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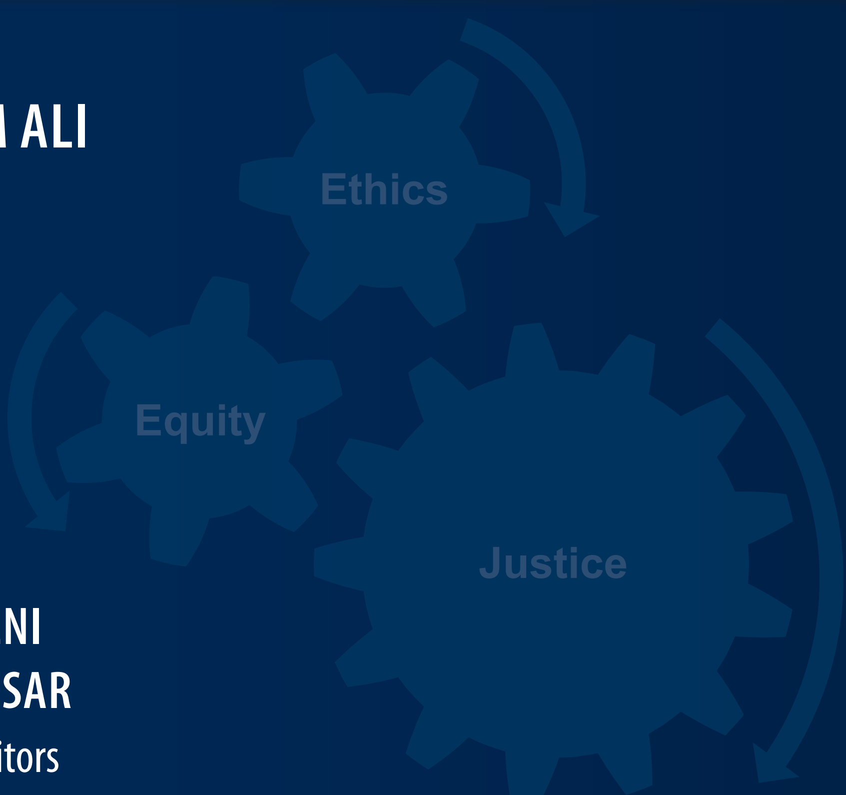
ISLAMIC FINANCE AND DEVELOPMENT

S. NAZIM ALI
Editor



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ISLAMIC FINANCE AND DEVELOPMENT

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Preface

Islamic finance emerged out of Muslim economists' criticism of the capitalistic model of economy, based on interest and devoid of morality. After colonialism, self-governance, the discovery of vast reserves of natural resources, and rising populations provided impetus to many of the newly independent Muslim countries to experiment with their new thinking. On the other hand, the developed world's aging economies, a recurring bout of economic and financial crises coupled with noticeable disappointment in poverty reduction, and continued impoverishment of staggering numbers of people across the globe led the new generation of Islamic economists and financial professionals in a kind of belief that many would term inertia and complacency.

After over four decades of practice of Islamic finance, most of the Muslim states face the same dilemmas and scrutiny out of which they initially emerged. No doubt, some of the biggest critics of Islamic finance today include many who had postulated some of the earliest theories of Islamic finance. This book, comprising selected papers presented at the Tenth Harvard University Forum on Islamic Finance, is a humble effort to re-examine Islamic finance in the context of development. It focuses on some of the most pressing questions relating to Islamic finance, such as how faithful Islamic finance has been to its professed goal of justice and equity; what role has it played, along with similar other groups, in promoting growth and development; and what has been its contribution toward ameliorating the situation of the poor at the grassroots level? These questions have been addressed in this book by contributors in their own inimitable style and manner.

This book would not have been possible without the collective efforts of many around me. Not all of them can be acknowledged by their names for obvious reasons. However, it is important that I mention some of the most noteworthy. The Islamic Finance Project (IFP) has shaped my thoughts over the last two decades, and continues to inspire me even today. It not only throws challenges at me but also provides me a unique platform from which to interact with the great thinkers, policymakers, and academicians of our era. They all have left an indelible mark on me and have motivated me to continue my efforts in facilitating dialogue among various faiths and Islamic finance stakeholders. None of my efforts would have been successful without the unflinching trust and unfailing support of IFP's sponsors, namely The National Commercial Bank, Mohammed Alsubeaei & Sons Investment Co. (MASIC), and Kuwait Finance House.

I am highly grateful to the Harvard Law School and the Islamic Legal Studies Program (ILSP) for its continued patronage and the support I have received from its staff and ILSP founding director Frank E. Vogel. Many faculty members of various Harvard schools, including Noah Feldman, Baber Johansen, Samuel Hayes, and Asim Khwaja, continue to be a great source of strength and encouragement for me.

IFP's real backbone is its affiliates and students, who come and go but contribute a lot to the project's activities. Many of them have become lifelong friends. An army of volunteers, both from Harvard and outside, have helped me in organizing the Tenth Forum, most notable among them Sarah Akhtar, A.B. '12, Muhammad Hassaan Yousuf, A.B. '12, Mudiurasul Rasool Adhan Hassan, A.B. '12, and Miranda Margowsky, A.B. '12.

I wish to extend my deep sense of appreciation and gratitude to Ibrahim Warde (Tufts University) and Rodney Wilson (Durham University) for their critical reviews and advice in arranging this book, and to Hanifa Dashti (University of Maryland College Park) for undertaking several tasks in preparing the book.

Last but not least, I am grateful to all my contributors in this book and to my co-editors, Umar A. Oseni and Shariq Nisar, for bearing with me all through this period and putting their best efforts into bringing out this book. I hope readers will find this book an important addition to the growing body of literature on Islamic banking and finance.

S. Nazim Ali
Director, Islamic Finance Project
ISLAMIC LEGAL STUDIES PROGRAM

Introduction

Various theories of economic development are much hotly debated and contested. However, there is less disagreement that better financial mobilization and management leads to higher growth and welfare. The emergence of Islamic finance has raised expectations of faster development in the Muslim world, especially because it talks about greater linkages between finance and real economy and higher emphasis on justice and equity in distribution of wealth among people. The strong growth of Islamic finance since its modest beginning in the mid-seventies provided an opportunity for the Islamic Finance Project of Harvard to organize the Tenth Biannual Harvard University Forum on Islamic Finance (2012) on the theme of Islamic finance and development. The main purpose of the Forum was to assess the contribution of Islamic finance to global economic development and its contribution to small and medium enterprises (SMEs). Some linkages between faith-based investments and socially responsible investments were also explored. Over fifty speakers, including top researchers, academicians, finance professionals, regulators, and experts from various faith-based initiatives, deliberated intensely on various facets of the theme for two days. This book is a modest attempt to gather all those thoughts and ideas in book form. Some of the best papers of the Forum are included after having been revised by their respective authors.

There are a total of eleven papers in the book, the first four of which focus on the role of Islamic finance in economic development. The next four examine the need for an alternative ethical financing and strategies to spur the development of the global economy. The last three papers provide specific case studies from three different countries in their quest to enhance grassroots-oriented developments through Islamic finance.

ISLAMIC FINANCE AND ECONOMIC DEVELOPMENT: A BIRD'S-EYE VIEW

From the very original value proposition of Islamic finance, there is an inextricable link between resources and development, and an unequivocal emphasis on economic development. One such example is the historical precedent for land grant and land use in Islam. A basic principle in Islamic economics is that land (or resources) should not be left unutilized and that failure to use such productive means warrants strict action. This understanding is premised on a prophetic precedent, which provides that:

"There is no right of ownership to be claimed on the land if the owner does not reasonably exploit it after three years of possession." By implication, resources cannot be left idle; rather, they must be reasonably exploited for the benefit of society. All transactions in Islamic finance therefore are required to contribute to the wellbeing of society, directly or indirectly.

Being an increasingly important segment of the global economy, Islamic finance assumes greater significance to promote economic development. This is the thesis of Volker Nienhaus's contribution, the opening paper of this book, which re-emphasizes the need of the hour: the development of instruments of participatory finance based on *musharaka* and *mudaraba*. Such instruments must have "an innovative risk-return profile" that is attractive to financiers. One must acknowledge the fact that since most Islamic financial institutions compete with conventional financial institutions, the former have focused their attention more on products which have similar risk-return profile as of interest-based. Consequently, most of the offerings of Islamic financial institutions hover around debt-based conventional financial products. This has become a matter of serious concern for many Islamic economists and financial experts, who blame the conventional financial system for the mess of the global financial system.

According to them, participatory finance instruments promote better economic development than debt-oriented financial instruments. These concerns are beautifully summed up in the opening paper of this book.

The important highlight of the opening paper is three key strategies that have been identified for Islamic finance to contribute to economic development. First, to prevent the loss of resources often triggered by financial instability; second, to provide resources to the real economy; and third, to support entrepreneurs through participatory financing.

Neil Miller examines the position of Islamic finance from a practitioner's perspective. He focuses on alternatives to the prevailing economic models, the potential role of Islamic finance in national development, its role in for-profit private entities offering shari'a-compliant services, and empirical evidence relating to the role of Islamic finance in development.

Miller brings his experience to bear by raising some relevant questions relating to the role of Islamic finance in economic development. The major argument of Miller's paper is centered on whether the Islamic finance industry is doing what it ought to do. It is very pertinent for the industry to reflect on these questions.

Islamic entrepreneurship in the realm of economic development has not attracted adequate attention from many researchers in the past. Rasem Kayed and Kabir Hassan, building on their book on Islamic entrepreneurship, have explored the role of Islamic entrepreneurship in the wider context of economic development. It is argued that the Islamic view of development, which is often linked with entrepreneurship, has two dimensions: creation of material wealth as well as fulfilling the spiritual needs of the individual and the community at large. The paper argues that the difference between the two worldviews of entrepreneurship and development might not provide a good platform for reconciling the different underlying theories. Hence, there is a need for an Islamic model of entrepreneurship that will take into consideration the specific requirements of Muslim communities based on the general philosophy of Islamic economics.

Zamir Iqbal and Abbas Mirakhor's paper closely examines the dynamics of financial inclusion in Islam and the framework Islamic finance provides for attaining this objective. Some of the conclusions of their paper are quite interesting. First, the paper argues that the underlying philosophy of Islamic finance supports and promotes financial inclusion through a number of redistributive channels, which according to the authors are underutilized in Muslim countries. Second, institutionalizing these conceptual frameworks would go a long way toward engendering development in Muslim countries while promoting financial inclusion. Nevertheless, an enabling environment is required with the requisite legal and regulatory framework to ensure transparency and accountability in the management of the funds provided by such redistributive channels. The paper therefore argues for the promotion of public policy formulation based on risk-sharing.

RELEVANCE OF ALTERNATIVE ETHICAL FINANCING TO GLOBAL ECONOMIC DEVELOPMENT

Local initiatives relating to financial inclusion that are geared toward enhancing access to finance must be well-grounded to be well-positioned to contribute to global economic development. Different models, practices, and strategies are explored in the second part of this book, which contains four papers on different aspects of reform-driven strategies for alternative ethical financing to trigger global economic development from the very grassroots level. The importance of ethical business cannot be overemphasized in the global financial system, where investors' awareness is increasingly tipped in favor of ethical investments, particularly among the various religious blocs.

It is on the basis of such a proposition that paper five explores the feasibility of having a socio-legal framework for faith-based investment (FBI) and socially responsible investment (SRI). Umar A. Oseni examines the need for faith-based investment initiatives to be integrated into the SRI sector for global economic cooperation. The recent global financial meltdown has rekindled the need to positively harness faith-based investment initiatives. While admitting the remarkable differences between faith-based investing and socially responsible investing (SRI), the paper discusses how the faith-based initiatives overlap with or complement socially responsible investments. With a focus on faith-based initiatives, the paper argues for re-examining the global economy for a better and a more sustainable solution.

Another important topic discussed in Oseni's paper is green financing or green business, which remains an emerging area of Islamic finance. He argues for investing in green *sukuk*, which involves investment in projects that are environmentally friendly. These may also include projects that provide green technology and renewable and alternative energy. Some of these initiatives are now being explored in the Middle East and North African (MENA) region. For example, the Climate Bonds Initiative, the Clean Energy Business Council of the MENA region, launched a Green Sukuk Working Group on March 5, 2012, and The Gulf Bond & Sukuk Association. These initiatives will have a better impact when a sound socio-legal framework is introduced to regulate such investments.

In their paper Vaishnavi Bhatt, Sajjad Shah, and Jahangir Sultan investigate the performance of mutual funds that promote values. Investment strategies are driven by different ideals and desires. Some investors tend to focus more on the need to maximize their profit, while others are more concerned about ethical and societal goals. These motives are also found in shari'a-compliant investments. The authors have divided investors into two groups: value-driven investors and profit-seeking investors.

Values-driven investors keep in mind non-pecuniary objectives as primary goals before applying the risk-return assessment. They optimize their utility functions in the three-dimensional space of compliance to values, return, and risk, and mostly utilize negative screens to narrow down the allowable investments before filtering further to choose the best return for a given risk. Profit-seeking Islamic finance investors, on the other hand, view Islamic finance investments as a source of additional return due to their lower leverage and businesses with reduced externalities, rather than pursuing Islamic finance investments solely because they comply with religious values.

The next paper explores strategies for financing the real economy through ethical principles with specific reference to hybrid *sukuk* for SMEs in France. In this paper, Anass Patel contends that SMEs might need to explore alternative routes for funding since banks are not favorably disposed to granting credit facilities to SMEs. The paper makes two major submissions: first, bank loans are not adapted to SMEs' position, as collateral is not the "holy grail" of risk mitigation for banks; second, the profit and loss sharing approach for SME financing in France can work well. The paper addresses the goal of putting together a low-cost structure finance program that is compliant with all regulation that protects borrowers and with the ethical principles of Islam and that is open to different financing partners such as banks, mutual funds, investors, and individuals.

Séamus Finn critically examines the capitalistic model of economy with special emphasis on the customs, rules, and regulations of financial and commercial transactions from the early ages through the modern period.

Finn has examined the evolution of credit through the Middle Ages based on Judeo-Christian teachings and also explored references to Roman Catholic and Islamic teachings.

Finn's paper emphasizes the need to ensure integrity, stability, and sustainability in the economic model. These, according to him, should be the cornerstones of the global financial system. He concludes that an economic model that achieves these goals would be consistent with the traditions of the faith community because socio-economic justice and welfare are shared values in the faith traditions.

CASE STUDIES: ISLAMIC FINANCE AND GRASSROOTS-ORIENTED DEVELOPMENT

The final part of this book comprises three important case studies which explore practical issues within certain geographical contexts related to the role of Islamic finance in economic development. Is-haq O. Oloyede and Abdulqadir I. Abikan give a preliminary investigation of the regulatory hurdles along the way in the quest for a more inclusive Nigerian economy.

Their paper discusses regulatory challenges in Nigeria and argues for more efforts to create awareness about Islamic finance in order to promote its greater acceptability among the masses. Some strategies like pilot projects, advocacy for sponsoring the Islamic Finance Act, or investment in research and personnel training and introduction of shari'a-compliant products like *muzara'a* (sharecropping), *musa'aqa* (irrigation), and *musharaka* are also suggested to address economic development needs in the country.

Saudi Arabia has a vibrant Islamic finance industry and contributes significantly to the global *sukuk* issuance. Craig R. Nethercott explores the achievements and ambitions of Saudi Arabia with emphasis on its infrastructure development. Nethercott notes that in recent years Saudi financial thinking has moved away from conservative Hanbali perspectives to become more inclusive. Consequently, a number of new construction projects in the petrochemical, gas, and power sectors have been financed through greater use of *istisna'a* and *ijara* models. Moving forward, Nethercott advises caution in the use of the build-transfer-operate (BTO) model, as he anticipates that liquidity squeezes will remain a limitation for medium and large projects.

Finally, Bridget Kustin undertakes an interesting ethnographic study to understand the priorities of clients and Islamic microfinance institutions in Bangladesh using the case study of the Rural Development Scheme (RDS), a flagship program of Islami Bank Bangladesh Limited (IBBL). Her paper informs us of some salient features of the scheme, such as: two-thirds of RDS operations are currently located outside urban areas; RDS' policy of focusing on a region still not covered by other microfinance institutions; and its focus on borrowers' income-generating activities. It also highlights how the *Qard Hasan* scheme is implemented through the discretion of field workers.

Overall it has been highlighted that the Islamic finance industry needs its own developmental agenda based on shari'a prerequisites and local needs with an aim to promote the development and welfare of society but without overlooking the spiritual aspect of human needs. The book also focuses on improvement in transparency and governance, expanding educational efforts and innovation, and investing in information and communication technology, while fully cooperating with the agenda of developing a robust legal and regulatory framework.

PART I

Islamic Finance, Financial Inclusion, and Economic Development

Islamic Finance and Economic Development

Volker Nienhaus

INTRODUCTION

Islamic finance is a growing segment of the global finance industry. Economic development requires, *inter alia*, financial resources, and Islamic financial institutions have an important role to play. Expectations are that Islamic finance is superior to conventional finance because it is based on a comprehensive worldview and tied to religious norms and values. As a consequence, it is expected that Islamic finance promotes economic development better than the profit-driven conventional finance.

However, a closer look at Islamic finance reveals a considerable discrepancy between the theory (or the idealized view) and the practice. The aim of the theory was to outline a financial system *different* from capitalism and communism. It should be based on profit and loss sharing contracts, and Islamic economists demonstrated the superiority of such a system with respect to allocation, distribution, justice, and stability. The practice of modern Islamic banking, however, was driven by the ambition of businessmen to get the *same* financial services as from conventional banks, but in a shari‘a-compliant form.

For practitioners, shari‘a is Islamic law, not Islamic business ethics. Bankers and shari‘a scholars teamed up and replicated a wide range of conventional products, which brought forth the well-known “form over substance” debate.

From a developmental perspective, this debate is not a prime concern. What is more critical is that Islamic banks focused their business initially on short-term trade financing and later added consumer finance (car and house financing) but neglected medium- to longer-term corporate finance. Over the last years *sukuk* became more prominent for corporate finance, but a *sukuk* issue is not a realistic option for most of the small and medium-sized

Volker Nienhaus, Visiting Professor, University of Reading, United Kingdom; Adjunct Professor, INCEIF, Kuala Lumpur, Malaysia.

enterprises and new ventures that are crucial for employment and income generation. Islamic investment banks did not fill this gap. They became more involved in large infrastructure projects. Recent trends in contractual engineering are also critical from a developmental point of view. Contractual engineers—with support from structuring departments of Western banks that made an inroad into Islamic finance—developed prototypes of shari'a-compliant securities that could be used for profitable financial transactions within the financial sector. This implies a decoupling of finance from the real economy—a major concern from a developmental point of view.

A cursory survey of the Islamic finance sector in selected Islamic countries does not give strong support to the idea that shari'a-compliant finance institutions have contributed significantly more to economic development than conventional banks. A more vigorous contribution of Islamic finance to economic development requires a type of financial engineering that is different from what is actually in the pipeline: Islamic banks should develop instruments of participatory finance with an innovative risk-return profile that is attractive both for SMEs and for the banks as providers of funds.

DEVELOPMENT AND ISLAM

a) The use of the term "development" is controversial amongst Islamic economists. For some people this is a too value-laden and misguiding term: development is understood in the Western world as an economic catching-up process, and the target for "developing countries" is the living standard of the West. The critique is that this reduces development to material progress and ignores the spiritual dimension of Islam. An ideal Islamic society and economy cannot be reduced to a materialistic and morally blind (or even immoral) capitalistic system as in the West. Islam had its material and spiritual "Golden Age" under the guidance of the Prophet Muhammad, and the history of the Islamic world after the period of the rightly guided caliphs is a continuous decay. It can only be reversed by the revitalization of Islamic morals, and the benchmark for development can never be the materialistic Western lifestyle.[1]

Other Islamic economists do not reject the Western concept of development as material progress in total, but they are also somewhat cautious in its use. They often point to escalating and unsolved problems of the materially better-off Western societies: volatile markets, increasing gaps between the rich and the poor, the loss of social cohesion, youth unemployment, wasteful consumption and ecological damages, depletion of natural resources, etc. The Muslim world should not catch up with the West in these respects, and to prevent misinterpretations in this direction, many Islamic economists prefer terms such "poverty alleviation" or "need fulfillment" over "development."[2]

b) While Western development economists will not find much common ground with the "rejectionist" Islamic economists (for whom moral education is the prime concern), they can agree with Islamic mainstream economists on strategic priorities for poverty alleviation and the improvement of the material living conditions of the poorer segments of Muslim societies. For example, it is recognized that employment and income-generating activities must be encouraged, and it is now widely accepted (although sometimes for different reasons) that private entrepreneurs are better suited to undertake this task than state enterprises or government bureaucracies. Entrepreneurs are people with good ideas for more efficient production processes, improved technologies, or better and new products, but insufficient own resources for their realization.[3] This is where financial institutions become crucial: they collect resources from the general public and provide financing for entrepreneurial innovations. Other functions of banks can also be welfare-enhancing, for example:

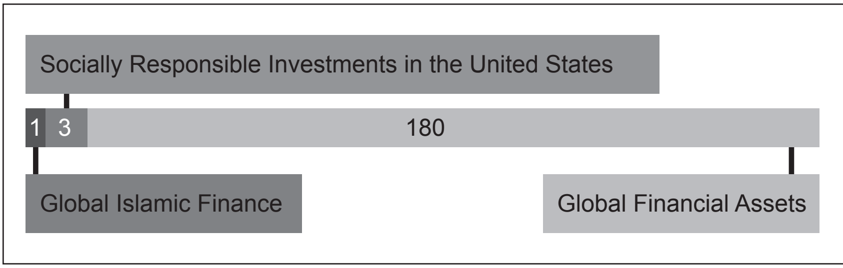
i) The inter-temporal restructuring of income streams (for higher individual expenditures at younger ages when a family is founded with a repayment at older ages when the income is higher);
ii) The stabilization of income or consumption levels over a lifetime through long-term savings products and pension schemes;
iii) The enhancement of risk-bearing capacities by the provision of insurance (*takaful)*; and
iv) The financing of long-term investments into the protection of the environment and the development of sustainable energy resources.[4]

Although socially beneficial, these functions are only supplementary to the financing of job creation and income generation in poor countries. This holds true for conventional as well as for Islamic finance, and it does not change even if further functions are added to the catalogue of functions of Islamic banks such as schemes for the financing of education, the promotion of social cohesion (including the management of *zakat*), or financial support for community development projects.

Such differences are only gradual compared to conventional financial institutions (banks and funds) which strive for more ethics in finance and more socially responsible investments (SRI). Admittedly, ethical banking and SRI are only small segments of the global finance industry, but movements such as "Occupy Wall Street" indicate that they have considerable growth potentials. What is also noteworthy here is the fact that the size of ethical banking and SRI in the US alone (approx. 3 trillion US$)[5] is roughly three times the size of global Islamic finance (approx. 1 trillion US$).[6]

Thus, given that banks in general do contribute to economic development, the relevant question is not whether Islamic banks contribute at all, but whether they do it more extensively, more consistently, or more

Estimated Total Financial Assets 2010 in Trillions of US Dollars



effectively than conventional financial institutions. More precisely, it has to be examined whether the specificities of Islamic finance—notably the prohibition of *riba*, *gharar*, and *maysir*—and their translation into the financial practice imply a superior developmental performance of Islamic banks compared to their conventional counterparts. The paper will show that this, unfortunately, cannot be taken for granted.

CONVENTIONAL AND ISLAMIC ECONOMIC SYSTEMS AND MODELS OF DEVELOPMENT

a) Islamic economists have written extensively on economic development from an Islamic perspective, in particular in the 1980s and early 1990s.[7] However, standard Western textbooks and handbooks of economic development outline twenty and more theories and models of economic development, but they do not pay any attention to the Islamic perspective.[8] This may be due to the fact that the character of most of the writings of Islamic economists was (and often still is) more prescriptive (dealing with the developmental qualities of an Islamic economic system and designing policies for an ideal Islamic state) than analytical (= explaining the actual [under]development of Muslim countries), while the realities of Muslim countries depart radically from the ideal.

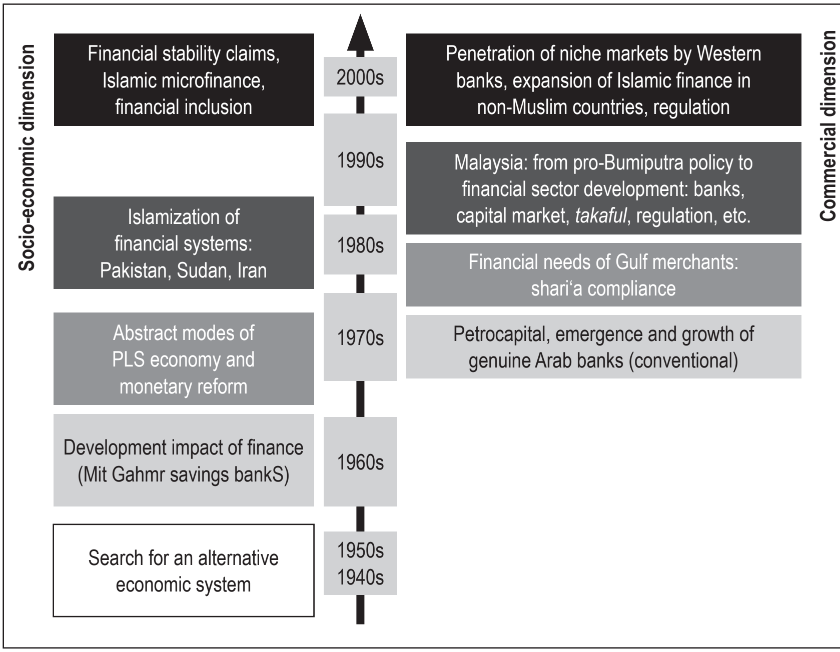
For most of the 20th century, Islamic development models deviated from mainstream neoclassical economics, and policy recommendations were in conflict with the so-called Washington Consensus (IMF, World Bank, US government). Islamic economists underlined the prime importance of justice, basic needs fulfillment, and poverty alleviation. Distribution was as important as allocation and growth. The Islamic specificity of the models can be seen in two main respects. First, political priorities and strategies were justified and legitimized with recourse to the Islamic worldview. In addition, some models assumed different utility functions of Muslims compared to non-Muslims ("*homo Islamicus*" versus "*homo oeconomicus*"). Second, nearly all models assumed a *riba*-free economy where interest-bearing loans were replaced by profit and loss sharing arrangements.

The distributive, allocative, and stability qualities of an Islamic economic system and its impact on the well-being of people were explicated, and the progress in economic development became apparent when the *status quo* of the Muslim world was compared to the ideal *riba*-free world. Unfortunately, this comparative static methodology did not deal with the necessary process of transition from the *status quo* to the ideal—apart from some indications for policy priorities such as basic needs orientation, poverty alleviation measures, and the prohibition of interest. What was lacking was an elaborate theory of systemic transformation.[9] Nevertheless, and irrespective of the lack of explicative power, one has to concede that Islamic economists had presented their own models of economic systems and economic development, which were different from the conventional mainstream, and the *riba*-free financial sector played a pivotal role in these models.

It may be that the ideas of Islamic economists had influenced the attempts to Islamize the financial sectors by the order of the rulers of Pakistan, Sudan, and Iran in the 1980s. But this approach has clearly failed in Pakistan, was an integral part of a rather unique system in Sudan, and became hardly relevant in the nationalized Iranian banking sector for more than two decades. In all other Muslim countries conventional finance has been and still is dominant, in spite of persistently high growth rates of Islamic finance. Existing Islamic banks had neither the strength nor—more important—the intention to convert the whole system. This may change in some jurisdictions in the future when governments intervene more strongly in favor of Islamic finance.

Commercial Islamic banking emerged in the 1970s without direct links to models of Islamic economists. While the economists looked at banking from a macro-systemic perspective, the founders and CEOs of the commercial Islamic banks and their shari‘a advisors followed a micro-legalistic approach. It was not before the 1970s that genuine and sizable Arab banks emerged in the Arab region (which was previously penetrated by European and American banks), but all new banks were conventional *riba*-based institutions.[10] The "stylized facts" of the parallel development of the socio-economic and the commercial approach to Islamic economics and finance are summarized in the figure "Evolution of Islamic Economics and Finance." Businessmen in the Gulf region took the initiative to rectify this shortcoming, and they set up individual Islamic banks (sometimes with the support of governments). But their basic idea was *not* to create financial institutions that follow a completely *different* approach than the existing banks (namely applying widely profit and loss sharing modes of finance). Their idea was to get the *same* range of financial services that was well known from conventional banks (with which the founders had worked in their businesses so far), but on a shari‘a-compliant basis. For the founders

Evolution of Islamic Economics and Finance



of Islamic banks, shari‘a was not a political ideology but first and foremost a legal system. Therefore, shari‘a compliance did not mean to change the substance of the financial system (macro-systemic approach), but to change the legal form of all known products and instruments which should be maintained in their commercial substance (micro-legalistic approach).[11]

If this interpretation of initial intentions is correct, then the “replication” or “reverse engineering” or “mimicking” of conventional products and instruments and the resulting “form over substance” is not a *deviation* from an original idea (that has to be criticized), but it is the initial idea which the banks have put into practice.

The situation changed, however, when representatives of Islamic banks took over arguments of Islamic economists and claimed that Islamic banks were superior to conventional banks with respect to efficiency, justice, and stability. They used macro-systemic metaphors and aspirations in PR campaigns, keynote speeches, and glossy brochures, but the practice remained micro-legalistic.

b) It seems that in the 1990s Islamic economists diverted their attention from “grand designs” of economic development—which had not found much support in the political arena—to more practical issues, and Islamic microfinance became an outstanding topic by the end of the century.[12] Ironically, this happened at a time when the Washington Consensus lost its effectiveness or even broke up (in the 2000s). The IMF and (particularly) the World Bank had revised their positions and became far less doctrinal or dogmatic than before. They acknowledged the importance of distribution, the possible usefulness of gradual liberalization and temporary controls of capital flows, and in general the relevance of the proper timing and sequencing of reform packages. These were lessons mainly learned in the 1990s, notably from the transformation experiences of Central and Eastern Europe and from the Asian Crisis. Further, it became widely recognized that religion can be a strong individual motivating factor and a vehicle for social cohesion that supports structural adjustment and development.[13] So the ideological gap between Western doctrines and Islamic economics narrowed, but Islamic economists seemingly did not respond to it. However, a dialogue with Western counterparts could be very fruitful. Based on historical transformation (= development) experiences and lessons learned from recent events, it might be possible to develop not only a model world where "*homo Islamicus*" and "*homo oeconomicus*" can live peacefully together (i.e., a model with more "realistic" assumptions regarding the behavior of different types of people), but also to outline jointly a transformation strategy.

c) The financial crisis of 2007–08 has again changed the scene.[14] The belief in near-perfect and rational financial markets was widely destroyed, and rules and regulations for the protection of the real economy against destabilizing impulses from the financial sector were high on the political agenda. The greed of bankers, extremely high speculative profits (and losses), and in general the widening gap between the income of top executives and the average wage earners became popular topics.

Issues such as poverty reduction, social security, adequate housing, or basic health care became issues in the US and—sometimes with a different problem setting—in continental Europe. They have been topics in the development-related writings of Islamic economists for a long time. But again, there is not much of a dialogue. Instead, claims about the superior stability of Islamic finance are presented over and again, allegedly with empirical evidence. Although this was echoed in Western media, the empirical evidence is far from decisive. On the one hand, some Islamic financial institutions failed and bailouts took place in a number of Muslim countries. On the other hand, conventional finance did by no means collapse completely. Large numbers of banks in the West with a strong deposit base, little exposure to global interbank and securities markets, and "old-fashioned" prudent lending policies as well as banks in many emerging economies were only scratched by the first-round effects of the crisis.[15]

d) The most important event from a developmental perspective is the still ongoing "Arab Spring" which began in 2011—an uprising of suppressed people and revolutions without revolutionary ideologies, motivated by the hope for a better life. This is a developmental challenge of an unprecedented dimension and urgency. It is probably not the right time to propagate models which cannot improve the living conditions of people within a short period of time. Neither models that require a restructuring of nearly all existing institutions for a better life in the long run nor microfinance for self-employed poor or cottage industries should be the top priorities. The top priority should be an employment-generating growth. This implies and requires the broadening of the entrepreneurial base in the transforming countries.

e) One should encourage the Islamic economists to enter into a new discourse with Western economists who have studied economic orders and transformations of economic systems all around the world. After long academic debates and political controversies, a broad consensus has emerged that an economic system with competitive markets at its core is a prerequisite for development. The implementation of such a market-based system in third world countries often required (and in some cases still requires) a transformation from a socialist or statist system, i.e., from a command economy or from an economy with a dominant public sector, to a market system. Western development models show a considerable variety for the role of the state in a market-driven system. The extremes are, on the one hand, systems inspired by the Anglo-American model with only a minimal role for the state, and, on the other hand, Nordic European welfare state concepts with large (but not dominant) public sectors. Both are based on private property, and they have faced specific challenges and problems. They were not sustainable in their extreme forms, but they still serve as ideals or benchmarks.

Islamic economists mostly refer to the Anglo-American system and emphasize the differences and asserted uniqueness of their own models. What they are rarely aware of is the considerable number of economic orders "in the middle" between extreme market liberalism and excessive welfare states that are in existence in continental Europe. Had Islamic economists taken a closer look, for example, at the German social market economy (both at its concept and its deterioration in practice) they would have discovered a large number of structural similarities.[16] Examples are the social obligation attached to private property, specific laws and an authority to restrict market power and to protect effective competition, the primacy of the real economy over financial markets, an elaborate social security system, and redistributive measures by the state via taxation and transfers. Even a religious background of this system would have been discovered. With knowledge about all these elements in a secular economic order, an Islamic economic system looks far less unique. Its originality boils down to a specific form of legitimation and a few specific institutions such as *zakat* and an interest-free financial sector.

Given these similarities, Western systems "in the middle" and Islamic models have a large overlap when it comes to recommendations for economic development. The establishment of competitive markets, the primacy of the real economy, the implementation of a social security system (notably for those who are negatively affected by structural changes enforced by competition), the broadening of the entrepreneurial class, private property with a social obligation, legal and monetary stability—all these are major elements of an economic order and development program on which both sides could reach a consensus (even if the underlying justification or legitimation of the various components differs). But one major topic for debates and controversies remains, namely the adequate financial system. In this sense, the financial sector is of crucial importance for the characterization of a development model as "Islamic."

THE ROLE OF THE FINANCIAL SECTOR IN ECONOMIC DEVELOPMENT

a) In general, the role of the financial sector in economic development is to mobilize funds from the surplus units in an economy and to channel them to the deficit units for productive use. More specifically, the traditional view was that banks collect savings in small amounts and with short maturities from the general public and employ them in larger amounts for investments with longer maturities in the entrepreneurial sector. Thus banks transform amounts and maturities and diversify risk. In most countries, the surplus units are households that do not consume their total actual income but put aside some portions of their purchasing power for later use. This money represents command over real resources and can be utilized for productive purposes in the corporate sector where enterprises are the deficit units. From a developmental perspective, both activities—the mobilization of scarce resources and their productive investment—are equally important.

In the Muslim world, some countries depart fundamentally from this pattern, namely the exporters of energy resources (oil, gas). These countries have huge trade balance surpluses which are at the disposal of the state. Here the state is the surplus unit. Even if the state distributes parts of the surplus to its population, the largest portion of the resource income remains with the state (which sometimes is hard to distinguish from the ruling family). The state can provide financing for domestic enterprises either directly (e.g., by financing large infrastructure projects) or through the banking system. Due to a limited domestic productive capacity, the state will also invest substantial portions in deficit units (enterprises or profitable projects) abroad. The major challenge for banks in these countries is to find profitable investments for the surplus funds at home or abroad, while the mobilization of investible funds is of less relevance. But even in capital surplus countries, a prudent and sustainable employment of surpluses in the real economy should be a prime concern because the financial surpluses come from the extraction of depletable resources given by God to the benefit of present and future generations.

In short, the developmental task of the financial sector is the provision of resources to the real economy in general and for entrepreneurial projects in particular. There is no fundamental difference between conventional and Islamic systems in this regard. However, the Islamic system has to observe the specific prohibitions of *riba*, *gharar*, and *maysir*.

b) The prohibition of *riba* does not automatically imply the substitution of debt financing by participatory modes of financing (*musharaka, mudaraba*) as presumed by early models of an interest-free economy.[17] Debt-creating modes of finance such as *murabaha* and *ijara* are permissible. But it is not only the economic closeness of shari‘a-compliant debt financing to interest-based loans that gives good reasons to push for more participatory financing: the engine of economic development is innovation, and innovation is the result of entrepreneurial efforts. Debt financing tends to restrain while participatory financing tends to encourage welfare-enhancing entrepreneurial activities. Entrepreneurial ventures can turn out to be a success, but they can also be a failure—the chance to gain is tied to the risk of loss. It is plausible to assume that entrepreneurial efforts will increase if the financial risk is not borne exclusively by the entrepreneur (as in debt financing), but shared with the financier (as in participatory financing). Therefore participatory financing can significantly contribute to economic development. This is true both for a conventional and an Islamic system, but only proponents of an Islamic system could argue that every individual actor (including the shareholders and managers of banks) is morally obliged to contribute to development—which makes a strong ideological argument in favor of participatory finance.

In a nutshell and in general, the Islamic financial sector should support economic development by:

i) Preventing the loss of resources as a result of financial instability;
ii) Providing resources to the real economy;[18] and
iii) Supporting entrepreneurs through participatory financing.

