Recent Quotes on Western Banking:

''In their current condition our banks are an existential threat to British democracy, a more serious threat than terrorism'' – John Lanchester in the London Review of Books dated 4 July 2013.

'' the public have a sense that advantage has been taken of them, that bankers have received huge rewards, that some of those rewards have not been properly earned, and in some cases have been obtained through dishonesty, and that these huge rewards are excessive, bearing little or no relation to the work done'' – by The Parliamentary Commission on Banking Standards on 19 June 2013.

''there is one key difference between the situation today and that in the Middle Ages. Then, the biggest risk to the banks was from the sovereign i.e the Monarch, due to the poverty of the Crown. Today, perhaps the biggest risk to the sovereign i.e the people comes from the sovereign'' – by Andrew Haldane, director of stability at the Bank of England.

Islamic Banks vs Western banks:

By way of introduction:

''Can I just say at the outset that I am neither an expert on banking nor an exponent/promoter of Islamic banking, nor do I think that Islamic banking is a panacea for all the ills of western capitalism or western banking system. My experience and interest in Islamic banking began during my living and working in the Middle East for a brief period, and especially following the meltdown of the financial markets, the universal discrediting of the Wall Street System in 2008, which triggered the worst global economic crisis since the Great Depression of the 1930's.''

There was one striking feature during that period, and that is, whilst the world was watching, with disbelief, the collapse of established western financial giants like Morgan Stanley, Lehmann Brothers, Goldman Sachs in USA, and Northern Rock, Royal Bank of Scotland and Lloyds TSB Banking Group in UK – whilst we were all witnessing that and the domino effect it had on other banks across the world, <u>not</u> a single bank or financial institution collapsed in the Middle East or Africa during that period.

The main accusation against the western banking system in all its forms (conventional or investment banking) is that

almost all of its profits are derived from one source and one source only i.e charging interest on debt. In other words their very existence and entire operations are concentrated on investing in debt, and charging interest on that debt (personal and business loans, mortgages, hire purchase finance, overdraft facilities) without any risk to their corporate shareholders – very often using the borrower's assets (e.g property) as collateral i.e security for the loan, or forcing him/her take very expensive Payment Protection Insurance with the lender in case of default. On top of that comes an array of other charges e.g arrangement fees, up-front fees, accounts fees, roll up fees in the event of defaults and so on and so forth.

The only time the buggers got stuck was during the Mortgage Crisis (for closure) in USA in 2008. As you probably know, American banks, encouraged by successive American administrations, were lending on an industrial scale to very low income groups (some of them were so poor, they could hardly afford to feed their children) so that those people could buy their homes and realise their American Dream ! Those mortgages carried very low interest rates in the first 2 years followed by astronomical and ever increasing rates of interest in the following/successive years (up to 20 – 30%). Those American banks then began to sell those mortgages i.e debts (in bundles of say 50,000 – 100,000) to other western banks, who were of course very keen to invest in debt themselves. When those homeowners defaulted on their

monthly mortgage payments, due to the astronomical rates of interest, the whole thing collapsed and with it came the melt down of the global financial markets (the domino effect).

Islamic banking operates on completely different basis. The Cardinal Principal of Islamic banking is that any financial gain/profit <u>must</u> drive from something tangible i.e trade or an investment project of some kind and <u>must</u> involve an element of risk on behalf of both the lender and the borrower . In other words any financial gain that simply derives or emanates from charging interest on money leant and does not involve any risk to the lender and borrower is regarded as unethical and immoral. Under an Islamic banking system charging interest on money leant is prohibited. Furthermore, Islamic banks do not invest on the 'unknowns' e.g hedge funds, derivatives, currencies because they all involve speculation.

The three Great Religions (Judaism, Christianity and Islam regard interest (usury) as sinful and ungodly. The practice was prohibited in both the Old and New Testaments, while Shakespeare and many other writers, particularly those writing in the 19th Century (Dickens for example) have attacked the barbarity of the usury. Early Jewish and Christian traditions also forbad usury. Even the Greek Philosopher Arsitotle condemned acquiring wealth by the practice of charging interest on money '' of all the ways of

getting wealth, charging interest on money leant is the most contrary to nature because it leads to the destitution of the poor and enrichment of the powerful''. Even Adam Smith, the father of modern capitalism, regarded the practice as harmful to the idea of free markets and asked for interest to be capped. It is not surprising therefore that Money Lenders across the ages and in all civilisations were regarded with disdain. I suppose the present day equivalent are: loan sharks, pay day loan companies (e.g Wonga) some of whom charge up to 2000% interest on these loans; this is why the Coalition Government is thinking of legislating to limit some of their practices.

The prohibition of paying or receiving fixed interest is based on the Islamic tenet that money is only a medium of exchange, a way of defining a value of something – it has no value in itself and as such it should not be allowed to give rise to more money. The human effort, initiative and risk involved in a productive venture are more important than the money used to finance it. There is no real 'lending' in Islam since all lenders obtain an ownership share in the project they finance. In order for an Islamic bank to earn a return on money leant, it is necessary to obtain an equity or ownership in a non-monetary assets. This requires the bank also to participate in the sharing of risk.

Growth of Islamic Banking:

Before going to explain the various financial products provided by Islamic banks without charging interest, I think it's worth saying something about the growth and popularity of this type of banking. Islamic banking has been growing at a breath-taking scale especially in the Middle East, Asia and Africa and even some European countries. In 1975 there was only one Islamic bank. Today there are over 300 in more than 75 countries, including the United Kingdom. Lloyds TSB offer few Sharia compliant Islamic financial products; HSBC, because of its international status offer an even wider range of these products. The British Islamic bank in the City of London is offering all sorts of Islamic financial products including business loans, hire purchase as well as a wide range of institutional and business banking products including commercial property.

