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Islamic Finance and the New Financial System

*An Ethical Approach to Preventing
Future Financial Crises*

TARIQ ALRIFAI

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Islamic Finance and the New Financial System

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Cover design: Wiley

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1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

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Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

Library of Congress Cataloging-in-Publication Data is Available

ISBN 9781118990636 (Hardback)

ISBN 9781118990698 (ePDF)

ISBN 9781118990681 (ePub)

Typeset in 10/12pt, SabonLTStd by Laserwords Private Limited, Chennai, India

Printed in Singapore by C.O.S. Printers Pte Ltd

10 9 8 7 6 5 4 3 2 1

I dedicate this book to my wife, Andrea, for her support and encouragement. Without her efforts, this book would have not been finished on time!

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About the Author

Tariq Alrifai has been involved in Islamic finance for more than 18 years. He is an active public speaker on Islamic finance around the world and a leading authority on Islamic funds and investment products. He has written for prestigious publications such as Euromoney Books and the Harvard University Forum on Islamic Finance, and was a contributing author of *Contemporary Islamic Finance: Innovations, Applications and Best Practices*, published in 2013. He is often quoted in print and electronic media, including the *Financial Times*, Bloomberg, Reuters, and CNBC Arabia.

Tariq was previously the Global Director of Islamic Indices at S&P Dow Jones Indices. He also served as vice president of UIB Capital, a U.S.-based private equity firm. Prior to this, he was vice president and manager of HSBC Bank's Islamic Finance Program in the United States. In 1996 Tariq founded Failaka Advisors, which was the first-ever organization to monitor and publish research on Islamic funds.

Tariq holds an MBA from DePaul University in Chicago and a bachelor's degree in international business from St. Cloud State University in Minnesota.

Acknowledgments

A lot of time and effort was spent researching this topic and gathering data. This would not have been possible without the support of the following people and organizations:

- Advisor Perspectives, Inc.
- Elliott Wave International
- Federal Reserve Bank of St. Louis Research Division
- KFH Research Ltd.
- Merk Investments LLC
- Professor Emmanuel Saez, Department of Economics, University of California, Berkeley
- Professor J. Lawrence Broz, Department of Political Science, University of California, San Diego
- Zerohedge.com/ABC Media Ltd.

Islamic Finance and the New Financial System

Introduction

Monday morning, September 15, 2008, I was sitting in my office settling into my daily routine when I heard a lively discussion among my colleagues who were gathered in our reception area. It was not uncommon for them to gather there and chat, since it was the only open space other than the meeting room where we could all talk. It was also where we had a flat-screen TV mounted on the wall blaring CNBC all day. I never paid much attention to it.

That morning, the chatter was different. I got up from my office to see what the day's topic was. What I saw was my colleagues staring at the TV in disbelief. "Tariq, get over here and check this out," said one of them. "We're screwed," said another.

In 2004, I had left my vice president's job at HSBC Bank in New York to join a start-up private equity shop in Chicago. The new firm was to be the U.S. investment arm of a Bahrain-based Islamic investment bank. The bank was also new, having been set up less than a year earlier. I was hired early on to help set up the U.S. operation and build the investment team. Management and shareholders of the bank believed that to be a world-class bank, as they strived to be, they must build up an investment capability in the United States. It was determined that private equity (PE) was the expertise they needed to develop, as they already had a good amount of expertise in real estate, which is a traditional favorite asset class among Middle East investors.

Since the dot-com bust in 2000, private equity had become one of the hottest asset classes on Wall Street, later spreading to Europe, but the Middle East was still way behind in developing a PE industry. Middle East financial institutions were envious of the high returns PE firms in the United States were generating. Middle East investors were successfully courted by these firms and invested heavily in some of the largest shops in the business, such as Carlyle Group and Thomas H. Lee Partners. All the big Wall Street firms also had PE arms and were generating high returns for their investors.

The Bahrain-based bank decided that launching a U.S. private equity office would be the best way to develop expertise in PE and eventually bring it to the Middle East. For the time being, the U.S. office would hire professionals from the PE industry and invest in U.S. companies using equity from the Middle East and leverage/debt from the United States. Thus, not only

were we reliant on our parent bank for equity, we needed to source leverage locally through banks and specialized lenders that catered to the PE industry. In addition, since we had to follow Islamic finance guidelines in all of our investments, the leverage we secured from the United States had to comply with Shariah guidelines. This attracted both curiosity and interest on the part of U.S. lenders; some of them liked the concept and were interested in working with us, while others felt it was too strange and foreign and had no interest in our enterprise. I'll explain more about the differences between Islamic finance and conventional finance in Part II of this book. Needless to say, without equity from Bahrain, and without leverage from U.S. firms, we could not invest.