The first two requirements are mandatory, the third is a desirable addition. It is not unreasonable to expect that the first two requirements are met by private for-profit entities. Things are different with respect to the desirable addition. In countries where corporate governance standards are weak and information asymmetries are widespread, participatory financing may lead to a kind of adverse selection. The participatory instruments attract entrepreneurs with projects that are more risky or/and less profitable than the average projects. This depresses the profitability of the bank and provides finance for projects that fall short of the usual benchmarks.[19] Both is not desirable—neither in a microeconomic (banking) nor in a macroeconomic (developmental) perspective.

EMPIRICAL IMPRESSIONS ON ISLAMIC FINANCE AND DEVELOPMENT

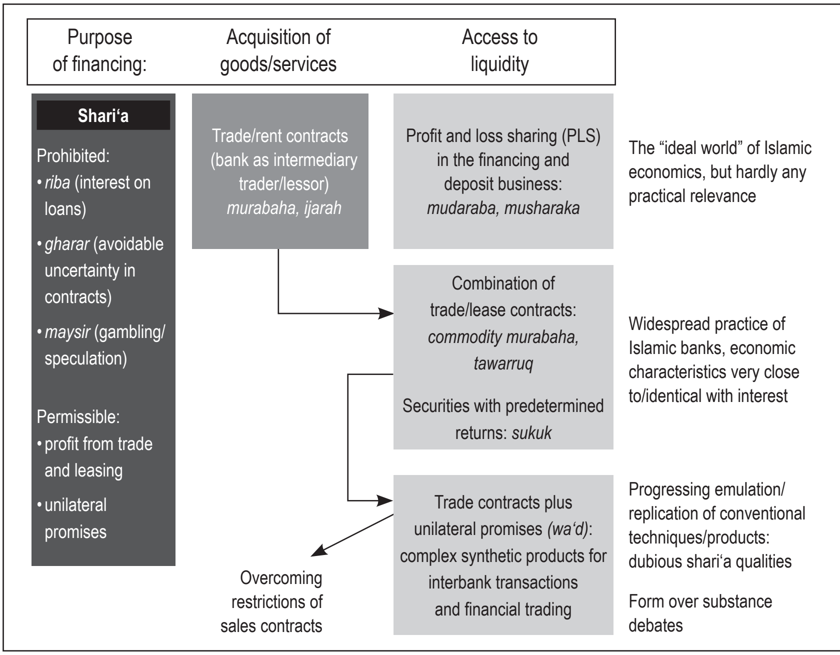
The following is not a comprehensive and systematic empirical study of the contribution of Islamic banks to economic development. It is just a compilation of recently observed trends in the Islamic finance industry with developmental implications and summary comments on the Islamic finance sectors in a number of Muslim countries. Its purpose is more to raise questions than to answer them.

Global Islamic Finance Trends

Islamic banks have developed functional equivalents for a wide range of interest-based instruments. Functional equivalence means that a given project can be financed on terms commercially equivalent to conventional financing—e.g., with respect to the time to maturity, the costs of funds, and the character of the outstanding obligation (debt-like fixed liabilities)—but on a different (shari'a-compliant) legal or contractual basis. Functional equivalents allow Islamic banks to offer financing in a shari'a-compliant form (contracts) but with a conventional (interest-like) substance. The widespread use of such instruments led to the "form over substance" controversy.[20] The evolution of the *riba*-free financing techniques in response to the needs of the financial institutions is summarized in the figure "Prohibition of *Riba* and Financing Techniques."

a) One frequently raised concern is the lack of participatory financing. This is factually correct, but there are reasonable arguments why the classical instruments of profit and loss sharing (*musharaka, mudaraba*) are not widely applied by for-profit institutions.[21] A specific version of this criticism recognizes the arguments in defense of the status quo but accuses the Islamic banks of insufficient efforts toward the development of innovative risk-sharing instruments which limit the downside risk (potential loss) of the financier and reduce the burdens of fixed interest payments for the entrepreneur in difficult times. Some governments had used revenue-sharing schemes for the financing of infrastructure projects, but the private banking sector did not adopt similar techniques. It may be that the shari'a issues are too critical in such schemes where the rate of return is flexible but the possibility of loss is totally eliminated. But there could be alternatives with variable returns and a limited but not eliminated downside risk.[22] For example, the traditional Islamic law knows sharecropping contracts; their rationale might be used as an alternative to exchange contracts for the design of modern forms of participatory instruments. An alternative approach can be based on *takaful* arrangements where capital protection is achieved by contributions

Prohibition of *Riba* and Financing Techniques



to a common risk pool, and independent third party guarantees have been used to shield *sukuk* holders from downside risks. If there would have been a will for more participatory instruments, most probably managers, law firms, and shari‘a scholars would have found a way.

This optimism is based on the observed pragmatism of shari‘a scholars when it comes to the approval of replications of advanced conventional instruments and techniques that enhance the financial efficiency and profitability in the interest of the shareholders of Islamic banks. Examples are, *inter alia*, the tradability of only partially asset-backed papers (as long as the share of fixed assets is more than 50%), the shari‘a screening of stocks (with sometimes quite generous tolerance thresholds for the interest income and impermissible activities),[23] the replication of derivatives (including short selling),[24] efforts to find equivalents to repo facilities (which are in the making), and swap arrangements which were designed to “plug in” Islamic investors to investment opportunities beyond the limits of the shari‘a-compliant universe (which were both approved and fundamentally criticized by leading shari‘a scholars).[25]

b) The lack of interest in participatory finance is not only an annoyance for Islamic economists. The rhetoric of Islamic finance (by proponents who know the realities very well) repeats frequently the claim that Islamic banking is based on superior ethical principles, including the sharing of risks with partners. But once the addressees of this message realize that substantial risk sharing hardly takes place in practice (only conceptually in the deposit business), they are disappointed and some react very adversely.[26]

However, the lack of interest in participatory finance becomes understandable once it is noted that most Islamic banks are predominantly engaged in short-term trade financing, medium-term leasing (*ijara*), consumer financing, and real estate transactions. Additional activities in medium- to long-term corporate financing in general and financing for start-ups or for the expansion of small and medium-sized enterprises in particular (where participatory instruments could be of particular relevance) are rare exceptions.

Such a business profile of Islamic banks does not contribute much to economic development. If a bank uses the savings of one group of private households for the financing of the consumption of another group of private households, then it only reshuffles purchasing power within the macroeconomic surplus sector. It is not transforming savings (from the surplus sector) into productive investments (in the deficit sector). Most trade financings and provisions of working capital for enterprises have only a marginal developmental impact. Trade is a useful entrepreneurial activity, but it is in itself neither innovative nor (or only under exceptional circumstances in some capital surplus countries) the engine of growth and employment. It is not too far-fetched to argue that usually trade follows production (manufacturing) and not vice versa. The developmental impact of investments in real estate is quite limited if the financing is for residential objects and for general office space (in contrast to production facilities). It is even less beneficial if all parties involved are less interested in a regular income from the use of the property but mainly in profits from a quick resale of the object to another party. This actually means participation in a real estate price bubble.

c) As long as profits are sufficient, banks do not have a strong incentive to change their policies. In capital surplus countries, this real estate business may be acceptable. But the situation is very different in countries with a shortage of investible funds. There, Islamic banks should not become property traders but invest mobilized savings in the corporate sector. Bank financing is particularly needed by enterprises which cannot directly draw resources from the capital market (e.g., by the floatation of *sukuk*). This is by far the majority of enterprises in most Islamic countries. To meet their financial needs, bank financing is of prime developmental urgency—the form (debt-like or participatory shari‘a-compliant contracts) is secondary.

The actual structure of the Islamic banking industry is not more conducive to economic development than the conventional banking sector: Islamic banks started as commercial banks with a focus on short-term trade finance. Later they added consumer loans and home financing to their retail portfolio. Medium- to long-term corporate finance (especially for SMEs) was not on their agenda.[27] Islamic investment banks emerged in the capital-exporting Arab countries, but the main focus of their investments was public and semi-public domestic infrastructure projects, domestic and international real estate, and investments primarily in developed European and North American markets. In corporate finance these banks did provide working capital and large-scale syndicated loans, but only for well-established customers and not for start-ups or SMEs.

The phasing in of new forms of shari'a-compliant instruments for transactions among Islamic financial institutions, notably the development of new tradable securities, did not strengthen the links with the real economy. They facilitate the emergence of a market for financial transactions (trading) within the Islamic finance industry. With such an option on the horizon, participatory finance for SMEs (which are crucial for employment-generating growth and economic development) is getting less attractive. However, the trend toward "more vibrant" secondary financial markets is beneficial for well-established and well-known (mostly larger) companies with an excellent track record, which can issue shares or *sukuk*. *Sukuk* are increasingly used for corporate finance, and there is a vast potential for further growth. But even if the *sukuk* volume grows rapidly and all funds raised by the *sukuk* issues are employed in productive ventures in the real economy, this does not prove that Islamic banks (or Islamic finance in general) support the corporate sector better than conventional finance. On the one hand, the growth may be due to tax incentives for the issuance of *sukuk* instead of conventional bonds. On the other hand, the growth may be due to a very strong demand for *sukuk* by Islamic financial institutions (banks, *takaful* operators, fund managers) which are lacking more profitable employments with similar qualities (maturity, rating, etc.) for the funds under their management. This is the result of persistent imperfections in the relatively young, small, and fragmented Islamic financial markets. Excess demand results in cheaper funds by issuing *sukuk* compared to conventional bonds. In such a setting lower costs of funding do not indicate a higher efficiency of Islamic finance but imperfections of this sector.

In total, there is a funding gap for exactly those types of businesses that are crucial for economic development, namely SMEs in general and start-up companies in particular. Islamic finance is not to blame for this gap—it is also a deficiency of conventional finance that has existed for a long time—but Islamic finance in its present form will not fill this gap either.

d) The actual contractual engineering in Islamic finance does not only not help to bridge this gap but it may even drive the system in a very different direction. The latest shari'a-compliant innovations have brought forth products and instruments that are mainly used for transactions within the financial sector. Derivatives trading among financial institutions was the main driver of high profits (and losses) in conventional finance before the crisis. The pricing of many traded derivatives was based on divergent expectations of the trading partners with respect to the future development of financial parameters (indices, stock prices, exchange rates, etc.).

It seems that Islamic banks are looking in the same direction. Examples include the design of various structured products and derivatives, hedging instruments, short-selling techniques, repo facilities, and even shari‘a-compliant CDOs. Not all of these products and instruments are already widely used. Some are still under development, but at least "prototypes" have been presented, and all have found the approval of shari‘a boards of high caliber.[28] These instruments can enhance the risk and liquidity management capacities of Islamic banks (and in the last instance the shareholder value). But their macroeconomic merits are very doubtful: the conventional counterparts were of particular importance for high-gain and high-risk transactions among banks and for (speculative) financial trading activities.[29]

e) The universe of financial papers that could be traded within the Islamic financial sector is still very limited, but contractual engineering expands the limits. *Sukuk* with an increasingly thin asset content have been approved, and items such as the air time of a telecom provider have been accepted as assets suitable for securitization.[30] Synthetic papers based on such assets (literally created "out of the air") could open the doors for a completely new asset class for Islamic banks in a knowledge-based economy. If intangible assets such as air time are considered equivalent to tangible real assets, the *sukuk* can be tradable. Suppose a new telecommunications company has a license for a mobile phone frequency, and based on this license the company can create "air time" as an asset for a *sukuk* issuance. The proceeds are used for setting up its business in a competitive market. The interesting topics are how much air time will be created and how this will be priced. In conventional finance such a paper would most likely be classified as (highly) speculative, and it would be well-suited for various kinds of "bets," i.e., expectation-driven trades. The shari‘a-compliant terminology may differ, but the economic substance will be the same. Most probably more shari‘a-compliant papers of the "air time type" are in the pipelines, and once they find broad acceptance, speculative trading could start within the shari‘a-compliant sector—and with the participation of conventional financial institutions because trading real assets with them is not prohibited.

The relevance for development is this: after the deregulation in the US, many banks have changed their business model. Instead of granting loans and keeping them on the balance sheets until full repayment, loans were securitized and sold off to other financial market players. This model and derivatives trading were much more profitable than the old-fashioned style of banking. It seems that "Islamic derivatives," "air time *sukuk*," property swap certificates, and other recent prototypes will create a class of shari‘a-compliant papers that facilitate the same trading practices in Islamic finance as in conventional finance. Besides potential threats for the stability of the financial system, the most important implication is that trading decouples the financial sector from the real economy, and this erodes the potential contribution of Islamic banks to the development of the real economy.

f) Over the past years, Western banks made an inroad into Islamic finance, and they have made a substantial quantitative and qualitative contribution to the Islamic finance industry. It is very hard to envision that icons of Western capitalism started shari‘a-compliant finance for the sake of the spiritual welfare of Muslims or with the ambition to alleviate poverty in Islamic countries. It is more plausible to assume that they had an eye on their bottom line and their shareholder value. They entered the market with a conventional mindset and experienced structuring departments that teamed up with British law firms and top shari‘a scholars to design functional equivalents for those synthetic products that were highly attractive in conventional finance. Before the financial crisis, large global players had earned much more from trading than from financing. If the Islamic financial services industry follows this trend (and it can hardly be denied that the profit motive is a strong driving force also in Islamic finance), then deposits from the general public could be used to meet margin requirements; they could become tools for shari‘a-compliant forms of leveraging, but they would not be channeled from surplus units to productive deficit units in the real sector.

Admittedly, this is a “speculative scenario” and not the market reality of today. But it can hardly be disputed that there are tendencies in the industry that can cause developmental concerns.[31]

Islamic Banking in Selected Countries

The concerns would be less serious if Islamic finance could point to a number of cases where its contribution to economic development is evident. Indeed, there are success stories, but they are hardly a general proof that Islamic finance contributes more to economic development than conventional finance.

The Islamic Development Bank was set up in 1975 as an intergovernmental institution.[32] Initially its activities were funded by the contributions of the member countries and were concentrated on the financing of oil imports of poorer Muslim countries from oil-exporting Gulf countries. Only later were longer-term projects (notably infrastructure projects) added, and the IDB evolved into a group with affiliated institutions with special mandates (for research and training, insurance, private sector development, etc.). The AAA-rated IDB has expanded its financial base considerably by the issuance of a series of *sukuk*. There is no question about the developmental impact of the IDB activities. However, the experiences of IDB as an intergovernmental development bank cannot be taken as a benchmark for private banks with commercial objectives.

For the rich Gulf countries with small local populations and large numbers of expatriates (UAE, Qatar, Bahrain, Kuwait) it is difficult to define the meaning of development. On the one hand, poverty is not a real issue in these countries (although the distribution of income and wealth is very uneven). On the other hand, economic diversification takes place but is driven by government initiatives and foreign companies. There is no fundamental difference in how conventional and Islamic banks contribute to this process.[33] However, Islamic banks were seemingly more exposed to bubble-prone real estate markets (and more seriously hit by their collapse). The Western influence on Islamic banking is notably strong in Bahrain and the UAE.

The situation in Saudi Arabia is different insofar as all banking operations are considered to be shari‘a-compliant since a couple of years ago, which makes it impossible to identify a specific developmental impact of Islamic banks. In this regard, Iran and Sudan are similar cases where all banks have been "Islamized." The question of whether Islamic banks did contribute better than conventional banks to economic development is meaningless in such settings; the relevant question (which is beyond the scope of this paper) would be whether banks as such have promoted economic development in these countries.[34]

In several other Middle Eastern countries (such as Egypt or Tunisia), Islamic banks have existed since the late 1970s or early 1980s, but governments were not in favor of an expansion of Islamic finance because they associated it with political opposition movements. As a consequence, their market share is too small and their businesses are too much influenced (restricted) by politics for any meaningful empirical evaluation of their developmental impact.[35]

The situation was similar in Turkey for a long time (where Islamic banks are known as participation banks; earlier they were known as special finance houses), but the climate has changed in the 2000s. Nevertheless it is difficult to identify a significant developmental contribution. The aggregate market share of the four participation banks is still very small (around 5%), the banks are focused on Istanbul as the commercial center, and the "Anatolian tigers" (who definitely pushed the economic development of Anatolia) have financed their growth largely by other means. On the other hand, Turkish participation banks seemingly had stronger links with the real economy than conventional Turkish banks, which invested in the past heavily in interest-bearing government bonds. This was not an option for participation banks. Further, the strong growth performance of the Turkish economy in recent years generated relatively high returns from the financing of real transaction, so that the more inward-oriented participation banks are seemingly less involved in the development of tradable structured products than Islamic banks in the GCC and Malaysia.[36]

The Middle Eastern country where Islamic banking has probably contributed most significantly to economic development is Jordan. This is not because of the original name of the oldest and largest Islamic bank in Jordan (Jordan Islamic Bank for Finance and Development, established 1978, now re-named Jordan Islamic Bank), which has the longest-serving general manager of the Islamic finance industry (Musa Abdul-Aziz Shihadeh). It is because Islamic banks have mobilized additional savings (largely from expatriates abroad) and channeled them into productive employments in the real economy of Jordan.[37]

Turning to Asia in search of countries where Islamic banking may have made a marked contribution to economic development, the first candidate is Pakistan. Islamic banking has a very eventful history in this country. It started with a top-down enforced Islamization of the whole financial system in the mid-1980s.[38] Bankers did not support this political decision, and they found regulatory loopholes that allowed them to practice “Islamized” banking in such a way that the highest shari‘a court declared the whole system to be un-Islamic in 1992.[39] Nevertheless the façade lasted nearly ten more years before it was officially terminated and replaced by a mixed system. The factual domination of Pakistan’s financial system by conventional banking practices was “legalized” again and Islamic banking was re-launched as an option after 2002 only.[40] The country has now five stand-alone Islamic banks and twelve Islamic branches of conventional banks with an aggregate market share of 7–8%.[41] Islamic banks have been financing the real economy, but the same is true for conventional banks. It requires a more detailed analysis to find out whether Islamic banks contributed more or better to economic development than conventional banks.

In two other countries attention should not only be paid to Islamic banking in general but to Islamic microfinance in particular. Bangladesh is the country where conventional microfinance took off in the 1990s. Muhammad Yunus’ Grameen Bank (established as a bank in 1983) has become the icon of microfinance, but in recent years also the focal point of growing critique. It is somewhat surprising that shari‘a-compliant microfinance institutions emerged only after a considerable time lag, and their share in the total microfinance of the country is at best marginal (only about 1% of all microfinance clients).[42] The situation is somewhat better in Indonesia: Besides eleven stand-alone Islamic commercial banks and twenty-three Islamic windows, Indonesia has about 150 Islamic rural banks (which are a kind of microfinance institutions). But in spite of this impressive number of Islamic banks, their market share is below 4%.[43] While quantitatively insignificant on a national scale, Islamic rural banks may well contribute to the development of their communities or regions. But it requires much empirical fieldwork to find out whether the local impact of Islamic rural banks is different from conventional rural banks—the number of which is more than 1,700.[44]

Finally, a note on Malaysia. Malaysia is the country with the most developed and diversified Islamic finance industry and the most elaborate legal and regulatory framework, plus strong support of Islamic finance by the government (through the central bank and securities commission).[45] Unfortunately this support makes it very difficult to identify the genuine contribution of Islamic finance to the Malaysian economic development because direct and indirect subsidies and various other supporting measures distort the data. For example, *sukuk* issues enjoy a tax advantage over conventional bonds,[46] and more than half of the "Islamic deposits" originate not from "ordinary savers" but from the public sector and government-supported businesses.[47] While therefore quantitative analyses can be tricky, a qualitative note is less disputable: Malaysia's dual banking model (with stand-alone Islamic banks and Islamic windows of conventional banks) opened the door for the conventionalization of Islamic finance. Most of the banks that started window operations were owned and managed by non-Muslims, and at least the ownership structure has not changed. Structured conventional products were developed next door under the same roof, and a "mental spillover" cannot be precluded. It seems that the dominant *shafi'i* school of law was particularly conducive to a comprehensive re-design of complex conventional structures in a shari'a-compliant form—both on the level of the shari'a boards of individual banks as well as on the level of the national shari'a boards of the central bank and the securities commission.[48]

ISLAMIC FINANCE IN PERSPECTIVE

The Islamic finance industry has been growing at high rates, and even if their developmental impact is not yet proven, it obviously had a value proposition for many customers.

a) One obvious value proposition for Muslims is the shari'a compliance of the financial transactions. This, however, comes at a price: the contracts used by Islamic banks are more complicated and less tested in courts and, from a consumer protection perspective, sometimes more rigid and disadvantageous than conventional contracts. *Sukuk* defaults were an additional eye-opener: many people found out that their particular *sukuk* did actually not transfer the true ownership of assets with a market value to them. In other cases, *sukuk* holders were true owners, but the market value of the specific assets was very low for users other than the *sukuk* issuer. Instead of owning assets, *sukuk* holders may own the right to usufructs which would be worthless in the case of a bankruptcy of the issuer. In conclusion, many *sukuk* holders found themselves in a situation very similar to that of holders of conventional bonds.[49]

The last crisis and its aftermath have also threatened the existence of some Islamic banks. A few Islamic investment banks underwent fundamental restructurings or were closed down while some other Islamic banks have been bailed out so that no losses were passed on to their "depositors" (who usually have entered into a *mudaraba*-type contract with their Islamic bank).[50] Would that have happened, savers might have lost their "deposit illusion": they would have been reminded painfully of their legal status as profit-sharing and loss-bearing investment account holders. It seems that savers consider investment accounts as shari'a-compliant substitutes to risk-free savings or term deposits. Otherwise it would be hard to explain why they are satisfied with returns not higher than the interest paid to conventional depositors whose money is guaranteed while theirs is not (at least not contractually in most jurisdictions). A bank in their position would definitely have charged a risk premium for such a kind of funding. Deposit illusion may also explain why investment account holders as conceptual risk-bearers accept a governance structure in which they are totally absent: except for the shari'a board, the corporate governance structure of Islamic banks is identical with the structure of conventional banks. Both are typically joint stock companies and subject to the same corporate law, and most regulators treat investment accounts like deposits. However, the legal status of investment account holders and depositors is fundamentally different. Nevertheless, holders of unrestricted investment accounts do not have specific information rights regarding the employment of their funds or their risk exposure. Participants in *takaful* schemes face basically the same governance problem.[51]

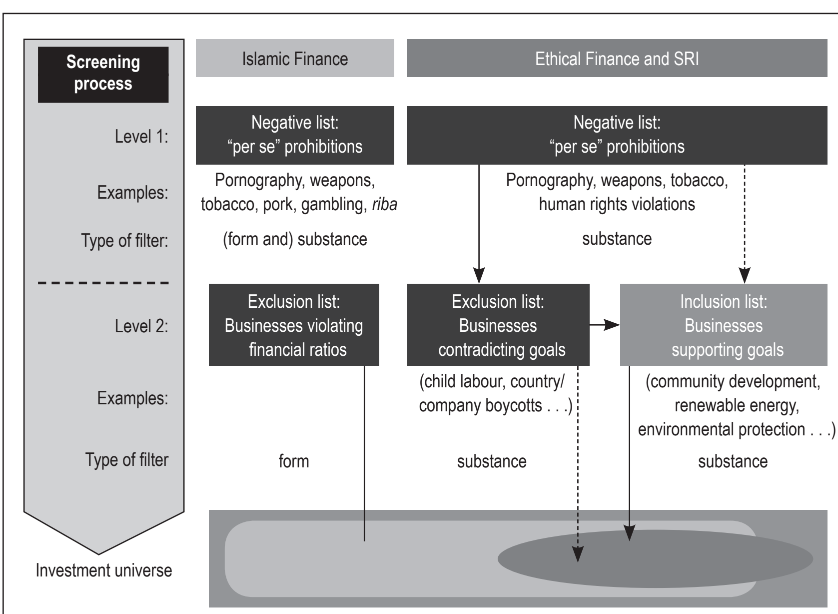
Customers of Islamic banks had to learn that it is more difficult to renegotiate the terms of shari'a-compliant financings than the terms of conventional loans. Conventional banks can easily adjust interest rates to early payments or extended repayment periods. Islamic banks are tied to their sales contracts, and buying back and reselling an object for a restructuring is not only complicated: renegotiated sales profits that vary with the repayment conditions come dangerously close to prohibited interest.

While the list of problems could be extended further, it has to be conceded that not all problems materialized at the same time and with all banks. On the contrary, the list of problems is composed of events and incidents that happened at different times in different places and with different banks. However, the problems point to some structural weaknesses that could affect other banks as well, and therefore have to be taken seriously.

b) Suppose the average bank customers—Muslims or non-Muslims—are not aware of (or do not worry about) such issues. Then the question is what value proposition other than the formal shari'a compliance (which is not relevant for non-Muslims) has attracted them to Islamic finance. After the banking crisis many people have become concerned about the use of their funds. The average conventional depositors have never benefited from speculative profits from trading, and they would hardly be willing to take the associated risks. In the aftermath of the crisis, banks and funds with ethical or socially responsible investment (SRI) strategies have received much public attention and gained in attractiveness. Non-Muslims were drawn toward Islamic finance by the claim and the expectation that Islamic finance is more ethical than conventional banking. However, it is neither obvious that the financing business of Islamic banks contributes more to sustainable economic development than the financing business of "prudent" conventional banks, nor is it guaranteed that the shari'a screening of stocks generates a particular ethical quality of Islamic funds. The figure "Islamic and Ethical Finance: Congruence and Divergence" summarizes the overlapping approaches but also indicates the differences between shari'a and conventional screening techniques.

There are best practice examples of a strong developmental impact of an Islamic bank financing or of socially responsible stock selections—but unfortunately "best" practice is not "general" practice. The observance of the prohibitions of *riba*, *gharar*, and *maysir* ensure "minimum ethics," but that is in substance not much more than what would result from the adherence to the principles of prudent conventional banking. Higher ethical expectations are often nurtured by a specific interpretation of the shari'a governance structure and of the role of shari'a boards as something like "ethics commissions." This interpretation is in a marked contrast to the understanding of shari'a scholars of themselves as lawyers and not as religious leaders, moral authorities, or advocates of investment account holders or *takaful* participants.

Islamic and Ethical Finance: Congruence and Divergence



c) In the coming years Islamic banks will continue to improve their operational efficiency, legal uncertainties will be removed, and more standardization will help to overcome market fragmentation and promote cross-border transactions. Competition will force Islamic financial institutions to become more transparent and to establish mechanisms for an organized communication with investment account holders and *takaful* participants. Compared to the status quo, this may look like a big leap forward. But factually this is not much more than the correction of shortcomings of the existing practice. It does not propel economic development, and it does not create a superior value proposition for the average "man on the street."

To gain wider recognition and to contribute more vigorously to economic development, Islamic finance must go beyond contractual innovation in form (= replication of conventional substance) and has to come to financial innovation in substance. This means that Islamic financial institutions must create genuine products with distinctive risk/return characteristics. They should address the deficiencies of conventional finance in developing countries, and that could mean priority for medium- and longer-term corporate finance, in particular for employment- and income-generating SMEs with good growth prospects on a participatory basis with a limited downside risk for the capital provider. This is a huge challenge, but Islamic finance can still build on a remarkable goodwill and trust and on a growing pool of qualified human resources. This should also facilitate a more demanding screening of stocks and design of shari'a-compliant ethical and socially responsible investment funds. Islamic economists should adjust their models to real-world conditions and develop a theory of transformation toward an economic system which is superior to the status quo and in which *riba*-free finance interacts with other Islamic institutions (*zakat*, *waqf*, etc.) in order to promote economic development. But this system must be achievable and not a utopian ideal.

Endnotes

1. Asad Zaman, *Islamic Economics: A Survey of the Literature* 1–5—A Survey of the Literature (Birmingham: International Development Department, University of Birmingham, 2008); Mehmet Asutay and Nazim Zaman, "Divergence between Aspirations and Realities of Islamic Economics: A Political Economy Approach to Bridging the Divide," *IIUM Journal of Economics and Management* 17:1 (2009): 73–96.
2. See, for example, Khurshid Ahmad, "Economic Development in an Islamic Framework," *Studies in Islamic Economics*, edited by Khurshid Ahmad (Leicester: Islamic Foundation, 1980), 171–188; Ziauddin Ahmad, *Islam, Poverty and Income Distribution: A Discussion of the Distinctive Islamic Approach to Eradication of Poverty and Achievement of an Equitable Distribution of Income and Wealth*. (Leicester: Islamic Foundation, 1991); M. Umer Chapra, *Islam and Economic*

Development: A Strategy for Development with Justice and Stability (Islamabad: International Institute of Islamic Thought and Islamic Research Institute, 1993); Aidit bin Ghazali, *Development: An Islamic Perspective* (Petaling Jaya: Pelanduk Publications, 1990); Munawar Iqbal, ed. *Islamic Economic Institutions and the Elimination of Poverty* (Markfield: The Islamic Foundation, 2002); M.A. Mannan and Mehboob Ahmad, eds. *Economic Development in an Islamic Framework* (Islamabad: International Institute of Islamic Economics, 1996); Abbas Mirakhor and Idris Samawi Hamid, *Islam and Development: The Institutional Framework* (New York: Global Scholarly Publications, 2009); Ataul Huq Pramanik, *Development and Distribution in Islam* (Petaling Jaya: Pelanduk Publications, 1997); AbulHasan Muhammad Sadeq, *Economic Development in Islam* (Petaling Jaya: Pelanduk Publications, 1990).

3. This understanding of Schumpeter (see Schumpeter, Joseph Alois, *The Theory of Economic Development*, [Cambridge, MA: Harvard University Press, 1934]) was further elaborated by New Austrians, for example by Israel M Kirzner, *Competition and Entrepreneurship* (Chicago: The University of Chicago Press, 1973); for a survey see Henrik Berglund, *Austrian Economics and the Study of Entrepreneurship: Concepts and Contributions* (2009). http://ssrn.com/abstract=1353902 or http://dx.doi.org/10.2139/ssrn.1353902.
4. See also Biagio Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development* (Washington: World Bank, 2000), and Kent Matthews and John L. Thompson, *The Economics of Banking*, 2nd ed., (Chichester; Hoboken: Wiley, 2008).
5. “Sustainable and Responsible Investing (SRI) is a broad-based approach to investing that now encompasses an estimated $3.07 trillion out of $25.2 trillion in the US investment marketplace today.” http://ussif.org/resources/sriguide/srifacts.cfm; for more details see Social Investment Forum Foundation, *2010 Report on Socially Responsible Investing Trends in the United States: Executive Summary* (Washington: Social Investment Forum, 2010).
6. Humayon Dar and Talha Ahmad Azami, eds. *Global Islamic Finance Report (GIFR) 2011* (London: BMB Islamic, 2011), 35.
7. Bibliographical references and brief summaries of the literature up to the 1990s can be found in the following bibliographies: Muhammad Akram Khan, *Islamic Economics: Annotated Sources in English and Urdu, Vol 1*. (Leicester: Islamic Foundation, 1983, reprinted 1991); Muhammad Akram Khan, *Islamic Economics: Annotated Sources in English and Urdu, Vol. 2* (Leicester: Islamic Foundation, 1991); Khan, Muhammad Akram, *Islamic Economics: An Annotated Bibliography, Vol. 3 (1988–1997),* (Islamabad: International Institute of Islamic Economics, 1998); further references can be found in the critical analysis of Timur Kuran, *The Long Divergence: How Islamic Law Held Back the Middle East* (Princeton: Princeton University Press, 2011), and the “response” of M. Umer Chapra, *Muslim Civilization: The Causes of Decline and the Need for Reform* (Markfield: The Islamic Foundation, 2008). Chapra’s book was published before Kuran’s book, but Kuran draws on a number of arguments that he had published before, and Chapra refers to these earlier writings; see also Mirakhor and Hamid, *Islam and Development*.
8. There is only one page in the over 800-page “Economic Development” by Nafziger (E. Wayne Nafziger, *Economic Development*, 4th ed. [Cambridge: Cambridge

University Press, 2006]) and zero pages in other widely used textbooks such as the 650-page *Leading Issues in Economic Development* by Meier and Rauch (Gerald M. Meier, and James E. Rauch, *Leading Issues in Economic Development*, 8th ed. [New York, Oxford University Press, 2005]), the 800-page *Economics of Development* by Perkins, Radelet, and Lindauer (Dwight H. Perkins, Steven C. Radelet, and David L. Lindauer, *Economics of Development*, 6th ed. [New York, London: W.W. Norton, 2006]) and the 800-page *Economic Development* by Todaro and Smith (Michael P. Todaro and Stephen C. Smith, *Economic Development*, 11th ed. [Harlow: Addison-Wesley, 2011]) or in the nearly 500-page *Handbook of Sustainable Development* by Atkinson, Dietz, and Neumayer (Giles Atkinson, Simon Dietz, and Eric Neumayer, eds., *Handbook of Sustainable Development* [Cheltenham: Edward Elgar, 2007]). Obviously, Islamic economists did not manage to get the attention of the Western academic development mainstream.

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10. Traute Wohlers-Scharf, *Arab and Islamic Banks: New Business Partners for Developing Countries* (Paris: OECD Development Centre, 1983).
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12. In recent years Islamic microfinance attracted much attention both from practitioners and academics, and the concepts and practices of Islamic microfinance are now well covered in the literature. See Mohammed Obaidullah, *Introduction to Islamic Microfinance* (New Delhi: International Institute of Islamic Business and Finance, 2008); Mohammed Obaidullah and Tariqullah Khan, *Islamic Microfinance Development: Challenges and Initiatives (*Jeddah: IRTI, 2008); Statistical, Economic,

and Social Research and Training Centre for Islamic Countries, ed. *Microfinance Institutions in the OIC Member Countries* (Ankara: SESRIC, 2008); S. Nazim Ali, ed. *Shari'a-Compliant Microfinance* (London: Routledge, 2012).

