYLE

It would be useful to bring to the attention of all people who have decided to join the RF lifestyle a few recommendations as to what to do. We need

not to overindulge. We need to live within our means, to stop overborrowing. We should not use credit cards as a means of borrowing, but should use credit cards judiciously and pay off credit card purchases within a month to avoid paying interest. We need to save (for a “rainy day”) ten cents of every dollar we earn. We should not panic and sell stock portfolios “low” nor invest in the stock market once we are too old for the risk required. (The formula recommended is to subtract your age from your family’s life expectancy—for example, if your family’s life expectancy is 75 and you are 65 years old, the maximum exposure to investing in stocks should be 75 minus 65, or 10 percent of your total assets.) Furthermore, we should strictly advise our children to stop taking excessive student loans to live it up. It is better for a student to graduate in six years with a part-time job and no debt than in four years with \$120,000 in student loans. We need to help each other, to buy within our communities, to reinvest in our communities, and to do business with our local community banks and credit unions. We need to help the elderly who were forced to take a 70-percent income cut because of the reduction of interest rates on CDs. It is sincerely hoped that the elderly Americans who live on Social Security and the few dollars they get from that reduced “interest” on their small savings will be helped and taken care of by the younger generations. After all, they are the ones who built the United States.

The RF bankers, bank branches, and Internet services should also become very active in the popularization of a new lifestyle—one that believes in minimum debt and in paying off that debt as soon as possible, in saving for the future, in living within our means, in offering a healing hand and resolution plan to those who need help, in encouraging students to do without student loans unless it is absolutely necessary. As RF bankers, we should lead a compassionate life that cares about others. This can most effectively be done in collaboration with local community and religious leaders in a wonderful interfaith cooperation that will lead to peace, prosperity, mutual respect, and a wonderful life for all.

NOTES

1. The highest insurance cost paid by AIG Insurance Company for a California earthquake was around \$8 billion.
2. Saskia Scholtes and Francesco Guerrera, Banks make \$38bn from overdraft fees, the *Financial Times*, August 10, 2009.