

Islamic Banking: Is It Really

Muslim scholars say the Qur'an prohibits collecting interest on loans. But many banks, both global and local, have found clever ways to meet religious strictures. It's a system that may be hypocritical, but also profitable. **BY AARON MACLEAN**

THE COVERAGE CAN be a little bit breathless: "La finance islamique en plein boom," *Le Figaro* reported in September. Yes, Islamic banking, structured along the lines that religion decrees, is in full boom. But is it really banking? And is it really kosher?

Islam prohibits the payment of interest on loans, so observant Muslims require specialized alternative arrangements from their banks. Many of the largest global financial companies, including Deutsche Bank and JPMorgan Chase,

have established thriving subsidiaries that strive to meet these requirements. As a result, optimists speculate that the common pursuit of lucre—divinely sanctioned, filthy, or otherwise—will bring bickering civilizations together. They may be right.

The Islamic aversion to interest collection comes from the Qur'an. Not that the term "interest" is ever used: the Arabic injunction forbids something called *riba*. The Qur'an offers no exact definition of what *riba* meant in seventh-century Arabia, the time and place of the Prophet Mohammed—let alone what

Kosher?

the term should mean today. In particular, the passages are ambiguous on the question of whether *riba* refers to *all* kinds of interest collection, or only usurious interest—that is, lending practices that are, according to some ill-defined standard, unfair and exploitative. What is clear in the divine financial critique is that, whatever *riba* may be, Jews are doing it. At one point God warns that they will face a “painful day of doom” if they keep it up.

This ambiguity was a practical problem for the early Muslim jurists, who formalized religious rules in a code called *sharia*. They were divided on the subject, but as time went on, the weight of consensus came to rest on the side of prohibiting all interest collection. The financial instruments that 20th-century Islamic theorists championed were updated versions of medieval commercial instruments, still known in the Islamic financial sector by their Arabic names:

You don't have to be Islamic to bank in accordance with sharia. All you need is a board of religious scholars to approve your operation.

In addition to bonds, known as *sukuk*, there are profit-and-loss sharing instruments known as *musharaka* or *mudaraba*, Islamic leases known as *ijara*, and a commercial trade instrument called *murabaha*, the flexibility of which

has made it extremely popular among Islamic financial firms.

Banking, as an institution, evolved at the same time as the unprecedented economic growth in Europe over the past 500 years. That growth was made possible in part by the codification, in the

12th century, of a distinction between usury and interest in the Christian tradition.

The Islamic world witnessed the development of corporate contract law and the European banking system from afar. A mixture of traditional arrangements and, later, imported Western practices prevailed in Muslim countries. But it wasn't until the 1960s that anyone tried to combine the two,

governing a modern bank according to Islamic law.

Islamic financial institutions, the argument went, would boost the economic development of Muslim societies. The fraternal style of Islamic banking—with its emphasis on equity financing rather than lending—would enhance social responsibility. In practice, however, Islamic finance has had to bend to the same pressures as any other kind of finance.

Social, religiously oriented investment in the development of the Islamic world is something people are more interested in publicly championing than personally doing. Khalid Ikram, who represented the World Bank in Egypt, says of Islamic banking, “It hasn’t had a lot to do with development.”

Pinning down the growth of Islamic banking is a challenge. Whether a banking system truly counts as *halal*—that is, compliant with the laws of sharia, or, in another religious context, kosher—is a religious question, hard for accountants to answer. Take Iran: should the country’s whole banking system, which is nominally Islamic, be counted as part of the sector even though many experts raise questions about its legitimacy?

The numbers I found were anecdotal. Rodney Wilson, professor of economics at Durham University in Britain and editor of the essay collection *The Politics of Islamic Finance*, estimates total assets within halal banking systems at just under \$500 billion. That’s roughly the size of Wells Fargo Bank, America’s fourth-largest. Hussein A. Hassan of Deutsche Bank predicts that Islamic finance will be the world’s fastest-growing banking sector for years, based on what he calls a modest estimate of 20 percent annual increases in deposits.

So it’s big business, getting bigger, and those who hesitate to enter it now risk suffering an expertise deficit later. The number of professionals trained to structure sharia-compliant products, and of religious scholars qualified to certify them, is small enough to be already causing problems. Governments are getting in the game, too: Japan is

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planning to become the first non-Muslim country to issue sharia-compliant bonds; the UK, Gordon Brown announced last summer, is revising its laws to make London the “gateway” for Islamic finance in Europe; and Malaysia has proposed substantial tax incentives in its 2007 budget for its Islamic financial sector.

Deutsche Bank, Chase, and HSBC, the giant London-based financial institution with an extensive presence in Asia, have all entered the sector within the last ten years. Their moves coincide with rising oil prices, echoing a phenomenon three decades ago.

When the 1970s oil boom gave Muslims and their governments wealth that seemed barely countable, Islamic financial institutions bloomed: the Islamic Development Bank (1975), the Kuwait Finance House (1977), the Faisal Islamic Bank of Egypt (1977), the Jordan Islamic Bank (1978), and others. In 1979, Bank Misr, a conventional financial house in Egypt, became the first mainstream bank to build a halal subsidiary, which in the late 1990s began to attract more capital than its chief domestic competitor, the Faisal Islamic Bank.

Oil prices and religious fervor are both on the rise again. This time, Western financial firms have noticed that you don’t have to be Islamic to bank in accordance with sharia. All you need is a board of religious scholars to approve your operation. Muslim is as Muslim does.

Hussein Hassan of Deutsche Bank is an example of the sort of expert required. He structures specialized Islamic bonds, or sukuk. For a bond to qualify as sharia-compliant, there must be an underlying asset backing it. One cannot simply issue bonds to raise money, the way it’s been done elsewhere for centuries, in return for a promise of a fixed rate of return. To be Islamic in nature, the securities that look like bonds must represent fractions of an equity asset, rather than fractions of a loan.