By 2008, we had built a team of eight people and invested in five companies worth more than \$300 million, in both equity and leverage financing. For the most part, our parent bank was pleased with our achievements but, at the same time, was under increasing pressure from shareholders to use more of the bank's capital for investments in the Middle East. We were asked to start reducing our reliance on equity from Bahrain and consider sourcing both equity and leverage financing from the United States. This made the events of September 15, 2008, particularly worrisome for us.

The news on CNBC was grim. The Dow Jones Industrial Average had already lost more than 700 points in early trading, and all other markets were sinking fast. The news driving this was the announcement that Lehman Brothers, one of Wall Street's oldest and largest banks, had filed for bankruptcy protection. This seemed to come out of nowhere. When I went home the previous Friday evening, all was well. By Monday morning, all of a sudden Lehman was going out of business. How could this be happening?

I remembered that in March 2008, Bear Stearns, another one of Wall Street's oldest and largest firms, collapsed and was forced to merge with JPMorgan in a Federal Reserve brokerage bailout deal. Back then, the bank's failure didn't cause such ripples through the market. What had changed now?

In the days following September 15, global credit markets froze and major financial institutions around the world were on the brink of failure. The United States, along with regulators and governments from around the world, agreed to pump trillions of dollars into the global financial industry to save it from the worst financial crisis in recent history.

The global financial crisis of 2008 shocked everyone. Much of the world was caught off guard because of its severity and reach. Now, nearly six years since the crisis began, the world is still reeling from its effects. Global growth has not returned to the level it had reached before the crisis, developed countries are saddled with debt, and unemployment rates have yet to recover to what they were at precrisis levels. Much of Europe, as an example,

has been seesawing in and out of recession, just as Japan has for the past two decades.

Never in our lifetime have we experienced such a severe recession. Governments and central bankers around the world have not been able to cure the economy of its ills, even after unprecedented government bailouts and central bank money printing.

The events of 2008 caught me and my colleagues off guard as well. We had worked in finance and banking for our entire careers, yet we failed to see this crisis coming. It hit all of us very hard—especially me. In 2006, I got caught up in the housing market. The pressure was on to buy a house before prices rose to an unaffordable level. At that time, the thought of paying rent was crazy because home prices were rising steadily, so owning a home became the best tool for building wealth. The housing market in Chicago was one of the hottest markets in the country. Quality single-family homes in Chicago were hard to find and not cheap. I decided to bite the bullet and “invest” in a new development. To avoid a big mortgage, I decided to make a large down payment (25 percent), since I wanted to build equity fast. I went with a conventional jumbo mortgage. To most financial experts, this was considered to be an excellent and conservative financial move. By the summer of 2009, I had lost my job at the firm and my 25 percent equity in the house went to zero.

So, yes, I was hit especially hard by the financial crisis. The bulk of my savings that was my home equity simply disappeared. The shock of losing my savings as well as my job led me to start asking myself questions, beginning with: How could I let this happen to me and my family? How could I not see this coming? Why didn't the experts in the field, along with all the economists and analysts, tell us about this? I spent the next five years reading, researching, and learning in order to figure out what had happened and how I could protect myself from future financial crises.

Much of what I learned I will share with you in this book. The book is divided into three parts. Part I talks about the financial system and financial crises. It also discusses the financial crisis of 2008 and the solutions that were applied. Part I ends with a discussion of the root causes of financial crises and why the next one will be worse than the last one. Part II is an introduction to Islamic finance. For those of you who are familiar with this industry, it will be nothing new. For those of you who are not familiar with Islamic finance, this will give you a good overview of its principles and practices. You will also see that some of the key principles of Islamic finance are based on sound financial and economic principles. We can all learn from this regardless of our differing faiths. This is not a religious book by any means; it's a book on financial crises and how to prevent them from happening again, for everyone's benefit. Part III outlines some practical solutions

the finance industry can take from Islamic finance and apply to building a better system.