How do Islamic Banks make money without charging interest?:

1. Deposit Account:

   Because Islamic banks do not offer interest on customer's savings, the term used by the bank here is 'Safe Keeping Account'. The bank regards itself as the 'safe keeper' of the fund. Unlike a conventional bank, there is no prior contractual agreement between the Islamic bank and the depositor with regards to the level of interest or the length of time the depositor is supposed to leave the money in the account. The

depositor is free to withdraw all or part of the fund at any time. At the end of the bank's financial (after it has done its profit & loss accounts) the bank rewards the depositor with a 'monetary gift', taking into account the amount of money in the account and of the length of time the depositor kept the money in that account. This may seem similar to charging interest just like any other conventional bank. However, there are fundamental differences: as I said above, there is no prior agreement between the depositor and the bank with regard to the level of interest and the term, also both the lender and the borrower have taken a risk. In other words, the 'monetary gift' is totally dependent on the return of the investments made by the bank in that particular year.

2. Business Loan:

The term used by Islamic banks is 'Profit Sharing'. An Islamic bank, like most conventional banks, would be prepared to lend money to an entrepreneur if the bank thought the business plan was viable. However, for an Islamic bank to earn a return (not interest) on the money leant, it is necessary to obtain an equity/share in the investment and thereby also participate in the sharing of risk. Profits are split between the bank and the entrepreneur (depending on the profit sharing contract between them) until all the original funds provided by the bank are repaid. The bank takes full

responsibility of the debt if the business fails, but the entrepreneur is not compensated; to expect the entrepreneur to repay the money leant to him to the bank would be the equivalent of the bank lending money and charging interest which is prohibited under Islamic law. As you can see in such a transaction there was no Interest involved and both parties have taken a risk.

3. Common Ownership Investment:

   This is similar to profit sharing, the only difference is that it involves the bank and a number of entrepreneurs – but works on the same basis with no charging of bank of interest and everyone takes a degree of risk.

4. Islamic Mortgages:

   An Islamic bank would not agree a mortgage to an individual and then charge interest on the money leant, for that would be prohibited under Sharia law. The bank would of course do the necessary surveys on the house to be purchased as well as the ability of the mortgagee to repay the money leant to him/her. The bank would then purchase the property (for say $100,000) and then sells it to the mortgagee for a reasonable price (say $110,000). This way the bank has invested in a property

and then sold it to the mortgagee for a profit, without charging interest. The mortgagee will then repay the bank $110,000 over an agreed period of time. Under a conventional mortgage the mortgagee is expected to repay the original loan given by the bank or building society plus interest which could amount to him paying well in excess of $110,000, depending on the rate of interest charged. The bank or building society reserves the right to possess the property in the event of default.

5. Islamic Hire-Purchase Finance:

As we all know this is normally used in financing consumer goods especially cars. There are normally two separate contracts: ‘leasing/renting’ or ‘purchasing’ of the vehicle. The bank would purchase the vehicle and sells it to the individual concerned at a reasonably agreed profit. The individual has the option of leasing/renting the vehicle from the bank at an agreed price. When the individual has paid rent equivalent to the original purchase price, he has the option of purchasing it from the bank, taking into account the depreciation of the value of the vehicle. Alternatively, the bank can purchase the vehicle (e.g $10,000) and sells it to the individual at a reasonable profit (say $12,000). The individual would then repay the bank the entire sum of $12,000. Again no interest is charged.

6. Islamic Certificates (Bonds)

The most significant growth of Islamic banking in the recent period, however, has been in Islamic Certificates the Arabic word is *sukuk,* similar to bonds in the western financial system. Unlike western bonds where the bond holder invests in what is effectively a debt and is guaranteed a fixed level of return by the issuer of the bond, an Islamic bond-holder owns an equity in a tangible asset and the returns are dependent on the performance of that asset. The first Islamic Bonds were issued by Malaysia in 2000, followed by Bahrain in 2001. Since then Islamic bonds have become important Islamic instruments in raising funds in many Arab, African and Asian countries to finance long term infrastructure projects. According to the 2012 Global Islamic Finance Report $1.34 trillion are being managed according to Islamic investment principles. In the Persian Gulf, Standard & Poor estimates that 20% of banking customers would now spontaneously choose an Islamic financial product over a conventional one with a similar risk-return profile.

Limitations of Islamic of Islamic Banking:

a. Managing assets, portfolios and funds according to Islamic principles is not always easy because of the complexities of the Stock Exchange and changing global markets.

b. There is no guarantee of return because the return of any Islamic financial product is dependent on the future performance of that product, and therefore not suitable for people about to retire. Retirees rely on the predictable income generated by conventional bonds especially government bonds which have low but 100% guaranteed return. Having said that we have seen in recent years pensions are affected by the down turn in the global markets.

c. Absence of International Commercial Laws that govern Islamic banking, as is the case with conventional commercial transactions.

d. Similarly, absence of Arbitration Islamic Courts to settle disputes, as is the case with western financial activities.

Any questions please?

Differences between Islamic Banks &Western Conventional Banks?

<u>ISLAMIC BANKS</u>	<u>WETERN BANKS</u>
Focus on investment	Focus on lending

Emphasis on soundness of.... Project	Emphasis on ability to repay money borrowed+interest
Apply moral criteria in ..... investment	Apply only financial criteria