ISLAMIC FINANCE IN RELATION TO CAPITALISM AND SOCIALISM

SPEECH GIVEN BY ROBERT E. MICHAEL, ESQ. TO THE AMBASSADORIAL LEVEL MEETING OF THE ORGANIZATION OF THE ISLAMIC CONFERENCE IN THE UNITED NATIONS ON APRIL 6, 2010

This is an intriguing topic because in many ways Islamic Finance is both older and newer than capitalism and socialism. All three had origins that go back in time and then disappeared and re-emerged in new forms centuries later.

If we include in socialism the communalism of clans and tribes, the concept that the most important economic assets of the social group belong to the group itself and not individual members, then Socialism clearly was the earliest economic system. Capitalism, based on attributing value to the possession and use of money, became a cornerstone of the growth and power of the Roman Empire around 2500 years ago. And, of course, Islamic Finance is clearly dated to the revelation of the Quran itself 1400 years ago.

So the first part of our topic is the relation of the Islamic Finance of the Quran and Prophetic Sunna to the Socialism and Capitalism that came before it. It is well known that before the Revelation began, Mohamed was a man of commerce. By then, pure tribal communalism had been replaced in the civilized world by both capitalism and various forms of ownership by private families and Aristocracies, and, of course, the Roman Empire had fallen. The economic world of the Prophet was therefore one dominated by what would later be known as Laissez-faire Capitalism and the Feudalism of the Middle Ages in the West – two systems where the dominance and dominion of the wealthy over the working classes was virtually totally unrestricted.

The disregard of the desires, or even needs, of the non-monied classes of the pre-Islamic economic systems marks the most significant difference from what we may call the Quranic Economic model. at the heart of the Islamic laws of Finance and Commerce is the principle underlying all of the Shari'a -- social responsibility and charity. It is not the socialism that is based on economic efficiency – the idea that certain business and public projects are best owned and operated by the State because they require either more capital or a non-profit vision to best succeed.

The Quranic Economic model is based on elevating Doing Good over Doing Well.

This is made perfectly clear by the primary textual authority for the Islamic law of bankruptcy in the Quran at verse 2:280. It is commonly translated as:

> If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew.

As this verse makes clear, this forceful Divine, but not compulsory, recommendation is to be kind to one's debtor. However, since the Quranic Economic model is also very clearly one that is not against earning Profits from one's work *per se*, this charitable directive is balanced by Quranic verse 5:1:

"O ye who believe! Fulfill (all) obligations."

Therefore, under the Shari'a, a Muslim is compelled to repay one's debts. It is a sin, and not just the violation of a legal obligation, to not pay off all of your debts that you have the capacity to repay.

In other words, not just creditors are compelled to exercise honest dealing and scrupulous fairness. This is a Divine instruction to fulfill one's contracts. To make this point, the jurists frequently cite a tradition from the Prophet that stated that it is unjust for a debtor to delay paying a debt or an obligation to a wealthy person without a valid excuse. Flowing from this, debt is frowned upon in Muslim ethical and moral perceptions. There is even a somewhat less authoritative Tradition that says that the Prophet Muhammad told his believers that the soul of the Muslim will be suspended with his debts, freed only when his debts are satisfied.

It is clear then that contextually and theologically-philosophically, there is a direct link between the Islamic law of finance, and social responsibility and economic equity. And a critical part of that is the prohibition on Interest, *Riba.* In fact, the verse in the Quran that outlaws all forms of riba (2:275) follows immediately the verses that require Muslims to be charitable. The two concepts are then blended together: "God destroys usury, but raises up charity." 2:276. The very next paragraph includes the verse I just quoted that establishes the Islamic bankruptcy law. Thus both lending and repaying are interwoven with powerful divine compulsions to be charitable and compassionate; and both are dynamically impacted by the static concept of money as a means of exchange and storage of value, a commodity that facilitates commerce, rather than something of intrinsic value as capital.