As we shall see, identifying the core problem is easy, but the solution is painful. Governments and central bankers do not have the will to take the necessary steps to fix the core of the problem, which is simply the ever-increasing mountain of debt in the world. The cure, therefore, is to reduce the level of debt, which then creates an entirely new set of problems and challenges.

We are now at the stage where the next financial crisis will put too much stress on our current system. As such, governments, economists, and central bankers will need to develop a new system to address the issues of the current one.

Islamic finance might seem like an odd place to look for ideas for a new global financial system, but, as we shall see, many of its key elements are based on sound economic principles. Global leaders may not know they are adopting Islamic financial principles when designing the new system, because they will be looking to build a system that will help protect us from the ills of the current one. Islamic finance has some of the answers to this problem.

PART

Financial Crises and the Current Financial System

A Brief History of Financial Systems and the Birth of Money

Most of us know very little about our financial system and its history. Even though I had worked in the banking and finance industry for close to two decades, I knew very little about the financial system's history until I started doing my research. I was surprised to learn that our current financial system is only about 43 years old. I knew that the world had been using paper currencies for hundreds of years and that, before this, coins were used, mainly gold and silver. However, the circumstances for the shift from coin to paper as well as the shift to fiat currency were all new to me.

What I came to realize was that our financial system moves in cycles much like an economy does. It goes through periods of growth and expansion and then decline. There have always been crises in financial systems. No financial system has ever been perfect and free of flaws. Crises can be sparked by many factors—wars, speculation (bubbles), runaway government borrowing and spending, and government mismanagement of the economy or its currency.

To understand where we are and where we are heading, we must first understand where we have been, beginning with the history of money and financial systems. Literally hundreds of books have been written on early currencies and financial systems. This topic alone deserves time to explain in detail. However, to keep focused on the topic of this book, I will attempt to summarize the evolution of currencies and financial systems in this chapter.

EARLY FINANCIAL SYSTEMS AND CURRENCIES

Financial systems existed long before gold and silver were used as a medium of exchange. One of the earliest forms of money was cattle and other animals, which were used as a medium of exchange and a store of value as early as 9000 BCE.¹ Animals were used as payment under Roman law, whereby

finances were paid in oxen and sheep.² Sacks of grain, salt, and even seashells have been used as a form of currency for trade at one point in time.³ Thus, trade, taxation, and payment of fines existed before metal coins and money as we know them today were used.

There is even some research supporting the idea that debt and credit existed before coins and other money came into existence.⁴ According to David Graber's research and his book, *Debt: The First 5,000 Years*, the first recorded credit and debt systems developed more than 5,000 years ago as means of accounting. Credit and debt existed in the Sumerian civilization around 3500 BCE. In this system of credit, farmers would often become so indebted that their children would be forced into slavery as a means to repay the debt. These debt slaves were periodically released by kings, who canceled all debts and granted them amnesty under what came to be known as the Law of Jubilee in ancient Israel. One of the conclusions of this research was that indebtedness throughout history often led to unrest, insurrections, and revolts.

Though barter was also used throughout ancient societies, it was never a complete system or means of account, as other social factors came into play. Social currencies (i.e., interaction among the community and mutual expectations and responsibilities among individuals) completed early financial systems. Social bonds were also created through gifts, marriages, and general sociability. This type of economy stood in contrast to the moral foundations of exchange, based on formal equality, reciprocity, and hierarchy. This system established the customs in a society, which also led to the development of caste systems (the "haves" and the "have nots").⁵

One of the first written codes of law mentioning money and debt was the Code of Hammurabi, enacted by the Babylonian king Hammurabi, who ruled from 1792 BCE to 1750 BCE.⁶ The code consisted of 282 laws dealing with a wide range of matters, from trade to family relationships. Nearly half of the code dealt with laws for contracts, the establishment of wages, interest rates on debt, inheritance, and property rights.⁷

The first mention of the use of money within the Bible is in the book of Genesis,⁸ which refers to the criteria of the circumcision of a bought slave. There are other early references to money going back as far as the twentieth century BCE, such as Abraham's reference to the purchase of the Cave of the Patriarchs.⁹

An example of an ancient currency is the shekel. It was an ancient unit of account used in Mesopotamia around 3000 BCE¹⁰ to define both a specific weight of barley and equivalent amounts of materials such as silver, bronze, and copper.