13. Katherine Marshall, and Marisa van Saanen, *Development and Faith: Where Mind, Heart and Soul Work Together* (Washington: World Bank, 2007); Jeffrey Haynes, *Religion and Development: Conflict or Cooperation?* (Basingstoke: Palgrave Macmillan, 2007).
14. See, for example, Group of Researchers, *Issues in the International Financial Crisis from an Islamic Perspective* (Jeddah: Scientific Publishing Centre, King Abdulaziz University, 2009); M. Umer Chapra, "The Global Financial Crisis: Some Suggestions for Reform of the Global Financial Architecture in the Light of Islamic Finance," *Thunderbird International Business Review* 53:5 (2011): 565–579; Ibrahim Warde, "After the Meltdown: New Perspectives on Islamic Finance," *Building Bridges across Financial Communities: The Global Financial Crisis, Social Responsibility, and Faith-Based Finance*, edited by S. Nazim Ali (Cambridge, Massachusetts: Islamic Finance Project, Harvard Law School, 2012): 19–30.
15. For more details, see Volker Nienhaus, "Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance," *Ethical Perspectives* 18:4 (2011): 591–623.
16. See Volker Nienhaus, "Fundamentals of an Islamic Economic System Compared to the Social Market Economy," *KAS International Reports* 11 (2010): 75–69; Some classic texts on the German model of a Social Market Economy are collected in Alan T. Peacock and Hans Willgerodt, eds., *Germany's Social Market Economy: Origins and Evolution* (Basingstoke: Macmillan, 1989); Alan T. Peacock, Hans Willgerodt, and Daniel Johnson, eds. *German Neo-Liberals and the Social Market Economy* (London: Macmillan, 1989); See also Wilhelm Röpke, *A Humane Economy* (Chicago: Henry Regnery Company, 1960); Anthony James Nicholls, *Freedom with Responsibility: The Social Market Economy in Germany, 1918–1963* (Oxford: Clarendon Press, 2000); More recent contributions with references to the systemic transformation in former communist countries can be found in Peter Koslowski, ed., *The Social Market Economy: Theory and Ethics of the Economic Order* (Berlin: Springer, 1998).
17. See in particular Muhammad Nejatullah Siddiqi, *Banking without Interest* (Lahore: Islamic Publications, 1973); Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking: Selected Papers* (Leicester: Islamic Foundation, 1983); Muhammad Nejatullah Siddiqi, *Partnership and Profit-Sharing in Islamic Law* (Leicester: Islamic Foundation, 1985).
18. This may require in less developed countries with capital scarcity specific efforts to mobilize (additional) resources from the household sector, and this implies efforts toward financial inclusion. These aspects are not covered in this paper, but the literature documents a long history from the first "experiments" of Ahmed El-Naggar with interest-free savings banks in the 1060s in Egypt up to recent global financial inclusion campaigns; see, for example, R.K. Ready,. "The Egyptian Municipal Savings Banks Project," *International Development Review* 9:2 (1967): 2–5; Ahmed El-Naggar, "Islamic Banks: A Model and the Challenge," *The Challenge of Islam*, edited by Altaf Gauhar (London: Islamic Council of Europe, 1978), 220–234; Mahmoud Mohieldin, Zamir Iqbal, Ahmed Rostom, and Xiaochen Fu, "The Role of Islamic Finance in Enhancing Financial Inclusion in OIC Countries," paper presented at 8th International

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19. See Volker Nienhaus, "Profitability of Islamic PLS Banks Competing with Interest Banks: Problems and Prospects," *Journal of Research in Islamic Economics* 1:1 (1983): 37–47.
20. A related topic is how to balance innovation and authenticity; see S. Nazim Ali, ed., *Islamic Finance: Innovation and Authenticity* (Cambridge, Massachusetts: Islamic Finance Project, Harvard Law School, 2010).
21. These arguments range from information asymmetries and moral hazard problems over ("wrong") expectations of "depositors" and the underdeveloped liquidity management infrastructure (which requires a close match of maturities of bank assets and liabilities) to a lack of entrepreneurial demand for a participatory form of finance.
22. For example, convertible *sukuk* deserve further examination, in particular those based on *ijara* contracts where the maturity of the *sukuk* and the useful life of the asset match.
23. See Ulrich Derigs and Shehab Marzban, "Review and Analysis of Current Shariah-Compliant Equity Screening Practices," *International Journal of Islamic and Middle Eastern Finance and Management* 1:4 (2008): 285–303; Catherine S. F. Ho, Nurul Afiqah Abd Rahman, Noor Hafizha Muhamad Yusuf, and Zaminor Zamzamin. "Comparison of Quantitative Shari'ah-Compliant Screening Methods," *ISRA International Journal of Islamic Finance* 3:2 (2011): 91–110.
24. See Asyraf Wajdi Dusuki and Abdelazeem Abozaid, "Fiqh Issues in Short Selling as Implemented in the Islamic Capital Market in Malaysia," *JKAU: Islamic Economics* 21:2 (2008): 65–80; Matthew Sapte, "Derivatives in Islamic Finance," *Islamic Finance News* 5:23 (2008): 19–20; Robert Rilk and Humayon A. Dar, "Product Innovation: Derivatives and Hedge Funds," *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*, edited by Humayon A. Dar and Umar F. Moghul (London: Chancellor Publications, 2009), 333–355; Sherin Kunhibava, *Derivatives in Islamic Finance* (Kuala Lumpur: ISRA, 2010); Priya Uberoi and Ali Rod Khadem, "Islamic Derivatives: Past, Present, and Future," *Islamic Capital Markets: Products and Strategies*, edited by M. Kabir Hassan and Michael Mahlknecht (Chichester: Wiley, 2011), 147–170.
25. See Mushtak Parker, "IIFM Repo Opens New Door for Debt Capital Market," *Arab News*, August 1, 2010. http://arabnews.com/economy/islamicfinance/article94058.ece; Deutsche Bank, *Pioneering Innovative Shari'a Compliant Solutions* (London: Deutsche Bank, 2007); Yusuf Talal DeLorenzo, *The Total Returns Swap and the "Shariah Conversion Technology" Stratagem* (2007). http://www.dinarstandard.com/finance/DeLorenzo.pdf.
26. It is correct that the exchange contracts used by Islamic banks in their financing business imply additional market risks (which do not exist in conventional loan contracts), but Islamic banks have developed a wide variety of risk mitigation techniques that minimize or factually eliminate market risks. A summary of risks and risk mitigation techniques can be found in *IFSB-1:* Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS); see also Tariqullah Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in Islamic Financial Industry* (Jeddah: IRTI, 2001); and Tariqullah Khan and Dadang Muljawan, eds., *Islamic Financial*

Architecture: Risk Management and Financial Stability (Jeddah: IRTI, 2005); Ioannis S. Akkizidis and Sunil Kumar Khandelwal, *Financial Risk Management for Islamic Banking and Finance* (Basingstoke: Palgrave Macmillan, 2008).
27. The same can be observed for conventional banks.
28. There are many reports and articles on such innovations in industry-related journals and magazines and client reports and newsletters, and they are hot topics in industry seminars and executive briefings.
29. This was a major topic for Islamic economists who diagnosed the collapse of the Western financial system.
30. See Craig Nethercott and Harj Rai, "Mobily Leads the Way in Jumbo Refinancing," *Islamic Finance News* 9:18 (2012): 19–20; for comprehensive surveys and discussions of *sukuk* structures, see Abdulkader Thomas, ed., *Sukuk* (Petaling Jaya: Sweet & Maxwell Asia, 2009), and Muhammad al-Bashir Muhammad Al-Amine, *Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation* (Leiden, Boston: Brill, 2012).
31. For recent innovations see, for example, Simon Archer and Rifaat Ahmed Abdel-Karim eds., Islamic Finance: Innovation and Growth (London and Manama: Euromoney, 2002); AAOIFI, Ali, *Islamic Finance*; Humayon Dar and Talha Ahmad Azmi, eds., *Global Islamic Finance Report (GIFR) 2010* (London: BMB Islamic, 2010); Dar and Azami, *GIFR 2011*; Al-Amine, *Global Sukuk*.
32. See Rodney Wilson, "Saudi Arabia: The Islamic Development Bank's Role as a Pan-Muslim Agency," *Islamic Financial Markets*, edited by Rodney Wilson (London: Rotledge, 1990), 196–222, 235–236; Shahid Hassan Siddiqui, "Islamic Development Bank: Operations, Prospects and Challenges," *Journal of Islamic Banking and Finance* 16:1 (1999).
33. For Islamic finance in the Gulf countries see Oliver Agha, "Islamic Finance in the Gulf: A Practitioner's Perspective"; Rodney Wilson, *The Development of Islamic Finance in the GCC* (London: Centre for the Study of Global Governance, 2009); For development in Saudi Arabia see Rasem N. Kayed and M. Kabir Hassan, "Saudi Arabia's Economic Development: Entrepreneurship as a Strategy," *International Journal of Islamic and Middle Eastern Finance and Management* 4:1 (2011): 52–73.
34. However, another segment of Islamic finance made a significant contribution to economic development also in fully "Islamized" countries such as Saudi Arabia through the introduction of the concept of *takaful*. The *takaful* concept paved the way for the development of markets for risk covers in many Muslim countries, and the availability of insurance or *takaful* enhances the risk-bearing capacities of individuals and corporations; see Mohd. Ma'sum Billah, *Islamic and Modern Insurance: Principles and Practices* (Petaling Jaya: Ilmiah Publishers, 2003); Mohd. Ma'sum Billah, *Applied Takaful and Modern Insurance: Law and Practice*, 3rd ed. (Petaling Jaya: Sweet & Maxwell Asia, 2007); Simon Archer, Rifaat Ahmed Abdel- Karim, and Volker Nienhaus, eds., *Takaful Islamic Insurance: Concepts and Regulatory Issues* (Singapore: John Wiley [Asia], 2009); Tobias Frenz and Younes Soualhi, *Takaful and Retakaful: Advanced Principles and Practices*, 2nd ed. (Kuala Lumpur: IBFIM, 2010).
35. For Tunisia see Robert P. Parks, "Aiyyu Bank Islami? The Marginalization of Tunisia's Best Bank," *The Politics of Islamic Finance*, edited by Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004) 240–264; For Egypt see Ann Elizabeth Mayer, "Islamic Banking and Credit Policies in the

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36. See Filiz Baskan, "The Political Economy of Islamic Finance in Turkey: The Role of Fethullah Gulen and Asya Finans," *The Politics of Islamic Finance*, edited by Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 216–239; Savas Alpay, "An Evaluation of Special Finance Houses: A Case Study on Turkey," *Advances in Islamic Economics and Finance, Vol. 1,* edited by Munawar Iqbal, Salman Syed, and Dadang Muljawan (Jeddah: IRTI, 2007), 369–382; and Participation Banks Association of Turkey (TKBB), *Participation Banks 2010* (Istanbul: TKBB, 2011).
37. See Ramadan Shallah, "Jordan: The Experience of the Jordan Islamic Bank," *Islamic Financial Markets*, edited by Rodney Wilson (London, New York: Rotledge, 1990), 100–128, 228–229; Stefano Miani and Demeh Daradkah, "The Islamic Banking Industry in Jordan," *Transition Studies Review* 16:3 (2009): 635–654.
38. See Nawazish Ali Zaidi, *Eliminating Interest from Banks in Pakistan* (Karachi: Royal Book Company, 1987); Izzud-Din Pal, *Pakistan, Islam, and Economics: Failure of Modernity* (Oxford: Oxford University Press, 1999); Izzud-Din Pal, *Islam and the Economy of Pakistan: A Critical Analysis of Traditional Interpretation* (Oxford: Oxford University Press, 2006).
39. The position of the Shari‘a Court was basically confirmed by the Supreme Court in 1999; see Muhammad Taqi Usmani, *The Text of the Historic Judgement on Riba (Interest), Given by the Supreme Court of Pakistan, 23rd December 1999: Section Written by Maulana Justice Muhammad Taqi Usmani* (Petaling Jaya: The Other Press, 2001).
40. See Mehboob ul-Hassan, "The Islamization of the Economy and the Development of Islamic Banking in Pakistan," *Journal of Islamic Banking and Finance* 25:3 (2008): 16–40; Shamshad Akhtar. "Pakistan Islamic Banking: Past, Present and Future Outlook," *Journal of Islamic Banking and Finance* 26:2 (2009): 53–61; Muhammad Ayub, "Islamic Banking in Pakistan: Time to Assess the Achievement," *Journal of Islamic Banking and Finance* 26:1 (2009): 20–28.
41. See the Islamic Banking Bulletin October–December 2011, published by the State Bank of Pakistan (http://www.sbp.org.pk/ibd/bulletin/2011/IBB-Dec-2011.pdf).
42. See M. A. Hamid, "Islamic Banking in Bangladesh: Expectations and Realities," *Studies in Islamic Banking and Finance in the 21st Century: Theory and Practice*, edited by Muhammad Anwar and Mohamad Aslam Haneef, (Kuala Lumpur: International Islamic University Malaysia, 2005), 241–281; Md Safiullah, "Superiority of Conventional Banks & Islamic Banks of Bangladesh: A Comparative Study," *International Journal of Economics & Finance* 2:3 (2010): 199–207; M. Mizanur Rahman and Fariduddin Ahmad, "Impact of Microfinance of IBBL on the Rural Poor's Livelihood in Bangladesh: An Empirical Study," *International Journal of Islamic and Middle Eastern Finance and Management* 3:2 (2010): 168–190; Dewan A. Alamgir, M. Kabir Hassan, and Hisham Haider Dewan,"A Comparative Review of Islamic Versus Conventional Microfinance in Bangladesh," paper presented at 8th International Conference on Islamic Economics and Finance: Sustainable Growth and Inclusive Economic Development from an Islamic Perspective (Doha, Qatar, December 19–21, 2011).

43. See Bank Indonesia, *Indonesian Banking Booklet 2011* (Jakarta: Bank Indonesia, 2011).
44. See Rifki Ismal. *The Indonesian Islamic Banking: Theory and Practices* (Jakarta: Gramata Publishing, 2011). Muhamad Abduh and Mohd Azmi Omar, "Islamic Banking and Economic Growth: The Indonesian Experience," *International Journal of Islamic and Middle Eastern Finance and Management* 5:1 (2012): 35–47.
45. See Awang Adek Hussin, "The Islamic Financial Landscape in Malaysia," *Studies in Islamic Banking and Finance in the 21st Century: Theory and Practice,* edited by Muhammad Anwar and Mohamad Aslam Haneef, (Kuala Lumpur: International Islamic University Malaysia, 2005), 349–365; Securities Commission Malaysia, *Introduction to Islamic Capital Market* (Petaling Jaya: LexisNexis, 2009); Aishath Muneeza, Rusni Hassan, and Ismail Wisham, *Islamic Banking under the Malaysia Law* (Kuala Lumpur: A.S. Noordeen, 2011).
46. Tax incentives for *sukuk* are listed on the website of the Malaysia International Islamic Financial Centre (MIFC): http://www.mifc.com/index.php?ch=menu_foc_suk&pg=menu_foc_suk_inc; see also "Malaysia Offers Tax Breaks to Secure Dominance of Sukuk Issues," *FTSE Global Markets*, May 23, 2012. http://www.ftseglobalmarkets.com/index.php?option=com_k2&view =item&id=3342:malaysia -offers-tax-breaks-to-secure-dominance-of-sukuk-issues.
47. See Balachandran Shanmugam, "Islamic Banking: Whither the Engine for Growth," *Islamic Finance News* 7:44 (2010): 20–21.
48. For compilations of shari'a resolutions of Malaysia's national shari'a boards see Securities Commission Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, 2nd ed. (Kuala Lumpur: Securities Commission Malaysia, 2006); Bank Negara Malaysia, *Shariah Resolutions in Islamic Finance*, 2nd ed. (Kuala Lumpur: Bank Negara Malaysia, 2010); for a critical analysis of the shari'a qualities of the most widely used instruments of Islamic banks see D. Ruse, *The BBA Condrum* (Kuala Lumpur: A. S. Noordeen, 2012).
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50. Prominent cases are The Investment Dar (Kuwait), Gulf Finance House (Bahrain), and Arcapita (Bahrain); see Mushtak Parker, "Light at the End of TID's Debt-Restructuring Tunnel," *Arab News*, June 19, 2011; Mohammed Khnife, Aatef Baig, and Frank Winkler, *The Rise and Fall of Gulf Finance House*, available at http://ssrn.com/abstract=1712059; IFSB, *Islamic Financial Services Industry Stability Report 2013* (Kuala Lumpur: IFSB 2013), 44, 47.
51. The IFSB has dealt with these issues in several standards and guiding notes; see in particular IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance

Institutions) offering only Islamic Financial Services (IIFS); IFSB-3*:* Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance [*Takaful*] Institutions and Islamic Mutual Funds); IFSB-8: Guiding Principles on Governance for *Takaful* (Islamic Insurance) Undertakings; GN-3: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders; and GN-4: Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) offering only Islamic Financial Services. All documents are available from the IFSB website: http://www.ifsb.org/published.php.

The Role of Islamic Finance in Development

Neil D. Miller

INTRODUCTION

This paper examines the role of Islamic finance in development.[1] The future role and growth of the Islamic finance industry over the next five to ten years seems to be dependent on various factors, including the untapped customer base and contemporary socio-political changes particularly prevalent in Arab countries (commonly referred to as the Arab Spring). The first factor is linked to a fundamental demographic observation, which recognizes that a major Muslim population (representing approximately 25% of the world's population) is currently underserved by an industry that presently only provides approximately 1% of total annual global financial intermediation. This represents an economic gap and a market opportunity that is begging to be narrowed. The second factor that seems to be playing a key role in shaping the role of the Islamic finance industry is the revival of Islamic thought in many countries around the world (more recently demonstrated by events in those countries affected by the Arab Spring). Besides bringing about various sociopolitical changes in many parts of the world, particularly in emerging and transitioning economies with significant Muslim communities, this revival of Islamic thought will also require the Islamic finance industry to play a key role in the economic development of such countries and communities. This in turn will also impact financial intermediation activities and institutions across those countries and communities. The precise form or character that such Islamic financial intermediation will take in those countries is uncertain: the manner in which existing or new governments will allow it to emerge and the basis upon which Islamic financial institutions will be able to operate remains unclear in many countries. In many respects, this uncertainty at a macro level echoes the issues of form and substance this paper is wrestling with at a micro level: What *form* will (or should) future Islamic financial activity take and what will it amount to in *substance*?

A complex philosophical question that the Islamic financial community seems to be wrestling with at the moment is whether the Islamic finance

Neil D. Miller, Global Head of Islamic Finance, Linklaters LLP, Dubai, UAE.

industry is providing development-based financial support and solutions to the community, and if not, then *should* the Islamic financial industry provide development-based financial support and solutions to the community? These questions are not dissimilar to the questions raised by legal positivism. In his *Treatise of Human Nature*, David Hume[2] argued that people invariably slip between, on the one hand, describing that the world *is* a certain way and saying, on the other hand, that we *ought* therefore to conclude on a particular course of action. Students of jurisprudence find themselves in a similar position while questioning what the law *is* (determined by historical social practice) and what the law *ought* to be (determined by moral considerations). Put simply, Islamic financiers need to ask: *Is* what I am doing today what I *ought* to be doing tomorrow?

In this paper, the author examines the following four key issues: Is Islamic finance an alternative to prevailing economic models? What is the potential role of the Islamic finance sector in national development? What is the role and responsibility of for-profit private entities offering Islamic financial services in development? And what is the role of Islamic finance in development in the light of empirical evidence?

IS ISLAMIC FINANCE AN ALTERNATIVE TO PREVAILING ECONOMIC MODELS?

This paper makes certain assumptions about the nature of Islamic economics. It may be a risk doing so, but if we get stuck in a debate about what Islamic economics is, we face the greater risk of not progressing with the further questions regarding what Islamic financial intermediation is actually achieving and whether such achievements have the characteristics of development finance or require adaptation because they fail that test and ought to be changed. The first and foremost assumption is that the fundamental objective of Islamic economics and finance is to achieve socio-economic and distributive justice. To help an "Islamic economy" achieve this goal, the Islamic economic system imposes a set of relatively straightforward parameters that should be followed. Ayub identifies these parameters and explains them in three main categories: i) The prohibition of interest, excessive uncertainty, gambling, and other games of chance; ii) An emphasis on a social welfare system based on mutual help, character building, and behavioral changes; and iii) Care and dignity for the poor.[3] Secondly, the term "development" is invariably used with narrow meaning and definition when discussed in an Islamic financial context. For the purpose of this paper, development is about outcomes. Development would be deemed to occur with the reduction of poverty, inequality, and unemployment within a growing economy through enhancing the production of life-sustaining necessities (such as food, shelter, and health care), raising living standards and individual self-esteem, expanding economic choice, and reducing fear.[4]

In the Islamic finance context, any discussion about the role of Islamic financial institutions in "development" invariably tends to spiral toward the lowest common denominator: namely, that Islamic finance is (or should be) about the provision of micro-finance and/or rural development.[5] This line of argument is not convincing, not least because such an approach would fail to mobilize the vast sums of money that are potentially available through the Islamic financial community. Such a focus would confine the Islamic finance industry to a restrictive area of activity that, despite its intrinsic merit, does not address the much larger developmental needs of many Muslim-majority countries. Further, defining "Islamic finance" in this way would shortchange both the wider *umma* as well as the shareholders of Islamic financial institutions (IFIs).

It is also important to realize that the conventional development agenda is much wider than such a limiting definition. Although such activity may often start with assisting agrarian communities in becoming more efficient (usually resulting in a shift toward greater "agro-industrialization" and eventually the urbanization of many communities), in the modern world many people live in cities (invariably in slum conditions). As these citizens seek to improve their lot, so there is a need for urbanization and industrial development that will enable them to build a future capable of fulfilling (and in due course exceeding) the UN development goals[6] (if we use these as our base case). Development finance, if properly undertaken, needs to help build the infrastructure (physical and intellectual) of the countries concerned, in order to deliver development goals in a far more sophisticated world than ever before.

It is interesting to note that development work is being carried out by a diverse array of organizations ranging from macro-development institutions (including but not limited to the International Finance Corporation [IFC], European Bank for Reconstruction and Development [EBRD], Commonwealth Development Corporation [CDC Group PLC] and the Islamic Corporation for the Development of the Private Sector [ICD]) to the micro-finance organizations and community development funds. Few commercial financial institutions would necessarily consider their role to be a "developmental" one in the same way as the aforementioned organizations (this is particularly the case if such activity connotes a return on investment that is less than "commercial").

The mandate of development finance organizations usually requires them to invest in areas where commercial banks will not and to take commensurately higher risks in the process. As a result, we often find development activity failing to be undertaken by governmental, quasi-governmental, or charitable organizations. This paper contends this is something that *ought* to be questioned by the wider financial community[7] and *must* be questioned by the Islamic financial community.

In the Islamic financial sector, the major developmental organization[8] is the ICD, whose mandate is

> to support the economic development of its member countries through [the] provision of finance to support sector projects in accordance with the principles of Shariah through promoting private sector development . . . Projects financed by ICD are selected on the basis of their contribution to economic development considering factors such as creation of employment and contribution to exports. ICD also attracts co-financiers for its projects and provides advice to governments and private sector groups on policies to encourage the establishment, expansion and modernization of private enterprises, development of capital markets, best management practices and enhance the role of market economy. ICD operates to complement the activities of IDB in member countries and also that of national financial institutions.[9]

This does at least indicate that some commercial IFIs are engaging alongside the ICD in certain of those projects that the ICD is involved with. The appendix to this paper contains some statistical data extracted from the series of ICD Annual Reports[10] that illustrate the breadth of this organization's engagement with the community.

Whilst the Qur'an, *hadith* and *fiqh al-muamalat* generally do not prohibit Muslim businessmen from engaging in trade with a view to making a profit, the type of activity they undertake should accord with broader principles: It should not be speculative in nature, it should be undertaken with an eye on the benefits the activity will bring to the community, and it should be undertaken pursuant to contracts that are equitable and transparent.

There is an ongoing debate in the Islamic financial community as to whether or not all current activity is truly in accordance with shari'a. The expression "in accordance" has been used purposefully because the author believes that the expressions "shari'a-compliant" or "shari'a-based" are not particularly helpful. In some respects they are too subtle and this means that people find them confusing. A similar criticism can be made of the expressions "asset-backed" versus "asset-based" in the continuing debate about what forms of *sukuk* are, or are not, permissible. It may also be worth noting that several of the more prominent scholars have publicly eschewed the relevance or helpfulness of the distinctions these terms seek to make and view them as unhelpful at best and positively harmful at worst.

The author's reservations about these expressions derive from the belief that the distinction simply bogs the industry down in a side discussion that misses much wider and more fundamental issues. The discussion itself is primarily concerned with the niceties of legal form, the shape of a transaction, and whether or not a particular mode of financing simply replicates a conventional equivalent. Typically, the conclusion of this debate is that IFIs need to move toward a model that utilizes more profit and loss sharing techniques. Whilst this view cannot be dismissed, there are major concerns about the way in which its conclusion is being (or more accurately not being) addressed. Notwithstanding continuous internal talk and external pressure from academic and regulatory quarters, the industry simply is not developing credible solutions that will facilitate an orderly migration toward a different model of financial intermediation based on such principles. Whilst this debate continues, another important and fundamental concern risks being overlooked, namely whether or not capital originating in the Muslim world is actually being *properly deployed* for the greater good of the populations living in the countries concerned. A more user-friendly approach might frame the question thus: "Is Islamic finance doing what it says on the tin?"

We live in a crowded world. In the first few weeks of November 2011 we learned that the global population exceeds 7 billion people. For several years, the Islamic financial community has convinced itself that annual financial intermediation may be worth approximately 1% of the total global financial value (as mentioned earlier).[11] The vast majority of the world's Muslim population lives in emerging, growth, or transitional economies and has relatively low standards of living. By far, the majority of this population is both unbanked and aspiring to improve their lot. This suggests that if Islamic finance could be better mobilized, there is a target population that would fuel a significant growth opportunity for the industry. Development finance is needed and has a role to play in achieving this.

Islamic finance, where it is properly conducted, does (or should) offer an alternative to other forms of development finance. By *properly conducted*, the author means that implicit within the Islamic economic view, holders of capital *should* deploy that capital in risk-sharing activities (ideally) and with a view to improving the well-being of the *umma*. If this is not believed to be happening, we should be discussing why not. That question will be the focus of the remainder of this section.

One of the difficulties encountered in many Muslim-majority countries in the modern world is that the difference between "public" and "private" capital is not always easy to discern. The way specific countries are governed; the way they tax (or in some cases do not tax) their populations, and the way in which they manage government funding vary significantly. At its simplest, this means that the responsibility for allocating the natural resources of these countries is invariably unclear. In contrast, the visible consequences are all too often clear to observe: namely that over the past fifty years many Muslim-majority countries have failed to develop their economies and their "caring" infrastructure commensurate with their Western counterparts.

Interestingly, we are perhaps starting to witness a change in this now, particularly post the global financial crisis, as various countries with significant Muslim populations start to present themselves as strengthening economies that are also exhibiting a greater willingness to allow and adopt Islamic modes of finance. Countries like Indonesia and Turkey are good examples of such transformation. Many other Muslim and Muslim-majority countries will continue to face the challenges of growth and industrialization and each country will have to face such challenges in its own unique way. The extent to which the still nascent (potentially global) Islamic financial industry can "up its game" and contribute in a much more comprehensive way to solving those demands remains to be seen.

Another facet of the development challenge, and something the author has previously discussed, is the notion that the global financial crisis arrived "too early" for the Islamic financial industry. The extended impact of the global financial crisis and the continuing problems being encountered in extricating the global economy from the adverse effects of the crisis are marking some sort of extended watershed in global finance and global capitalism. In this situation, it is not apparent that the Islamic financial services industry has managed to make the most of the opportunity to impose (or at least outline) an alternative ethical and behavioral approach to the way finance is conducted around the world. The main reason for this failure is the unfortunate fact that the industry still lacks the products, the infrastructure, the capital, the scale, and the human resources needed to be able to vigorously expand and materially narrow the statistical "gap."

Ironically, the next challenge for the industry will be whether or not it can continue to hold onto the moral high ground it purports to occupy at present. The nexus between financial intermediation and real underlying business activity is important. Even where Islamic financiers went astray in some parts of the GCC, one can argue that in many cases physical assets (albeit unoccupied skyscrapers) at least represent *tangible evidence* of poor business planning; this contrasts with the "shadow economics" of the synthetic, often speculative, trading that was the product of much conventional financial engineering. As mentioned above and reiterated on November 6, 2011, in response to the "occupation" of grounds outside St. Paul's Cathedral, there are some senior bankers in the United Kingdom who have begun to acknowledge that Western bankers do need to start acting in a more responsible and ethical manner.[12]

A question that the stakeholders of the Islamic financial industry must consider is this: What are they willing to do with the capital entrusted to them in order to better serve the communities they live in? It seems that in order to answer this question, an equation revolving around a consideration of the following further questions has to be studied and conclusions drawn:

a) Where should the balance lie between private profit and public benevolence?
b) Is there an "appropriate" or "fair" profit that the "private entrepreneur" should be entitled to receive when funding projects for the greater good of the community? In a risk-sharing context, this would probably be better expressed as what sort of "return" should a financier "expect" to be able to make when undertaking such activity?
c) Are the shareholders of existing IFIs willing to accept the levels of profitability that are implicit in this equation? The point being that they will in all likelihood face lower returns than they may have enjoyed before the global financial crisis.
d) How many years of profitable activity were wiped out by the global financial crisis? Would it not be better to enjoy steady growth that benefits society and provides a reasonable (but not exorbitant) return to the capital provider?

Answers to questions of this nature will help us understand whether or not "private" capital will ever be truly mobilized with development goals at the forefront.

In theory, Islamic finance contains an embedded ethical driver. If the prevailing consensus is that this embedded driver is failing to ensure the right sort of conduct on the part of Islamic financiers and IFIs, what can be done to change this state of affairs? Is it too naïve to suggest that stakeholders need practical, easy-to-follow guidance on what it means to run a financial institution in a manner that *better accords* with shari'a principles? Alongside other prominent practitioners in the industry, the author has suggested that the Islamic financial community does need to develop a roadmap that outlines the goals of the industry and better describes the types of financial intermediation that IFIs are "expected" to undertake.[13] This will include such things as the development of infrastructure that genuinely addresses the factors that achieve the sort of developmental activity described above.

Another idea being discussed, particularly amongst younger Muslims interested in themes of social justice, ethical behavior, and sustainability, is that "white lists" of approved investment classes and assets could be developed. Such white lists would seek to encourage acceptable investment behavior on the part of Islamic finance professionals and firms.

Ideally, the industry should seek to achieve such goals with the use of better-designed tools or financial instruments that start to incorporate elements of profit and loss sharing. Such techniques do exist and it should not be beyond the intelligence of Islamic financial engineers to develop instruments that start to facilitate a "fairer" allocation (sharing) of risk and reward. Historically, there has been a singular failure to invest the time and effort needed to design and deploy these tools in many Muslim or Muslim-majority countries. This needs to change.

POTENTIAL ROLE OF ISLAMIC FINANCE SECTOR IN NATIONAL DEVELOPMENT

This section examines the role of the financial service sector in general, and the Islamic financial services sector in particular, in national development in the medium and long term. It also examines the role of the Islamic finance sector in the developing regions as well as globally. As mentioned previously, the inability to distinguish between public and private funds in many of the countries we are concerned with complicates the analysis and makes general statements very difficult to substantiate. In the conventional Western democratic model, governments are elected by the population and their mandate assumes certain responsibilities towards their citizens. The precise scope of these responsibilities may vary significantly between countries (the different approach to the state's responsibility for the provision of health care in the US and the UK is a good illustration of this) but essentially the government will provide a variety of public services and utilities. Governments fund their activities by raising taxes or borrowing in the international capital markets. They then have the task of allocating these limited funds to discharge all of the obligations for which they have assumed responsibility. The equation is straightforward to rationalize. In modern democratic states with elected governments and citizens who pay taxes, a sophisticated infrastructure exists for the redistribution of wealth. The efficiency (or otherwise) of such systems need not be considered for the purposes of this paper.[14] However, at its simplest and implicit in the model, it means that once citizens and corporations have discharged their tax burdens, their "duty" to society has in many respects been fulfilled. Provided taxes lawfully due are paid, the capitalist business model leaves shareholders to focus on maximizing returns.[15] In this model, "development finance" in its fullest sense is largely left to governmental and quasi-governmental bodies to undertake as part of the bundle of responsibilities assumed by government.

In more mature economies, a further effect sometimes witnessed is that of extremely wealthy entrepreneurs starting to give away or donate their accumulated wealth to charitable or social causes. Such individual citizens may build and endow educational institutions or devote resources to combat disease. The Bill and Melinda Gates Foundation is perhaps the best-known modern example of such phenomena. [16] However, such activity is no replacement for the deeper role of government in this sector.

This relatively simplistic formulation is challenged in much of the Muslim world by several factors:

a) First and foremost, the ethics embedded within Islam suggest that business activity should be tempered by notions of justice, equity, and fair dealing. In effect, businessmen do not necessarily have the same freedom to consider their duty to society as having been discharged merely by paying secular tax.
b) Secondly, many Muslim states (particularly in the GCC and MENA region) do not have the developed architecture of methodical tax collection and redistribution. Whilst the payment of *zakat* on hoarded wealth is a Pillar of the faith, does that payment suffice to discharge a Muslim citizen's obligation, whether to his conscience, to God (Swt), or to the *umma*? And *zakat* is not a progressive charge on hoarded wealth, so the rich do not pay proportionately more than the poor. At the time of the Prophet Muhammad, zakat may have been sufficient to alleviate the worst disparities in society. However, the ongoing dialogue within the Islamic financial community itself (and the clamor amongst academics and scholars—if not others—for more micro-finance initiatives, etc., is also indicative) suggests that it is probably not sufficient in today's world.
c) Thirdly, many financial institutions (conventional and Islamic) in these jurisdictions are effectively controlled by the government, because the ruler often has a direct or indirect shareholding in the firm concerned. This may mean that the government has the ability to direct such firms to deploy their resources in activities that support the paternalistic role of the ruler.

As a consequence of the foregoing, a discussion regarding the allocation of scarce resources in relevant Muslim jurisdictions needs to be entered into. These issues will become all the more pressing and their resolution of critical importance in many (if not all) of the countries swept up by the events of the Arab Spring. The affected jurisdictions are now faced with creating new political frameworks and the associated administrative institutions required for the orderly management of countries that hope to be "democratized" in some yet-to-be-ascertained fashion. At the forefront will be the need to draw new lines between public and private funds. The failure to manage this distinction in the past has undoubtedly been a factor in the poor development of the countries concerned, culminating in uprisings.

The type of approach that can be adopted in countries that have relatively small populations but significant wealth (one naturally thinks of countries like the UAE and Qatar) will not necessarily work in more populous countries like Egypt. The considerations change again in other parts of the world where major Muslim populations are found; for example, when looking at countries with massive populations such as Indonesia, or complex multi-religious and ethnic populations, like Nigeria. A "one size fits all" approach cannot work across such widely differentiated situations.

But in all these cases, what is the role of the financial services sector? In particular, what will Islamic finance have to say about where and how the lines between public and private funds should be drawn? Financial intermediation is a tool that both should and will have a role to play in the development of all these countries. Western states, conventional bankers, and others will also eventually invest in these countries notwithstanding the global financial crisis and prevailing political uncertainty. IFIs have a role to play and it is imperative that they step up and assume their role. If IFIs cannot identify opportunities and create markets in the developing, emerging, and growth economies that are the homes of much of the world's Muslim population, they can justifiably be accused of letting themselves and their Muslim brothers and sisters down. This has never been truer now than at any time since modern Islamic finance commenced.

Many of these countries will need to identify and develop methods of financial intermediation that can be designed to meet their differing needs and varying political systems. Islamic financial institutions will likely need to bring a new kind of thinking to bear on the different problems that will be faced. Some of the biggest issues many of these countries will have to deal with for the foreseeable future are right in the middle of the development agenda and include the following: The management of population growth; the development of sustainable supplies of energy, food, and water; major improvements in health care and education; and the creation of new jobs.

If largely Muslim countries want to handle the financial intermediation needed to support these massive demands in a manner that fits with their faith, they have to find a way of building a financial architecture that is "fit for purpose" and is able to operate on a far bigger scale than at present. With one or two minor exceptions, this activity is not happening at the moment.[17] The Islamic financial services sector clearly *ought* to have a medium- and long-term strategy and role in the development of countries and regions around the world where there are major Muslim population densities. Aside from the niceties of defining and classifying activities being discussed in this paper, the main issues that IFIs will face in the future are the lack of a consistent industry framework and the shortage of human resources. These issues are not new and have been well rehearsed by experts in the industry. An approach to building an industry framework far more substantial than anything contemplated in the past needs to commence, and imaginative lateral thinking will be needed to achieve it.

To provide one example, the issue of the day is the lack of liquidity instruments available to support the short-term money management requirements of the Islamic financial community. If this is a problem for a US$1 trillion industry, it has the potential to prevent a US$5 trillion industry ever emerging. The problems will also get worse in a global system where Basel III demands eligible collateral in the form of rated sovereign paper. Little paper of the right quality exists in the Muslim majority world, although the International Islamic Liquidity Management Corporation (IILM) hopes to start making inroads into this problem.

Another radically different approach to managing short-term liquidity by exploiting Muslim-world commodity resources could solve the liquidity problem in one go. Imagine if all of the oil produced by Muslim states were traded via a platform (or platforms) that supported an alternative money market to that currently achieved via the LMA and Platinum and Palladium markets in London. A continuous "flow" of real commodities being bought and sold once only, as opposed to a stock of metal being shuffled around warehouses and sold and re-sold, would allow the natural carbon and mineral wealth of the countries concerned to underpin a truly shari'a-compliant real asset based financial system.

ROLE AND RESPONSIBILITY OF FOR-PROFIT PRIVATE ENTITIES OFFERING ISLAMIC FINANCIAL SERVICES IN DEVELOPMENT

This section examines the extent to which for-profit private entities offering Islamic financial services can be charged with the responsibility of contributing to development. First and foremost, it is a question for every stakeholder in every IFI to resolve for their businesses and to reconcile in their consciences. The general purport of this paper suggests that for-profit IFIs *ought* to be playing a significant role in development activity. The following paragraphs seek to explore this further but also ask whether or not IFIs are actually already achieving these ends, albeit in a manner perhaps less obviously (or traditionally) thought of as "developmental."

If we begin with the premise that IFIs have a role to play in development, several fascinating supplemental questions then need to be considered. Should every IFI devote 100% of its time and resources to "development finance" or just a proportion of them? What existing activities being undertaken by IFIs already qualify as developmental? To answer this question, we have to return to the definition discussed above and reconsider exactly what we mean by "development" and "development finance."

Looking at the first question above, if the answer were a proportion, what should that proportion be: 10%, 25%, or 50%? Alternatively, in light of the juristic reasoning based on the saying of the Prophet Muhammad "one third is big or abundant" should the figure either "approach but not exceed" or should it be "not less than" one third of their resources? Would any such judgment have some unintended consequences? For example, could a situation arise—perhaps over time as patterns of behavior emerge—whereby several different "degrees" or "shades" or "types" of Islamic financial intermediation can be observed? In solving one problem, is another created: first class and second class Islamic financial activity? Do we have this already? Would this be a worse problem or a better problem to have than the difficulties of legal artifice? Imagine a scenario where issues of form over substance have been resolved; would it then be logical to assume (or deduce) that *all* financial transactions carried out in accordance with the agreed form are by definition shari'a-compliant? The answer to this proposition would, in all probability, be no. Clearly, there are additional tests and these will concern the subject matter and purpose of a transaction. In this context, where does the definition of "development" start and where does it finish? This brings us right back to where this paper started and the question: What do we mean by "development"?

A different approach to the issue might take into account the ideas of King and Levine (1993).[18] This argument suggests that there is a close correlation between growth and the development of the banking sector. Banks do play a fundamental role by acting as facilitators of payments and stimulators of savings and deposits and allocating resources. Simply opening a shari'a-compliant retail banking operation—even on full commercial lines—in a country where the Muslim population is largely unbanked could be argued as sufficient to demonstrate the achievement of developmental goals. If this is the case, then arguably we are already beginning to see the green shoots of such activity.[19]

King and Levine's ideas also force us to reconsider the potential scope of what types of financial activity might be described as developmental financial activity. If we consider the different types of financial activity an IFI might engage in, we can review their activities by classifying "development" along the following lines:

a) Pure or narrow development activity. This applies to the type of activity generally defined earlier, namely activity specifically undertaken with a view to achieving the outcomes and goals identified by the UN;
b) General development activity. This has the potential to describe some of the general activities undertaken by banks (for example, when they commence general retail banking operations in previously unbanked communities or if they participate in facilities that support the activities of the ICD);
c) Bespoke development activity. This would encapsulate micro-finance and small-scale financial support to help improve the living standards of rural dwellers and the urbanized poor.

Implicit within the classification suggested above is that:

i) In the case of (a), pure or narrow development activity involves higher risks and subsidized financing led by a development agency—commercial banks may or may not participate in linked "commercial" facilities;

ii) In the case of (b), general development activity covers the wide range of commercial "for-profit" banking activity—one of the issues IFIs will be faced with in the coming years is how should (or can) they provide this sort of intermediation in jurisdictions that will undoubtedly be "difficult" places to operate for several years to come? This is particularly the case when we look at the Arab Spring nations and certain other Muslim or Muslim-majority countries.[20] There are already indications that several Gulf-based IFIs will be willing to make investments in these countries. Whilst that is to be encouraged, whether such firms can find ways to cooperate together and raise the significant capital sums that will be needed to aid the rebuilding of these countries remains to be seen. At the moment, there is limited evidence to suggest that these firms can work together in a holistic manner to achieve this; and

iii) In the case of (c), few "for-profit" institutions currently believe it is their role to provide bespoke development activity. Many of the renowned international shari'a scholars concur with this view: they generally believe that private "for-profit" institutions are not obliged to devote resources to activities that should be addressed by government or the "ruler."[21] In practice, there are some exceptions where banks devote a small percentage of their balance sheet (for example, up to 3%) to micro-finance and seek to run such activities along commercial lines.[22] Countries such as Indonesia do have an active shari'a-compliant micro-banking sector, but the author does not have sufficient information about how the sector operates to be able to comment on the applicability of the Indonesian approach in other markets.