The prohibition of *Riba* is certainly the most famous difference between the Quranic Economic Model and capitalism and socialism. Historically, it followed a similar prohibition in Jewish law, while Roman law made a clear distinction between interest and the regulated rate above which it became usury. The prohibition of Riba, however, preceded the complete ban on interest imposed by the Catholic Church, which only was put into canon law at the Third Lateran Council of 1179. In between, the economic systems of the West had degenerated into the simple survival systems of the agrarian Dark Ages. Neither capitalism nor Socialism was relevant in that period since there was neither accumulated wealth nor strong Nation-States.

The reality of the 8th through roughly the 14th Centuries (depending on where you were – with Italy generally being far ahead of the rest of Europe) was therefore that, on a macroeconomic theoretical basis, there was very little difference between the economic systems of Europe and the various Caliphates – with the Muslim world, practically speaking, tending to be far more developed in almost every way. But beginning in the 14th Century, profound changes in the law and economic models of Europe and the U.S. changed that dramatically, and in many ways that reflected the differences between the Quranic Economic Model and Capitalism and Socialism.

Those changes centered on the development of three very closely interrelated things: First, interest-based banking and Capital Debt markets; second, limited liability business entities; and third, having ownership rights of intangible and non-existent things. For historical or religious reasons, none of these were part of the Quranic Economic Model. And since they are the three basic elements of Post-Enlightenment Western law that underlie all modern capitalist systems, I think it's worth taking a closer look at them, or as Western lawyers and economists might call them – (i) the time and risk value of money, (ii) limited liability, or as it's more formally known, entity-shielding, and (iii) intangible and non-possessory assets and rights.

I'd just like to note here that most of this discussion is based on work I am presently doing for an article on the Islamic Law of bankruptcy with my friend Abed Awad, also a practicing lawyer, but Abed, additionally teaches courses in Islamic Law at two of our local law schools.

The prohibition of *Riba* means that the Shari'a rejects the time and risk values of money. The **time** value of money is the opportunity value of having control over, and use of, the money for the period involved; while the **risk** value of money is the risk of its not being paid back for reasons having nothing to do with the purpose for which the money was provided to the recipient, as distinct from the profit or loss from assuming risk in return for one's investment of value – which can certainly be in the form of money. As a result, in Islamic law and finance, money is viewed solely as either a commodity itself or a universal unit of exchange. This has sweeping consequences.

Without interest, a debt of $1,000 incurred today must only be repaid with $1,000 in the future, with no accounting for any value to the use of the funds in between. Therefore, a dollar, or Euro, or Dinar, tomorrow has the same value as it has today – the Shari'a accords no value to the ability to utilize the money in the meantime, it's so-called "opportunity value" over time. In other words, lending someone $1,000 dollars to be paid back in one year as $1,100 dollars is considered unlawful riba – unethical and sinful. That is not to say that there is no concept of "time value" to tangible assets recognized in Islamic law that is identical to that of Western capitalism's inflation and asset appreciation. For example, an owner of a building is willing to sell it to a buyer for $1,000 dollars cash at closing or $1,100 over 12 months, recognizing both the increase in value of the house and the service provided by the seller to allow the buyer to have more time to pay him. But what the buyer CANNOT do is borrow that same $1,000 and repay it to his or her lender in one year with that same $100 as interest. Similarly, if I was to invest in any of my relatives' brilliant schemes to sell sand in the desert, and he made a profit using my money to buy and sell the sand, I am perfectly entitled to get a fair share of the profits based on the high risk of the enterprise. And if for whatever unforeseen reason, no one living in the desert wants to buy his sand, he doesn't owe me anything, because that's the risk of losing my investment I took. But what I CANNOT factor into my share of a return is the risk that he might actually sell the sand and then doesn't pay me because he spends it on something that I hadn't agreed with.

