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Can Wall Street Learn Something from Islamic Finance?

Increasingly people have lost faith in our financial institutions. We are seeing lower valuations in currencies, massive leveraging of debt, and out of control commodity prices from what appears to be a reckless disregard for how free markets are suppose to work. And to make matters worse, our government leaders appear to be just as blind to how far removed we are from a disciplined marketplace.

Free markets are not about doing what-ever we please. Free markets are more about creating value for everyone. So much of what we do now is just for us and us alone – how do I turn a quick profit anyway I can. We now live in a world where over 60% of all stock trading is done by computers in nano-seconds. We now live in a world where the Federal Reserve engages in something called “quantitative easing” to positively impact Wall Street over Main Street .

Given the fact that our leaders have become so short-term focused and the fact that our markets are serving fewer and fewer people in terms of adding value, it's time to re-think how a free market should work. Many of these answers may reside in Islamic Finance.

Islamic Finance is based on a set of simple truth's that all businesses must abide by. For example, under Islamic Finance all financial transactions must disclose the cost and the profit to the buyer. And the determination of cost must include all of your cost. You are prohibited from hiding some of your cost. Full disclosure of pricing is critical to Islamic Finance and what constitutes a good free market.

Another important principle of Islamic Finance is that all transactions must be supported by the physical existence of the subject of the trade. Contrast this to Wall Street which trades in commodities with no real existence of the commodity. It is now estimated that paper trading in gold is leveraged by more than 30 to 1 in terms of the actual physical gold that exists to support the trades. This gives rise to bubbles and eventually every bubble (such as the housing bubble) must pop. Is this how we want our free markets to work?

Another important rule of Islamic Finance is “constructive possession” for every financial transaction. What this means is that you must have some ownership stake in what it is you are selling. You cannot sell something that you do not own. If you do, then you have introduced enormous risk and speculation into the marketplace. Under Islamic Finance this is disallowed.

Islamic Finance also prohibits the selling of something that has no assigned value. For example, you cannot enter into a business transaction that someone can readily obtain for free or no-one in the marketplace has a use for. All objects of a transaction shall have some perceived value by someone within the marketplace. Things that have no use to anyone are not allowed under Islamic Finance.

Islamic Finance requires a measure of specificity to each transaction. For example, you cannot tell someone that you will sell them a car off your lot. You must first determine what it is they desire and you locate the specific item that will meet their needs. You cannot sell things to people they do not want. All business transactions must be clearly defined and specific to pass this truth under Islamic Finance.

Certainty of price is another key component of Islamic Finance. You cannot engage in transactions where there no basis for pricing of the transaction. There must be knowledge about pricing in order for a free market to work. You can also not engage in conditional selling. All sales must be unconditional. Our current markets have made things so conditional that we can't assign any real pricing – how do you assign a value to Credit Card Default Swaps? The debt associated with these financial instruments is a staggering 1 Trillion dollars and 90% of this debt is from less than 20 banks. Once again, would anyone want a free market to work like this?

When you compare Islamic Finance to Wall Street, you can't help but wonder how far we have sunk. It is important that we all understand our morale obligations when conducting business. And these lessons can be brought home quite easily if you just look at Islamic Finance.

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February 11, 2011

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