If the classification of developmental activities suggested above (extrapolated from the work of King and Levine) is accepted, it may help to frame expectations as to what passes for development activity when scrutinizing the actual day-to-day activities of IFIs.

Embedded within the question of whether or not an IFI can be *charged with responsibility* for contributing to development is: What role does law have to play in the development arena? This issue can be approached from two different perspectives. Firstly, are there any legal injunctions that require or compel private, commercial concerns to *actively engage* in development-related financial intermediation? Secondly, are there legal impediments which actively prevent or hinder the ability of such firms to participate in such activity? Looking at the question of whether there are any legal injunctions that require or compel private, commercial concerns to *actively engage* in development-related financial intermediation: most legal systems impose a primary duty upon the board of directors to look after the interests of the company. In the UK, the duty of a director is to "act in the way he considers, in good faith, would be the most likely to promote the success of the company for the benefit of its members as whole."[23] In the Companies Law Review that led to the established common law rule being enshrined in legislation, there was much discussion as to whether or not the duties of the directors should be extended beyond the company to third parties such as suppliers, local communities, the environment, or employees, etc. The conclusion was that the position should remain as described above but that directors should have regard to what the government termed "enlightened shareholder value," which would require directors to consider:

a) The likely long-term consequences of any decision;
b) The interests of the company's employees;
c) The need to foster business relationships with suppliers, customers, and others;
d) The impact of the company's operations on the community and the environment;
e) The desirability of the company maintaining a reputation for high standards of business conduct; and
f) The need to act fairly as between members of the company.[24]

These factors do not impose legally binding obligations to perform in a particular way, although the then–attorney general, Lord Goldsmith, when pressed on why the list was included in the Companies Act, expressed the view that if directors were not thinking in this manner then they should be.[25] However, provided the directors *have regard*, they may still take a decision that has an adverse impact, if they believe it would most likely promote the success of the company. In the United Kingdom at least, prudent directors should have their decisions documented to reflect the due regard they had for the list of factors (and any others) but this must be balanced against turning compliance into a box-ticking exercise. In this paper, these principles have only been considered from a UK law perspective. However, since most IFIs are incorporated under the laws of other jurisdictions, it would be appropriate to review the laws applicable to directors in their home countries to understand if their actions might be similarly circumscribed.

From a companies' law perspective, whilst there is no *legal* obligation upon the board of directors to undertake development activity, would they be at risk if, in so doing, they were perceived as failing to act in the best interests of the company? In other words, by actively engaging in development financing activity that might prove less remunerative than other "commercial" transactions, could the directors be accused of failing to maximize shareholder value? This question really identifies the very essence of the development dilemma from a shari'a perspective. In the minds of many critics of the Islamic finance industry, undertaking financial intermediation that achieves the developmental goals earlier described ought to be the default business proposition. The fact that this does not seem to be happening at the moment raises the question: Why not?

Maximizing shareholder value over the long term may be the primary activity, but is it possible for the constitution of a company to have different aims? Ultimately, the focus of an IFI—and what shareholder value should mean for that institution—can be set by the shareholders. The purposes of the company can be set by the founder shareholders, or they can be amended subsequently by special resolution at the annual general meeting or extraordinary general meeting. The point being that there is no legal reason, or prohibition, against a financial institution determining that it will engage in a particular type of financial intermediation that may appear to be less remunerative than alternative types of financial activity it might otherwise be able or empowered to undertake. This general principle may be qualified in certain situations: for example, in a takeover offer the best price available to the shareholders will become the primary concern of the board of directors, and when a company is in financial difficulties the interests of the creditors become paramount. In the latter scenario, difficult decisions can arise in practice where the directors have to balance minimizing the loss to creditors whilst still promoting the success of the company as a whole.[26] However, the overall direction of the company is in the gift of the shareholders.

ROLE OF ISLAMIC FINANCE IN DEVELOPMENT IN THE LIGHT OF EMPIRICAL EVIDENCE

It is appropriate to examine what, if anything, we can learn from empirical evidence about the role of Islamic finance in development. The author only had a limited opportunity to undertake a preliminary review of a limited amount of empirical evidence concerning the role of finance (Islamic and/or conventional) in the development of an economy. Empirical evidence derived from observing conventional financial systems does exist, is reasonably plentiful, and supports the premise that the financial sector plays an important role in the overall development of an economy.[27] Initial enquiries suggest that there appears to be limited evidence in the Islamic context. The papers that the author has reviewed tend to focus on the role of IFIs in general development work by providing simple banking services with little suggestion that pure development activity is undertaken.

When it comes to reaching conclusions about the achievement of IFIs in any sort of development role, one particular study suggested that the picture was not very encouraging in those countries that have tried to establish wholly Islamic financial systems. Ahmed cites financial disintermediation in Sudan during the period 1992–97 and the failure of Pakistan to eliminate *riba* as examples of two countries where the experiment to convert an economy to a wholly Islamic financial system has not worked.[28]

According to Ahmed there is a need to "analyze and evaluate" the role of the Islamic financial system in facilitating economic growth. In the analysis he conducted nearly a decade ago, he seems to have broadly concluded that whilst the "modes" of Islamic finance were "theoretically" capable of supporting economic growth, varying degrees of "operational problems" were a hindrance to effectiveness, particularly in the equity modes of finance (where the well-known issues of asymmetrical information and moral hazard prevail) and the difficulty of providing working capital finance. The functional problems identified by Ahmed still remains largely unresolved and it is clear that some fresh empirical studies would be needed to help illuminate any progress that may have been made. Islamic banks still do not have all of the tools they require in order to provide financial intermediation in the way it is needed to benefit emerging economies. Alternatively, where they have the tools, they either lack the desire to fund or simply do not have the scale to pursue appropriate developmental transactions. Some examples illustrate this:

a) Plain working capital remains difficult to provide.
b) Profit and loss sharing contracts are not favored because the risks of using them are perceived as being too high. More work needs to be done along the following lines:
   i) There is a lack of "bankable" instruments that offer some sort of balance in these risks—there are only a few examples of debt to equity instruments that have the characteristic of mezzanine finance. A wider universe of such instruments along a spectrum of risk/reward characteristics might offer a roadmap toward the type of systemic transformation discussed by Volker Nienhaus in his paper above;[29] and
   ii) Specialized financial institutions need to be established which are better equipped to focus on, understand, and manage the risk inherent in profit and loss financing. The industry has to find a way to create an architecture that allows such specialized finance firms to operate and may need to create a series of regulatory safety nets in order to do so.
c) Where means do exist for supporting large scale infrastructure—save for limited exceptions, IFIs have been bit players in providing debt facilities to support this type of activity. The lack of liquidity tools also makes the tenor of such transactions extremely hard to fund.

Ahmed also comments on the effectiveness of a financial system being a factor of how well-designed it is and the establishment of the legal, regulatory, and supervisory environment. Essentially, well-designed, robust systems with good laws that enforce contracts, protect creditors' claims, and have transparent accounting, etc., tend to facilitate better-developed financial firms. This in turn supports economic growth. As mentioned above, Ahmed's general focus concerns the wider definition of growth and development rather than the narrower concept mentioned above. The overarching conclusion of Ahmed leans in favor of the author's earlier remarks that more work needs to be done to better understand the problems faced by institutions wanting to use profit-sharing models and to find ways of removing the constraints they face.

A more recent empirical study is that of Goaied and Sassi.[30] Their study notes that not all the studies on the links between the financial sector and growth are positive about the clarity of the link.[31] They therefore sought to test the theories regarding this effect by an empirical study of the ability of the "Islamic banking industry to lead . . . economic development" by looking at several MENA countries.[32] Some of the introductory remarks in this study about the superior characteristics of an Islamic financial system are less than convincing; however, what may be more disturbing is that these authors concluded that "financial development has an unfavorable effect on growth in [the] MENA region; even Islamic banks don't make an exception in the financial markets and show a weak relation with growth. It's not proved that MENA economies have benefited from a strong banking system or developed financial sector."[33]

Some of the empirical evidence may therefore be less than convincing about Islamic finance having played a positive role to date in the development finance arena, excepting of course the activities of the Islamic Development Bank. We know that law (secular law in any event) does not compel such activity but that shareholders whose outlook on life is through the prism of shari'a may have a moral incentive to reconsider the business philosophy of their firms. Assuming that shareholders were willing to change their investment return expectations, are there other legal or structural impediments that would still prevail against IFIs taking part in development activity? Worryingly, the answer is that hurdles do remain.

We have already looked at the difficulties encountered in many Muslim and Muslim-majority countries in distinguishing between public and private sources of funds. If public funds are not deployed or are insufficient, can private funds be deployed and if so, are the Islamic banks and capital markets able to help facilitate that deployment? The evidence is sketchy.

There is a generally well-founded understanding (often repeated by writers and commentators) that Islamic finance and infrastructure projects are an ideal fit. The design, development, construction, and financing of assets such as power stations, desalination plants, ports and airports, roads and bridges, schools and hospitals, and the general residential housing stock all present clearly identifiable asset-based opportunities. Many scholars and subject matter experts including Obaidullah[34] are of the view that Islamic finance has a lot to offer for developing the infrastructure sector in a shari'a-compliant and ethical manner, particularly in Muslim jurisdictions. Despite this realization over a decade ago, the implementation of this ideal is still in its relative infancy. The irony of the situation can be understood by the example of shari'a-compliant BOT projects. As mentioned, over a decade ago, Obaidullah explained how traditional BOT techniques could be used in permissible Islamic contracts. He recognized that some of the risks involved in this type of finance were not necessarily palatable for private financial institutions but could be "mitigated by suitable government initiative."[35] The conclusions reached in Obaidullah's paper remain as true today as they were in 1999. Although there has been progress and there are sufficient examples of *istisna'a*, *istisna'/ijara* and a few cases of diminishing partnership (*musharaka mutanaqisa*) to be able to claim that many banking and legal practitioners are comfortable with the "bankability" of such structures, the sad reality is that there has been an insufficient volume of transactions and only limited progress in further structural development.[36]

The development and construction of civil infrastructure projects is typically the responsibility of the state, although, in many Western countries, the private sector has stepped in as various forms of privatization-driven or public/private partnership initiatives have evolved. The ostensible purpose of such initiatives has been to reduce the burden on the public purse, although recent studies (in the United Kingdom in particular), have started to question the overall financial effectiveness of such schemes. From an Islamic finance industry perspective there have been very few attempts by governments of Muslim countries to raise funding through the Islamic capital markets to support such projects and, as mentioned, there has been relatively little Islamic financing provided by commercial IFIs in support of such projects over the years. Attempts to privatize (in a Western sense) the delivery of various government services have also been limited, but this may have more to do with the issues that relate to the understanding of the difference between public funding and private sector funding. Services that generate revenue when provided by the ruler, or by a quasi-governmental entity, may be too attractive to relinquish to private providers on an arm's length basis in economies that do not raise taxes on income or capital gains.

This paper will conclude with a discussion concerning several examples of financial transactions that may be indicative of IFIs playing a role in development activity. Before doing that, it is worth mentioning some of the specific factors that currently militate against commercial IFIs participating in this sector, even assuming that their shareholders were directing them to do so. The factors discussed in the following paragraphs do not include generic issues such as the lack of legal certainty, bankruptcy codes, or non-capricious dispute resolution systems, since these apply equally to all forms of financial intermediation.

a) Liquidity and the funding model. At its simplest, the type of large-scale infrastructure projects that will make a difference to the needs of the population have to be funded or paid for over many years.[37] The Islamic banking model relies on equity and *mudaraba*-based depositor funding and Islamic banks have to be sufficiently liquid to be able to respond to deposit redemption demands. This is the fundamental liquidity dilemma. These projects represent long life, illiquid investments that tie up bank capital for significant periods of time. Most Islamic assets are relatively short-term in tenor and it is safe to say that in the entire global infrastructure space there have only been a handful of shari'a-compliant deals financed with tenors in excess of ten years.

b) Scale. Islamic financial institutions are simply not yet big enough to handle the potential volume of the forecast infrastructure requirements of Muslim states over the next ten years or so. This means that single obligor limits and sectoral and geographic limits are rapidly reached. Although the market has witnessed a few benchmark-scale[38] Islamic financial transactions, the overall number of such deals remains relatively limited. A handful of large-scale infrastructure financings funded by full-fledged IFIs would rapidly start to absorb capacity in the market and threaten liquidity. The Islamic financial industry still appears to be immune to calls that it should start to consolidate in order to start building organizations that can have true pan-regional scale and reach. It seems unlikely that this will change in the near term unless financial regulators start to insist that institutions should become larger and/or stop issuing licenses for new firms. Some countries have sought to impose such policies in recent years as they have sought to clean up their financial service sectors and build stability. Nigeria and Indonesia both provide examples where this has happened. Interestingly, both of these countries are now being viewed as nascent Islamic finance jurisdictions in view of the demographic characteristics driving potential demand in each.

c) Who actually funds the large scale deals? To date (or more accurately, prior to the global financial crisis), the majority of the funding provided to Islamic project and infrastructure transactions (at least in the Middle East) has been from the windows of conventional banks. These multi-billion-dollar transactions were predominantly financed on a globally syndicated basis and have relied upon many Western institutions willing to take regional risk and first priority mortgage positions. Over the years, the author has helped a number of investor groups establish funds intending to be shari'a-compliant and targeting the infrastructure sector, but the ability of such funds to undertake major deals has proven to be limited.

d) Pricing. A further factor that has militated against the willingness of IFIs to participate in infrastructure projects (regardless of their development characteristics) has been the relatively low returns available. Typical debt returns in these deals have been too low when measured against the cost of tying up capital in illiquid structures. Consequently, IFIs have favored commercial real estate in the belief that it is an asset class capable of delivering consistently more attractive returns.

e) Lack of sovereign funding techniques. A further factor that hinders the development of Islamic finance industry support for infrastructure is the relative dearth of sovereign capital market instruments. In the Middle East, the oil-rich economies have generally proven to be agnostic when it comes to the use of third party financing to fund many of these projects (whether conventional or Islamic). They have either funded the projects from current account revenue, or when financing them have been driven primarily by cost considerations (i.e., cheapness) and speed of execution. When Islamic tranches have been introduced, they have had to "fit into" the overall structure and accept *pari passu* pricing and ranking alongside the conventional debt. Since the majority of such funding was being provided via the Islamic windows of conventional banks, as previously mentioned, this has not generally been an issue. The desire of regional governments to utilize Islamic techniques has not extended to them doing a great deal to facilitate the development of alternative markets, particularly the Islamic capital markets. This is a significant issue: were it to be properly addressed, it has the potential to drastically change the complexion of the industry. A thriving sovereign *sukuk* issuance program would effectively become the lungs of the Islamic finance industry. The existence of a deep universe (i.e., a mix of short-term, medium-term and long-term papers with tradability where feasible, or the certainty of repeat issuance in the case of treasury bills) of shari'a-compliant, rated sovereign paper, backed or based (which of these matters not since the risk would be sovereign) on assets or outputs approved for shari'a purposes would achieve two goals:
   i) First, it would overcome some of the tenor problems because the paper could be held to maturity or sold as needed. Notwithstanding sovereign risk tensions in certain Western markets, such paper would ideally be treated as risk-free and/or fungible; and
   ii) Secondly, it would facilitate Islamic institutional support for development initiatives conducted by governments. The ability to liquidate means that it would attract a different type of capital, generally short-term in nature, and these instruments would eventually replace the short-term commodity deposit receipt. This might also overcome some of the pricing issues since much of the funding for these instruments should come from pools that were either previously un-invested (because of the lack of acceptable

forms of short-term/tradable instruments), or might otherwise have been invested in short-term commodity *murabaha*. These sources of funds would actively start to achieve returns where none were previously available. With increased tradability and fungibility, IFIs will be able to liquidate these instruments relatively easily in the event that they wish to take advantage of other investment opportunities as and when they arise and so should be more willing to participate in them.

These are precisely the sort of goals that the operations of the IILM are intended to start addressing. The IILM element will only be a part of the overall solution as it will provide a tool for converting Muslim-world government assets into a form of short-term and/or tradable paper. More work needs to be done at the primary issuance level to identify new and unique ways of creating *sukuk*.

TRANSACTIONS AND CONCLUSIONS

In many respects it is extremely difficult to determine empirically, whether directly or indirectly, the effect (positive or negative) that any particular form of shari'a-compliant product, service, transaction, or financial intermediation might have upon any particular economy. Any attempt to aggregate such transactions and objectively assess their social impact will always be qualified by extraneous factors, statistical variables, and subjective views on the success or failure of the activity concerned. Arguably, there are only a limited number of countries[39] where an attempt could be made to determine if their gradual adoption of Islamic finance methods is noticeably improving the lot of the citizens of that country when assessed against an earlier period of time or reasonable assessments of what might have happened had Islamic finance not emerged.

In this difficult landscape, perhaps the only real test is to analyze specific transactions on a case-by-case basis with a view to assessing their impact on (a) the parties connected to them and (b) the immediate environment in which their affects can most likely be felt or measured. In doing this, the reader needs to realize that there is a wide universe of Islamic financial products, each operating in a slightly different way from the others. This means that the commercial, business, and/or social purpose of each product will vary and cannot necessarily be compared with a similar but slightly different form of financial intermediation. Although it garners all the news headlines, *sukuk* is not necessarily the most effective form of financial instrument when it comes to development-related activity, so one should not always assume that it will be relevant. None of the transactions discussed below were primarily financed using *sukuk*.

The first example is intended to create a conundrum for the reader: Would the construction of social housing targeted at the needy (i.e., people who may require government support in order to be able to afford to occupy housing on anything approaching commercial terms) be considered more "socially beneficial" than the construction of luxury homes built on a speculative basis for the very wealthy? Both schemes will create employment opportunities and stimulate the production and supply of construction goods and services within the economy, but one has an obvious social dimension as its primary purpose, while the other is driven purely by the profit motive. Do the secondary effects of job creation and raw material production outweigh the primary effect of providing housing in any assessment of these two activities from a developmental perspective?

Similarly, financing the construction of a new airport or a new shipping port may not be an obviously social undertaking if contrasted to building a school or a hospital, but each of these activities will add value and benefit to the communities in which they are constructed in different ways.

Does the establishment of a new shari'a-compliant wholesale investment bank in a secular country that then proceeds to facilitate shari'a-compliant investment in the real estate of that country or other business ventures qualify as acceptable development activity in an Islamic context? If the financial institution concerned were a retail bank offering current accounts to Muslim and non-Muslim customers in the same country, does that change the analysis? If the retail bank were to be established in a country with a significant Muslim minority population (perhaps 40% of the population), does that change the analysis?

Significant shari'a-compliant projects and capital market transactions have been taking place in recent years to facilitate the financing of power stations, heavy industrial facilities, LNG carriers, commercial aircraft, shopping centers, roads, bridges, schools, and hospitals. Transactions of the nature described have taken place in Muslim countries, in secular countries with significant Muslim populations, and in some cases in non-Muslim countries. Another interesting factor is that the source of funding for these deals varies significantly (as mentioned in one of the earlier observations[40]). The author is not providing statistical evidence to support this contention but, based on many years of transactional experience, a significant proportion of the funding for many large-scale infrastructure projects and "big ticket"[41] asset transactions in particular has been provided by Western banks who have been willing to participate in shari'a-compliant transactions at the request of the sponsors (in many cases, the sponsors have been MENA-region governments or government-related entities) who wanted to see them structured in this manner. One of the noticeable consequences of the global financial crisis is that the level of participation by local or regional investors has increased as Western firms have retracted in the last few years. Consequently, when the profits from these activities flow back to the shareholders of the participating institutions, this too will increasingly benefit the citizens of Muslim states. Over time, this recirculation of capital may also start to have an impact on the regional economies that economists and statisticians can start to measure.

This paper was written with several objectives in mind. The first was to try and broaden the dialogue surrounding the discussion of Islamic financing in the development context. In particular it wished to direct a move away from the narrow and confining discussion that seeks to align Islamic finance with (and sometimes imply that this is its only acceptable form) micro-financing and similar initiatives. The paper discussed the identification of development goals in detail before seeking to identify and classify some wider definitions of development activity and explain how Islamic finance has a role to play with regard to each classification.

Secondly, the paper sought to compel the various stakeholders in Islamic financial institutions (but particularly the shareholders) to think more deeply about whether they are deploying their capital in the most appropriate manner in view of the embedded ethical driver that the author contends is the main factor differentiating the *proper conduct* of Islamic finance from mainstream conventional finance. The discussion regarding how to determine institutional behavior drew upon the distinction between what behavior *is* and what it *ought* to be. The paper recognized that this is not necessarily an all or nothing decision and that IFIs do have choices to make about how they deploy their capital. In the real world in which Islamic financiers operate, many different forms of financial intermediation are needed by a wide variety of customers, but the paper asks participants in the Islamic financial industry to consider whether they are making the right decisions about capital deployment and how those decisions will impact the communities they serve. It was also noted that as a matter of principle, there were no legal reasons why the shareholders could not embed a desired course of behavior, if it was felt necessary to empower the management of the firm to behave differently (i.e., in a manner that might not produce such financially remunerative returns as alternative but arguably less socially or developmentally based forms of investment).

Thirdly, the paper considered some of the empirical evidence regarding the impact IFIs were having on development issues. It was difficult to find readily available and convincing empirical evidence showing a positive impact. A reason for this may be that not enough work has been undertaken in this area and/or previous studies have focused on the narrower definition of development, which the author contends is not the right approach. The Islamic financial services industry is in a continuing state of growth, development, and evolution. The paper identifies several of the well-known areas where the industry needs to continue the process of development to help create more of the tools it requires to deliver its wider goals.

In many respects, the ability of the Islamic financial services industry to respond to the huge opportunities it faces in the Arab Spring nations, as well as in other Muslim communities in other parts of the world (where major populations are presently under-serviced by the financial services industry in general), will depend upon whether it can achieve efficiency and productivity gains combined with a significant increase in scale. The recent economic story of China has been about a nation lifting millions of people out of poverty through the growth of its economy and the emergence of a more affluent middle class. The Muslim populations around the world do not have the advantage of a single government directing policy and behavior as in China, but they do have a common belief system that allows cross-border communication in a unique way. For many years the major challenge faced by the Islamic financial community has been how to raise awareness about what it is doing and to instill credibility in its own communities. That challenge remains the same today, but one way to unlock these opportunities would be to demonstrate that the industry *is* doing what it *ought* to do. If Islamic financiers can deliver the wider development goals discussed in this paper in a manner that is coherent, reliable, and recognized and broadly understood by the wider population, they will have a better chance of securing the future of the industry.

APPENDIX

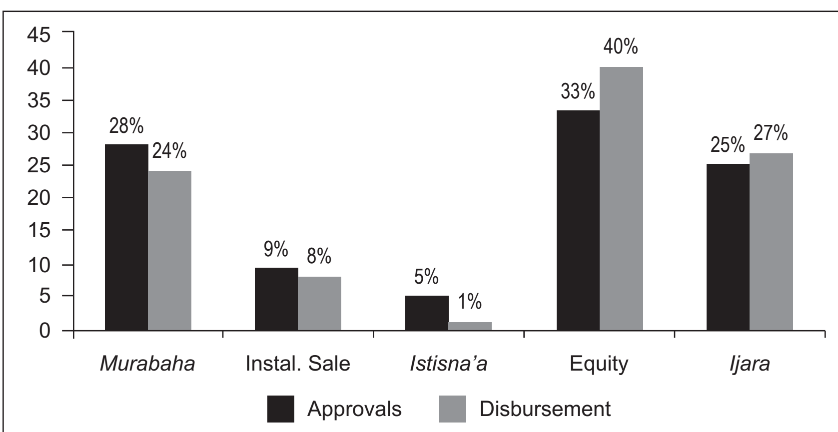
The role of the ICD in the development sector

The following has been extracted from pages 23–24 of the ICD Annual Report 1433H (2011–12).

1. Approvals and disbursement since inception, by mode of finance

Since its inception in 1999, ICD's accumulated gross approvals reached $2.59 billion, which was allocated to 243 projects across the member countries. The cumulative gross approvals of ICD by modes of finance include 78 projects in equity for $862.4 million, 57 in *murabaha* for $718.3 million, 61 in *ijara* for $651.5 million, 39 in installment sale for $223.1 million, and eight projects in *istisna'a* for $134.1 million. By the end of 1433H, 33 percent of approvals were allocated to equity participation, followed by 27 percent in *murabaha*; the rest was distributed to other modes of financings (Figure 1).

Figure 1. Approvals and Disbursement since Inception, by Mode of Finance



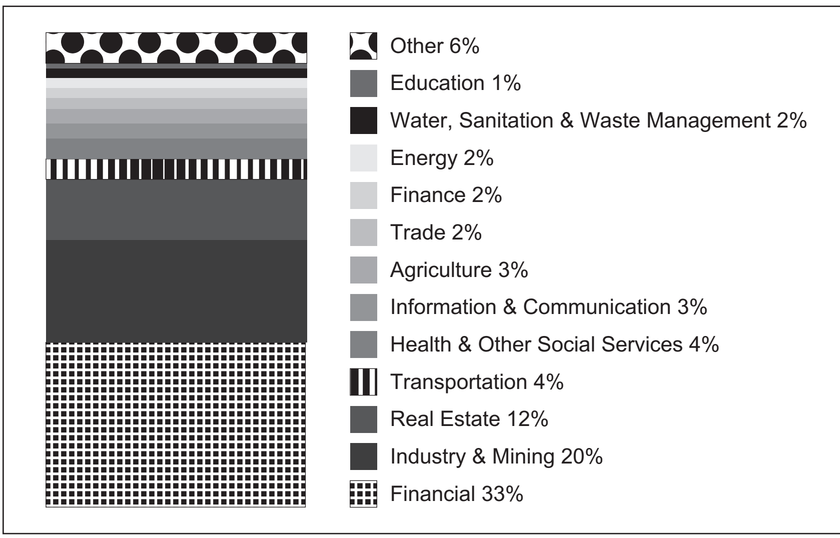
In terms of disbursement, ICD disbursed a total of $1.022 billion. The disbursement also varies according to the modes of finance. While equity and *murabaha* projects acquired the largest share, amounting to 64.6 percent, *ijara* operations accounted for 26.7 percent, followed by installment sale and *istisna'a* at 7.8 and 0.75 percent respectively (Figure 1).

2. Approvals since inception, by sectors

Sector-wise accumulated approvals are spread over a number of industries, ranging from financial to real sector industries such as infrastructure, agriculture, oil and gas, manufacturing, and others. As a priority sector, the financial industry accounted for the largest share, representing 33.1 percent of the gross approvals since inception. The industrial and mining sector has the second largest share with a gross approved amount of $730.7 million. This is followed by the real estate, transportation, health, and other social services, accounting for 21 percent of gross approvals.

The remaining $461.6 million, representing 18 percent of the accumulated approvals, are allocated to seven different sectors (Figure 2).

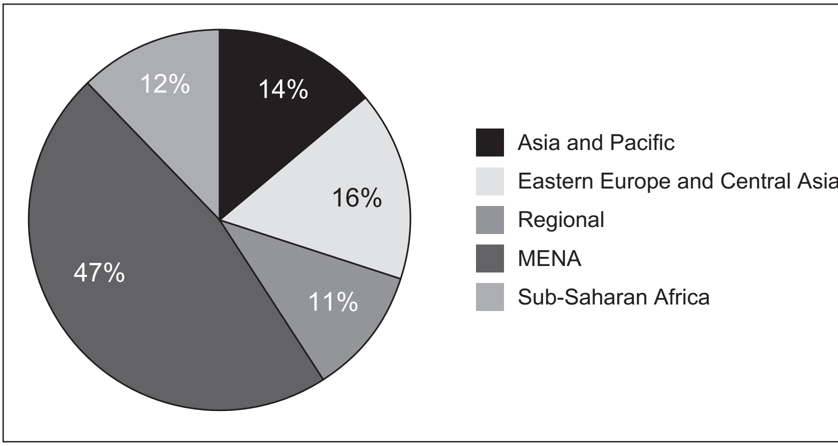
Figure 2. Approvals since Inception, by Sectors



3. Approvals since inception, by region

In terms of geographic distribution, ICD's approvals also underscore diversity. Between 1420H and 1433H, investment operations managed to reach 39 member countries, in addition to a number of regional projects that cover several economies. The Middle East and North Africa (MENA) region accounts for the bulk of ICD's accumulative approvals, representing 47 percent of the gross approvals. This is followed by regions such as Eastern Europe and Central Asia (16 percent), Asia and the Pacific (14 percent) and Sub-Saharan Africa (12 percent). The share of regional projects covering several countries stood at 11 percent of the gross approvals (Figure 3).

Figure 3. Approvals since Inception, by Region



Endnotes

1. Readers of this paper are asked to keep in mind that the approach to this topic has been framed around several key factors that influence the discussion. First, the author has a legal background and is a practitioner whose predominant experience has included advising financial institutions and their customers in the profit-seeking private sector as well as governmental bodies in the public sector. Second, the author has always adopted a practical, business-orientated approach to problem solving. Third, the author does not claim familiarity with the technical jargon used in the development sector, so has endeavored to utilize non-technical language wherever possible.
2. David Hume, *A Treatise of Human Nature* (Oxford: Clarendon, 2007).
3. Muhammad Ayub, *Understanding Islamic Finance* (England: John Wiley & Sons, 2007).
4. Shahid Saleem, *Role of Islamic Banks in Economic Development* (Graduate research chapter) (quoting Dudley Seers [1969] and Todaro & Smith) (February 2008), 4–5. Also available at SSRN, USA website as http://ssrn.com/abstract+989055.
5. Kjetil Bjorvatn, "Islamic Economics and Economic Development," *Forum for Development Studies* 2 (1998): 237.
6. This is a reference to the indices developed by the United Nations to measure development: (a) the Human Development Index, which measures a country's average achievements in three dimensions (i) life expectancy; (ii) educational attainment; and (iii) adjusted real income per person ($PPP) and (b) the Poverty Index, which measures deprivation using the percentages of (i) people expected to die before 40; (ii) illiterate adults; (iii) people without access to health services and safe water; and (iv) underweight children at age five.
7. There are signs that some firms in the wider financial community have started to question their own behavior in these terms in the aftermath of the global financial crisis and as a response to government and public pressure in certain countries such as the United Kingdom. We have also witnessed the establishment of several social financing programs and initiatives, but this movement (if it can be so described) is still in its very early days.

8. At this stage of the discussion the author has not considered *zakat*, *waqf* funds, and other charitable endowments, although the role of each may be a factor in the response to some of the questions raised in this paper.
9. The Islamic Corporation for the Development of the Private Sector, “About ICD,” http://www.icd-idb.com/irj/portal/anonymous?NavigationTarget=navurl://85a1ba033d81e8e0a1a5e77d882f0924 (Assessed on July 9, 2013).
10. Available at: http://www.icd-idb.com/irj/portal/anonymous?NavigationTarget=navurl://6ffc30fb99f5cf6f264ee200b61abf32&LightDTNKnobID=926820335&guest_user=icd_en.
11. Although quoting this figure, the author is not convinced about its accuracy, since it is based on extrapolations of work done several years ago. Further primary research is needed to validate its accuracy, not least because the figure may be higher now.
12. Ken Costa (former chairman of Lazard International), “The City Must Rediscover its Morality,” *Financial Times*, November 6, 2011. This was one particular article that caught the author’s eye amongst several being written in a similar vein around the period concerned.
13. Mukhtar Hussain, Global Chief Executive Officer, HSBC Amanah, is one such practitioner who, speaking at the 2011 Euromoney Annual Islamic Finance conference in London, also addressed this issue.
14. In the context of the present situation in Europe there is a case to be made that the problems being faced by Greece have arisen precisely because that model has been found wanting in that state because the institutions of government failed to collect the taxes they needed to redistribute.
15. It may be arguable that the precise balancing point of this equation has been shifted in the case of some firms post the global financial crisis. The author has in mind the majority state-owned financial institutions in the United Kingdom where governmental inputs are having degrees of influence on certain aspects of the behavior of such firms. In the UK too the morality of previously lawful tax “avoidance” is being brought into doubt by the political class as the government seeks to limit leakage from the tax system. This is a boundary whose edges may start to become blurred in the near future.
16. The Bill & Melinda Gates Foundation was established in 1994 and is based in Seattle, USA.
17. The establishment of the International Islamic Liquidity Management Corporation (IILM) is one such exception and an example of an attempt to fill an important missing element of the wider enabling environment in which the Islamic financial services industry seeks to operate as discussed above.
18. R. King and R. Levine, “Finance and Growth: Schumpeter Might be Right,” *Quarterly Journal of Economics* 108 (1993): 717–735; R. King and R. Levine, “Finance Entrepreneurship and Growth: Theory and Evidence,” *Journal of Monetary Economics* (1993): 513–540.
19. For some examples, consider Abu Dhabi Islamic Bank’s operations in Sudan and Egypt; ABG’s aspirations to open branches in Libya; the operations of Maybank and CIMB in Indonesia and their desire to expand those businesses; and finally the launch of Jaiz Bank in Nigeria and the recently launched Bank Nizwa in Oman.
20. The author has been speaking with participation bankers in Turkey recently where participatory banking has made strong inroads in the Turkish SME space. Talking

to the bankers involved, they explain how they focus on building close relationships with their clients so as to help mitigate the risk of asymmetrical information and moral hazard.

21. This statement is based on evidence stemming from discussions the author has participated in attended by scholars about the topic during the course of several "closed door" debates.
22. Bank Syariah Mandiri in Indonesia offers one such example.
23. Section 172(1) of the Companies Act 2006 (United Kingdom).
24. Section 172 of the Companies Act 2006 (United Kingdom).
25. Richard Slynn, "Directors' Duties," *A Practitioner's Guide to Directors' Duties and Responsibilities*, Tim Boxell (London: 2007), 73–112.
26. See: Tim Boxell, "Chapter One," *A Practitioner's Guide to Directors' Duties and Responsibilities*, 3rd ed., City & Financial Publishing.
27. Ibid footnote 22 and works referred to in these monographs that sought to empirically test the argument of Joseph A. Schumpeter, *An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle,* translated from the German by Redvers Opie, with a new introduction by John E. Elliott (New Brunswick, NJ: Transaction Books, 1983).
28. Habib Ahmed, "The Islamic Financial System and Economic Growth: An Assessment," *Islamic Finance and Economic Development*, edited by Munawar Iqbal and Ausaf Ahmad (New York: Palgrave Macmillan, 2005) 29–48. In the case of Sudan Ahmed states that ". . . there has been financial dis-intermediation in the country during 1992–1997. Furthermore the financial sector has failed to mobilize resources for investment . . ." and with respect to Pakistan he says: ". . . the reversal of the judgment on eliminating *riba* in Pakistan by the Sharia'a Appellate Bench of the Supreme Court shows the difficulties of implementing a comprehensive Islamic financial system. In the note to this remark, Ahmed also explains that on June 24, 2002, the Sharia'a Appellate bench of the Supreme Court of Pakistan set aside its earlier judgment in which it had directed the government of Pakistan to eliminate *riba* from the economy by June 30, 2002.
29. Ibid.
30. Mohammed Goaied and Sefallah Sassi, *Financial Development and Economic Growth in the MENA Region: What about Islamic Banking Developmen*t (2010).
31. Ibid.
32. Ibid.
33. Ibid.
34. Mohammed Obaidullah, "Designing Islamic Contracts for Financing Infrastructure Development," *Islamic Finance: Local Challenges, Global Opportunities* (Cambridge, MA: Islamic Finance Project, Harvard Law School, 1999).
35. Ibid.
36. Although one of the more interesting developments during this period has been the willingness of shari'a scholars to broaden the underlying asset classes capable of being financed in certain *sukuk* and other transactions, from purely tangible assets to assets that may not always be tangible in the traditional sense of being physical things that can be touched but are the measurable outputs of modern industrial processes or services. Typical examples include the ability to finance telecoms companies by reference to units of "air time" generated by their transmission networks or the right to fly as measured in the ATKMs (available tonne kilometers are units used in

the aviation industry to measure total capacity and formed the basis of the Emirate Airline *sukuk* issued in March 2013).

37. Very often we are contemplating projects that require billions of dollars of funding to support. An example is the announcement in Saudi Arabia of the award of contracts worth US$22.5 billion for the design and construction of a Metro rail system in Riyadh, the capital of Saudi Arabia (as reported in *The Gulf News*, Tuesday, July 30th, 2013).
38. For this purpose, transactions worth in the region of US$1 to 5 billion or above.
39. At the present time, perhaps only Malaysia, Saudi Arabia, and the UAE are capable of being studied in this context. They represent examples of three distinctively different types of economies where the penetration of Islamic financial intermediation has been most marked in recent years. Although Iran and Sudan both have theoretically wholly shari‘a-compliant financial systems, they are both closed, or virtually closed, economies and this means it is difficult to make any realistic, independent assessment of how efficient they might be, or if they offer any form of helpful demonstration effect to other economies.
40. See paragraph c) above, “Who funds the large scale deals?”
41. The expression “big ticket” is not a term of art but is usually a reference to the financing of high-value assets such as ships, floating oil production and storage platforms, aircraft and satellites, etc.

