Chapter 6

Islamic Finance and Limited Purpose Banking (LPB): Two Sides of the Same Coin

Edib Smolo

https://orcid.org/0000-0002-7645-4581

SARAYCON - Saray Consultancy for Socially Responsible and Ethical Finance, Bosnia and Herzegovina

ABSTRACT

The saying that “history repeats itself” is best manifested in capitalist financial system operating worldwide. It seems people are not learning lessons from the history of financial crises. Leading economists and capitalist gurus are warning about an inherently fragile capitalist financial system and about an urgent need to do something about it before it is too late. After the recent global financial crisis, Kotlikoff proposed the most radical and the most comprehensive reform of the existing financial system. His proposal became known as the Limited Purpose Banking (LPB). Kotlikoff’s proposal runs hand in hand with the aspirations of the pioneers of Islamic finance. He envisioned a financial system that is based on risk sharing, cooperation, and overall public interest (maslahah). In short, the idea of the LPB – after certain modifications and minor adjustments – can be applied in developing a true Islamic financial system. Thus, it can be said that the LPB and Islamic finance are two sides of the same coin.

INTRODUCTION

Humans are faced with decision-making processes every day. Regulators, government officials and managers in general are faced with same issue day after day. It is only when we are faced with severe situations that we will try our best to find ways out of the problem. These extreme cases that happen every now and then represent unique opportunities to change the course and take on new roads. The same is true for financial crises. When they happen, and they do happen, more or less, on a regular basis we need to rethink our overall financial system. Even though they represent these unique opportunities to take on different path and make our overall financial system a bit better and sound, we usually fail to do so.

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In this regard, the global financial crisis of 2007-2009 was unique in many ways and offered a hope that we might rethink the way we do the finance. This is, at least, what Laurence J. Kotlikoff had in mind when writing his book, *Jimmy Stewart is Dead*, and drafting his proposal known as the Limited Purpose Banking (LPB). He offered a completely new blueprint on how we can structure our financial system that would prevent it from entering into similar troubles. This view, however, was not shared by majority of people in the White House and the Wall Street. Obama’s administration started bailing out one financial institution after another preserving the existing financial system as it was. By doing so, Kotlikoff believes, they were treating the symptoms, not the disease, making us fiscally and financially weaker.

The Islamic financial system (IFS), although existing since the birth of Islam, is relatively new financial model and offers unique ways for financial intermediation. Original ideas around the IFS are pretty much in line with Kotlikoff’s LPB proposal. It is for this reason that we are focusing in this chapter on these two models or proposals. Hence, the main objectives of this chapter are: (i) to discuss briefly anomalies inherently installed within the capitalist financial system (CFS); (ii) to review Kotlikoff’s proposal of LPB; (iii) to summarize ideas behind the IFS; and (iv) to relate LPB to IFS.

The rest of the chapter is structured as follows: Section two provides an overview of the global financial crisis that motivated Kotlikoff to propose his LPB model as a viable alternative to the existing financial system. In section three we will briefly discuss the LPB model and the way it is supposed to work in practice. This is followed by section four that will provide an overview of the IFS and elaborate on how the LPB model goes hand in hand with ideas behind the IFS. Finally, section five is reserved for concluding remarks.

**CRITICS OF CFS AND THE GLOBAL FINANCIAL CRISIS: THE EVENT THAT LED TO LPB**

Since the starting of the 21st century alone, about 24 economic and financial crises hit economies worldwide. Among these 24 crises, the most severe one is the recent global financial crisis of 2007-2009. In fact, it is so severe that basic tenets of the CFS, such as the notion of *‘the invisible hand’*, are questioned openly.

This notion of *‘the invisible hand’* was introduced by the 18th century Scottish philosopher and economist Adam Smith in his book *‘The Theory of Moral Sentiments’*. He used this phrase in two other places, but with a different meanings (Rothschild, 1994). In this case he refers to some rich landowners who are selfishly interested in their own wellbeing ignoring values such as “humanity” and “justice”. They go after precious commodities “from the labours of all the thousands whom they employ”. In doing so, They are led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society, and afford means to the multiplication of the species (Smith, 2006, pp. 215-216)

Nowadays, *‘the invisible hand’* is considered as the unobservable market force standing behind the demand and supply of goods and services in a free market and bringing about beneficial social and economic outcomes from an individual’s self-interested actions. This is, at least, how economists see the notion of *‘the invisible hand’*, although this may not be at all Adam’s intention – as pointed out by Rothschild (1994).