The use of coins later developed primarily as a means to pay soldiers in ever-expanding empires around the world. The rise of great empires in

China, India, and the Mediterranean was marked by extreme violence as these empires grew and required more and more resources to pay for their expansion. In this way, coins developed to pay soldiers in far-off lands as well as to enforce the payment of taxes by the state's subjects to subsidize its growing armies. Around 1000 BCE, money in the shape of small knives and spades made of bronze were in use in China. The first manufactured coins appeared in India, China, and cities around the Aegean Sea between 700 and 500 BCE.¹¹

GOLD AND SILVER

Throughout history, gold and silver have been the most common form of money. In many languages, such as Spanish, French, and Italian, the word for silver is still directly related to the word for money. Although gold and silver were commonly used to mint coins, other metals were used, such as iron and copper.

The earliest known records of gold and silver being used for monetary exchange date back as far as the third millennium BCE, when gold, specifically, was used in Mesopotamia and ancient Egypt.¹² The first gold coins were minted in Lydia (modern-day Turkey) during the Grecian age around the year 700 BCE.¹³ By the fourth century BCE, coins had become widely used in Greek cities. The coins were supported by the city-state authorities (the issuing authorities), who strived to ensure they retained their value regardless of fluctuations in the availability of whatever base precious metals they were made from.

Once well-established in Greece, the use of coins spread slowly westward throughout Europe and eastward to India. By the second century BCE, coin usage in India had become central to commercial transactions. Monetary systems that were developed in India were so successful that they spread through parts of Asia well into the Middle Ages. During the fourteenth century, much of Europe had converted from use of silver in currency to minting of gold.¹⁴

Metal-based coins had the advantage of carrying their value within the coins themselves. One disadvantage, however, was that they could be manipulated. The clipping of coins was a fairly frequent practice. The clippings were then traded and recycled. Governments, over time, also had the habit of diluting the precious metal content in coins, such as blending copper with gold or copper with silver. This, of course, caused inflation and, in some cases, loss of faith in the issuing authority. Governments did so because they were short on precious metals and had bills to pay.

A bigger problem was the use of coins made of different metals—copper, gold, and silver in Europe. Gold coins, for example, were valued more than

silver coins, and silver coins were valued more than copper coins. In England in the 1670s and 1680s, the gold-based guinea coin began to rise against the English silver-based crown. The huge amounts of gold coming into Europe from discoveries in the New World shifted trade away from silver and into gold. In Asia, the situation was the opposite: Gold was leaving for Europe in favor of silver. Some prominent Europeans such as Isaac Newton, Master of the Royal Mint, were uneasy about these movements, as they created instability and made it difficult to value one metal over another.¹⁵

Soon thereafter, national banks were set up to bring stability to the system by guaranteeing to change money into gold at a promised rate. This, however, did not come without its own challenges. The Bank of England came close to a major financial crisis in the 1730s when customers demanded their money be changed into gold at a moment of crisis. The crisis was avoided only when London's merchants saved the national bank with financial guarantees.¹⁶

What's important to note about this period is that money evolved from being a unit of weight to being a unit of value. A distinction could be made between its *commodity value* (i.e., its weight in gold) and its *specie value* (its value in the market).¹⁷

PAPER MONEY, PROMISSORY NOTES (*SUKUK*), AND BILLS OF EXCHANGE

Once money became a unit of value, it no longer needed to be held in commodity form. Paper money began to appear in China in the seventh century, under the Tang Dynasty.¹⁸ The development of banknotes (paper currency) was rooted in merchants' desire to avoid the weight and bulk of transporting coins to settle large commercial transactions. They developed a system whereby they would issue credit notes, which were for a limited duration and at a discount to the promised amount. This new paper currency did not replace coins until later, in the Song Dynasty, in the eleventh century. The banknotes were used alongside the coins until the central government noticed the economic advantages of printing banknotes and holding a monopoly right over their issuance.

It was not until the thirteenth century that paper money reached Europe through the accounts of travelers, such as Marco Polo.¹⁹ In medieval Italy and Flanders, money traders started using promissory notes due to the high risk and impracticality of transporting large sums of money over long distances. These notes are considered to be the predecessor of the regular banknotes we know today. In 1661, the first European banknotes were issued by Stockholms Banco, later known as the Bank of Sweden.²⁰