Finance, Entrepreneurship, and Economic Development in Islam

Rasem N. Kayed and M. Kabir Hassan

INTRODUCTION

And shake towards thyself the trunk of the Palm-tree:
It will let fall fresh ripe dates upon thee
The Qur'an (19:25)

There is a dearth of an inclusive inquiry, literature, and field research dealing with Islamic perspectives on entrepreneurship in the realm of Islamic development. An inclusive inquiry should attempt to explore the approaches, views, and attitudes of Muslim entrepreneurs toward entrepreneurial activity and the role Islamic entrepreneurship plays in the wider issue of "development." In this paper, we endeavor to survey entrepreneurial activity from an Islamic perspective. Section one deals with Islamic perspectives on entrepreneurship and the case for the development of models of Islamic entrepreneurship. Section two delves into the unique nature of Islamic entrepreneurship and integrates Islamic specific features into the suggested Islamic model of entrepreneurship.[1]

There have long been presages regarding the gradual demise of the influence of religion in public life as secularism emerges to dominate public life. These predictions were premised on the idea that the seeming rigidity and backwardness of religion could not withstand the evolutionary and dynamic nature of modernization, materialism, and technological innovation. In the face of these forces, religion would slowly and surely crumble and peter out. These predictions have not come to fruition. Religion, especially in Islamic countries, has witnessed resilience.[2] The presence of religions all over the world and particularly Islam is being restored on more solid foundations. It is thus not yet ripe to celebrate the universality of modernization, which is an upshot of secularism. To this end, Voll foretells the "end of secularism."[3] In sum, we cannot yet neither proscribe religion from developmental issues

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Rasem N. Kayed, Associate Professor, Arab-American University, Palestine.

Kabir Hassan, Professor of Finance and Hibernia Professor of Economics and Finance, University of New Orleans, New Orleans, Louisiana, USA.

nor discount its role in our economic behavior. "Religion," as the former president of the World Bank 1995–2005, James Wolfensohn, believes, "cannot be excluded from the debate."[4] There is a need for in-depth study of the under-researched topic of the relationship between entrepreneurship and religion.[5]

Dodd and Seaman are among a small number of researchers who have investigated the relationship between entrepreneurship and religion, focusing on this relationship in UK. Their research is demarcated into three levels; One: the relationship between society, religion, and entrepreneurship. This level investigates how a religious attitude influences the creation of new firms. Two: the relationship between an individual's faith, religion, and entrepreneurship. The focus of this level of study delves into the resolution and the motivation of an individual to become an entrepreneur; the entrepreneur's behavior and work ethics, and the entrepreneur's set of connections. The last level of the study is centered on the relationship between theory, religion, and entrepreneurship. In this level, the authors explore the envisaged role of religion in entrepreneurship development. They conclude that there exists a "complex and interdependent" relationship between religion and entrepreneurship.[6] Moreover, the study finds that "the low level of religiosity amongst the surveyed British entrepreneurs was comparable with the level of religiosity among the non-entrepreneurial surveyed samples."

There are four hypotheses that can explain the nature of the relationship between religion, development, and entrepreneurship.[7] The first theory proposes that each religion, particularly Islam, plays a developmental role, which culminates in liberation.[8] This is because all religions share a near-universal goal of bettering humankind by "being more," as opposed to "having more." Religions also have mutual expectations and require their adherents to exercise both moral and ethical deeds and conduct at all times and predominantly in all business undertakings.[9]

The second hypothesis advocated by Perkins[10] and Sutcliffe[11] views religions, and notably Islam, as "outdated, unnecessary and divisive." Religions are thus unnecessary hindrances to progress and impediments to development. This view, through an oversimplification and a generalization, presents the role of religion in development in a generalized sense of "either/or." A more impartial view of how religion and development are related is proposed by Goody, who argues that religion has twin developmental effects.[12] However, his propositions are more skewed toward the perspective that religion is an obstacle to both progress and development. This, he argues, is premised on the seemingly universal thinking that religion tends to inhibit the process of free thought and the scope of inquiry. "It is possible that the very absence of a world religion, with the various restrictions that implies, was in part responsible for the enormous expansion of intellectual horizons in Greek thought."[13]

The third hypothesis upholds that religion and all its appurtenances are strictly private and individual issues.[14] To this end, religion and all other human undertakings, including economic activities, should be strictly distinct and separate. This is the more popular view officially approved by Western nations, since it advocates for dual exclusion of religious and state affairs from each other's domain. This view has been enshrined in the constitutions of these nations. The idea behind this view is that religion (which is a personal matter) should not mix with business (public lives of individuals).

The last proposition is hinged upon Weber's thesis. This view divides religions into two main categories:

a) Religions that are pro-development and entrepreneurship (religion plays a beneficial role in the advancement and progression of entrepreneurial activities); and
b) Religions that are anti-development and entrepreneurship (religion is a catalyst of conflict and a stumbling block to development of entrepreneurship).

The Weberian thesis is popular in intellectual debates and studies examining the function of religion in development. In sum, the degree of support or encumbrance religion affords to entrepreneurial undertakings in a given culture is still an unsettled issue.

Methodological tools do not exist to test causality and gauge the effects of religion on entrepreneurship.[15] However, it is imperative and certainly intuitive, especially in religion-based cultures, to investigate and explain religious attitudes toward and views of entrepreneurship. Theoretical development of Islamic entrepreneurship is still budding. Since the literature available on the subject is especially limited in breadth and depth, this study attempts to fill this gap.

ENTREPRENEURSHIP: AN ISLAMIC PERSPECTIVE

The aim of this study is to investigate the existence and expand our perception and knowledge of any differences in views regarding Islamic entrepreneurship on the one hand and Western entrepreneurship on the other hand. If differences in views exist, two fundamental questions could be answered:

a) Are these differences too stark to be reconciled?
b) Is it then justifiable to develop an Islamic entrepreneurship model to capture idiosyncratic Islamic entrepreneurship issues not captured by Western models?

Since the Western entrepreneurship model has been extant for eons, this study limits its scope to the Islamic view of entrepreneurship as a feasible developmental stratagem.

Debate about to Islamic entrepreneurship has been around for a long time. Prominent Muslim intellectuals have pointed out the distinction between the logical foundation of Western economics and the spirit of the Islamic moral code of behavior and value system.[16] These scholars have emphasized the need for development of Islamic economics to enhance awareness and recognition of an Islamic worldview. This is because Western economics neither acknowledges the peculiarities of religion-based Islamic culture nor does it accommodate Islamic economic concerns. However, Chapra argues that "Islamic economics is only necessary and justified if the more advanced Western economics, with all its variables, methods of analysis and mechanisms, fails to attend to Islamic views of what constitutes suitable allocation and fair distribution of scarce resources."[17]

From the foregoing and by the same token, the great debate revolves around whether the Islamic entrepreneurship model is necessary, granted the existence of the extensively recognized and accepted Western entrepreneurship and development model. The creation of a new Islamic model is warranted if and only if:

a) Such a model could provide solutions to unresolved issues or questions; and
b) Such a model would integrate issues that the existing conventional model has failed to exemplify.

If these two conditions are met, we can, with a degree of assurance, state that the proposed model will afford practical and theoretical benefit to the universal foundation of Islamic entrepreneurship.

TOWARD AN ISLAMIC ENTREPRENEURSHIP MODEL

If a religion propagates economic productivity and a positive attitude toward work, it will positively contribute to the creation of new, high-quality businesses and nurture an environment conducive to entrepreneurship. A positive attitude toward work, buttressed by political goodwill, firm commitment by the government, and an all-inclusive framework, will yield abundant and rewarding results.

Several studies have investigated, in a general context, how religion and economic activity are connected.[18] However, the submission that religion is pivotal in determining the form and degree of entrepreneurial activity is gaining extensive recognition and acceptance.

All individuals are entitled, and should actually enjoy, the basic right of access to income opportunity. Using the theory of "social equilibrium," it has been argued that socioeconomic justice implicitly demands that all individuals have a right to equal opportunity.[19] However, socioeconomic justice does not talk about equality in poverty or richness. The ability to earn lawful (*halal*) living is justifiable if individuals engage in productive activities. The two aspects of productive activities are employment (working for others for a fixed salary), self-employment, and employing others (engagement in entrepreneurial activity). Islam advocates and encourages Muslims to engage in entrepreneurial activities to earn *halal* income as opposed to employment.

Islam encourages Muslims to undertake entrepreneurial activities and work hard to earn *halal* income not only to meet their immediate needs but also to cater to the needs of society at large.[20] The ability to generate *halal* income through entrepreneurial activities and simultaneously assist others in earning a living not only ensures that public wealth is not misused by a small clique of people, but also dissuades people from relying on the state. This is because public wealth is owned by the public and should thus be invested in projects that meet the common interest and needs of society.

To this end, Islam offers both the incentives and favorable structures for entrepreneurship and economic development. These arguments are premised on the interpretation of the Qur'anic verse "And when prayer is over, disperse in the world and search for the bounty of God,"[21] and on the many traditions of the Prophet Muhammad. Other scholars have cited the verse "It is He Who made the earth manageable for you, so traverse ye through its tracts and enjoy of the sustenance which He furnishes: but unto Him is the resurrection."[22]

The command to "search and steer through the earth's tracts" transcends simple engagement in entrepreneurship or looking for employment opportunities. The "search" involves exploring unfamiliar territories to find new horizons and unearth fresh opportunities to profit humankind. An active search of this nature entails risk-taking and innovative thinking. This is the true spirit of "entrepreneurship."[23]

The traditions of the Prophet Muhammad and the Qur'an explicitly extol entrepreneurship and laud moral entrepreneurial activity: "But God hath permitted trade (*bay*) and forbidden usury (*riba*)."[24] The buying and selling activities to consummate economic transaction (*bay*) for profit means that an entrepreneur is extant. It is narrated that the Prophet Muhammad said, "A faithful and trustworthy businessperson will be resurrected on the Day of Judgment with the prophets, the truthful, and the martyrs" (Ibn Majah; al-Tirmithi). Furthermore, the Prophet Muhammad and many of his close friends were successful and truthful entrepreneurs. The Prophet Muhammad clearly stressed the need for entrepreneurship and encouraged Muslims to actively get involved in business activities. Nu'aym Ibn Abd Al-Rahman recounted that the Prophet Muhammad said, "Nine-tenths of the sustenance (*rizq*) is derived from trade (business ventures)." The second Caliph, Umar bin Al-Khattab, used to say that "Nothing is more beloved to me than to earn my living through my own hard work and efforts."

The concept of communal responsibility (*fard kifayah*) in Islam hinges on the capacity of society to derive basic needs from a particular activity or meet public challenges and commitments. It is thus imperative that a good proportion of the Muslim population ought to have the latitude to engage in entrepreneurial activities to guarantee the stability of the nation's economic feasibility. If such a level of economic performance is not achieved by the private sector, the Islamic government has the moral and legal obligation to step in and clear the deficit. Perkins investigated the function of Islam in the "wealth creation" process, and ascertained Weber's conclusions: "There is no doubt that Islam is an economic hindrance and barrier to prosperity and fulfillment of human ambition, potential and welfare."[25]

However, the assertions that Islam has the tendency to daunt development[26] and that Muslims generally have low achievement[27] have been theoretically questioned even by Western scholars. Numerous Western intellectuals as well as Muslim scholars have recognized the progressive character of Islam and its ability to inculcate positive attitudes toward success and the yearning to engage in entrepreneurship activities. Islam generally has firm rights of ownership and instills a positive attitude toward entrepreneurial activities.[28] Wilson recognizes the singular nature of the Islamic code of business ethics and the helpful role of cost effectiveness and organizational competence that "trust" can render to economic activity. This view is supported by Sullivan, who concedes that Islam is "a religion of knowledge,"[29] and Wienen, who states that "Islamic tradition has always included a positive approach to economic activity."[30] He also notes that the Prophet Muhammad was "a merchant before his prophetic mission." Hooker has documented Muslims' seminal contributions to the world's civilizations. He argues that

> One can write volumes on the contributions of medieval Islam to Western science and letters . . . There is every reason to assume that Islam can provide the foundation for a tolerant and prosperous culture today, as it has done in the past. It will not be a clone of the Western culture.[31]

In a similar vein, Pelletreau recognizes these contributions and gladly understands the value system that led to the demonstration of these contributions:

> Muslim scholars preserved classical learning during the Dark Ages and made vital contributions at the dawn of the Renaissance in the areas of science, astronomy, mathematics, commerce, law, history and medicine.

And today, we see in the traditional values of Islam—including respect for knowledge, for justice, for good works, for private entrepreneurship, profit with honesty, and compassion for the poor.[32]

THE MOTIVES AND INCENTIVES

Among the most significant factors that can explain the importance and course of entrepreneurship activities in a country is the individual's drive and motive for starting a business. The motives of the founding owners of a business and their ability to coordinate and direct economic revolution results in elemental changes in the cultural, social, and economic frameworks and realms of a country. Policymakers also use motives as a bellwether of their policy options and in targeting entrepreneurs in resource allocating. This is because entrepreneurs and their businesses later become the engines of economic growth and creation of new employment opportunities.

The motives for starting a business vary among individuals and range from the desire to be independent and exercise more control over one's work to the need to earn more money, the drive to create a new and elevated social status, the availability of opportunities to be more innovative, the compelling fear of unemployment, and the aspiration toward a secure and comfortable standard of living. From an academic perspective, researchers have classified the motives of business start-ups into discrete categories which include creativity of small firms, economic and lifestyle reasons, self-employment through starting up small businesses, and the social aspects of being self-employed. The "push/pull" motive drives business start-ups.[33] This view, which has gained currency in research studies, is based on classical economic theory. Storey argues that people are "attracted by the opportunity or the 'pull' of perceived profit."[34] The "push factors" are so called because they "push" people to consider self-employment as the only available and best option under prevailing circumstances. Such "push factors" include career dissatisfaction[35] and the threat of unemployment or unemployment itself.[36]

Islam highly approves of entrepreneurship, whether it is opportunity-or necessity-driven. The necessary condition is conformity of such entrepreneurship with the Islamic moral and ethical code of business conduct. This is unlike Western entrepreneurship, which is primarily premised on the prospect of financial rewards. Islam does not prohibit Muslims from engaging in business activities to generate profit, but it requires every Muslim to acknowledge and recognize that every business venture takes the form of worship (*ibadah*), intended firstly to appease The Almighty God. Accordingly, all business undertakings are meant to build up the Muslims' faith (*iman*) by entrusting them to the tribute of God and attending to His religious duties. "[are] men whom neither traffic nor merchandise can divert from the remembrance of God, nor from regular prayer, nor from the practice of regular charity."[37]

Islamic entrepreneurship is punctuated by high moral standards and stringent guidelines, which forbid greed, dishonesty, exploitation, and monopoly in accumulation of profits. Islamic entrepreneurship aims to bring forth high-value Muslim entrepreneurs who are allowed and goaded to undertake only socially desirable and morally acceptable productive business ventures. To this end, Islam strictly forbids business undertakings that involve prostitution, alcohol, gambling, drugs, usury, and highly speculative business activities irrespective of their potential for economic viability.

The motives of Islamic entrepreneurship also sharply contrast with Western entrepreneurship in the areas of religious and altruistic motives. That is, Islamic entrepreneurship is not only a way of worship that partially enables Muslims to fulfill their religious obligations and make their faith complete (*iman*), but it is also a vehicle by which Muslim entrepreneurs can extend assistance to their fellow Muslims and others in the society. Islamic entrepreneurship thus takes a wider dimension, while the altruistic role assumed by entrepreneurs goes beyond satisfaction of personal interest and immediate needs. Therefore, the "pursuit of self-interest"[38] and "self-centered wealth creation"[39] lack a fit with the principal motives of Islamic entrepreneurial undertakings, since altruistic motives supersede personal and self-interest, which are considered natural and spontaneous outcomes of advancing the society's shared well-being.

Islamic entrepreneurship is also considered a means of appreciating God for His countless blessings and a way of assisting others:

> But seek, with the (wealth) which God has bestowed on thee, the Home of the Hereafter. Nor forget thy portion in this World: but do thou good, as God has been good to thee, and seek not (occasions for) mischief in the land: For God loves not those who do mischief.[40]

There are many Qur'anic verses and traditions of the Prophet Muhammad that recommend that Muslims ought to give munificently to propagate the spirit of collaboration among Muslims and promote socioeconomic equality among Muslims. It can be persuasively argued that opening a new business motivated by the need to provide employment opportunities to others can be considered a form of giving to God. Actions of this nature by Muslim entrepreneurs enable them not only to generate potentially high returns on investment and self-satisfaction, but also warrant rewards in the hereafter. Thus, the Islamic motivation for involvement in entrepreneurial activities has both moral and material dimensions. Entrepreneurial activities in Islam are based primarily on a divine incentive system. Islam as a religious system not only advocates for divine incentive, but it also endorses and accepts Western motives.[41]

Muslims are required to devote their intellectual, moral, physical, and financial resources in seeking the good pleasure of God with the twin benefit of making progress in worldly life and in the hereafter. The ability to earn *halal* through entrepreneurial activities enables Muslim entrepreneurs to meet their *ibadat* of a "financial nature," like giving *zakah* and contributing for charity, while simultaneously fulfilling their personal needs and those of their extended family. These actions will be rewarded munificently in the hereafter.

In sum, the design and building of a new developmental model requires compatibility and integration among its various components, and the most noteworthy components are institutional and cultural. Therefore, the Islamic culture and its entrepreneurial spirit require strong institutional structures and an enabling environment for it to succeed in fulfilling its will.

THE ROLE OF ISLAMIC FINANCING IN ENTREPRENEURSHIP DEVELOPMENT

Every country has a unique set of hurdles that impede the growth of the entrepreneurship sector. Individual entrepreneurs, on the other hand, face unique challenges in their efforts to create a business. However, many entrepreneurs across different countries share certain common challenges. These difficulties range from government regulations and inadequate financial resources to social attitudes that frequently depress risk-taking.[42] Among the many hindrances to business start-ups, inability to access adequate capital to start a business is by far the best-known and most difficult obstacle facing all entrepreneurs across the world. This problem is not limited to certain cultures or backgrounds, but it is more prevalent in developing countries.

There are some well-known causes of limited collaboration between existing and/or potential entrepreneurs and conventional commercial lending institutions in Muslim countries. First, commercial financial institutions are hesitant to grant credit to (potential) entrepreneurs primarily due to high failure rates and the prohibitive administrative costs of granting credit to SMEs. Usually, the amount of the loan is too small to be economically feasible. However, failure to fully comprehend the operational nature and dynamics of SMEs, coupled with commercial bank personnel who are not adequately qualified to correctly appraise viability studies and assess and monitor small business loans are perceived to be the actual reasons driving such lending reluctance.

Commercial lending institutions often impose unreasonable prerequisites before extending credit. For example, the demand for historical business records showing profitability trends as an indicator of ability to repay the loan are difficult to fulfill, particularly by fresh and potential entrepreneurs without an established credit history or a prior record of success. Moreover, most lending institutions are unwilling to finance innovations or new products without either a track record of success or a guarantee of future performance due to unknown acceptance by the markets arising from insufficient reliable information. Since providers of loans have to guard their investments and ensure the loans are secure, banks request that potential entrepreneurs produce sizeable collateral, the value of which often times far exceeds the amount of the loan. Since most entrepreneurs cannot meet such tough requirements demanded by commercial banks, they cannot rely on conventional banking institutions to secure start-up capital. The entrepreneur is left with two difficult options: either try to secure an alternative financing and pay exorbitant interest charges, or simply abandon their vision of entrepreneurship.

Nevertheless, potential entrepreneurs who satisfy the requests of the lending institution and become eligible for a loan are still burdened with repayment of predetermined interest charges in addition to the principal amount borrowed. The prohibitive costs of accessing capital to engage in business ventures inflict a weighty financial burden on the entrepreneur. The high interest charges put the entrepreneur in a precarious position even before the business picks up. This increases the odds against the success of a business venture. Worse still, the fixed financial obligation to repay the loan and related interest is invariant to future performance and activity of the business. If the venture is successful and generates a higher rate of return relative to interest rate, then the fixed interest rate is seemingly unfair to the lender. Conversely, if the venture is unsuccessful, the lender still recovers the entire loan and interest while the entrepreneur bears all the losses. This practice is seemingly unjust and undeserved and is explicitly prohibited in Islam.

Second, the majority of potential Muslim entrepreneurs do not deal with conventional commercial banks on a religious basis. They regard commercial banks as unethical institutions that expand the gulf between the needy and wealthy via the morally wrong interest (*riba*)-based financial practices. Studies by many scholars often ignore this element, but it has important and enormous implications. Third, a large fraction of Muslim entrepreneurs prefer sharing instead of taking the risks associated with new business ventures.

FROM A DEBT-BASED TO AN EQUITY-BASED BANKING SYSTEM

Islamic economics is not a new concept even though the modern attention given to Islamic economics is fairly current.[43] The cradle of Islamic economics can be traced to the period of the revelation of the Qur'an about fourteen centuries ago.

The subsequent argument in this study limits itself to the scale and depth of the Islamic financial system and the potential function that Islamic banking can play in promoting the development of a dynamic Islamic entrepreneurship segment. We start with some definitions. The legal rules that dictate the social, political, economic, and cultural issues of Islamic societies are called shari'a. The main sources of shari'a are the Qur'an and *sunna.* The tenets of the Islamic financial system are based on the philosophical belief that wealth accumulation and distribution should be fair and just. It should neither be biased against the majority poor nor favor the minority rich. The intended goal is to broaden socioeconomic justice amongst all. Islamic banking is not equal to the Islamic financial system, although there exists the widespread erroneous belief that the Islamic financial system can be provincially and exclusively defined by Islamic banking.[44] Likewise, most observers define the whole economy as an "interest-free" economy.

> . . . Describing the Islamic financial system simply as "interest-free" does not provide a true picture of the system as a whole. Undoubtedly prohibiting the receipt of and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation.[45]

The exclusion and ban of interest (*riba*) in Islamic economics has received a great deal of attention. Most Western scholars argue that the proscription of interest in Islamic economics goes against the grain of capitalism and it not only impedes the efficient functioning of a modern economy but also limits economic growth and development. Conversely, other Western proponents of a ban on interest argue that charging or receiving interest lacks moral or economic justification. They opine that imposing interest on entrepreneurs increases their financial burden and is effectively counterproductive. Therefore, an interest-based economy cannot effectively afford socioeconomic justice.

Ahmad investigates the potential association between prohibition of interest and economic development and makes several interesting conclusions. First, money made from charging interest and other forms of "rent-seeking activities" generates new but artificial capital, which is the core means of support for the markets. Ahmad finds that "the essence of the market is entrepreneurship" and explains that "trade, not banking, is the primary function of markets."[46]

Second, the partnership agreement involving the entrepreneur and financier removes the negative impact, if any, of forbidding interest. Islamic finance utilizes two main partnership-based financial instruments, namely *mudaraba* and *musharaka.* These two are used as substitutes for interest rate–based mechanisms used by conventional banking. Specifically, *mudaraba* and *musharaka* hinge on the concept of "rate of return," where the financier and the entrepreneur share the risk (profit/loss generated by the investment) based on a pre-agreed ratio. This is unlike the predetermined fixed "interest rate" and principal paid by the entrepreneur regardless of the upshot of the business venture.

Third, Islam strictly prohibits paying or receiving interest on borrowed/lent money based on a pre-specified fixed rate of return. The novel idea behind this is that imposing interest (*riba*) creates more of a financial burden on the poor and increases their poverty level while the rich generate more wealth without engaging in any economic activity or sharing the risk of any business venture. Essentially, *riba*, which is neither a result of productive economic activity nor an outcome of an increase in commodity supply, generates wealth for a minor sector of society. Therefore, according to Islam, any form of interest-based financial arrangement is unjust, unfair, and morally unjustifiable. Moreover, any money generated by interest-based transactions is considered as unearned money since *riba* is unlawful. Fascinatingly, the Abrahamic faiths (Judaism, Christianity, and Islam) and other world religions such as Buddhism and Hinduism mutually deplore charging interest as unethical and morally wrong.

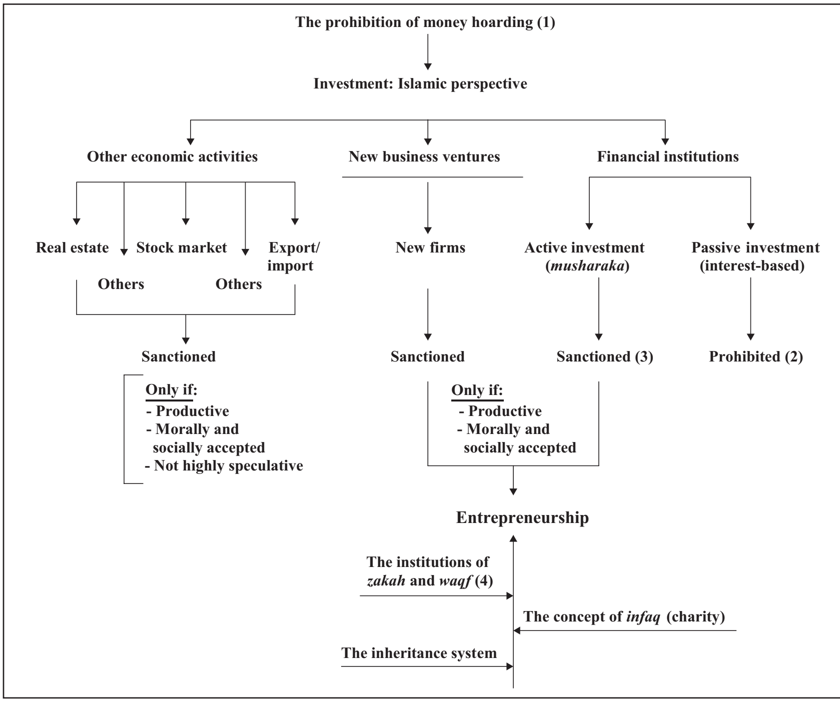
Early studies advocated for an interest-free economy.[47] Other studies persuasively argue that an equity-based economy will outperform a heavily credit-dependent economic system.[48] Another study on Islamic finance makes the suggestive conclusion that a movement toward equity-based financing will be a future global event.[49] From an Islamic perspective, Muslim governments can only receive finance through equity-based financing to provide public goods and services. This does not impose a debt burden on future generations, unlike debt-based financing, which runs the risk of imposing a heavy financial burden on future generations as they have to repay current public debt.[50] The debt-based economic system has led to insurmountable problems among most developing nations in Africa and Asia. The G8 summit of 2005 reported that debt servicing by African countries consumes all of their GDP.[51]

KEY ISLAMIC FINANCIAL THEMES CONDUCIVE TO ENTREPRENEURSHIP DEVELOPMENT

The main challenge facing individuals with financial resources is how to protect their money while remaining true to the core tenets of Islamic financing. Figure 1 below outlines the key premises of the Islamic financial system. The revolving theme reveals the developmental and entrepreneurial nature of Islam while simultaneously reflecting how the Islamic financial system is committed to the preservation of both the socioeconomic and spiritual welfare of humankind.

Money hoarding is forbidden in Islam since it amounts to preventing money from serving its intended purposes. This also stifles its function as a feasible tool of facilitating development as well as obstructing the achievement of socioeconomic fairness for all. "Those who hoard up gold and silver and do not spend it in the way of God, give them the tidings of a

Figure 1. Key Islamic Financial Themes Conducive to Entrepreneurship Development



painful punishment."[52] The sound alternative to money hoarding is investing it by choosing investment opportunities.

Passive investment of money in financial institutions to generate fixed interest income is reviled and prohibited in Islam and hence unlawful. Other alternative investment channels, such as investment in the stock market, real estate, and import/export, among others, may constitute both productive and unproductive or even destructive business undertakings. Islam specifically permits productive business activities which conform to Islamic rules as laid down in shari‘a and which conserve Islamic ideals.

Islam propagates investment of money in productive, socially desirable, and moral business activities as an alternative to hoarding, and spending money in a way that pleases God. To this end, Muslim investors are encouraged to initiate their own business ventures or engage in partnership contracts with potential entrepreneurs to start new business ventures. The concept of contractual partnership arrangements is premised on the idea that individuals may be endowed with financial resources but lack entrepreneurial skills and traits. Conversely, potential entrepreneurs may have the requisite traits and entrepreneurial skills but lack financial resources. This resource mismatch calls for the partnership between potential entrepreneurs and potential financiers, which enables both to have a stake in a business venture. This partnership arrangement is exemplified within the realms of Islamic financial arrangements called *musharaka* and *mudaraba* (direct partnership with the entrepreneur or through an Islamic financial institution). The partnership arrangement guarantees that the potential entrepreneur will not commence the business and bear the heavy burden of paying interest and principal borrowed invariant of the performance of the business venture.

Capitalism regards money as capital, while Islam treats capital as the share of wealth used in productive undertakings. Money is not a commodity for speculation but rather a measure of worth and medium of exchange. Therefore, money remains potential capital in anticipation of investment in productive economic activity in addition to other factors of production (land, labor, and entrepreneurship). Islamic banking thus performs the critical role of converting money into capital via entrepreneurship to achieve economic development. While Islamic and classical economics treat capital as a factor of production together with land, labor, and entrepreneurship, a sharp difference arises in the definition of profit generated by capital as an upshot of the production process. Classical economics considers interest income as return on capital, while Islamic economics takes profit/loss generated by the capital invested in the partnership arrangement as the capital's share of income. Therefore, profit loss sharing (PLS) between the financer and the entrepreneur is a key feature of Islamic entrepreneurship.

Table 1 illustrates the convergent and divergent points between Islamic and classical economics in relation to return for each of the four factors of production generated by entrepreneurial activity.

Table 1: Factors of Production

Factors of production		**Entitlements/remuneration**	
		Classical economics	**Islamic economics**
Human-related	**Entrepreneurship**	Share of profit (PLS)	Share of profit (PLS)
	Labor	Wages	Wages
Material-related	**Land**	Share of profit/rent	Fixed fee/compensation
	Capital	Interest	Share of profit (PLS)

Table 1 provides evidence that the classical and Islamic economic systems have a similar opinion regarding entitlement of human resources (labor and entrepreneurship) as factors of production, while they differ on defining returns to material-related production factors/physical and financial resources, namely land and capital.

ISLAMIC BANKING AND ENTREPRENEURSHIP

In Islamic banking, *mudaraba* and *musharaka* instruments are favored as means of enabling Islamic banking to play a constructive role in promoting the roots of Islamic entrepreneurship. In this setup, human and financial capitals are combined to create new business ventures. Islamic banking affords potential entrepreneurs *halal* capital to initiate and/or enlarge their businesses. The partnership arrangements protect entrepreneurs against risk and uncertainty by sharing risk (profits and losses) with the investor (financier). It is further expected under *musharaka* that banks have dedicated units or departments equipped with highly qualified and trained professionals with managerial expertise to guide and encourage entrepreneurs to engage in new and innovative business ventures. The quality of entrepreneurship is also promoted since, as entrepreneurs try to win available financial capital, financiers are spontaneously presented with the opportunity to assess the proposals and business plans of multiple entrepreneurs and engage in partnership contracts that present the best prospects.

The most widespread Islamic modes of finance are *musharaka* (active partnership), *mudaraba* (passive partnership), *murabaha* (cost plus financing), and *qard hasan* (benevolent or good loan). *Mudaraba* and particularly *musharaka* are the two most important forms of Islamic financial instruments to Islamic entrepreneurship, since they operate within strictly defined risk realms and strict PLS rules. *Qard hasan*, on the other hand, is a form of interest-free loan whose repayment amount is equal to the principal borrowed. *Mudaraba* is a partnership contract between two parties: the bank and the entrepreneur. The bank is the financer, since it provides required capital, while the entrepreneurs devote their time, ideas, skills, and expertise to investing the money in socially desirable and productive *halal* business activity. The partnership arrangement is premised on the doctrine of PLS; profit, if realized, is shared by both parties on the basis of pre-agreed ratios. If the business venture generates a loss, the bank shoulders the financial burden to the extent of incurred losses, unless the loss is occasioned by irresponsible actions, misconduct, or negligence on the part of the entrepreneur or violation of the mutually agreed-upon conditions. The loss to the entrepreneur is limited to the time invested and effort expended in managing the business.

Evidence from diverse research studies shows that banks have been extremely wary in their reaction to potential entrepreneurs in the past. In many instances, banks were not willing to engage in these forms of financial arrangements, since under *mudaraba* the entrepreneur totally manages the business while the bank becomes a passive partner with minimal or no actual ability to shape the course of the business venture. The bank more often than not uses faith, trust, and a reasonable confidence that the entrepreneur will uphold the requisite Islamic business ethics. To this end, the bank demands that the entrepreneur provide a convincing case for the economic viability of the proposed business venture.

Musharaka, in Arabic, means “partnership.” It is a PLS-based financial instrument that strictly obeys the Islamic financial rules and norms. *Musharaka* is similar to the *mudaraba* contract between the entrepreneur and the financial institution, except that in the former, the entrepreneur contributes to the starting capital in addition to his/her physical and mental contributions toward the business venture.

Therefore, unlike *mudaraba*, the *musharaka* contract affords both the entrepreneur and the bank the twin chances of sharing the finances (assets or working capital) and management of the business. Under *musharaka* arrangements, the entrepreneur bears some exposure to capital loss and the bank can influence the management and operation of the business. Profits and losses are shared on the basis of pre-agreed ratios (such as a percentage of the total start-up capital contributed) after deducting the management fees of the entrepreneur. Anwar (1987, p. 24) argues that in an interest-free Islamic economy, Muslim entrepreneurs work very hard to optimize their returns, thereby also maximizing the earnings of their partners. A mutually beneficial relationship is thus created and this promotes a proper spirit of collaboration and partnership between the entrepreneur and the local investors. This ultimately has the effect of advancing the foundation of entrepreneurship in development by ensuring wider participation by the community.

The partnership between Islamic banking institutions and potential entrepreneurs also results in the emergence of high-quality business ventures. This is because Islamic banks, morally obligated to defend the interests of their depositors and shareholders, will implement guarded but practical investment measures and alternatives. This motivates them to engage in partnership agreements offering the most promising business prospects.

Islamic banks prefer *musharaka* arrangements to *mudaraba* arrangements, as the former exposes entrepreneurs to the potential risk of losing a share of their invested capital. This is enough to motivate any entrepreneur to be careful in investment decisions and make extra effort in managing the business venture. Besides this benefit, *musharaka* arrangements present the financial institution with the opportunity to actively participate in entrepreneurial activity and supervise the operations of the business.

The structure of Islamic entrepreneurship does not integrate taxes. However, the fourth pillar of Islam, *zakah* (religious alms), which literally means “purification,” obliges all Muslims (with minimum threshold), to pay 2.5% to enable the state to properly and justly redistribute the *zakah* funds among the poor. The moral obligation of the Islamic state to fulfill its role of ensuring the general welfare of all its citizens, especially the less privileged, does not make it a *welfare state*. *Zakah* is construed and effectively defined as an empowerment tool and *zakah* funds are utilized to attain the critical goal of achieving socioeconomic justice. This is the spirit of *zakah*; hence it should not be defined, viewed, or interpreted in terms of *welfare*.

According to Metwally, Islam condemns hoarding money and passive investments such as bank deposits to earn interest. There is unanimous agreement among Muslim scholars that idle money exceeding *nisab* still falls within the realm and characterization of money hoarding.[53] According to Ibrahim (1994), idle wealth is still hoarded money irrespective of whether the Muslim has paid the due *zakah* on such inactive wealth. This is aimed at goading Muslims not to accumulate wealth but rather spend it by investing in productive and beneficial ways in the cause of God. There is a strong argument that imposing *zakah* on all idle wealth is not only a clear and obvious mechanism of calling upon Muslims to invest their wealth in productive business ventures but also acts as a fine to enforce the utilization of such idle wealth (through involvement in entrepreneurship) and contribute to the welfare of the Muslim *umma.*[54]

CONCLUSION

This paper has explored and critically examined Islamic forms of economic development and entrepreneurship. It started by briefly reviewing differing views on the nature of the relationship between religion and development. It highlighted the Islamic perspective of development and the role of entrepreneurship as a developmental tool in realizing the ultimate goal of development, according to each society's own definition and convictions. The Western conceptualization of development does not differentiate between economic development and development in its wider context, since the overriding objective of the Western model is the creation of material wealth. This is in contrast to the Islamic holistic view of development as a two dimensional process that accounts for both material and spiritual needs. The discussion further concluded that such differences between the two incompatible perspectives are too real to be overlooked or reconciled, thus justifying the call for building an Islamic model of entrepreneurship.

It has been demonstrated throughout this study that Islam goes beyond displaying a positive attitude and passive encouragement, to profoundly attaching a religious significance to entrepreneurial activity. Islam considers entrepreneurial activity to be *fard kifayah* on the Muslim *umma* intended for pleasing God, and to contribute to the spiritual as well as to the socioeconomic well-being of Muslims. Such a dynamic attitude entails that Islam puts in place an enabling framework to create a supportive environment where entrepreneurship can develop and flourish.

Endnotes

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Financial Inclusion: The Islamic Finance Perspective

Zamir Iqbal and Abbas Mirakhor

INTRODUCTION

There is evidence suggesting that financial development and improved access to finance—also referred to as financial inclusion—in a country is likely not only to accelerate economic growth but also to reduce income inequality and poverty. Despite its essential role in the progress of efficiency and equality in a society, 2.7 billion people (70% of the adult population) in emerging markets still have no access to basic financial services,[1] and a great part of them come from countries with predominantly Muslim populations. In conventional finance, financial access is especially an issue for the poorer members of society, including potential, or would-be, entrepreneurs. They are commonly referred to as "non-banked" or "non-bankable" and in the case of potential entrepreneurs they invariably lack adequate collateral to access conventional debt financing. While access to finance may be important for economic growth, the private sector may not be willing to provide financing to some areas because of the high cost associated with credit assessment and credit monitoring, and because of the lack of acceptable collateral.

Authors argue that the core principles of Islam place great emphasis on social justice, inclusion, and sharing of resources between the haves and the have-nots. Islamic finance addresses the issue of financial inclusion from two directions—one through promoting risk-sharing contracts, which provide a viable alternative to conventional debt-based financing, and the other through specific instruments of redistribution of wealth among society. Both risk-sharing financing instruments and redistributive instruments complement each other to offer a comprehensive approach to enhancing financial inclusion, eradicating poverty, and building a healthy and vibrant economy. They help reduce the poor's income-consumption correlation.