This of course is also one of the main differences between Marxist communism, or as Marx called it, Utopian Socialism, and Capitalism. I do not believe either Marx or David Riccardo, who is famous for the earlier Labor Theory of Value, associated their economic theory with the same position of the Shari'a, but it is based on the same thing – that investment capital is inherently exploitative. Marx and Riccardo believed that the only real increase in value came from the contribution to the finished product of the physical things that went into it and the efforts of those who actually worked on it. That is strikingly similar to the learned commentaries on *Riba*. However, unfortunately for the economic systems that tried to follow both the Marxist and Islamic systems built without this element, it is inherently at odds with both human nature and economic realism – people have different appetites for risk in giving their money to someone else, but the vast majority of them want to get something back in return for giving someone else the use of their money.

meanwhile, the opposite side of getting something back for the use of your money is not wanting to have someone else do something that makes you lose your money. This is another area of before and after, for similar reasons. When the Roman Empire began to outgrow its simpler lifestyle and powers in the 4th Century B.C., it started to dream of huge projects to both improve its functioning, like the Appian Way, and entertain itself, like the Circus Maximus. But it did not have an effective way to raise that kind of money fast enough. So they came up with the idea of the *societas publicanorum* – a public company that one could invest in and that limited your possible loss to the money you invested. When Rome fell, the idea of the *societas publicanorum* went with it – not to be revived until Western Europe, 1,000 years later, finally reached the same level of growth as Ancient Rome. Confronted with the same need to raise money to build its grand capital cities and roads and ports and ultimately railroads, the West gradually, over a period of 500 years from the first stock companies of the early 17th century through the creation of limited liability companies in the late 20th Century, created the same and better risk limiting devices than the ***societas publicanorum***.

However, entity-shielding simply has never been a part of the Shari'a. As I quoted above from verse 5:1, this is entirely consistent with the responsibilities of a Muslim to pay his or her debts in full. Consequently, the corporate form never developed in Islamic law, nor such more modern vehicles as limited liability partnerships or companies. All personal and economic activities are conducted through either direct proprietary ownership or one of the so-called nominate forms of partnerships that were approved through relevant Hadith or the use of *ijma*, and the only acceptable entities were all forms of general partnerships. There is, by the way, one fascinating exception, the *mudaraba* partnership, known in the West as the *commenda* of the Law Merchant. The possibly pre-Islamic, and certainly fully Islamic, *mudaraba* partnership originally involved an investor with liability limited to his investment and a voyager/trader/merchant who was exposed to personal liability for incurring debts exceeding the enterprise's assets. Lost in time, however, is whether the limited liability aspect of the investor was based on a recognized legal rule or the simple practicality of being too far away for the legal systems of the times to reach. I am not aware of any explanation of the inconsistency of the limited liability of the *Mudaraba* and the clear language of Verse 5:1. What is clear is, as I'll discuss in a minute, that the *Mudaraba* has become the cornerstone of modern Islamic finance.

In any event, it is also clear that this lack of shielding is another very important factor in the Quranic Economic Model in that it acts to reduce the willingness of people to put their excess assets into potentially profitable use. In other words, if you cannot get a safer, preferred return through debt over equity, and risk losing not only all of your loan but also be responsible for unlimited liabilities to third parties you have never had anything to do with, your partner better have a REALLY good business plan!

The other major aspect of this spectrum of safer, low return investing versus high risk, high return investment, is the ability to enforce your rights. We don't have time to go into Islamic debtor-creditor law, but we can discuss the third major difference between the Quranic Economic Model and modern Western capitalism – the lack of intangible assets and rights, such as intellectual property rights and such key accounting concepts as goodwill and deferred income and expenses, and more directly, the concept of non-possessory liens and security interests.

The almost exclusive focus on things that one could touch and see is not surprising given when classic Islamic law was developed. As with so many other areas, Roman law had in fact developed many of these concepts, but they were not resuscitated for nearly 1,000 years after Rome fell. In many ways, classic Islamic law was far ahead of the West in these. For example, the Shari'a recognizes the usufruct of real property and leaseholds (Ijara) and allowed common ownership through a partnership. Joint tenancies of real estate was not a feature of English common law until after the 15th century.

