OPINION/IDEAS

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The zero percent solution

A renaissance for 'Islamic finance' -- a version of capitalism that avoids interest -- offers innovative financial tools to Muslim and non-Muslim alike

By Drake Bennett | November 4, 2007

LAST MONTH, two economists published a working paper suggesting an unusual way to diversify one's investment portfolio: buy something called sukuk, or bonds that conform to the demands of Islam.

The Koran, most Islamic scholars agree, forbids the charging of interest, so traditional bonds are off-limits to devout Muslims. But sukuk generate a steady income from actual, tangible assets, like a rented piece of land.

Sukuk are also, it turns out, more stable than traditional sovereign bonds. While the sample size was small, the study by Selim Cakir, of the International Monetary Fund, and Faezeh Raei, a graduate student at the University of Texas, suggested that a portfolio that mixed sukuk with traditional bonds would do a better job than an all-bond portfolio of hedging against unpredictable seesaws in the financial markets.

One of the fastest growing areas of finance today is based on the 1,400-year-old strictures of shariah, or Islamic law. Sukuk are part of the field of "Islamic finance," which - while it emerged in its modern incarnation in the late 1970s - has in recent years been attracting money at a precipitously quick clip. Sukuk issuance in 2007 is on pace to at least double last year's total. And while exact figures are impossible to come by, industry analysts estimate that as much as $500 billion is now invested worldwide under Islamic guidelines. Most of the world's leading banks and investment companies, including Chase Manhattan, Goldman Sachs, Deutsche Bank, and HSBC have started offering financial tools and services that meet the Koran's requirements.

Now the industry is broadening its reach, from oil-rich Middle Eastern royalty to the middle class, raising the prospect that the impact of Islamic finance could be felt well outside the Muslim faith. More than 60 percent of the money in the investment firm Saturna Capital's shariah-compliant mutual funds comes from non-Muslims, attracted by the funds' industry-leading returns. Last year a Texas-based oil and gas company raised $165.67 million by issuing sukuk, many of which were snatched up by American hedge funds. And regional banks in parts of the United States with large Muslim populations have started offering a growing range of innovative financial products - Islamic home and business financing instruments, Islamic savings accounts - that they believe could attract non-Muslim investors as well.

"Islamic finance is just finance - it's conservative, people-oriented finance," says Shaykh Yusuf Talal DeLorenzo, a Virginia-based shariah scholar who consults for many of the banks and firms that have set up Islamic financial instruments. At a time of volatile markets, he says, "I think a lot of people are going to start taking a look at what we're doing."

In the United States, the growth of Islamic finance fits into a larger trend of so-called "ethical investing," where funds and financial instruments are tailored to accord with ethical principles, whether it's the tenets of the Catholic church or those of the environmental movement. Shariah-compliant mutual funds and asset management companies don't invest in companies that make money from anything Islam considers haram, or forbidden: alcohol, tobacco, gambling, pornography, pork, or interest.

What sets Islamic investing apart, though, is the degree to which its prohibition on interest requires that its adherents rethink the way they make their money. And the ideals that are enforced by Islamic financial contracts - that there should be sharp limits on someone's ability to profit from someone else's indebtedness, that risk and reward be shared equally between the two parties - could, Islamic bankers believe, make a powerful sales pitch to prospective borrowers, no matter what their faith.

"Our strategy is to first go after the very devout, because there's so much pent-up demand there," says Hussam Qutub, a spokesman for the Virginia-based Islamic investment firm Guidance Financial Group. "But there is a larger demand out there, and I think we will find ourselves spilling into the non-Muslim market."

The prophet Mohammed, himself a merchant, saw nothing inappropriate about turning a profit - unlike, for example, early Christian church authorities, who took a dim view of moneymaking. Mohammed taught that it was interest and speculation that were sinful, because they divorced money from tangible goods and allowed people to make money merely by having money.

Partly as a result, Muslims were for centuries more advanced than Christians in the development of trade law. Merchants in Europe often turned to Islamic law to make financial agreements - the partnership contract that allowed Christopher Columbus to sail for the New World was drawn up by Muslim lawyers.

Christian authorities in the late Middle Ages began to change their thinking, eventually reaching a consensus that neither profit nor interest were sins after all (as long as the latter wasn't deemed usuriously high), but Muslim religious authorities have continued to separate the two.

The current renaissance of Islamic finance has its roots in the 1970s. Recently independent after decades of Western control, Muslim countries from Southeast Asia to the Persian Gulf were trying to reassert what they saw as their own cultural and religious traditions. The Middle East, flush with oil money, was a natural arena for the practice and display of Muslim financial piety.

Today, with oil and gas prices at record highs, there are vast sums of Middle Eastern money looking for places to be invested. And banks, hedge funds, and other financial-services companies are stumbling over each other to create those opportunities. The process has been greatly aided by the creation, in 1999, of the Dow Jones Islamic Market Indexes, which list stocks that a board of shariah scholars has deemed deserving of investment, and by firms such as Shariah Capital, which advises companies on shariah compliance.