Zamir Iqbal, Lead Investment Officer, World Bank, Washington, DC.

Abbas Mirakhor, Distinguished Scholar and the First Holder of INCEIF's Chair in Islamic Finance, INCEIF, Malaysia).

In other words, the poor are not forced to rely on their low- (or no-) level income to maintain a decent level of subsistence living for themselves and their families.

The paper concludes that Islamic finance provides a comprehensive framework to enhance financial inclusion through promoting micro-finance, SME financing, and micro-insurance structured on the principles of risk-sharing, and through Islam's redistributive channels, which are grossly under-utilized in Muslim countries. The study argues that redistributive instruments should be developed as proper institutions to optimize the function of such instruments. Institutionalizing these instruments would require an enabling environment, a sound legal framework, and transparent collection and distribution. Applications of financial engineering can devise innovative ways to develop hybrids of risk-sharing and redistributive instruments to enhance access to finance to promote economic development.

WHAT IS FINANCIAL INCLUSION AND WHY IS IT IMPORTANT?

Many poor families in the developing world have limited access to formal financial services, including credit, savings, and insurance. They instead rely on a variety of informal credit relationships with moneylenders, relatives, friends, or merchants. Traditionally, banks and other formal financial service providers, including insurance companies, have not considered the poor a viable market, and penetration rates for formal financial services in developing countries are extremely low. Increasing access to financial services holds the promise of helping reduce poverty and improving development outcomes by enabling the poor to smooth consumption, start or expand a business, cope with risk, and increase or diversify household income.

The concept of "financial inclusion" initially referred to the delivery of financial services to low-income segments of society at affordable cost. However, during the past decade, the concept has evolved into four dimensions:

a) Easy access to finance for all households and enterprises;
b) Sound institutions guided by prudential regulation and supervision;
c) Financial and institutional sustainability of financial institutions; and
d) Competition between service providers to bring alternatives to customers.[2] Typical indicators of the financial inclusion of an economy are the proportion of the population covered by commercial bank branches, the number of automated teller machines (ATMs), sizes of deposits and loans made by low-income households and small to medium enterprises (SMEs). However, availability of financial services cannot necessarily be equated with financial inclusion, because people may voluntarily exclude themselves from

financial services for religious or cultural reasons, even though they do have access and can afford the services.[3]

Understanding the linkage of financial inclusion with economic development is important. There is voluminous literature in economics and finance on the contributions of finance to economic growth and development. The main reason why "finance" or "financial inclusion" or "access to finance" matters is that financial development and intermediation has been shown empirically to be a key driver of economic growth and development. Development economists suggest that the lack of access to finance for the poor deters key decisions regarding human and physical capital accumulation. For example, in an imperfect financial market, poor people may find themselves in the "poverty trap," as they cannot save in harvesttime or borrow to survive starvation. Similarly, without a predictable future cash flow, the poor in developing countries are also incapable of borrowing against future income to invest in education or health care for children.

Given the significance of financial inclusion, a developed financial sector in a country can play a critical role in promoting growth and in reducing poverty by enabling the poor to borrow to finance income-enhancing assets, including human assets such as health and education, and to become micro-entrepreneurs in order to generate income and ultimately come out of poverty.[4] In addition, financial sector development could enable the poor to channel their savings to the formal sector—i.e., bank accounts and other saving schemes and insurance—which would allow the poor to establish a buffer against future shocks, thus reducing vulnerability and exposure that otherwise could put undue strain on future income prospects.

There is growing evidence identifying linkage between economic development and financial inclusion. Financial exclusion not only holds back investment, but results in persistent income inequality, as it adds to negative incentives to save and work and encourages repeated distribution in a society.[5] Empirical studies show that countries with deeper financial systems experience faster reductions in the share of the population that lives on less than one dollar a day.[6] Almost 30% of the cross-country variation in changing poverty rates can be explained by variation in financial development.

ISSUES WITH CONVENTIONAL APPROACHES TO FINANCIAL INCLUSION

The experience with microcredit or microfinance has been mixed, as there is growing consensus that expectations were overestimated and that there are serious challenges in achieving sustainable impact on poverty alleviation. The key challenges facing the microfinance industry are summarized below:

a) *High interest rates*. Conventional microfinance institutions are often criticized for charging very high interest rates on loans to the poor. These high rates are justified due to high transaction costs and high risk premium. However, this imposes undue stress on the recipient to engage in activities that produce returns higher than the cost of funding, which may not be possible in many cases.
b) *Not every poor person is a micro-entrepreneur*. Merely making the capital accessible to the poor is not the solution without realizing that not every poor person or recipient of microcredit has the skill set or the basic business sense to become an entrepreneur. There is the need to provide proper training, skill-building, and institutional support to promote entrepreneurship among the poor. Such capacity-building requires funds that are often not readily available.
c) *Diversion of funds.* There are chances that the funds will be diverted to non-productive activities such as personal consumption. In some cases, microcredit may lead the poor into a circular debt situation where borrowing from one micro-lender is used to pay off the borrowings from another lender. Poor households clearly have other financial needs such as school fees, risk mitigation against health and crop exposures, and even personal consumption.
d) *Large-scale fund mobilization*. While some microfinance institutions (MFIs) have had a significant impact on poverty, others have been less successful, making it difficult because MFIs generally cannot mobilize funds on a large scale and pool risks over very large areas in the way that more traditional, formal financial institutions can. In addition, most MFIs have only limited coverage and are reaching only a minority of the bankable population.[7]
e) *Product design.* The financial services needs of poor households may require different product features with different payment and delivery structures as opposed to typical debt-based lending to micro-borrowers. A more suitable product targeted to match the needs of the poor may prove to be more welfare-enhancing.
f) *Absence of private sector participation*. As mentioned above, due to limited supply, coverage, products set, and funding by the informal, semi-formal, and non-commercial sectors, effectiveness of MFIs is often compromised. There is the need to move toward a market-based or private sector–based solution within the formal financial sector or capital markets. Without participation by the private sector, some core issues may not be overcome.

It is worth looking at the evidence on the effectiveness of micro-lending. Recent experimental evidence from three randomized impact evaluations suggests that while increasing access to credit does not produce the kind of dramatic transformations expected by earlier literature, it does appear to have some important—though more modest—outcomes. There is some evidence of a shift away from non-productive activities in favor of productive ones, but not one drastic enough to result in significant uplift in poverty levels. This suggests that microloans help some households reprioritize their expenditures and smooth consumption—a valuable function for poor households that suffer from irregular and unpredictable income streams.[8]

THE CONCEPT OF FINANCIAL INCLUSION IN ISLAM

It is widely recognized that the central economic tenet of Islam is to develop a prosperous, just, and egalitarian economic and social structure in which all members of society can maximize their intellectual capacity, preserve and promote their health, and actively contribute to the economic and social development of society. Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system. All members of an Islamic society must be given the same opportunities to advance themselves; in other words, a level playing field, including access to the natural resources provided by God. For those for whom there is no work and for those who cannot work (including the handicapped), society must afford the minimum requirements for a dignified life by providing shelter, food, health care, and education.

Islam emphasizes financial inclusion more explicitly, but two distinct features of Islamic finance—the notions of risk-sharing and redistribution of wealth—differentiate its path of development significantly from the conventional financial model. According to the Islamic perspective, risks are mitigated in various ways. First, the economic system is a rule-based system that has provided rules of behavior and a taxonomy of decisions—actions and their commensurate payoffs are based on injunctions in the Qur'an. Complying with these rules reduces uncertainty. Clearly, individuals exercise their freedom in choosing to comply or not with these rules. That rules of behavior and compliance with them reduce uncertainty is an important insight of the new institutional economics. Rules reduce the burden on human cognitive capacity, particularly in the process of decision-making under uncertainty. Rules also promote cooperation and coordination.[9] Second, Islam has provided ways and means by which those who are able to mitigate uncertainty by sharing the risks they face by engaging in economic activities with fellow human beings through exchange. Sharing allows risk to be spread and thus lowered for individual participants. However, if a person is unable to use any of the market means of risk sharing because of poverty, God has ordered a solution here as well: the rich are commanded to share the risks of the life of the poor by redeeming their rights derived from the Islamic principles of property rights.[10] Islamic laws of inheritance provide further mechanisms of risk sharing.

Islam ordains risk sharing through three main venues:

a) Contracts of exchange and risk-sharing instruments in the financial sector;
b) Redistributive risk-sharing instruments that the economically more able segment of the society utilize in order to share the risks facing the less able segment of the population; and
c) The inheritance rules specified in the Qur'an through which the wealth of a person at the time of passing is distributed among present and future generations of inheritors.

Islamic finance, the foundation of the belief that such a system facilitates real sector activities through risk sharing, has its epistemological roots firmly in the Qur'an, specifically verse 275 of chapter two.[11] This verse, in part, ordains that all economic and financial transactions are conducted via contracts of exchange (*al-bay'*) and not through interest-based debt contracts (*al-riba*). Since in the *Ayah* the contract of exchange appears first and no-*riba* after, it is reasonable to argue that requiring that contracts be based on exchange constitutes a necessary condition of a permissible contract. Based on the same logic, the requirement of "no-*riba*" constitutes the sufficient condition of contracts. The necessary condition (*al-bay'*) and sufficient condition (no-*riba*) must be met for a contract to be considered Islamic. Classical Arabic Lexicons of the Qur'an define contracts of exchange (*al-bay'*) as contracts involving exchange of property in which there are expectations of gains and probability of losses,[12] implying that there are risks in the transaction.

One reason, inter alia, for non-permissibility of the contract of *al-riba* is surely due to the fact that this contract transfers all, or at least a major portion, of risk to the borrower. It is possible to imagine instruments that on their face are compatible with the no-*riba* requirement, but are instruments of risk transfer and, ultimately, of shifting risk to taxpayers.

By entering into contracts of exchange, parties improve their welfare by exchanging the risks of economic activities, thus allowing division of labor and specialization. Conceptually, there is a difference between risk taking and risk sharing. The former is antecedent to the latter. An entrepreneur has to first decide to undertake the risk associated with a real sector project before financing is sought. In non-barter exchange, it is at the point of financing where risk sharing materializes or fails to do so. The risk of the project does not change as it enters the financial sector seeking financing. Not clarifying this distinction has led to the confused belief that the two concepts are one and the same. In the contemporary economy, at the point of financing, risk may be shared but it can also be transferred or shifted. The essence of financial intermediation is the ability of financial institutions to transfer risk. All institutional arrangements within the financial sector of contemporary economies are mostly geared to facilitate this function. One of the chief characteristics of the 2007–08 global financial crisis was the fact that many financial institutions shifted the risk of losses but internalized the gains of their operation. Hence, the concept of "privatized gains and socialized losses."[13]

In a competitive market economy, in which markets are complete and Arrow securities whose payoffs are state-contingent are available, it would be Pareto optimal for the economy if its members were to share risk according to each participant's ability to bear risk.[14] In the absence of complete markets, which include all possible future contingencies, the efficiency of risk-sharing mechanisms will depend on the institutional structure, the degree and intensity of informational problems, and policies designed to render the economy resilient to shocks.[15]

To summarize, the Islamic system advocates for risk sharing in financial transactions and a financial system based on risk sharing offers various advantages over the conventional system based on risk shifting. Use of risk-sharing instruments could encourage investors to invest in sectors such as micro-small-medium-enterprises (MSMEs), which are perceived as high-risk sectors. Given an enabling environment, investors with matching risk appetite will be attractive to providing capital for these sectors. This argument can be supported by the growing market for the private equity. With the increased availability of funds for these sectors, one could expect an increase in the financial inclusion in the system.

REDISTRIBUTIVE INSTRUMENTS OF ISLAM

As will be argued here, the second set of instruments meant for redistribution are used to redeem the rights of the less able in the income and wealth of the more able. Contrary to common belief, these are not instruments of charity, altruism, or beneficence, but they are instruments of redemption of rights and repayment of obligations.

In practical terms, the Qur'an makes clear that creating a balanced society that avoids extremes of wealth and poverty, a society in which all understand that wealth is a blessing provided by the Creator for the sole purpose of providing support for the lives of all of mankind, is desirable. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating a mass of economically deprived and destitute people. The rich consume opulently while the poor suffer from deprivation because their rights in the wealth of the rich and powerful are not redeemed. To avoid this, Islam prohibits wealth concentration, imposes limits on consumption through its rules prohibiting overspending (*israf*), waste (*itlaf*), and ostentatious and opulent spending (*itraf*). It then ordains that the net surplus, after moderate spending necessary to maintain modest living standards, must be returned to the members of society who, for a variety of reasons, are unable to work; hence the resources they could have used to produce income and wealth were utilized by the more able.

The Qur'an considers the more able as trustee-agents in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able in the income and wealth of the more able are redeemed. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism for redeeming the rights of the less able in the income and wealth of the more able are the network of mandatory and voluntary payments such as *zakat* (two and a half percent on wealth), *khums* (twenty percent of income), and payments referred to as *sadaqat*.

The most important economic institution that operationalizes the objective of achieving social justice in Islam is that of the distribution-redistribution rule of the Islamic economic paradigm. Distribution takes place post-production and sale when all factors of production are given what is due to them commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution refers to the post-distribution phase when the charges due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in one's income and wealth. Redeeming these rights is a manifestation of belief in the Oneness of the Creator and its corollary, the unity of the creation in general and of mankind in particular. It is the recognition and affirmation that God has created resources for all of mankind, who must have unhindered access to them. Even the abilities that make access to resources possible are due to the Creator. This would mean that those who are less able or unable to use these resources are partners of the more able.

Qard hasan is a loan mentioned in the Qur'an as "beautiful" (*hassan*), probably because in all the verses in which this loan is mentioned, it is stipulated that it is made directly to God and not to the recipient (see, for example, verse 17, chapter 64). It is a voluntary loan without the creditor's expectation of any return on the principal. Additionally, while the debtor is obligated to return the principal, the creditor, of his own free will, does not press the debtor for an exact timing of its return. Again, in the case of *qard hasan*, God promises multiple returns to the "beautiful loan." Unfortunately, the full potential of this institution to mobilize substantial resources for the empowerment of the economically weak or dispossessed has not been realized. Much has been written about microfinance and its potential to reduce poverty. However, it is an irony that institutions of microfinance are growing rapidly in Muslim countries, but it is seldom realized that Islam's own institution of *qard hasan* is a more effective means of providing credit to those who cannot access formal credit channels.

Very early in the history of Muslim societies the institution of *waqf* appeared, through which a person could contribute up to one third of his/

her wealth over which he/she is allowed by shari‘a to exercise control at the time of his/her death. A *waqf* is a trust established when the contributor endows the stream of income accrued to a property for a charitable purpose in perpetuity. This institution has already been partially instrumentalized—although not in the sense used in this talk—since the legality of cash *waqf* (i.e., endowing the future income stream of a cash trust instead of a physical property) has been recognized in most Muslim countries. Here, too, the potential of mobilizing large amounts of financial resources through implementation of this institution by a globally credible Islamic financial institution is substantial.

PUBLIC POLICY IMPLICATIONS

Analysts suggest that public policy and strengthened institutional framework in developing countries can go a long way toward enhancing financial inclusion. Better governance that can reduce damages to households due to mismanagement, achieving and sustaining economic and political stability, and financial sector development are examples of policy improvements. In terms of institutional framework, clear and secure property rights, contract enforcement, trust among people and between government and people, and other institutions can reduce risk, uncertainty, and ambiguity, strengthen social solidarity, bring private and public interests into closer harmony, and ensure coordination to achieve in risk sharing.[16] Public policy could also help in mobilizing the savings of poor households and thus reduce vulnerability to income shocks.

Public policy to forge integration and support saving mobilization in developing countries could help risk mitigation and sharing, thus building resilience in the face of shocks. With regards to microfinance, as discussed earlier, there is empirical evidence suggesting that while these contracts help reduce poverty in low-income countries by providing small, uncollaterized loans to poor borrowers, there is no evidence to suggest that those contracts allow businesses to grow beyond subsistence. Aside from high interest rates that reduce available resources, it is thought that the structure of typical microfinance contracts have features, such as peer monitoring and joint liability designed to reduce moral hazard risk, that create tension between risk taking and risk pooling. The latter allows greater opportunity for informal risk sharing due to repeated interaction between borrowers. Joint liability and peer monitoring—which are features common to most microfinance programs under which small groups of borrowers become responsible for one another’s loans and all members are held responsible for consequences of one member’s failure to repay the loan, but do not reward other members in case of success—discourage risk taking and development of entrepreneurial impulses among borrowers.[17] In addition to saving mobilization and encouraging microfinance, better access to the financial sector through developing microcredit and insurance markets in rural and poverty-stricken regions are promising ways and means by which public policy can assist development of risk sharing to allow households to cope with risk.

There are powers available to a government that the private sector does not have. For one thing, in its capacity as the risk manager of society and as its agent, it can promote risk sharing broadly by removing many of the barriers to its spread. It can reduce informational problems, such as moral hazard and adverse selection, through its potentially vast investigative, monitoring, and enforcement capabilities. Through its power of implementation of civil and criminal penalties for non-compliance, a government can demand truthful disclosure of information from participants in the economy. It can force financial concerns that would attempt to appropriate gains and externalize losses by shifting risks to others to internalize them by imposing stiff liabilities or taxes. Using its power to tax and to control money supply, a government has the significant ability to make credible commitments on current and future financing issues. It can use its power to tax to create an incentive structure for intergenerational risk sharing whereby the proceeds from taxation of current income-earning generation is redistributed to reduce risks to human capital of the youth of current and future generations. Without government intervention, individuals are unable to diversify the risk to their most valuable asset: their human capital. The young have significant human capital but insufficient financial capital. For the old, on the other hand, the case is the opposite.[18]

GOVERNMENT AS THE RISK MANAGER PROMOTING RISK SHARING[19]

In a society, risk can be shared among its members and/or between its members and its state. Both in industrial and developing economies, people find ways and means of sharing risks to their livelihood. In particular, they use coping mechanisms to increase the variability of their income relative to their consumption. In more developed financial systems, the coping mechanism is investing in financial assets or in acquiring insurance to mitigate against personal risk. In developing countries with weak financial markets, people rely on informal insurance, borrowing, or saving to cope with idiosyncratic risks. In such societies, theory suggests that perfect informal insurance is possible if communities fully pool their incomes to share risks. Then, each member of the community could be assigned a level of consumption dependent on the aggregate level of income and not on that of the member. This arrangement would assure perfect risk sharing to mitigate idiosyncratic risk so that a given household's income would not affect its level of consumption. Generally, empirical studies suggest that in low-income countries, saving, borrowing, the use of buffer stock, working longer hours or taking a second job, gift exchange, and private transfer of cash and clothing are mechanisms used in risk sharing.

It could well be argued that in contemporary societies, risk management is the central role of government and, therefore, government is the ultimate risk manager in a society. In most economies, governments play a major role in bearing risk on behalf of their citizens. For example, governments provided social safety net measures and insurance for a variety of financial transactions. The history of economic explanation for government's role in the economy spans more than a century as economists attempted to explain the justification of the role as being necessitated by the divergence between public and private interests. Some six decades ago Arrow and Debreu focused on finding precise conditions under which public and private interests would converge as envisioned in a conception of Adam Smith's invisible hand conjecture.[20] The result was an elegant proof that competitive markets would indeed have a stable equilibrium provided some stringent conditions were met. It was clear, however, that even under the best of actual conditions, markets did not perform as envisioned either by Smith or Arrow-Debreu. Consideration of violations of the underlying conditions spawned a voluminous body of literature on the theory and empirics of market failure. This concept became the starting point of the analytic reasoning that justifies government's intervention in the economy to protect the public interest.[21]

The reason that contemporary societies implement social safety nets, such as social security, health care, and public unemployment insurance programs, is that individual households face substantial risk over their life span such as mortality risk, wage and other income-wide risks, and health risks. Because private insurance markets do not provide perfect insurance against all risks, there is said to be a market failure and government intervention is called for to correct it. What has become clear in the wake of the global financial crisis is that even in the most advanced industrial economies, existing social safety nets have become incapable of coping with the adverse consequences of the crisis. Not only has the crisis shaken previous levels of confidence in markets, nearly all analyses of its causes attribute it to market failure in one dimension or another. This has intensified calls for governments' interventions to counter the adverse effects of the crisis on income and employment, to strengthen social safety nets, and to reform the financial sectors. The most important lesson of the crisis has been that people at large carry too large a risk of exposure to massive shocks originating in events that are beyond their influence and control. Hence, attention has been focused on ways and means of expanding collective risk sharing.

Heretofore it has been assumed that government intervention, in the form of activities such as providing social safety nets, public goods, and deposit insurance, were solely for the purpose of addressing various kinds of market failure. While this is a crucial justification for intervention, there is an important dimension of government's role that has not attracted much attention. Much of these activities in provision of social safety nets, from a minimal amount in some countries to substantial amounts in welfare states, are also about collective risk sharing. This dimension has been particularly neglected in the analysis of government provision of social insurance and services in which the sole focus has been on the issue of tradeoff between equity and efficiency; the issue at the heart of state vs. market debates.

NEED FOR DEVELOPING SUPPORTIVE INSTITUTIONAL FRAMEWORK

As discussed earlier, access to finance is hampered by informational asymmetries and market imperfections that need to be removed before one could think of enhancing finance. When it comes to developing countries where the financial sector is not very developed and the formal financial sector is underdeveloped, it is important that attention is paid to improving institutions critical for financial sector development. Improved access to finance in many developing countries is constrained by an underdeveloped institutional framework, inadequate regulations, and a lack of specialist supervisory capacity. Policymakers need to take steps to enhance key legal, informational, and regulatory institutions in the country.

a) *Regulators should give financial inclusion a priority*. Despite the significance of financial inclusion, it is observed that it is still not a priority for financial regulators in most OIC countries. OIC countries need to develop a regulatory and supervisory framework that supports wide financial inclusion based on sound risk management and with sufficient consumer protections. Financial inclusion should be considered as a goal alongside prudential regulation and financial system stability. The 2010 CGAP and World Bank Financial Access survey of financial regulators worldwide found that regions that include financial access in their strategies and mandate their financial regulators to carry such agendas are also the countries that reform the most. Regulators with a financial inclusion strategy are more likely to have more financial inclusion topics under their purview and more resources and staff dedicated to working on these matters.[22]

b) *Improving financial infrastructure, especially the improvement of the current credit informational system, should be given priority.* Core components of the financial infrastructure such as credit information, investors' rights, insolvency regimes, etc., are essential irrespective of type of financing (i.e., conventional or Islamic). Deficiencies in financial infrastructure are one of the major obstacles for further

SME lending in the MENA region.[23] Sharing borrower information is essential to lowering costs and overcoming information constraints. Lack of access to credit information and low coverage ratio of the credit history of individuals are two main features that contribute to financial exclusion in OIC countries, especially for SME financing. Muslim countries interested in enhancing financial inclusion need to improve the financial infrastructure, which will entail expanding the range of collateral, improving registries for movables, and improving enforcement and sales procedures for both fixed and movable assets. It also entails upgrading public credit registries and, more importantly, introducing private credit bureaus capable of significantly expanding coverage and the depth of credit information.[24] Financial infrastructure improvements will reduce the information asymmetry that constrains access to credit and raises the costs and risk of financial intermediation.

c) *Develop infrastructure conducive to shari'a-compliant products.* The growth of Islamic microfinance will depend to a large degree on whether financial institutions can develop sufficiently attractive financial products and services that are competitive with conventional products in terms of pricing, transparency, processing time, and burden on the client. Shari'a-compliant microfinance and SME financing are limited in their scope and scale because of the lack of knowledge concerning shari'a products, the absence of accounting and regulatory standards for shari'a-compliant microfinance, and adequate monitoring and supervisory setups.

   Integrating shari'a-compliant products and customers' information into the formal financial sector will not only enhance access, it will also help integrate Islamic finance with conventional finance. For example, by bringing borrowers' information to credit bureaus, financial institutions of all types could extend access to new customers, while managing risks and costs more effectively. This will also help shari'a-compliant financial institutions expand their funding source and enhance their risk-sharing mechanism, as an institution with its clients' credit information available to the public can establish its reputation much more easily than an institution with an informal credit history system.

d) *Develop and promote micro-insurance.* There is evidence of a positive causal relationship between insurance penetration and economic growth. The policyholder benefits by increased access to a wider range of products with increased coverage and greater sustainability, and the partnering insurance company has access to a new market without taking on extensive marketing, distribution, or administrative costs. More importantly, the partner-agent model facilitates the pooling of risks between the formal and informal sectors.

Despite the success and rapid growth of Islamic insurance (*takaful*) and micro-insurance's contribution in poverty reduction, micro-*takaful* institutions are still significantly underdeveloped in OIC countries. Similar to low-income individuals, SMEs are also less covered by insurance services in poorer OIC countries. In the MENA region, 34% of SMEs in GCC countries have access to insurance services, while the figure falls sharply to 19% if the SMEs in non-GCC countries in the same region are considered.[25] One major reason for the slow expansion of micro-*takaful* may be linked to the fact that micro-finance institutions in Muslim-populous countries are less likely to offer insurance services which are shari'a-compliant.[26]

If the policymakers in Muslim countries wish to promote Islamic microfinance and SMEs, these measures need to be complemented by the promotion of micro-*takaful* by designing an adequate regulatory framework and by providing incentives for insurance carries to enter into this market. Study by the Islamic Development Bank (IDB) rightly suggests that *qard hasan* funds could be used to develop micro-*takaful* capacity in a country in addition to credit guarantee systems.[27] Similarly, *zakah* funds can be utilized to cover the default risk of the poor spectrum of micro-enterprises, to build capacity and skills, and to reduce operating costs of microfinance and micro-insurance. Implementation of such ideas and innovations requires the development of institutions supporting transparent governance to ensure the effectiveness of such mechanisms.

e) *Encourage formal sector engagement.* Based on the experience of micro-finance, the development community is shifting the emphasis away from micro-credit institutions to an array of other financial institutions, such as postal savings banks, consumer credit institutions, and, most important, the banking system, with the view that this broader approach can lead to overall financial system efficiency and outreach to the whole population. Widening of financial services to the poor and small enterprises by private sector institutions (particularly commercial banks) in the formal financial sector requires proper incentives and the removal of regulatory barriers without sacrificing the promotion of stability or the security of the financial system.[28]

INSTITUTIONALIZATION OF ISLAMIC REDISTRIBUTIVE INSTRUMENTS

As discussed earlier, Islam provides a set of redistributive instruments that could play a critical role in enhancing access and reducing poverty. Given Islam's emphasis on social and economic justice and the eradication of poverty, we would expect Islamic instruments that targeted addressing inequity, such as *zakah*, *khairat*, *waqf*, and *qard hasan*, to play an important role if the required institutional structures are developed.[29] Therefore, there is the need to formalize or institutionalize Islamic redistributive mechanisms designed to empower the economically weak segments of society.[30]

By institutionalization, we mean building nationwide institutions and a surrounding legal infrastructure to maximize the effectiveness of these redistributive mechanisms. This institution-building exercise can take place in three steps. The first step is the development of institutions. An institution is nothing more than the legalization of the rules of behavior and therefore would require crafting rules pertaining to these instruments as envisioned by shari‘a. The next step would be to establish these institutions and to integrate them with the rest of the economic and financial system. In this process, either existing channels of distribution, i.e., banks or post offices, can be utilized to interact with customers, or new means can be introduced leveraging new technologies. Finally, there should be a mechanism to ensure enforceability of rules through transparent means.

The objective of the institutionalization of redistributive instruments is to formalize and standardize the operations to facilitate each instrument. For example, for *zakah*, *khairat*, and *qard hasan*, a formal network of institutions needs to be developed to collect, distribute, and recycle the funds in the most efficient and the most transparent fashion.[31] In some countries, points of sale such as automated teller machines (ATMs) or cash-dispensing machines are used to give customers the option of making donations or contributions on the spot, to make it easy for the customer to make such contributions. The financial institution can collect and aggregate funds and then disburse them to the needy through selected channels.

The use of *qard hasan* for the microfinance sector should be exploited further. Many of the characteristics of the *qard hasan*–based funds could be shared by micro-finance institutions. Therefore, the infrastructure of the latter can be utilized to effectively achieve the objectives of the former. While it is difficult to explain why this very important Islamic redistributive institution is so underutilized in the Islamic world—and requires some research efforts by sociologists and economists to investigate the behavioral causes—one can speculate that lack of knowledge, in the first instance, and concerns about the safety and security of the contributed principal may be important factors. The latter could be provided by a credible Islamic financial institution through issuance of financial instruments that would provide safety and security to the contributors. The Islamic financial institution can also instrumentalize the asset side of its balance sheet. Furthermore, it can provide *qard hasan* resources to existing microfinance institutions to reduce the burden of their interest rate charges on their borrowers. But how would such an Islamic financial institution cover its administrative costs? There are two possible sources:

a) Through investing a fraction of the mobilized resources; and
b) Through profit-sharing via *qard hasan* resources through which the Islamic financial institution invests in the productive investment projects of young entrepreneurs that have no access to formal credit markets.

Policymakers need to pay attention to this set of tools to enhance access and they should encourage development of such institutions through the development of a legal framework to protect the institutions, donors, and stakeholders, and to ensure transparent governance. With well-developed redistributive institutions supplemented by formal and semi-formal sector financial institutions, one would expect a more effective approach to poverty reduction.

FINANCIAL ENGINEERING

Financial innovation and engineering have changed the face of the global financial landscape in the last three decades. Although some of the innovations have been criticized and have been the source of volatility in the markets, their positive contribution cannot be denied. There is no reason why financial engineering cannot be used in the area of financial inclusion and to enhance financial access. One way could be to introduce the application of securitization to securitize assets generated by microfinance and SMEs. *Sukuk* (Islamic bonds) are a successful application of securitization and, working along the same lines, a marketable instrument can be introduced to provide funding for much needed microfinance and SME financing. With the introduction of securitization of microfinancing and SMEs, financial institutions will be able to pool their assets and issue marketable securities. In this way, they will share the risks with the market as well as free up the capital for further mobilization of microfinancing and SME financing.

Several researchers have put forth ideas of formalizing and institutionalizing Islamic modes of redistribution through an integrated approach by applying financial engineering and by combining different modes. These approaches include establishing a nonprofit financial intermediary based on the *qard hasan* model or establishing microfinance institutions based on hybrid of *zakah*, *awqaf*, and *sadaqat*. The institution of *awqaf* (trust or endowment) was once a very well-established institution in Muslim societies but with its gradual decline, the institution lost its effectiveness. Policymakers need to encourage revival of these institutions and should encourage financial engineering to create hybrid solutions where Islam's redistributive instruments are mixed with market-based instruments to address the issue of sustainable development.

Let's take an example of financial engineering where a market-based solution is combined with a redistributive instrument to strengthen its viability in the market. As argued earlier, securitization could be used to securitize

MSME sector assets and to mobilize funding from the market. However, given the perception of high risk and lack of the credit enhancement tools that are a standard feature of conventional securitization, both the originators and structures shy away from the securitization of such portfolios. In addition to conventional credit enhancement techniques through trenching, one could raise enough funds based on *qard hasan* to provide an additional buffer of security to investors against the credit risk. If the securitized portfolio consists of micro-lending, a default by the micro-borrower could be covered by the *qard hasan* which could be forgiven if a business loss occurs despite the earnest efforts of the borrower.

Similarly, issuing an equity instrument on the portfolio of domestic development projects has the added advantage of improving domestic income distribution. Provided that these instruments are issued in low denominations sold in the retail market, these instruments can serve the households and firms in their attempts to hedge their idiosyncratic risks. In essence, they would be macro-market instruments similar to those proposed by Shiller.[32] These instruments could anchor the development of the high end of the risk spectrum.

The abovementioned innovative techniques should be explored further by Islamic financial institutions. Policymakers should aim to develop a financial system where financial innovation is encouraged but there are checks and balances as well as incentive mechanisms to avoid misuse of financial engineering. The availability of an enabling environment and supporting institutions are prerequisites and should be developed before such innovations can take place.

CONCLUSION

Risk sharing serves one of the most important desiderata of Islam: the unity of mankind. Islam is a rules-based system in which a network of prescribed rules governs the socioeconomic and political life of society. Compliance with these rules renders the society a union of mutual support by requiring humans to share the risks of life. Risk sharing intensifies human interaction. The dazzling pace of financial innovations in the several decades prior to the crisis created opportunities and instruments of risk shifting—where risks were shifted to investors, borrowers, depositors, and, ultimately, to taxpayers—rather than risk sharing. The financial sector became increasingly decoupled from the real sector with the growth of the former outpacing that of the latter by double-digit multiples.[33]

Instruments of Islamic finance allow risk sharing and risk diversification through which individuals can mitigate their idiosyncratic risks. On the other hand, mandated levies, such as *zakah*, are means through which the idiosyncratic risks of the poor are shared by the rich as an act of redemption of the former's property rights in the income and wealth of the latter. Other recommended levies beyond those mandated, such as *sadaqat* and *qard hasan*, also play the same role. They help reduce the poor's income-consumption correlation. In other words, the poor are not forced to rely on their low- (or no-) level income to maintain a decent level of subsistence living for themselves and their families. It is possible that at some point in time even these levies can be instrumentalized to be included in the full-spectrum Islamic finance menu of instruments for risk sharing. In that event, Islamic finance becomes a risk manager of the society.

Islamic finance's instruments of risk sharing will help blunt the impact of economic shocks, disappointments, and suffering on individuals by dispersing their effects among a large number of people. It will have instruments of finance available for all classes of people to allow them to reduce their idiosyncratic risks and smooth their consumption. It will ensure that innovators, entrepreneurs, and small and medium-sized firms have access to financial resources without the need to take all risks on themselves or, alternatively, abandon productive projects altogether. It will have instruments of insurance that not only provide protection against health and accident risks but also insure against risks to livelihood and home values to protect people's long-term income and livelihood. Such a full-spectrum Islamic finance can then truly be said to have "democratized finance" without transferring risks of any venture to a particular class or to the whole society. This would be in sharp contrast to the results of the "democratization of finance" project that led to the recent global financial crisis of the conventional system, in which the risks of financial innovations were shifted away from financiers. The consequence was that while the gains of this "democratization of finance" project were privatized, its pain was socialized.[34]

Given the rules governing property rights, work, production, exchange, markets, distribution, and redistribution, it is reasonable to conclude that in an Islamic society—a rule-complying and "God-conscious" society—absolute poverty could not exist. It can be argued that there is no topic more emphasized in Islam than poverty and the responsibility of individuals and society to eradicate it. The Prophet Muhammad said that poverty is near disbelief. It is almost axiomatic that in any society in which there is poverty, Islamic rules are not being observed. It means that the rich and wealthy have not redeemed the rights of others in their income and wealth and that the state has failed to take corrective action.

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PART II

Ethical Financing and Global Economic Development

Toward a New Socio-Legal Framework for Faith-Based and Socially Responsible Investments

Umar A. Oseni

INTRODUCTION

The aftermath of the recent global financial meltdown has rekindled the increasing need to positively harness faith-based investment (FBI) initiatives in the global economy. Since the recent crisis, there has been a paradigm shift in investment strategies. One important strategy that has increasingly dominated the global economic scene is socially responsible investments (SRIs), which to a large extent have a number of areas of convergence with faith-based investments.[1] It is important to clarify at the onset that the term "faith-based investments" is used in this paper to refer to those investment models introduced or practiced by faith communities across the world with particular reference to common grounds identified in the finance models of Islam, Christianity, Judaism, Buddhism, and Hinduism, respectively. Even though there are notable differences between faith-based investments and socially responsible investments, which are identified in this study, there is no need to argue about these differences, as rightly suggested by Siddiqi, because all faith-based investments satisfy most of the SRI criteria but not all SRIs are faith-based investment models.[2] But it is useful to recall that SRI itself had its roots in religious institutions.[3] According to Ciocchetti, "[r]eligiously-motivated investing (RMI) is a rapidly evolving core component of the larger socially responsible investment community."[4] Such "religiously-motivated investing" may also be regarded as faith-based investing or faith-consistent investing.

Meanwhile, the events that led to the recent financial downturn in the global economy call for concerted efforts to safeguard the economy from future meltdowns through the implementation of proper paradigms that address the socioeconomic needs of humanity while transcribing the beliefs of faith communities into meaningful financial practices.[5] According to the

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Umar A. Oseni, Assistant Professor, Faculty of Law, International Islamic University Malaysia, Kuala Lumpur.

Gallup Report of 2011 on the religiosity index, nine in ten Americans believe in God.[6] The religiosity index in most countries plays an important role in structuring SRI models even though such paradigms are not necessarily faith-based investments.

This has led to many initiatives at the micro level in the faith community, but Islamic finance seems to have distinctively captured global attention in the past few decades. The positive effects of globalization as a neutral notion should usher in a new global economic paradigm where the faith community is allowed to play a more active role based on shared principles of investments that promote the objectives of SRIs. The efforts of the faith-based community have led to many initiatives at the micro level, but Islamic finance seems to have distinctively captured global attention in the past few decades. The positive effects of globalization as a neutral notion should usher in a new global economic paradigm where the faith community is allowed to play a more active role based on shared principles of investments that promote the objectives of SRIs. At the micro level, the efforts of the faith-based community economic development (CED) seem to have recorded tremendous successes in the United States.[7] Against the foregoing backdrop, this paper examines the common ground among the faith communities. While this study seeks to give some preliminary remarks on the issues enumerated above, most of the questions require further deliberation and consensus by experts and policymakers to forge ahead with the proposal.

