The Current Plight of the Banking System: Solutions from Islam

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In 2008 a man named Bernard L. Madoff, made off with 50 billion dollars of people's money. These people had invested their money with him and were enjoying good returns year over year. Mr. Madoff delivered investment returns better than most. Many speculated about how he could do it. Some thought he traded using inside information. Others alleged he was manipulating electronic market trading systems he had invented (now called NASDAQ). None of these theories held up. Mr. Madoff continued to deliver better than average returns for more than 15 to 20 years, but in late 2008 he could do it no more. When investors wanted to withdraw their money, there was no money to be found. Mr. Madoff confessed that all these years he had been running a Ponzi scheme and, in fact, never made any significant money by investing.

A Ponzi scheme is a fraudulent investment system where the investment house eats up the investors' money, but gives them the impression that their money is producing good returns. This is accomplished by paying dividends to earlier investors using the money coming from later investors rather than from profit. Any incidental withdrawals are also managed the same way. The system works if the amount of new money coming in is more than that required to pay these returns and withdrawals and to cover operating expenses. The scheme however fails if too many investors want to withdraw their money or enough new investors are not coming in. Both of these events are likely to happen in an economic downturn. This is exactly what happened to Mr. Madoff's Ponzi scheme and its disastrous results are now well known.

What is less well understood however is that banks are, in effect, also a legalized Ponzi scheme and therefore are also subject to the same pressures. Banks in the United States are allowed to leverage themselves up to almost 50 times their total assets, which means that when fully leveraged, a 2% loss will wipe out their assets. The bank will have therefore eaten up the investor's money. Because 2% losses in business are common place, this asset wipe out is not an unlikely phenomenon. Under these circumstances, what keeps the bank operational and appearing healthy is the money coming in from new deposits. These new deposits are used to pay operating expenses, to service withdrawals and to pay any dividends that become due. Just as in a Ponzi scheme, if the new deposits fall below a critical level, the whole banking system will come crashing down. This appears to have been the case in the United States at the end of 2008. Although Mr. Madoff's Ponzi scheme had to come to an end with investors losing their money, having the banks fail in the same way will destroy confidence in the system for a long time to come and therefore will damage the economy severely. The banks therefore needed to be supported by large infusions of cash making up for the missing new deposits that did not come in because of the economic downturn. This support will need to continue until the economy recovers to a point that the new deposits exceed the amount needed to service withdrawals, dividends and running expenses.

Essential Functions of Banks

- Safe keeping of money and valuables.
- Act as a clearinghouse for financial transactions.
- A source of loans.

Islamic Principles Applicable to Banking

- Amaanat: Keep safe what is given for safekeeping.
- Riba is prohibited.
- Fairness: The user of a service should pay for the service.

In the light of currently existing banking and financial knowledge, the above three principles can be translated into a banking concept as follows:

- Banks will remain a private sector institution, but will be required to function as not-for-profit corporations.
- The current system of deposits and transactions will continue to exist. However, operating costs will entirely be paid for by transaction fees.
- The current system of FDIC insurance will continue.
- Banks will not pay interest to depositors. Instead they will charge fees for maintaining their accounts.
- Banks will not borrow any money.
- Banks may act as a clearing house for loans issued by Federal Reserve. The risk of these loans will be borne by the Federal Reserve. Banks will charge transaction fees to cover expenses.
- Banks will charge no interest on the loans they issue. Instead they will levy a service charge comprised of:
    - Operating costs i.e. cost of servicing the loan.
    - Cost of bad loans.
    - Depreciation due to inflation.
- Banks will be allowed to invest or loan a safe percentage of deposits. This percentage will be determined from time to time by academic advice.
- Any profits made by a bank will be used to lower its service charges and to create a financial reserve.
- All service charges will be based on actual cost plus a small mark-up as cushion, such as 10%. Service charges levied by banks will be capped by the government to avoid price gouging. However, banks will be free to charge lower fees to attract customers. Any banks that cannot manage their business within the capped service charges for three years consecutively will be dissolved in an orderly fashion or be taken over by other banks.

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