The general absence of intangible assets and rights – and there are some notable exceptions, such as the most basic one – contract rights – is clearly consistent with the Quranic prohibition of *Gharar* – unquantifiable risk. Unquantifiable risk means that if it doesn't exist in the physical world – either because it is intangible or just simply hasn't been made yet – like next year's crops – you can't deal with it. This prohibition, which covers gambling as well, is the third major difference from modern capitalism and the socialism that developed since the late 19th century in Europe. In the financial world, while *Gharar* has the arguably beneficial elements of no gambling and no speculation (some on Wall Street would argue, with some validity, that so long as market information is imperfect, all investing involves some degree of gambling and speculation), it is offset by the inability to have hedging of real risk, such as crop failures, through market arbitrage (which is speculation) or derivatives (being clearly intangible) and future delivery and purchase options (a sale of something that doesn't exist). and no insurance. For what is more like speculative risk-taking than buying an insurance policy? The whole industry is based on betting that something will or won't happen in the future. What insurance **<u>is</u>** permitted is using a classical Shari'a partnership form, like the basic *Musharaka*, to create a mutual insurance pool known as *Takaful*. Remarkably, even A.I.G. now has a *Takaful* product – which led to a lawsuit in Michigan challenging the Federal bailout of A.I.G. as being an unconstitutional violation of our Establishment Clause because supporting A.I.G. means supporting Islam!

That of course is nonsense. But what is not nonsense is the fact that these major aspects of the Quranic Economic Model act to amplify each other in limiting capital formation. *Riba* and *Gharar* create roadblocks to making investment decisions that match each separate CLASS of investors' willingness to place their assets in the hands of others in return for a profit or usage return that suits their reasonable desires. And *Gharar* also blocks the creation of arbitrage and hedging devices – clearly healthy ones as well as potential disasters like credit default swaps and subprime mortgage pool CDO's – that provide for a free flow of liquidity into and out investments.

That is what I believe are the primary aspects to any comparison of capitalism and socialism and the Islamic Finance of the Shari'a in its classical form. The difference between the Quranic Economic Model and capitalism shrunk substantially from the side of the West as the Darwinism of Laissez-faire capitalism was replaced by a much more socially responsible Welfare Capitalism – even if the reasons were more likely a self-protecting response to 19th century revolutionary movements based on Marxism and Evolutionary Socialism than any enlightened desire to uplift the plight of the working class.

But there was no real movement in the other direction from Islam until the last 30 years or so. Until that time, there simply was NO Islamic banking or finance industry to push back. When I was given the task way back in 1980 of drafting the original model loan documents for the-about-to-be created Saudi American Bank, SAMBA, no one I could find had taken any of these issues either very creatively or seriously. Since then, as Islamic banking and finance has grown into a worldwide One TRILLLION dollar industry, or to be more precise, Indus**tries**, there has been an increasingly vocal and vibrant exchange of both creative ways to work through – or, perhaps more often, AROUND – the capital formation limiting aspects of the Quranic Economic Model.

Which leads us to the final part of my topic – what is the relationship TODAY between Islamic Finance and Capitalism and Socialism? In light of the collapse of the Marxist-Socialist model, even in places like the People's Republic of China, which has a Marxist political system but a increasingly purely capitalist economy, it is hard to place it in this discussion any more. Cuba and North Korea are hardly paragons of successful economies. Nevertheless, as my wife keeps trying to raise my spirits by saying 60 is the new 40, in some ways, classic Socialism is the new Capitalism, with the latest rash of Government Bailouts and

Take-overs proving that point. By the same vein, it a very important player in Islamic Finance in that most of major successful – and unsuccessful – Islamic capital market investments have been either by Government entities, such as the Central Bank of Bahrain, which announced its latest *Sukuk Al-Ijara* just about a week ago, or Government owned entities, like Nakheel. Ultimately, it does not really seem to make much sense in distinguishing Capitalism from Socialism, since they run so smoothly into each other as you go around the world.