THE GLOBAL ECONOMY AND FAITH-BASED INVESTMENTS

The global faith community consists of a number of religious traditions. A number of them share common origins, such as the Abrahamic faiths and Dharmic religions.[8] However, it may not be possible to examine every religious tradition in the process of identifying shared ethical values that can be incorporated into the global economy. A focus on a few religious traditions may provide a general outlook on what others represent. Hence, this discussion paper focuses on four major religious traditions: Judaism, Hinduism, Christianity, and Islam.

A cardinal question this study seeks to address is the relevance of faith-based investments to the global economy. The phenomenal rise in faith-based investments in the last decade has reinvigorated SRI initiatives despite the differences between the two concepts. The propensity of faith-consistent investors to only invest in stocks that are compliant with their religious beliefs is now well known and well researched.[9]

Many of the teachings of religion are truisms that remain principles that are important for the success of any business. The meaning of some religious terms and principles, of course, may be subject to disagreement on their application at times. For example, Islamic finance is a type of faith-based investment. It overlaps with ethical investment. The basic idea is that profit maximization is not the only criterion, because certain ethical or moral goals or limitations are incorporated into investment decisions. There are various forms of faith-based investing depending on the faith and the ethical precepts employed to guide or restrict investment decisions. Most religions teach moral norms that are almost universally accepted. Unless a person wishes to lead an unethical life, there would be at least some principles that the person would have to follow. Religion offers a set of principles that are easily identifiable. Additionally, ethical business would in the long run increase the profits of a business when conscientious investors recognize it as a green business.

One cannot agree more with Finn, who argued, "Faith-consistent investors . . . have a window of opportunity, through the leverage afforded by their vast and varied financial holdings, to press for changes in regulations and corporate practice that would foster a more sustainable, ethical, and equitable global economy."[10] This invariably makes a case for the relevance of faith communities in the global economy.[11] Merging faith and finance is a step in the right direction, though necessary safeguards must be put in place

Table 1: Major Differences/Similarities between Islamic Finance Investments and SRIs[14]

	Islamic Finance Investments	SRIs
Origin (D)	Islamic ethical principles of commercial transactions. Qur'an and *sunna* are extrapolated to emerging issues through legal interpretation	No unanimously agreed-upon origin. Different origins include Christianity, common practices of the Quakers and Methodists, Jewish law, etc.
Faith-Based Rules (D)	Faith-based rules are derived from the primary sources of shari'a	Not faith-based but based on certain ethical principles that are self-delineated
Definition of Limits (D)	Clear definition provided in the primary sources of Islamic law	There is no universally acceptable definition of the action limits of SRIs
Supervisory Committee (D)	Shari'a supervisory boards are set up to ensure shari'a compliance	Usually not applicable, but in some cases ethical committees are set up
Restrictions on Investment Management (D)	There are restrictions on the use of some financial instruments and investment activities such as derivatives that involve speculations	Generally, there are no restrictions on investment management
Shareholder Advocacy as Management Strategy (S)	Shareholders are allowed	Shareholders are also allowed, particularly in North America
Screens Based on Environmental Filters (S)	Available in theory but gradually gaining ground in practice	Available as a matter of practice

* D = Differences S = Similarities

to avert future economic crisis. Building bridges across major faith traditions on business and investments would provide such ethical safeguards.[12]

Even though faith-based investments may be likened to SRIs, there are some notable differences. For instance, "[o]ne main difference between a faith-based fund and a typical socially responsible fund is that many faith-based funds avoid business involved with abortion, whereas most socially responsible funds do not include abortion as part of the screening factors."[13] This modern trend does not blot out the historical links of SRIs to faith-based investments. Figure 1 singles out Islamic finance as a faith-based model for comparison with SRIs. The first five areas compared represent the differences while the last two issues highlight some areas of convergence between Islamic finance investments and SRIs.

PARALLELS: FAITH-BASED INVESTMENTS AND SRIs

Though there are many parallels among the faith communities, this study focuses on five key issues that represent common ground among all the faith-based investment strategies similar to the SRIs. These are: community development, shareholders' activism, global development, ethics, and environment. Focusing on these key issues, particularly during an economic downturn, will push for a new global paradigm for economic development. However, it is important to focus more on how RMIs and SRIs can be harmonized to forestall future economic crisis.

COMMUNITY DEVELOPMENT

Most religions tend to focus on human development within a society, which is expected to positively impact the society. Religious practices and rites are mostly performed in a communal way to emphasize and reinforce the bond between the people and the society within which they live. On the other hand, it is also known that one of the main pillars of SRIs is community development or investing where investments are structured in a socially responsible manner that would contribute to the development of the society. When one considers the history of SRIs, it would not be out of place to conclude that the objectives of community investing in both the SRIs and faith-based models are analogous. In a typical model of community investment, the financial needs of the low-income earners are met through properly managed programs. The much-needed capital is often provided for micro-enterprises and affordable housing. Wilkinson defines faith-based community economic development thus:

> Faith-based community economic development may be defined as the involvement of faith-based institutions in projects designed

> to revitalize their communities, establish sustainable economic development initiatives, attract investments, build wealth, and encourage entrepreneurship. In order to launch their projects, faith-based institutions often form a separate nonprofit community development corporation (CDC) or partner with an existing CDC, foundation, local government, or other faith-based institution.[15]

There are a number of faith-based initiatives that are directly targeted at community development. For instance, a number of faith-based community economic development initiatives have been documented by researchers commissioned by the Public and Community Affairs Department of the Federal Reserve Bank of Boston.[16] In this report, three successful examples of faith-based community economic development initiatives—the REACH program of Greater Christ Temple (Meridian, MS); the Revolving Loan Fund of First AME Church (Los Angeles, CA); and NOI Security Agency, Inc., of the Nation of Islam (Washington, DC)—were analyzed.[17] The findings of the report reveal three significant common traits despite the differences between the three models. First, they all address and solve an existing problem or need. Second, they all participate in growing markets through micro-enterprise initiatives. Third, they do not require skilled labor or employees with extensive formal training.[18] Focusing on such emerging markets would reduce the harsh effect of the downturn on the low-income earners and provide them with sustainable alternatives in the long run.

The faith-based initiatives explained above show quite a good congruence with the SRI initiatives. In essence, SRIs focus on investments that yield social good, such as poverty alleviation and financial inclusion of under-served communities. Green or sustainable businesses have a positive impact on the global environment, community, and the economy as they seek to meet the "triple bottom line": people, planet, and profit.[19] When these principles are transposed into the global financial setting with the synergy from faith-based initiatives, the world may be moving toward a new global paradigm. The "triple bottom line" concept is "an inspiring metaphor that challenges contemporary corporations to meet economic, environmental, and social goals simultaneously."[20] Therefore, while strongly interrelated, the contextual bases of SRIs and faith-based initiatives are fundamentally different. But the convergence of the initiatives in terms of green businesses for community development is a good starting point for global economic initiatives.

From the Islamic perspective, the Islamic microfinance model can be harmonized with the conventional microfinance initiatives when the model is structured in a way that reflects the religious beliefs of the target group. While the former is a faith-based investment initiative, the latter is an SRI program, both targeted at the low-income earners who are financially excluded from traditional financial services including credit facilities.[21] Harmonizing best practices in microfinancing will present a golden opportunity for community development models that are most suited to a particular category of people. There are conventional microfinance projects in countries like Afghanistan, Bangladesh, and Yemen. In Afghanistan, there is the Microfinance Investment Support Facility for Afghanistan (MISFA), which had 230,195 active borrowers as of October 31, 2011.[22] Even though MISFA is a conventional model of microfinance targeted at community investing through microcredit facilities, there are initiatives to harmonize its current models with the demands of the people to reflect common values in community investing. A path toward sustainability in community investing represents the development initiative that would consider the moral and ethical values of the people. Considering the conservative disposition of most people in rural societies, values-guided initiatives that agree with the people's ethos and values should form the bulk of community development initiatives. As part of the research and development initiatives of MISFA, actionable research on product development is being carried out to support the microfinance institutions operating in Afghanistan. Based on client demand, MSFA has developed some financial services such as shari'a-compliant agriculture/livestock loan products.[23] This is a good example of harmonization of best practices from faith-based microfinancing and SRI.

In a similar vein, other faith communities have explored ways to develop their immediate community through socio-religious initiatives. For instance, the Liberty Trust of the Liberty Church in New Zealand has been promoting community economic development through interest-free initiatives, which nearly cost it its charitable status under the extant laws of New Zealand.[24] Since 1989, when Liberty Trust was established, it has given out interest-free mortgages to over 290 households and churches.[25] In order to emphasize the role of religion in finance and the economy at large, Liberty Church chronicled what it refers to as "Bible Study on Finance" on its website. This website contains a long list of issues ranging from debt to mortgage, environmental stewardship, and community investing. With particular reference to community investing, Liberty Trust targets students, singles, corporate bodies, and those in financial difficulties in society generally. The funds of the Trust are mainly derived from donations and they are used in building an interest-free storehouse to assist other people.

Furthermore, the initiative of the Jewish Funds for Justice (JFSJ) reiterates the thin line between faith-based investing and SRIs. Though originally created in 1984, it was transformed to its current form in 2006 when it merged with the Shefa Fund. Though JFSJ is grounded in religious principles, it claims to be an SRI program specifically targeted at modest investors.[26] Based on the concept of *tzedakah*, community investing is considered a support for economic justice. Such focused investments are considered both philanthropy and justice in Judaism.[27] In addition, JFSJ encourages its investors to consider lower interest rates and if possible a zero percent interest rate to conform to the Hebrew tradition of free loan. It appears this Jewish approach to transform the community is not in any way different from the Islamic or Christian initiatives in terms of their respective objectives.[28] The activities of the Bhumi Project of the Oxford Centre for Hindu Studies is aimed at service to the community that also reenacts the community development initiatives in other faith-based models.

GLOBAL DEVELOPMENT

As a shared objective of religiously motivated investing and SRIs, global development involves targeted investing in companies that undertake international operations. While SRI is a global phenomenon, faith-based initiatives also try to foster global development through cross-border initiatives. The distinctive values and attitudes concerning global development are translated across faith communities, especially with the increasing nature of social and commercial intercourse among people of diverse backgrounds. For instance, the Bhumi Project of the Oxford Centre for Hindu Studies is developing "a set of standards based on the principle of *ahimsa* (non-violence) that will assist the community in ethical buying in line with its ethos and values."[29] This concept does not only apply to human beings, but also to animals. So, going by the Hindu traditions, meat from a slaughtered animal is not to be consumed by man since such an animal was hurt in the process. While this seems like a community initiative, it has global implications for ethical buying within the Hindu community and probably for vegetarians who do not eat meat or other animal products for religious, health, or ethical reasons.[30] Similarly, there are a number of overlapping values in Islamic investing and buying where ethical practices are encouraged. The *halal* labeling is assuming a global dimension where Muslims, particularly those who live in Western countries, prefer *halal* products. This brings to mind the significance of ethical investment in trans-boundary movement of food products.[31] This, remarkably, triggered the "exportation" of Islamic finance products and investments from the Arab world and Southeast Asia to elsewhere. These practices are not different from the ethical business initiatives introduced about three centuries ago that heralded modern SRIs. In the modern globalized world, rather than focusing on individual ways of promoting social and ethical investing among faith communities, a step further should be taken to maximize the positive synergies across faith communities. For instance, when the Charity Trust in New Zealand collaborates with other faith-based initiatives such as that of the Federation of Islamic Associations of New Zealand (FIANZ), one should expect a robust model that would transform the economy of the country. This has the potential of ushering in a new global paradigm for ethical investing acceptable to all despite the existence of some theological differences. Global development may be another important way to promote "global ethics containing a set of minimums on common values, standards, and basic attitudes by a fundamental consensus of representatives of the world's religions."[32]

Multinational companies must enhance their corporate social responsibility role to promote global development. The approach of Father Finn in promoting faith-based SRIs is a good match between the two concepts of faith-based investments and SRIs. The global financial crisis affects virtually the whole world; hence, the solution to the crisis should also be global through concerted efforts among stakeholders. The faith communities, being one of the main stakeholders in the global economy with faith-consistent investments worth billions of dollars, "have a window of opportunity, through the leverage afforded by their vast and varied financial holdings, to press for changes in regulations and corporate practice that would foster a more sustainable, ethical, and equitable global economy."[33] The necessary prerequisites to sustainable global development involve social investing with prudential supervision based on principles of faith-consistent investing. There is no doubt that "we need wise prudential supervision in the West and in the East, because the financial crises that our children face will be global and will require a global solution."[34] Such a global solution is not the exclusive prerogative of economists and financial experts. The faith communities must lend their voices and make their much-needed contributions to the ongoing efforts to engender sustainable social investing or green business that would not only cater to the present generation but also take into consideration the interest of future generations.

ENVIRONMENT

Sustainable investments and green business also critically take into consideration the environmental impact of certain business activities. As part of the key pillars of SRIs, corporate governance policies are directed toward promoting environmental stewardship.[35] This is a practical necessity in a world that seeks to promote sustainable development. Economic growth must be sustained through environmentally sound policies.[36] After all, without a sound and healthy environment, business activities cannot thrive and economic growth would be stunted. Viewing the economy from the environmental prism unravels the need to promote conservation of the environment to boost business transactions. Dam and Heijdra aptly capture the modern notion of investing with special reference to SRIs:

> The notion nowadays is that many investors do not only care about cash flows, but also about how these cash flows are generated. An investor might, for example, abstain from investing in firms that use child labor or adopt heavily polluting technologies. The

> modern investor thus distinguishes between "sin stocks" and clean investment opportunities.[37]

This increasing awareness among investors has rekindled the importance of green business or social investing. To this end, terms like "green shares" and "green investing" have been couched to reflect the need to promote SRIs in an increasingly troubled global economy.[38] A good example of the interrelationship between business and the environment and the increasing awareness among the people of the need to promote green business was the reason for the cancellation of Dow Chemical's sponsorship contract of the 2012 London Olympic Games. The reason for such repeated calls from the Indian government and the India Olympic Association against Dow was due to a company owned by it, the US-based Union Carbide Corporation, which was responsible for the 1984 Bhopal gas tragedy in India.[39]

Similarly, there are instances of outright boycott of certain products as a result of their perceived linkages to environmental degradation. In recent years, such successful boycotts include dropping kangaroo meat from major UK stockists in 2009, ending Book Trust's sponsorship deal with Nestlé in 2008, ending Wildlife Photographer of the Year Award's sponsorship deal with Shell in 2008, and the withdrawal of the sale of bluefin tuna by Auchan, Carrefour, Co-op, and ICA supermarkets in 2008.[40] These boycotts do not have religious undertones but are purely environmental concerns that are required to be taken into consideration in the business plans of such companies. These SRI environmental concerns are shared values among the faith communities.

The imperatives of conservation of environment are rooted in Islamic principles, which are jurisprudentially extended to business transactions.[41] Cardinal concepts of sustainable development as recognized in Islam include ecological balance (*mizan*), vicegerence (*khilafah*), prevention of harm (*mafsadah*), sustaining beneficial practices (*maslahah*), and social security and mutual assistance (*takaful*).[42] There are ample regulations on the conservation of environmental resources in Islam.[43] These include clear-cut rules about water usage, prevention of air pollution, protection of vegetation and conservation of forests, care for animals, and proper waste management.[44] "Though development is necessary for human progress, the impact of such development on the environment must be given due consideration. This is where the sustainability principles in Islam come to play to adequately balance the need for development and the conservation of the environment."[45]

The traditional Christian perspective on the environment vis-à-vis ethical investing is similar to the Islamic perspective. In Christendom, it is believed that God has blessed the world with the environment and whatever it contains. So, it is the responsibility of mankind to protect the earth's resources through prudent financial decisions. Christians are encouraged to invest in companies that endeavor to protect the environment. This is the core of ethical investing. In fact, this takes us back to the history of SRIs, where churches came up with policies that encouraged their members to shun businesses involved in gambling, alcohol, tobacco, pornography, weapons, and illicit drugs. Making money in ethical ways is compatible with the religious teachings of Christianity.[46] For instance, Christian Super, a not-for-profit industry fund in Australia, has been at the forefront of introducing a biblical ethical framework for investing. The negative screen of Christian Super includes the production of goods and services "with addictive, violent, or harmful effects on people," and activities that have harmful effects on the environment, including nuclear energy and its sources.[47]

Judaism also has a rich tradition of human interaction with the environment.[48] There are beneficial ideas in the Jewish tradition that may contribute to the discourse on environmental ethics with particular reference to social investing.[49] Since humans share the same origin with nature, it is the responsibility of the former to protect and preserve the latter in all ramifications.[50] A number of Jewish concepts point toward a sustainable environment. These concepts include: alienation from the natural world; the command to humanity to subdue the earth; rituals and commandments regarding environmental regulations; the treatment of animals; and *bal tashchit* (do not destroy).[51] To this end, Arthur proposes a new theology for the Jewish Reform movement that takes into account social and environmental concerns. This is specifically proposed for Jewish business leaders to promote eco-friendly investing.[52]

The Hindu perspective on green business and sustainable development, with particular reference to the environment, is based on *Atharva veda*, the sacred text of Hinduism. Hindus believe the sacred text is "the first of its kind of scripture in any spiritual tradition where the concept of respect to the earth has been propounded."[53] A clear conception of environmental ethics includes respect for the earth's resources, the interdependence of humanity and nature, and proper sanitation.[54] Environmental conservation is practiced as a way of life (*dharma*), which is ingrained in people's daily lives and social institutions to ensure sustainable development.[55]

ETHICS

While discussing ethics, focus is directed at examining specifically the business ethics and moral values that would assist in sharpening and enhancing global practices in the financial industry.[56] We need to consider major ties that bind the faith communities in order to unravel distinctive overlapping values that could form the basis of further discussion of a new global paradigm that merges faith-based initiatives with SRI initiatives.[57] Quddus, Bailey, and White give perspectives on business ethics from three

Abrahamic faiths—Judaism, Christianity and Islam.[58] In the research, they examine the provisions of the legal codes of the three religious traditions on a number of ethical issues in business transactions such as bribery, corruption, fraud, cheating, discrimination, and rights of employees, customers, and stakeholders.[59] One of the important areas identified for future research directions is the relevance of the moral values in religious codes to the global economy. Ethical values represent a general theme that runs across financial communities, which initially spurred the introduction of SRIs.

From the Jewish tradition, the ethical values for economic activities are based on the age-old ethical system of laws and customs in Judaism.[60] Jewish business ethics[61] include provisions for private property, competition with compassion, and social welfare, and prohibition of theft and fraud.[62] The prohibition of usury is contained in the Judeo-Christian traditions. Interest on loans is prohibited: “If you lend money to any of my people with you who is poor, you shall not be to him a creditor, and you shall not extract interest from him.”[63] These laws were put in place to avoid economic hardship on the part of the less privileged or unjust enrichment from someone else’s misery. Other underlying principles in Jewish business ethics include mercy toward debtors, protecting the less privileged against theft and fraud in society, and making charity an obligation.[64]

Similarly, the principles of economic justice and mutual assistance are core biblical concepts that permeate modern church-related business ventures. From the Catholic tradition, moral economy has been the core issue in its social thought. The social encyclicals of successive popes since the 1870s raise issues about “just wages and the morality of capitalism.”[65] In fact, this is considered the first stage of “ethics in business” in the history of business ethics in the United States.[66] There is a clear reminder in the encyclical of the importance of ethical business in the world economy. It provides: “Efforts are needed—and it is essential to say this—not only to create ‘ethical’ sectors or segments of the economy or the world of finance, but to ensure that the whole economy—the whole of finance—is ethical, not merely by virtue of an external label, but by its respect for requirements intrinsic to its very nature.”[67] The encyclical has given the way forward in forestalling future global economic crisis: the global economy should embrace ethical values in all ramifications. This sums up the Christian perspective on ethical business shared by most other faith-based communities, which also replicates the ethical values advanced in SRIs.

Further, the Islamic perspective of business ethics may not be so different from the Judeo-Christian traditions. The Islamic concept of economics is built on ethical business practices that promote social justice, equality, circulation, and just distribution of resources.[68] According to Islamic economic principles, resources are not meant to be dormant or concentrated in the hands of a few individuals. This establishes a workable nexus between resources and development; hence, the concept of sustainable development in Islam is enriched by ethical rules from the moral values of Islamic religion. So, business ethics cannot be discussed in Islam without referring to economic development.[69] Clear and direct stipulations abound in the Qur'an on business ethics. These include the prohibition of exploitation in business transactions, which informs the proscription of *riba* (interest) in Islamic commercial law. In addition, fraud, cheating, excessive speculations, gambling, and discrimination are expressly proscribed in Islamic law. As an alternative that would promote economic activities resulting in mutual benefits, commercial transactions are permitted through partnerships and entrepreneurship. These principles form the bedrock of the modern practice of Islamic finance.

The Hindu ethical values regarding business transactions reflect common principles in other faith communities.[70] "Hinduism provides a rich framework within which the dimensions of business and business ethics find their own footing."[71] Such business ethics include benevolence and honesty. There is much emphasis on the deed itself, which should serve social purposes rather than profit maximization. This is based on a Hindu maxim: "Your business is with deed and not with the result."[72] This emphasizes the maxim of "principle before profit." In addition, *ahimsa*, which means there should be no harm or injury in dealings with others, including business transactions, is another Hindu principle that is analogous to other faith communities.[73] These are ethical values that are common to the other faith communities already discussed. What is required is a step toward emphasizing these shared principles and adapting them to the modern economy with a view to creating a just global economy.

SHAREHOLDER ACTIVISM

Shareholders of a company can collectively use their powers to bring positive positive changes in corporate behavior toward social responsibility. "The two basic options are the use of shareholder resolutions (proxy voting at annual general meetings of corporations) or engaging in (usually private) dialogue with the management of companies on various issues."[74] There is a link between shareholder activism and corporate governance, especially when it comes to repositioning the corporation toward its corporate social responsibility. In the Islamic finance industry, shareholder activism is a requirement of Islamic investors. Muslim jurists consider ownership of shares in a business corporation as a transaction of partnership (*shirkah*). So, Islamic investors have the right to participate in the business through shareholder activism and voice their opinions on certain policies or transactions of the corporation.

The above agrees with the SRI and Christian perspectives of shareholder activism. For instance, shareholders in an automotive corporation may file shareholder resolutions to pressurize the company to reduce auto emissions, either through the manufacturing of green cars (electric or hybrid cars) or by recalibrating the emission rate of automotive engines to drastically reduce carbon emissions. It is also possible for SRI and Judeo-Christian funds to deliberately invest in certain companies that undertake "objectionable" business with a view to influencing and turning around the business of the company through shareholder resolutions, thereby embracing green business.[75] Even in the Hindu traditions, shareholders will necessarily move against a company that pollutes the earth. Though one may run the risk of over-generalization, the Judeo-Christian and Islamic principles that prohibit the consumption of pork and the prohibition in Hinduism of the consumption of beef,[76] taken together, may form the basis for prohibiting pork in its entirety in the business of a company. Though the possibility or limits of combining exclusive and inclusive screens may pose a challenge to such initiatives, it is left for the promoters of such corporations to agree on common values. Apart from very few instances, most faith communities agree on the objectives of green business. So, the shareholders can collectively unite and pass a shareholder resolution to influence the corporation to change its course from the current trajectory to more socially responsible and religiously acceptable business.

PROPOSAL FOR A SOCIO-LEGAL FRAMEWORK FOR GREEN BUSINESS

There is no doubt that a good socio-legal regulatory framework for green business championed by FBIs and SRIs would go a long way toward promoting impact investments in the society. To this end, the first step is to establish a regulatory framework for building bridges across financial communities in order to foster economic development. Though some believe that such a proposal appears too ambitious, as each of the financial communities has its unique traditions, one may still argue that there are a number of shared values that could be identified and streamlined to suit common needs. It is possible for the FBIs and SRIs to maintain their individual traditions. Even within the FBI community, there are diverse practices based on various religious traditions. However, the imperativeness of impact investing, value-driven initiatives, and role of law will tremendously change the outlook of things when the individual traditions are viewed through a global prism.

BUILDING BRIDGES ACROSS FAITH-BASED INVESTMENT MODELS

There have been several individual and institutional initiatives to build bridges across the faith communities, especially on the subject of religiously motivated investments, which are meant to promote key aspects of SRIs. The CED report mentioned earlier is a good example of ongoing efforts toward identifying the distinctive values and ethics of business that can be translated across faith communities. One thing the faith communities promote is the responsibility of corporations to the society within which they operate. This provides the impetus for "making business more socially responsible"[77] through corporate social responsibility (CSR).[78]

Though many faith-based investment models, including Islamic finance, are not averse to profit maximization, there is emphasis on the need to optimize social, environmental, and ethical requirements in business. These are SRI requirements, which are overlapping principles in the faith-based models. From the faith communities, there are many overlaps in the screening criteria of Islamic and Christian funds.[79] In fact, "[a] new faith-based index introduced in 2008 is the Dow Jones Dharma Index, which targets members of Dharmic religions. The key concepts that it follows are non-violence, environmental stewardship, caring, purity, and self-control."[80] Perhaps the Dow Jones Islamic Index could have been harmonized with the defunct Dharma Index in areas where the faith communities agree to produce a new global index of ethical stocks. But, unfortunately, the Dharma index failed despite the determined efforts of Dow Jones. This would have enhanced the acceptability of the Dow Jones Islamic Index on the one hand and the Dharma Index on the other. What should be discussed as the way forward is summarized in the encyclical on faith-consistent investment models, which provides that

> [S]pace also needs to be created within the market for economic activity carried out by subjects who freely choose to act according to principles other than those of pure profit, without sacrificing the production of economic value in the process. The many economic entities that draw their origin from religious and lay initiatives demonstrate that this is concretely possible.[81]

Creating the necessary synergies across faith communities is important for a new global economic regime. Investors from different faith communities are united on a number of ethical issues. Identifying the common elements shared by faith communities provides the basis for further discussions on how to effectively build and solidify bridges to promote best practices in the global economy.

LAW AND THE SIGNIFICANCE OF GREEN BUSINESS IN ISLAMIC FINANCE AND SRIs

Of late there has been a gradual but powerful paradigm shift in Islamic finance investments. Perhaps such investments have been largely influenced by the increasing importance of green business in the 21st century. But a major challenge that cropped up along the way is the need to strike a fair balance between the values-driven and profit-driven motives in fiduciary relationships in FBIs and SRIs. There is no doubt that a central ethical imperative in the modern world in business investments is the need to build a new global economic paradigm that is not only economically viable but also socially and environmentally sustainable. In doing this, law plays a cardinal role.[82]

There is a growing interest in what is known as "green *sukuk*," which is the term used to refer to Islamic investment certificates that seek to promote social responsibility or impact investing. According to the Climate Bonds Initiative, the Clean Energy Business Council of the Middle East and North, green *sukuk* are "shari'a-compliant investment securities that finance projects meeting eligibility criteria developed by the International Climate Bond Standards scheme."[83] While the new green *sukuk* initiatives meet the requirements of SRIs, the additional layer in its approval is undoubtedly the shari'a compliance element. A good model of the combination of SRIs, FBIs, and impact investing initiatives is the green *sukuk* targeted at investing in projects relating to renewable energy. These clean energy investments initiatives are gradually gaining momentum in the Middle East and North African (MENA) region. The Climate Bonds Initiative, the Clean Energy Business Council of the MENA region, and the Gulf Bond and Sukuk Association launched a Green Sukuk Working Group on March 5, 2012.[84]

A number of green *sukuk* have been proposed recently. According to a recent survey, "[n]ew innovative financial products are emerging, such as green *sukuk* (environmentally friendly Islamic bonds), which is supported by the World Bank and the Islamic Financial Services Board."[85] This over $15 billion sector of the Islamic finance industry would enhance the drive toward a greener and sustainable Gulf.[86] While there are ongoing efforts to issue green *sukuk*, the First Energy Bank (FEB) has been established in Bahrain; the FEB's areas of investment include renewable energy. FEB is licensed under the Central Bank of Bahrain and it has a standing shari'a board comprising three leading scholars in the global Islamic finance industry.

As shown in Table 2, there are ongoing initiatives to develop clean energy through some shari'a-compliant financing initiatives. "With Saudi Arabia planning investment of at least USD 100 billion into clean energy resources over the next decade, and the UAE and many other MENA countries following suit, there are substantial and viable projects in the region that are ideally suited to *sukuk* investors."[87]

Apart from deliberate measures to invest in green *sukuk*, the existing retail and commercial Islamic banks should adopt simple green policy in their transactions. This includes the requirement for environmental impact assessment for all major projects involving *istisna'a* (manufacturing contract) and social relevance of commercial transactions ratified by the

Table 2: Clean Energy Initiatives in the MENA Region

Jurisdiction	Proposed Investment (USD)	Project	Originator
Abu Dhabi (UAE)	600 million	100 MW Shams CSP	Abu Dhabi Future Energy Company (Masdar)
Bahrain	2 billion	Diverse investment activities relating to sustainable energy	First Energy Bank
Kuwait	2.5 billion	Electricity from sustainable sources	Government
Morocco	9 billion	Solar-thermal energy	Government
Qatar	1 billion	Polysilicon manufacturing plant	Qatar Solar Technologies
Saudi Arabia	100 billion	5 GW of solar-generated power	Government
Tunisia	2.79 billion	40 solar energy projects	Public-private partnership

shari‘a boards. To achieve this, there is a need for an enabling legal backing through statutory enactments or regulations issued by the apex banks to compel Islamic financial institutions to adopt such green policies. For instance, a development activity undertaken by a financial institution that involves the destruction of wetlands and coral reefs or further depletion of the ozone layer through carbon emissions should necessarily be avoided in furtherance of the green policy. This is in compliance with the legal maxim in Islamic jurisprudence: “Harm should be eliminated” (*al-darar yuzal*).[88] This empowers the regulatory body in a country to introduce appropriate legal mechanisms to protect the socioeconomic and environmental fabrics of society.

THE ROLE OF LAW IN ENSURING “IMPACT INVESTING”

There is a gradual paradigm shift from SRIs toward impact investing and this has called for an enabling law to promote such investments. This is related to social entrepreneurship, which is another term for impact investing.[89] It has been suggested that there should be socially responsible investment law or social impact investing law to complement the fundamental objectives of SRIs. In his review of Richardson’s *Socially Responsible Investment Law: Regulating the Unseen Polluters*, Williamson aptly observes:

> SRI can be made more widespread when governance mechanisms interact with and are supported by formal regulation. In practice, this means that self-regulatory mechanisms (e.g., voluntary codes, performance measurements using market indexes, pressure from activists) can be made more effective when they are supported by and interact with regulatory enforced mechanisms (e.g., reporting standards, tax incentives, additional fiduciary obligations on investment institutions).[90]

Proposals for impact investing have appeared threatening to mainstream investors. They argue that they need not pay attention to the social impact of their investment activities, as these are the duties of charities and the government.[91] Undoubtedly, a series of violations of ethical rules through the unethical environmental practices occasioned in some investments necessitates such an enforceable regulatory mechanism for impact investing, which seeks to serve two major objectives. First, it impresses upon the investors (and of course the corporations) of "mainstream investment in generating sustainable and equitable economic growth."[92]

It appears the transformative power of impact investing is inherent in FBIs, with particular reference to Islamic finance. However, it is often downgraded in the decision-making process, while more attention is given to shari'a compliance. It is therefore argued that the original value proposition of Islamic finance emphasizes social entrepreneurship or impact investing. But in practical reality, the case is different. A case that readily comes to mind is the labor camps involved in the construction of Burj Khalifa in Dubai.[93] In the overcrowded and disease-ridden labor camps, "it is common to find dozens of workers sandwiched in cramped, dirty living spaces. One activist says he recently visited a camp where he counted 39 in one room."[94] Incidentally, the construction of this tallest building in the world is being driven by an Islamic finance mechanism of *sukuk* (Islamic investment certificates), but it is believed that the project partly failed to uphold the Islamic ethical standards regarding proper treatment of employees. The wider social and ethical concerns in huge investments of this kind include questions related to the environment and labor rights. The Islamic finance industry must be interested in these issues in furtherance of the comprehensive principle of *maslaha*, which encompasses ethical and social values with an overarching emphasis on impact investing. This is apparently the original objective of Islamic jurisprudence. Hence, there is an extricable nexus between social responsibility, impact investing, and the law itself. Therefore, apart from investing in socially responsible investments, Islamic funds should go beyond negative screening by adding positive screening to its portfolios in furtherance of its original value proposition of social and ethical investments.

Hence, the law has a significant role to play in ensuring impact investment through mandatory provisions. There should be standard mechanisms for benchmarking impact investments. The performance metrics of each investor/corporation must be easily determined through such mechanisms. The Global Impact Investing Rating System (GIIRS) may be relevant in this regard. Complementing this with the imperativeness of law in ensuring impact investing would further establish common grounds between SRIs and FBIs in an increasingly competitive world. Having emphasized the imperativeness of law in enhancing SRI and FBI initiatives, there is a pertinent need for proper regulatory supervision to ensure compliance.

CONCLUSION

This study is meant to provoke further thoughts in order to come up with reasonable recommendations on how to move forward and identify a new course for the global economy with particular reference to ethical investing. At least for once, the global economy should be reexamined through the religious prism. This paper has examined how Islamic finance (and other faith-based paradigms) overlap with or complement socially responsible investment. It also brought to the fore the five key issues that are common to all faith-based investment strategies: community development, shareholders' activism, global development, ethics, and environment. Some modicums of ethico-legal and moral principles in the faith communities have been discussed to show the inherent nature of some of these principles in the faith traditions. Such best practices and synergies across faith communities can be translated into faith-based principles, which can be structured into viable commercial practices that will foster economic development and prevent future global financial crises. However, it is pertinent to observe that though there is a significant overlap between SRIs and FBIs, the two do not necessarily need to be brought together in a "forced marriage" to be effective. However, areas of convergence could be emphasized for a healthy dialogue. The shared goals and the two paradigms should be emphasized with a joint focus on their potential to reach members of the community through impact investing. Providing the necessary legal backing for these initiatives is essential to their successful orchestration in different jurisdictions across the world. From the Islamic finance perspective, social and ethical considerations are inherent in the original proposition of Islamic jurisprudence, which should reflect in the decisions of the shari'a boards.

A discussion that revolves around these questions should focus on the collaborative efforts among the faith communities to reposition the global economy. Identifying common ground is a step toward building bridges across the faith communities. It is not enough for the faith communities to continue to decry the unethical practices that led to the global financial crisis. They must provide a sustainable solution to rescue the global economy from a terminal crisis in future.

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Performance of Values-Driven and Profit-Seeking Investment Strategies

Vaishnavi Bhatt, Sajjad Shah, and Jahangir Sultan

INTRODUCTION

Two of the core alternative investment strategies today are faith-based and socially responsible investing (SRI). Faith-based investing (also closely related to morally responsible investing, or MRI) sets religiously motivated moral standards that guide an investor's choice of investing in a particular stock index,[1] screening for stocks, or mutual funds that cater to a particular style or theme.[2] Among the three Abrahamic religions (Christianity, Islam, and Judaism), there are a lot of similarities when it comes to setting a moral standard for work, living, property, investment, and personal relationships. In fact, a set of common unifying themes bind these religions together, especially for investment and economic functions. All three religions prescribe screening investments for certain social, moral, and personal values, in addition to profit motives (see Table 1).

For designing mutual funds, a portfolio manager needs to identify what really motivates a certain type of investors. From the perspectives of risk and return trade-off, it is important to identify whether investors care about values or profits. For example, one may wish to identify the segment of shari'a-compliant investors that is values-driven and the segment that responds more to profit motives. A study by Derwall, Koedijk, and Horst suggests that SRI investors[3] are not homogenous with respect to their shared expectations and goals for their investments. According to the authors, the market is divided into values-driven and profit-seeking SRI investors. As witnessed recently, SRI performance is usually viewed through the lens of corporate social responsibility (CSR). Values-driven investors invest in SRI stocks with the primary objective of adhering to values that typically

Vaishnavi Bhatt, Assistant Professor of Finance, Ramaiah Institute of Management Studies, Bangalore, India.

Sajjad Shah, Assistant Vice President, Wellington Management Company, Boston, Massachusetts.

Jahangir Sultan, Professor of Finance, Bentley University, Waltham, Massachusetts.

Table 1. Similarities among Religiously Sensitive Investment Strategies

Category	Judaism	Christianity	Islam	Hinduism/ Buddhism	SRI
Adult entertainment	X	X	X		X
Music			X		
Alcohol		P	X	P	X
Companies open on Sabbath	X				
Contraceptives/abortion		P			
Gambling	X	X	X	P	X
Highly indebted companies			X		
Interest	P	P	X	X	
Killing of animals				X	
Labor relations					P
Non-kosher food	X		X		
Nuclear power		X			X
Pork	X		X		
Stem cell		P			
Tobacco		X	X	P	X
Violence		P		X	X
Weapons and defense	X	X	X	X	X
Corporate social responsibility				X	
Environment					X
Corporate governance					X
Human rights					P

Note: X indicates no investment and P indicates partial investment.
Source: Compiled from various Internet sources including Credit Suisse (2011) and Ghoul and Karam (2007).

include ethical, moral, religious, environmental, and human rights issues. The second segment of investors' primary motivation is monetary return, suggesting that they care more about the profitability of investments than about deriving utility out of nonmonetary objectives. Rather, they expect SRI investments to provide better returns, especially over the long term, than comparable investments. This segment of investors mandates that these investments should provide additional profits because firms in this category have lower externalities, lower legal costs, and have a committed customer base interested in investing in firms that do good for society in general.[4]

Other explanations of SRI stocks providing superior returns include shunned stocks and the errors-in-expectations hypothesis. Accordingly, socially controversial stocks (shunned stocks) trade at relatively lower prices in order to offer investors higher expected returns. In contrast, the errors-in-expectations hypothesis predicts that SRI stocks can deliver superior returns due to the fact that investors do not incorporate CSR in valuing SRI stocks, especially in the short run. Over time, prices fully reflect all CSR practices.