Middle Eastern investors "are a very large and wealthy population, and managing their money the way they want it to be managed has become much easier," says Tim Krochuk, managing director of GRT Capital Partners, a Boston-based investment advising firm that offers shariah-compliant asset management strategies. "Why wouldn't we get involved?"

But Islamic finance is no longer just about managing oil fortunes. Growing numbers of middle-class Muslims are also starting to run their financial lives according to shariah principles. Much of the recent growth in Islamic finance has come from consumer finance instruments - basically Islamic alternatives to car loans, home mortgages, and other consumer loans - that are designed for the middle and working class rather than the wealthy, according to Abdulkader Thomas, CEO of a Kuwait-based Islamic financial consultancy called Shape Financial. Here in the United States, Guidance Financial last year sold more than a billion dollars in Islamic home finance instruments.

Designing these instruments - and fitting them into the existing tax and regulatory structures - has demanded creativity on the part of banks. One popular loan option, for example, is called a murabaha. In a murabaha, someone who wants to buy, for example, a car, rather than taking out a loan, goes to an Islamic bank and has the bank buy the car for him. He then buys it from the bank, usually in installments, with a mark-up for the bank's having provided the service.

Another, called a musharaka, is a joint venture set up between the customer and the bank. In the context of a home purchase, if the customer has put in 20 percent of the money for the house, he gets a 20 percent share of it, and then gradually buys out the bank's 80 percent (along with a utility fee to the bank for letting him stay in the house) until he owns it outright.

The growing sector has its critics, among both economists and conservative Islamic clerics, who describe it as a casuistic bait-and-switch. According to Timur Kuran, a professor of political science and economics and chair of the Islamic Studies program at Duke University, "Islamic banks come up with these convoluted ways of lending money that make interest look like something else, when in fact they're really just operating like conventional banks."

Sohrab Behdad, an economics professor at Denison University and another critic, sees murabahas as particularly egregious. He sees no difference between entering into a murabaha and simply taking out a loan and buying the car outright, especially since the title to the car is often transferred from the bank to the customer almost immediately. To economists like Behdad, the bank's service charge is simply a disguised interest payment.

All these obfuscations, the critics charge, add layers of bureaucracy, and end up cutting into the revenue that Islamic financial arrangements create, hurting the cash-strapped clients that the system prides itself on taking care of.

To the bait-and-switch critique, the industry's proponents respond that the difference is there because Islamic law sees one, even if functionally it's hard to find it. "It's like the difference between a wife and a live-in girlfriend," says David Loundy, vice president of the Chicago-based Devon Bank, a national leader in Islamic finance. "They may serve some of the same functions, but there's a legal difference between the two, in terms of inheritance and taxes."

Others in the industry argue that the difference is more than legalistic. Amjad Quadri, national director of the Ann Arbor, Mich.-based University Islamic Financial Corporation, points out that the partnership structure of a musharaka is not mere symbolism. In the case of a typical mortgage, if the borrower is unable to make his payments and the bank is not able to recoup its initial investment by then selling the house, the bank can often come after the borrower for the rest of the money. In an Islamic home financing arrangement, however, the bank does not have that recourse. "The risk has to be shared, and lenders aren't allowed to take advantage of borrowers in that way," Quadri says. "There's a concept of being merciful to people in debt and hardship."

UIFC and Guidance have started to see a trickle of non-Islamic customers, attracted by the more forgiving financial model they offer. To critics such as Kuran, the idea that economic relationships would be structured around religious doctrine is wrongheaded and dangerous.

But the scholars and financiers who truly believe in the tenets of Islamic finance describe something more benign: a buffer against the vicissitudes of the market.

One Islamic financial instrument that hasn't yet made it to the United States is Islamic life insurance, or takaful. For-profit insurance is not allowed in shariah, in part because it turns a profit on the misfortune of others. Takaful, on the other hand, is a mutual assurance arrangement in which members' regular payments are used to help other members who are in need, with no money set aside for profit.

According to Ibrahim Warde, author of the 2000 book "Islamic Finance in the Global Economy," takaful companies, even when connected to investment funds, are ultimately controlled by the policy-holders themselves, and as a result are usually more generous in terms of payouts.

There's nothing exclusively Islamic about this idea: Many of the biggest insurance firms in the West descended from similar mutual association societies. But industry analysts see takaful as a major growth area. Global reinsurance giants such as AIG, Swiss Re, and Munich Re have gotten into the business.

In the United States, at a time when the public image of home insurance companies has been tarnished by complaints, especially in the two years since Hurricane Katrina, of inadequate payouts and canceled policies, it may be that such a pitch, with its faith-infused promise of fair treatment and mutual support, could find an audience among even the most committed heathens.

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