According to sharia scholars signing off on the prospectuses, the practices of the multinationals

are fully Islamic. That is good news for corporations that want to raise money from Muslims, and for the observant clients themselves. But the potential clientele is by no means captive. As Hassan put it to me, "Money always looks for the best deal." If Islamic finance couldn't provide results close to those of secular institutions, it wouldn't exist.

Khalid Ikram, who headed the World Bank's operations in Egypt in the late 1990s, looked into the performance of Faisal Islamic Bank of Egypt (FIBE) back during the early boom days. It turned out that, despite the bank's citing "religious fervor" to him as the reason for its growth, Coptic Christians made up about 10 percent of the bank's clients, just as they do of the country's population. When returns dropped, so did investment and market share. Egyptians with foreign capital generally preferred to keep their cash overseas, even though the returns there were less than the roughly 20 percent returns FIBE was promising on current accounts. The greater security of foreign deposits made up for their lower rate of return. The rational profit motive never lost its place as the key factor in investor behavior.

Timur Kuran, professor of economics and law at the University of Southern California and author of *Islam and Mammon: The Economic Predicaments of Islamism*, points out that investing in sharia-compliant fashion doesn't just buy you decent returns—it can also buy political legitimacy. "Islamic finance didn't come into its own until the 1970s. Why during the oil boom? Huge amount of assets, petrodollars, were accumulating in the sheikdoms and with the Saudis. These regimes were considered quite illegitimate, and there were a lot of opposition movements, so they wanted to legitimize their regimes and invest the money at the same time.... They could claim that they were promoting Islam and avoiding interest."

Since the inception of Islamic economics as a distinct discipline in the 20th century, it has always been held up as a champion of ethical development.

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Islamist writers such as Sayyid Qutb and Sayyid Abul-A'la Maududi envisioned Islamic finance as the economic arm of a new, sharia-guided political order. Free of the scourge of interest, the instrument

by which fat-cat colonial and imperial capitalists make money from money, Islamic financial institutions would effectively become private equity or venture capital firms, providing sorely needed investment and support

for the region's economy. By investing in Islamic finance, you weren't just being pious—you were aiding development and helping the poor as well.

But the post-capitalist utopia that reliance on these instruments was meant to inaugurate was dead on arrival. Those involved in the first wave of Islamic banks realized that equity financing does not make for a stable banking sector, and, after a series of shocks and bad investments, they became



very conservative. It was a race to the loopholes—a search for means of sharia compliance less risky than straight-out equity investing.

The chief loophole was murabaha. Let's say that you, a small businessman, wish to go into business selling cars. A conventional bank would examine your credit history and, if all was acceptable, grant

you a cash loan. You would incur an obligation to return the funds on a specific maturity date, paying interest each month along the way. When you signed the note and made the promise, you would use the proceeds to buy the cars—and meet your other expenses—yourself. But in a murabaha transaction, instead of just cutting you the check, the bank itself would buy the cars. You promise to buy them from the bank at a higher price on a future date—like a futures contract in the commodities market. The markup is justified by the fact that, for a period, the bank owns the property, thus assuming liability. At no point in the transaction is money treated as a commodity, as it is in a normal loan.

But here's the catch: most Muslim scholars agree that there is no minimum time interval for the bank to own the property before selling it to you at the markup. According to Timur Kuran, the typical interval is "under a millisecond." The bank transfers ownership of the asset to its client right away. The client still pays a fixed markup at a later date, a payment that is usually secured by some sort of collateral or by other forms of contractual coercion. Thus, in practice, murabaha is a normal loan.

Since murabaha must be asset-based, however, it can't help a small businessman who needs a working-capital loan, for example, to provide cash on hand to meet payroll or other expenses. To get such capital from an Islamic financial institution, an entrepreneur would have to sell the bank an equity interest in his business. This is far riskier for the bank and thus much harder to obtain.

The experts tell me that every Islamic bank has at least three-quarters of its investments structured as murabaha. Even the inaptly named Islamic Development Bank was, as of the mid-1980s, doing four-fifths of its business through murabaha, and only 1 percent through equity transactions.

What the "Islamic" label might mean is left to the beholder. The sharia scholars make it their business to pronounce only upon the letter of the law. Like

legal practitioners everywhere, they focus on the technicalities. The spirit, being intangible, tends not to cloud their rulings.

The leading critics of this inconsistency are political Islamists themselves. Majed Jarrar, a personable young man who studies electrical engineering, wears a long beard, and is keen to discuss his faith, recently opened an account with FIBE here in Cairo, only to let it sit empty. He's been investigating whether "it's actually Islamic or not," and he doesn't like what he's finding.

When I asked him about the sort of innovation that, for example, Hussein Hassan at Deutsche Bank is involved in, Majed scoffed. Recalling a similar campaign by a Gulf-based Islamic financial house ("Creative Islamic Solutions" was the slogan),

Majed argued that sharia law is less about innovation than it is about a return to the ways of seventh-century Arabia.

Despite the zeal of purists like Jarrar, an entire banking sector without debt would be far too unstable. Such a system has

never had to exist—medieval Islam had extensive regulations governing trade relations and individual contract law, but there was no banking, so there were no banking rules.

While no one I interviewed argued that sharia-compliant financing directly retards economic and social development, there was agreement that it does much less than the original rhetoric claimed. Not only are working-capital loans, critical to many small businesses, rare, but also sharia-compliant transactions tend to be short-term.

Still, there's something reassuring about the way that the rational profit motive trumps strict ideology. The willingness to put profit first is, it turns out, the real shared value that links Islamic and Western civilizations. ■

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