Somewhat similarly, the worlds of Western Capitalism and Islamic finance are trying to move together. Certainly, the strongest movement in the Islamic Finance community is to find ways to emulate capitalism's ability to, well, raise capital. That effort, itself controversial inside Islamic Academic circles just for its goal, and much more so for some of its methods, is primarily built upon modern Shari'a-compliant businesses and investors turning to three devices: The first is using the accepted forms of doing business like building blocks in very complex structures, combining the approved partnership vehicles, notably the *Mudaraba*, and approved transactions, such as the *Ijara* lease and the *Bai Salam* deferred sale, to create both flexible investment vehicles and new combination forms, like the Malaysian finance lease – the *Ijara Muntahia Bittamleek.* In doing so, a number of financial types, primarily in investment banks and English law firms, have relied on the law-making power of *ijma*, consensus of the scholars, the *Ulema* -- with one major difference: Instead of the consensus being of all Islamic scholars then alive, or of all time, as the traditional view has been of *ijma*, these financiers and advisors have elevated Shariah Advisory Boards to being the entire *ulema* on the theory that they are the only ones with sufficient understanding of both Shari'a and finance to qualify. And the third, and unfortunately perhaps most common device, is telling the Shariah Advisory Boards only about the parts of the transaction that can be Shari'a-compliant and leaving out the other parts.

Islamic capital markets have followed the same path, using the *Mudaraba* partnership form in combination with the *Sukuk* property ownership trust device and *Ijara* leases to create gigantic public security issuances that were virtually indistinguishable from traditional Western capital market public leveraged lease and equipment trust vehicles.

We have an old saying: A rising tide lifts all ships. So when things were going great everywhere, a lot of these transactions were completed with no one paying much attention. However, when the global economy virtually collapsed, the underlying assets in many of these transactions came under great pressure – and then scrutiny.

And that has brought to the forefront the simmering antipathy of conservative Islamic scholars and religious leaders to any effort to circumvent the rules of the Quranic Economic Model. Ultimately, the greatest difference between

Western Capitalism and Islamic Finance, in their view, MUST remain the difference between a system built to maximize personal accumulation of wealth and a system built on principles of social responsibility and charity. This dispute has featured both a *fatwa* from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) that held that around 85% of the 300 Million Dollars of public *Sukuk* were **not** Shari'a-compliant, and a *fatwa* from the Fiqh Academy of this very Organization last Summer that outlawed a common device, *Tawarruq*, used to replace conventional working capital loans with precious metals commodity trading accounts.

It may well turn out that these current conflicts are ultimately looked back on as a very valuable period of growing pains in a young industry. A young industry that is 1400 years old. If that is the case, then the relation between Islamic Finance and Capitalism will have become a close one of parallel and complementary financial opportunities. It will mean that the discipline imposed on the Islamic Finance industry by closer religious oversight resulted in more transparency throughout and better products. On the other hand, that same transparency and religious oversight might also result in a much smaller industry, as the strict limitations of *Riba* and *Gharar* push some of the modern expansions back into the envelope.

I think we are in a defining period for Islamic societies in deciding upon the economic path they choose to take. The choice is a classic one, the struggle between maximizing personal benefit or the common good. "From each, according to his ability; to each, according to his need." was the Marxist maxim that made his version of Socialism Utopian – and ultimately unattainable. For modern Welfare Capitalists, the maxim might be “To me, to the extent I can have it without everyone else suffering too much.” Islamic Finance in the last few years spoke of goals that sounded very much like that of Marx, more importantly, very much in line with the goals of social responsibility and charity of the Quranic Economic Model, but produced products that tended toward the latter.

However, while most of the advances made in Islamic finance over the last 30 years have moved it much closer to the Capitalist model and away from the Quranic Economic Model, the last two years have seen a reversal in that trend. Whether, or in my opinion, to what extent, the movement toward Capitalism – in the sense of finding ways to encourage capital formation and accumulation for large-scale development projects – starts up again, is the question that we are all interested in.

Thank you.