Based on the preceding discussion, there are three distinct investment strategies that financial managers can incorporate into the design of financial products: values, shunned stocks, and profit motives. This study investigates the performance of mutual funds that promote values, irresponsible stocks (shunned stocks), and profit. While we focus our attention on shari‘a-compliant investors, we also compare their performance with both conventional and SRI groups of investors. Specifically, we use the shari‘a-compliant universe of stocks to design investment products that respond to values, shunned stocks, and profit screens. Subsequently, we evaluate the performance of these strategies using two other universes of stocks: conventional and SRI.

The remainder of this paper is structured to provide details about the framework of segmenting shari‘a-compliant investors into profit-seeking and values-driven categories to examine whether their behavior confirms the shunned stocks or errors-in-expectations hypothesis.

BACKGROUND AND LITERATURE REVIEW

It is interesting to note that the lines separating religious and socially motivated investment strategies are slowly disappearing. In other words, capital markets are slowly combining diverse religious and social principles for attracting various groups of investors interested in the social, religious, and moral aspects of investments. Jewish guidelines for investing are very similar to SRI and shari‘a-compliant investing. Foremost, there is a prohibition of interest-based lending among fellow men, which has been classified as the worst form of sin in the Torah, the holy book. Talmud encourages investments for community development. Furthermore, the Jewish investment principles discourage investment in pork, weapons, adult entertainment, and the non-kosher food industry, among others.

Christianity has always prescribed how its followers should live, work, and pray. A close examination of the teachings of the Christian religion reveals a number of familiar concepts that are also embedded in other religions, such as dignity toward human beings, doing good for society, sharing material possessions with those less fortunate, and living morally. There is an emphasis on prohibiting investment in morally reprehensible activities. In particular, the Catholic religion discourages investing in companies that promote pornography and alternative lifestyles, contraceptives (which violate the right to life), stem cell research, social injustice, inhuman treatment of animals, and anti-family entertainment. As Latkovic indicates, these activities are contrary to both Catholic moral teachings and the preservation of human dignity.[5]

The unitary perspective of life in Islam, which includes an economic system, essentially strives to establish harmony, equality, and balance between the individual and society as a whole in a worldly context, but also between the individual and God in a spiritual sense. Since the "rules governing permissible and forbidden economic behavior [. . .], as well as questions of property rights and of production and distribution of wealth, are all based on the fundamental Islamic concept of justice," it becomes evident that the notions of economic justice and equitable distribution of wealth represent two fundamental pillars of the Islamic economic system.[6] Islamic investment principles, governed by the teachings of the Qur'an and the *sunna,* promote social justice, fairness in business transactions, and personal moral responsibility. According to shari'a-compliant investing, there are prohibitions against investing in highly levered firms, firms earning income from interests, firms that promote pornography, firms producing weapons, and firms engaged in the business of pork, gambling, and tobacco (Credit Swiss, 2009). Since 1999, major Western stock exchanges have initiated listing Islamic indices, such as the Dow Jones Islamic Market Index (DJIM) and the FTSE Global Islamic Index Series, to promote the industry's development. In the US, the Shari'a Supervisory Board of the DJ Islamic Market Index (listed in 1999) ensures that the security universe is only composed of shari'a-compliant companies. As of January 24, 2012, the index included 2,599 companies from 55 countries with a total market capitalization of $16,476 billion.[7] According to a survey by Ernst and Young, by the end of 2010, while global assets under management (AUM) by mutual funds reached a level of $25.6 trillion (1st quarter, 2011), shari'a-compliant investment (SC) funds are estimated to manage about $52.3 billion.

Other than the aforementioned religions, Hinduism, Shintuism, Buddhism, Jainism, and Sikhism, to name a few, have similar goals with respect to investing ethics and norms that can be broadly classified as MRI. For example, Dharma, the code of religion for followers of Buddhism and Hinduism, calls for a "karmic" way of investing and managing wealth in an honest manner. According to the Hindu religious scripture (the Vedas), the four goals of life are *dharma* (religion), *artha* (wealth), *karma* (work), and *moksha* (spiritual freedom). All four goals are intertwined, contributing toward achieving *moksha* (spiritual freedom). Specifically, investment strategies as shaped by adherence to Hindu and Buddhist religions stress that the maximization of wealth should not come at the expense of *daan* (giving) and *daya* (compassion). For instance, the "dharmic way" of investing encourages investments in firms emphasizing *ahimsa* (non-violence) as popularized by Mahatma Gandhi. A variant of such a style of investing would demand that firms maximize profit without sacrificing employee welfare.[8]

Other non-religiously sensitive investment strategies eschew investing in firms that go against personal and social norms, shaped by adherence to a particular religion. For instance, an investment strategy that has gained wide acceptance is SRI that prescribes investing in firms that do not violate social norms or personal beliefs. According to recent estimates, total assets under management in the SRI industry is about $3.07 trillion out of a total $25 trillion investible funds in the US.[9] To a large extent, the SRI investment strategy has been shaped by religion, especially by the teachings of Christianity. SRI has its roots in the teachings of religious groups in the US dating back to the 1700s, when religious leaders and investors decided not to invest in companies involved in religiously questionable businesses like alcohol, tobacco, and gambling[10]. Over the subsequent years, however, SRI has attracted a diverse investor base with wide-ranging motivations and objectives.[11] In the recent past, the focus has shifted more to ESG (ethical, social, and governance) and CSR (corporate social responsibility) while traditional religion-based investing vehicles are more tagged as MRI[12] that are based on permissible investing.[13]

Overall, religiously motivated investments are intertwined with MRI and SRI investment strategies in the capital market by a new breed of investors who are motivated to work, live, and invest in a morally responsible way. Table 1 offers unique similarities among the negative screens employed by these SRI and MRI strategies (X indicates no investment and P indicates partial investment).[14] Note that the MRI and SRI investment strategies are in large part strikingly similar. As noted above, the addition of labor relations, human rights, CSR, and ESG makes SRI different from MRI.[15] Although the diversity of nonpecuniary objectives from such a diverse investor base seems great, conceptually it is thought that there is a common thread in terms of their nonmonetary objectives. All such investors opt for MRI and SRI investments to achieve far more than the monetary return on investment.

Traditionally, all these investors have been lumped together to form a group whose motivation is to obtain the best possible bundle from a three-dimensional space of risk, return, and values. Recent work by Derwall, Koedijk, and Horst[16] and references therein suggest that not all investment motives are alike. Discriminating among distinct investment motives creates a clientele effect on designing various styled investment products.

Several hypotheses have been advanced in the literature to explain the actual performance of values- vs. profits-driven SRI investment strategies. These include the shunned stocks and errors-in-expectations hypotheses.[17] The shunned stock hypothesis states that values-driven SRI investors tend to maximize non-pecuniary aspects of their investment goals and therefore create an excess demand for responsible stocks by investing only in these stocks. A consequence of such altruistic investment behavior is that socially controversial stocks (shunned stocks) trade at relatively lower prices in order to offer investors higher expected returns. In contrast, the errors-in-expectations hypothesis predicts that SRI stocks can deliver superior returns due to the fact that the market consistently fails to appreciate the importance of CSR in valuing stocks, especially in the short run. As the values and non-monetary objectives of today's SRI investors are more in line with environmental/ human-rights issues than moral or religious motivations, CSR measures and metrics are the main contributors to and indicators of SRI performance. As a result, the errors-in-expectations hypothesis suggests that SRI investments are in general undervalued in the short run, but these investments appreciate to their true value in the long run as investors slowly come to terms with the benefits of good CSR practices. So, in the long run, both of these effects cancel each other out such that SRI funds and conventional funds offer similar returns.[18]

As noted previously, shari'a-compliant investment (SC) is an alternative investment strategy that has a number of features similar to SRI. Investors of both SRI and SC may maximize nonpecuniary objectives, in addition to maximizing profit motives. There are many similarities between the SRI and SC strategies (see Table 1). In particular, SRI stresses the "three P's rule":

> Socially responsible investing (SRI) is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis . . . It is a process of identifying and investing in companies that meet certain standards of Corporate Social Responsibility (CSR).[19]

Therefore, SRI fund management emphasizes financial profit, without sacrificing responsibility toward our society and environment.

In other words, both Islamic and SRI investment strategies stress profit-based investing, without disregarding the paramount objective of the betterment of society. Traditionally, in the context of Islamic investment, profit motives are expected to follow the religious responsibilities and regulations outlined in shari'a. Again, the objective is to promote the betterment of the moral Islamic economic system and a just society. As of today, shari'a SCI[20] is a fast-growing segment of the capital markets (currently around $1.3 trillion, and expected to reach $2 trillion by 2014). The objective of looking at shari'a-compliant investing through the lens of an SRI framework is twofold: first we examine if the shari'a-compliant financial products also attract two investor classes with different motivations, and second, whether it is possible to generalize this segmentation to any investment decisions which aim to optimize both pecuniary and non-pecuniary objectives. Most shari'a-compliant investing selects assets that yield the best possible return for a given level of risk, as long as the investment choices are shari'a-compliant. Such edicts manifest as investment constraints for certain activities like the disallowance of interest, investment in morally questionable businesses like alcohol, pork, tobacco, excessive uncertainty, gambling, etc. So the majority of such investors and their investment behavior is similar to the behavior of the values-investor segment of SRI, which considers the values aspect of investment at least equally important if not more so.[21]

However, shari'a-compliant investing exhibits few structural differences from both the conventional and SRI investments that make shari'a investing and sin stocks perform like shunned stocks only during tranquil periods when general market volatility is low. During high volatility periods, shari'a-compliant investors are expected to perform better because they avoid risky investments.[22] Empirical analysis of portfolios made of conventional, SRI, and shari'a-compliant stocks would most likely offer support to the conjecture that shari'a-compliant stocks' performance lags during low to moderate volatility but outperforms during times of high volatility.

It is conceivable that a segment of shari'a-compliant investors, smaller than the aforementioned segment, is primarily motivated by profits—to earn higher returns for a given level of risk, as compared to conventional finance. Tying this with the outcomes of the shunned stocks and errors-in-expectations hypotheses, the majority of shari'a-compliant investing attracts values-driven investors and hence is consistent with the shunned stocks hypothesis. This might be especially applicable to markets where SC investors are a significant part of the capital market, like some of the Muslim countries with a vibrant Islamic finance industry. So shari'a-compliant investing is expected to earn less than irresponsible investments in terms of pecuniary returns in those markets, because the shunned stocks hypothesis predicts that the less diversified ownership investor base for controversial assets results in expectations of higher returns to compensate for the reduced level of diversification.[23]

Considering that there may be more than one segment of shari'a-compliant investors, an analysis of investment performance yields deeper insights into the forces of demand for such investments and the resultant impact on asset prices. As noted earlier, our analysis is similar in spirit to the work by Derwall, Koedijk, and Horst.[24] The authors look at the demands of SRI investments from different groups of investors as well as the contribution of concepts like ESG and CSR to the performance of SRI investments. Specifically, the authors create two portfolios. Portfolio one includes shunned stocks (sin stocks) classified as such by the KLD STATS database.[25] Sin stocks are those that are not permissible under the SRI screening. Portfolio two is made up of the top 30% of stocks that are ranked high on the KLD employee relationship index. Next, the authors estimate the following Fama-French (1992) three-factor model

$$(1)\ r_t - r_{ft} = \beta_0 + \beta_1(r_{mt} - r_{ft}) + \beta_2 R_{t,SMB} + \beta_3 R_{t,HML} + \varepsilon_t$$

where $r_t - r_{ft}$ in equation (1) is the weekly excess return on the portfolio, r_{ft} is the weekly risk-free rate (US T-bill), $r_{mt} - r_{ft}$ is the market risk premium (*MktRf*), the difference between the return on a portfolio of small stocks and the return on a portfolio of large stocks (*SMB*, small minus big), and the difference between the return on a portfolio of high-book-to-market stocks and the return on a portfolio of low-book-to-market stocks (*HML*, high minus low). The intercept term (β_0) is the excess return (alpha) and $\beta_{1\text{-}3}$ are factor loadings on the familiar risk factors.

Equation (1) was estimated for a number of sub-periods dating from 1992–2008. The results indicate that the time varying excess return on a values-driven portfolio (a portfolio based upon stocks scoring high on employee relations) decline over time, supporting the hypothesis that valuation mistakes do not persist in the long run. In contrast, their results show that shunned stocks portfolio abnormal return stays fairly stable over the period.

We also believe that the presence of shari'a-compliant investors increases the demand for responsible investments in the marketplace, as these investors are motivated by reasons other than pure profit motives. Values-driven investors value SC investing by partially assessing the firms' future cash flows and partially examining the compliance of the investments with the values investors are concerned with. The preference for responsible investments allows for a transfer of wealth from non-responsible investments. In other words, the values investors shun stocks that are socially controversial. This split in demand for different kinds of investments impacts asset prices in a manner consistent with Merton's incomplete information and segmented capital markets model.[26] This model implies that information asymmetry is largely responsible for market segmentation, which eventually leads to nonvisibility of stocks by a segment of investors. This creates a downward pressure on the prices of these assets. Reduced investor base also causes limited risk sharing among the small investor base. All these effects make it difficult for the socially controversial asset to trade at close to its intrinsic value. However, investors with a longer investment horizon can enjoy the true value growth of such an asset as over the period actual cash flows outperform the expected cash flow and push the stocks to trade at their intrinsic values. So according to this hypothesis of shunned stocks, socially controversial investments outperform shari'a stocks due to the differences in demand from investors' groups.

However, this conclusion is more relevant in markets where shari'a-compliant investors constitute a substantial part of the market to impact prices of underlying investments by collectively participating in trading. In most of the world capital markets, especially the ones in developed economies, the shari'a-compliant investors bloc is not a large enough group to cause the downward pressure on shunned stocks prices. So for SC investing, the errors-in-expectations hypothesis seems to hold. This would imply that SC investing provides excess return in the short run, but over a longer time horizon these excess returns disappear.

EMPIRICAL ANALYSIS

We use weekly data for approximately 4000 stocks from 55 countries from January 2000 to June 2011. Our sample of conventional and SRI stocks includes both financial (banks, S&Ls, credit unions, mortgage financing companies, real estate firms, and insurance companies) and non-financial firms. In contrast, the shari‘a-compliant universe of stocks specifically excludes the above stocks. In the end, the universe of stocks designated as shari‘a-compliant is carefully selected by the Dow Jones shari‘a board. We test four different investment strategies: benchmark (passive indexing), values, sin stocks, and profit motives. These strategies are described next.

Investing Style: Benchmark

The benchmark investment returns are based upon all stocks included in each of the three distinct universes of stocks: the Dow Jones Global Index, the Dow Jones Islamic Index, and the Dow Jones Sustainability Index. Based on these three universes, we form three equally weighted portfolios—conventional, shari‘a-compliant (SC), and SRI—and examine their performance over multiple investment horizons.

Investing Style: Values (Low Debt/Market Cap)

The second investment strategy examines whether investors maximize their non-pecuniary objectives, in this case, by investing in firms that rank high on some measures of CSR. Several studies have considered KLD employee relations as an indicator of CSR in valuing investment performance. In addition, firms can be also ranked using alternative indicators such as the Gompers, Ishii, and Metric index of corporate governance.[27]

Unfortunately, none of these measures reflects one of the most important taboos in Islamic finance: the prohibition on interest or *riba*. We consider the debt ratio ([short-term debt + long-term debt]/market capitalization) as a measure of a firm’s exposure to the credit market as well as the extent to which the firm is involved in interest-based borrowing activities. The decision to exclude stocks on the basis of the debt-equity ratio has been contentious. Note that while the Dow Jones Islamic Index sets the maximum debt ratio for firms included in the index at 33%, critics claim that there is no scientific or religious basis for deciding on 33% as the maximum leverage for a firm to be classified as shari‘a-compliant.[28] Several studies have traced the origin of the rule to the times of the Prophet Muhammad when he advised Abu Bakr that donating one third of one’s wealth may be too much. However, such references to the Prophet Muhammad’s conversation may have been taken out of context.[29] There are also some issues regarding the impact of the one-third rule. As El-Gamal (2006) suggests, the rule introduces pervasiveness in the way fund managers are forced to buy and sell stocks. For example, fund managers buy stocks when the price is rising (implying that the debt/market cap is low). Subsequently, an increase in the debt/market cap in a falling market would prompt the firm to be excluded from the shari‘a-compliant universe. This would again force fund managers to sell the stock when the price is too low.

Whether the one-third rule is arbitrary or not, the principles behind using this rule as an indicator of values are based upon the fact that a positive debt/market cap ratio suggests firms’ extent of engagement in the debt market and as such the extent of interest expense to service debt. We believe that the debt-equity ratio should be lower, suggesting a lower level of interest expenses. Furthermore, our choice of a *low* debt/market cap stems from the ongoing debate in the literature on the attractiveness of equity financing over debt financing. A voluminous literature exists which firmly establishes the superiority of equity financing over debt financing for a variety of reasons, including fairness, social equity, and reduced exposure to the interest rate volatility, among others.[30]

The formation of annual portfolios on the basis of the leverage ratio is simple. The investor sorts the universe of shari‘a-compliant firms on the basis of the debt/market cap at the end of the current year and selects the top 100 firms with the lowest debt ratio to form a portfolio for the upcoming year, and the process is repeated for successive years. Similarly, we use the conventional and SRI universes of stocks to build similar equally weighted[31] portfolios. The exercise allows us to demonstrate if non–shari‘a-compliant stock universes can produce shari‘a-compliant like returns.

Investment Strategy: Shunned Stocks

The third investment strategy examines the performance of a portfolio based upon stocks that are shari‘a-compliant but are less desirable because of their high leverage. To form the annual portfolio with high leverage firms, the investor sorts the universe of shari‘a-compliant firms on the basis of the debt/market cap at the end of the current year and selects the top 100 firms with the highest debt ratios. Similarly, we screen the conventional and SRI universes of stocks to build similar equally weighted portfolios.

Investing Style: Profit Motives

The fourth investment strategy is based on profitability. We rank stocks on the basis of an index of profitability. We use the methodology presented in

Joel Greenblatt's *The Little Book That Beats the Market* (2005) to sort stocks included in the DJIM Index.[32] Our choice of Greenblatt's methodology to rank stocks reflects the fact that this methodology has been proven successful in extensive back-testing analyses.[33] The investment philosophy basically identifies undervalued stocks and is based upon earnings yield (EY) and return on capital (ROC) ratios. Note that high earnings yield identifies stocks that are selling cheap and the return on capital ratio identifies companies that are capable of reinvesting their earnings at a high rate. Therefore, firms with high ROC result in high earnings growth and are expected to have a competitive advantage. These variables are calculated as follows:

1. EY = EBIT/Enterprise Value
2. ROC = EBIT/(Working Capital + Net Plant, Property, and Equipment)

Thereafter, the EY and ROC ranks are added together for each security to generate its final combined ranking.[34] Stocks scoring high according to Greenblatt's methodology will be included in the first portfolio. The formation of an annually rebalanced portfolio is accomplished by sorting the shari'a-compliant universe of stocks on the basis of basis of the previous year's data on profitability. The top 100 firms are then selected to form an equally weighted portfolio. A similar approach is taken to form two equally weighted portfolios using conventional and SRI stocks.[35]

Investment Horizons

We select four different investment periods: overall (January 2000–April 2011), low-volatility regime (January 2000–December 2006), financial crisis (January 2007–February 2009), and post–financial crisis (March 2009–April 2011). Our focus is on examining the relative performance of each strategy across various time divides, in particular the financial crisis of 2007–09. According to Batram and Bodnar,[36] the global equity market, which stood at an all-time high of $51 trillion in October 2007, dropped to $22 trillion by the end of February 2009. There are several factors responsible for the crisis, and a complete analysis of these factors and the magnitude of their effects on the economy is beyond the scope of this paper. In short, according to a recent report,[37] excessively high leverage ratios among financial institutions, corporations, and mortgage dealers are the principal culprits behind the credit crisis. By the end of the year 2008, the entire global economy experienced massive asset writedowns and the excessive indebtedness essentially stalled the worldwide economy.

Our choice of this high volatility period is related to the selection of leverage in this study as an indicator of "values" according to shari'a-compliant investing. We simply examine to what extent shari'a-compliant stocks were exposed to this period of low liquidity and high volatility.

Especially given that shari‘a-compliant stocks are characterized by low leverage, they are expected to have low exposure to such volatility. Furthermore, it would be worthwhile to compare how values- and profit-driven investment strategies performed during the credit crisis. A priori, it would seem that picking stocks with low debt ratio would have offered a substantial level of protection to investors during this period of high volatility. Naturally, we would expect SC investing to perform better than the competing portfolios based upon conventional and SRI universes.

Data

The data for the weekly stock returns for the period January 2000 to April 2011 are obtained from Bloomberg and Datastream, while data related to economic fundamentals like size, return on capital (ROC), earning yield, debt, and book-to-market equity are extracted from FactSet. Stock returns are in US dollar terms and are based upon log relatives of weekly stock prices. The weekly rate on a one-year Treasury Bill, which is used as a proxy for global risk-free rate, is obtained from the St. Louis Federal Reserve website.[38]

Sample Characteristics

Table 2 reports the general characteristics of the firms in the sample. Note that the annual rebalancing strategy employed in this study assumes that an investor screens stocks on the basis of publicly available information at the end of the previous year to select stocks for the next year. Annual selection of stocks through sorting on the basis of leverage and profitability adjusts for changes in these ratios given recent volatility in the market. For example, in a falling market, the debt ratio could rise not because firms are leveraging up but simply because the market value of the firm is falling. Furthermore, annual sorting also reduces survivorship bias because the exact composition of the portfolio changes from year to year.

We highlight a few salient observations regarding the progression of these firms with respect to selected fundamentals over the years. First, in terms of assets size, conventional firms were ranked as largest both in 1999 and in 2010. With respect to market cap, the SRI group of stocks was ranked largest in 1999, though the shari‘a-compliant group of stocks was ranked largest in 2010. The conventional group of stocks had the highest level of long-term debt both in 1999 and in 2010, but the SRI group of stocks had the highest level of short-term debt in 1999.

As expected, shari‘a-compliant stocks had the lowest amount of debt (short term and long term) in both years. Similarly, shari‘a-compliant stocks had the lowest debt/equity ratio in both years, indicating the fact that this

Table 2. Descriptive Statistics Are Reported for Representative Years

In this setting, the investor selects firms on the basis of firm-specific fundamental data.

	Universe of Firms: Conventional								
	1999			2009			2010		
Variable	N	Mean	Std Dev	N	Mean	Std Dev	N	Mean	Std Dev
Assets	2498	558421.12	3146987.95	2622	1421230.49	10854896.14	2582	1551925.65	11766633.58
Market-cap	2646	189662.82	1653617.44	2617	370865.46	3502158.90	2566	556143.04	5902639.30
EBIT	1884	22727.18	168211.77	1980	48527.29	460117.91	1944	61674.55	543511.08
Short-term Debt	2646	70807.74	398918.47	2592	140929.82	888739.61	2545	164292.92	1115594.60
Long-term Debt	2646	107206.90	796339.84	2618	222218.21	1800075.27	2580	228005.04	1721204.87
PE	2062	88.14	2233.91	1950	60.71	762.69	2221	29.57	87.51
EPS	2491	–2311.86	118186.64	2623	260.11	9472.35	2582	405.43	7747.18
Return on Capital	2400	3.36	61.53	2606	3.18	26.04	2572	5.39	19.18
Return on Equity	2375	1.30	235.79	2585	1.22	136.53	2550	6.90	101.54
Return on Assets	2412	2.74	8.65	2614	1.72	9.44	2578	3.09	9.87
Earn-yield	2465	–5.76	723.97	2617	–3.01	48.51	2566	0.50	73.79
Price to Book	2430	5.25	125.95	2582	1.78	7.62	2529	1.78	2.89
Long-term Debt to Equity	2458	140.28	2407.62	2583	100.62	663.71	2542	81.23	151.39
Debt to Equity	2459	255.48	3263.53	2586	150.80	718.58	2544	128.75	233.38
Debt to Assets	2646	27.54	20.38	2621	27.87	19.24	2582	27.15	19.08
Operating Margin	2479	–5.43	622.64	2618	4.89	141.94	2572	5.92	205.05
Dividend Yield	2469	4.98	141.38	2601	2.66	2.66	2529	2.35	2.41
Interest Coverage	1851	15.54	74.95	1953	148.05	3578.04	1917	85.69	2401.10
Current Ratio	1869	1.57	1.29	1977	1.69	1.87	1946	1.67	1.32
Net Profit Margin	2490	0.82	659.99	2619	14.73	611.70	2578	2.08	936.26
Debt to Market Cap	2468	3.30	64.49	2585	1.43	3.70	2527	1.51	11.09

Table 2. Descriptive Statistics Are Reported for Representative Years (continued)

Universe of Firms: Shari'a-Compliant

	1999			2009			2010		
Variable	N	Mean	Std Dev	N	Mean	Std Dev	N	Mean	Std Dev
Assets	1200	164266.84	1272810.48	1372	385725.98	4323084.94	1353	437108.73	4762854.10
Market-cap	1390	143209.69	1585801.76	1369	556687.48	6405505.35	1347	683978.11	6670889.04
EBIT	1196	14977.41	184158.95	1360	53519.39	729994.43	1334	66658.04	822142.39
Short-term Debt	1390	24070.80	252236.06	1333	27597.49	376776.31	1328	26773.17	325809.03
Long-term Debt	1390	28418.05	301139.59	1367	33507.19	426174.83	1351	35500.27	475637.90
PE	998	58.37	359.26	1144	33.37	126.13	1222	61.65	995.81
EPS	1202	92.61	1641.90	1372	183.16	8175.24	1351	389.77	6340.75
Return on Capital	1144	7.11	22.65	1362	8.26	18.96	1345	11.29	30.66
Return on Equity	1131	11.39	49.60	1363	9.87	27.68	1345	14.09	40.80
Return on Assets	1147	4.46	12.29	1370	5.21	12.01	1352	7.04	9.54
Earn-yield	1175	2.82	113.70	1369	3.31	15.47	1346	4.01	12.25
Price to Book	1155	4.38	8.04	1360	2.52	2.74	1340	3.13	6.28
Long-term Debt to Equity	1181	44.56	74.20	1358	25.29	37.99	1345	31.81	189.31
Debt to Equity	1182	66.18	101.07	1358	34.52	46.94	1346	41.50	199.83
Debt to Assets	1390	19.51	19.12	1367	14.75	13.68	1353	14.24	13.58
Operating Margin	1190	–4.35	254.96	1356	–9.38	419.93	1328	–31.25	1157.58
Dividend Yield	1181	1.63	2.43	1364	2.34	2.87	1336	2.01	2.13
Interest Coverage	1158	104.19	1045.85	1268	1068.86	15637.10	1242	1098.18	59918.47
Current Ratio	1189	2.16	1.93	1360	2.95	7.41	1340	2.76	4.32
Net Profit Margin	1191	40.84	1765.20	1356	68.14	2681.58	1333	18.65	2042.45
Debt to Market Cap	1173	0.57	1.87	1330	0.18	0.28	1320	0.16	0.24

Table 2. Descriptive Statistics Are Reported for Representative Years (continued)

Descriptive statistics are reported for representative years. In this setting, the investor selects firms on the basis of firm-specific fundamental data.

Universe of Firms: Socially Responsible Investing									
	1999			2009			2010		
Variable	N	Mean	Std Dev	N	Mean	Std Dev	N	Mean	Std Dev
Assets	278	547422.54	2079931.21	278	924995.19	4156820.12	278	1047755.53	5163743.78
Market-cap	284	385410.14	2299969.46	277	409726.81	3054882.22	276	426722.37	2531628.66
EBIT	216	27212.23	158461.49	216	37600.64	297167.37	216	52669.97	412108.06
Short-term Debt	284	83524.70	330895.74	276	130032.15	750216.56	276	155635.33	983201.15
Long-term Debt	284	105349.50	424737.39	278	177373.02	800298.93	278	192157.70	933328.15
PE	246	40.19	86.27	217	25.71	32.28	259	18.74	18.26
EPS	277	93.45	1032.47	278	231.02	2734.42	278	301.77	3480.80
Return on Capital	275	7.50	30.75	278	4.49	13.52	278	8.95	8.25
Return on Equity	274	14.12	24.62	274	10.61	56.86	275	16.51	26.94
Return on Assets	275	4.45	5.39	278	2.34	8.69	278	5.27	5.90
Earn-yield	271	3.80	8.78	277	–0.21	24.59	276	6.99	6.20
Price to Book	270	4.53	7.86	273	2.70	6.43	273	2.30	2.10
Long-term Debt to Equity	276	85.32	147.45	274	150.98	578.41	275	94.40	122.43
Debt to Equity	276	171.74	317.54	274	216.49	696.10	275	146.42	261.62
Debt to Assets	284	25.21	16.23	278	27.96	15.84	278	26.17	14.94
Operating Margin	274	13.36	12.62	276	9.07	46.16	276	14.69	13.34
Dividend Yield	272	2.13	2.14	277	3.11	2.16	276	3.00	2.03
Interest Coverage	209	16.17	54.96	213	120.41	1149.79	210	77.78	821.36
Current Ratio	219	1.44	1.10	216	1.48	0.85	216	1.43	0.72
Net Profit Margin	275	9.09	13.40	276	–4.72	67.63	276	13.15	28.24
Debt to Market Cap	272	0.74	1.63	275	1.25	3.02	274	1.27	4.30

Table 3. Average Weekly Raw Returns from Various Investment Strategies Are Compared

Panel A has average weekly returns from equally weighted benchmark portfolios. The number of stocks in each stock universe is as follows: 1648 (conventional), 1024 (shari'a-compliant [SC]), and 192 (SRI). Weekly raw returns in Panels B through D are specific to the particular investment strategy chosen. For example, in Panel B (values strategy), we select the top 100 firms with the lowest debt-to-market cap from each universe and calculate the weekly average raw returns. In Panel C, we have returns from shunned stocks portfolios (the top 100 firms with the highest debt ratios). In Panel D, we select the top 100 firms according to Greenblatt's profitability indicator. Greenblatt's investment philosophy identifies undervalued stocks and is based upon earnings yield (EY) and return on capital (ROC) ratios. Note that high earnings yield identifies stocks that are selling cheap and the return on capital ratio identifies companies that are capable of reinvesting their earnings at a high rate. Therefore, firms with high ROC thus result in high earnings growth and are expected to have a competitive advantage. For all investment strategies, stock screening is conducted on the basis of firm-specific fundamentals for the year 1999. Standard deviations are listed in parenthesis.

Stock Universe	2000–2011	2000–2006	Jan. 2007–Feb. 2009	March 2009–April 2011
Panel A: Benchmark Returns (All Firms)				
Conventional	0.0017 (0.0213793)	0.0022 (0.0165246)	–0.0056 (0.0302899)	0.0085995 (0.0234375)
SC	0.0030 (0.0226701)	0.0035 (0.0185176)	–0.0036 (0.0317802)	0.0092 (0.0231473)
SRI	0.0012 (0.0238596)	0.0017 (0.0177633)	–0.0064 (0.0342952)	0.0082 (0.0277276)
Panel B: Investment Strategy: Values (Top 100 Low Debt Firms)				
Conventional	0.0021 (0.0196048)	0.0024 (0.0176159)	–0.0033 (0.0252322)	0.0074 (0.0186966)
SC	0.0024 (0.0236728)	0.0031 (0.0205042)	–0.0049 (0.0321596)	0.0092 (0.0053553)
SRI	0.0008 (0.0216994)	0.0010 (0.0176212)	–0.0047 (0.0305689)	0.0070 (0.0225399)
Panel C: Investment Strategy: Shunned Stocks (Top 100 High Debt Firms)				
Conventional	0.0037 (0.0329147)	0.0056 (0.0261551)	–0.0069 (0.0431321)	0.0092 (0.0402666)
SC	0.0073 (0.0295638)	0.0085 (0.0251441)	0.0016 (0.0384765)	0.0103 (0.0335345)
SRI	0.0026 (0.0031947)	0.0025 (0.0189989)	–0.0082 (0.0396939)	0.0099 (0.0359748)

Table 3. Average Weekly Raw Returns from Various Investment Strategies Are Compared (continued)

Panel D: Investment Strategy: Profit (Top 100 Firms)				
Conventional	0.0037 (0.0254328)	0.0048 (0.0201523)	–0.0058 (0.036199)	0.0111 (0.026)
SC	0.0059 (0.0531092)	0.0078 (0.0612534)	–0.0034 (0.0427932)	0.0108 (0.0283)
SRI	0.0016 (0.0240475)	0.0026 (0.017416)	–0.0061 (0.0372126)	0.0073 (0.0251)
Panel C: Investment Style: Shunned Stocks: January 2000–April 2011 In this section, we sort firms on the basis of debt/market cap. We consider low debt ratio as an indicator of values. For each type of portfolio, we include the top 100 firms with the highest debt/market cap ratio.				

group of stocks had lower reliance on debt financing. This is also reflected in interest coverage ratio. Shari‘a-compliant stocks had the highest interest coverage ratio, indicating that this group had traditionally lower levels of debt and interest expenses associated with servicing the debt. In terms of financial performance, conventional stocks had the highest PE ratio in 1999 but shari‘a-compliant stocks were ranked the best in this category in 2010. Net profit margin suggests that the shari‘a-compliant group was ranked the best in both years, indicating higher profitability. In terms of ROE, the SRI group was ranked the best in both years, followed by the shari‘a-compliant group. While the SRI group was ranked the best on return on capital in 1999, the shari‘a-compliant group was ranked the best in 2010. With respect to dividend yield, the shari‘a-compliant group performed worse than the conventional and the SRI groups of stocks. Earnings yield, which indicates the amount of profit as a percentage of the market cap, was the highest for the SRI groups in both years. Finally, as expected, shari‘a-compliant stocks had the lowest debt-to-market cap in both years.

In Table 3, average weekly raw returns of various groups of stocks from various investment strategies are compared. Panel A has benchmark weekly returns from three equally weighted portfolios created by selecting all stocks in each group. The number of stocks in each stock universe is as follows: 1648 (conventional), 1024 (shari‘a-compliant), and 192 (SRI). Weekly raw returns in Panels B and C are specific to the particular investment strategy chosen. For example, in Panel B (values strategy), we select the top 100 firms with the lowest debt-to-market cap from each universe and calculate the weekly average raw returns. In Panel C, weekly returns from the shunned stocks portfolios are presented. Shunned stocks portfolios are created by sorting each stock universe on the basis of debt-to-market cap and selecting the top 100 firms with high debt ratio. In Panel D, we select the top 100 firms according to Greenblatt's profitability indicator. Greenblatt's investment philosophy identifies undervalued stocks and is based upon earnings yield (EY) and return on capital (ROC) ratios. Note that high earnings yield identifies stocks that are selling cheap and the return on capital identifies companies that are capable of reinvesting their earnings at a high rate. Therefore, firms with high ROC thus result in high earnings growth and are expected to have a competitive advantage. For all investment strategies, stock screening is conducted on the basis of firm-specific fundamentals for the year 1999. Standard deviations are listed in parentheses.

In Panel A, during January 2000–April 2011, shari'a-compliant stocks had the best performance, followed by conventional and SRI portfolios, respectively. For the next three sample periods, January 2000–December 2006, January 2007–February 2009 and March 2009–April 2011, the pattern did not change very much. The shari'a-compliant group was the best performer. The group's performance in terms of risk (standard deviation of portfolio returns) was somewhat similar to the conventional and SRI portfolios. Interestingly, during the financial crisis (January 2007–February 2009), the shari'a-compliant group performed best, followed by the conventional and the SRI group of stocks, respectively. Their post–financial crisis period performance was similar: shari'a-compliant portfolios performed the best. Panel B shows that, with the exception of the financial crisis period, during January 2000–April 2011, January 2000–December 2006, and March 2009–April 2011, values investment (stocks with the lowest leverage [debt/market cap]) strategy-motivated shari'a-compliant portfolios performed the best.

In Panel C, we report the results for the shunned stocks hypothesis. As discussed earlier, shunned stocks are firms with high leverage, and as such an Islamic investor would be less inclined to select them. As previous authors have suggested, these stocks are expected to generate high returns in the short run given the increased perception of riskiness for investing in these stocks. Our results indicate that high leverage translates into high returns. High-leverage shari'a-compliant stocks performed better than low-leverage shari'a-compliant stocks (Panel B) while still conforming to shari'a principles. In addition, compared to the conventional and SRI portfolios, the shari'a-compliant portfolio has higher returns across all periods.

The results have powerful implications for the role of leverage in determining stock returns. Recall that there is a 33% upper limit on the debt ratio for this group, while this restriction does not hold for the conventional and the SRI groups of stocks. Our results suggest that for these two groups, taking on excessive leverage simply does not allow investors to outperform high-leverage shari'a-compliant stocks. So our results offer convincing support for the notion that shari'a-compliant investment can be lucrative to anyone interested in high leverage and at the same time investing within the guidelines of shari'a principles. In other words, despite high leverage, shari'a-compliant stocks also have better financial performance (see Table

2), suggesting that investors are being rewarded for investing in firms that are not involved in activities not permissible under shari‘a constraints.

Panel D reports performance results for the profit-motive driven investments strategy. Recall that Panel D results are based upon screening stocks using Greenblatt's indicator of future profitability of stocks. Shari‘a-compliant stocks generate better returns across all sample and sub-sample periods than their nearest competitors. Only during the post-crisis period did the conventional portfolio have better performance. Overall, these returns are quite interesting and point to the notion that leverage-based investment strategies using shari‘a-compliant stocks perform well and that shari‘a-compliant investment is a better alternative choice during the financial crisis.

GARCH REGRESSION RESULTS

The asset pricing model in this section assumes that stock returns can be described by their sensitivity to the Fama-French systemic risk factors.[39] To construct the Fama-French factors, we eliminate stocks with negative book-to-market equity.[40] Also, the number of stocks each year used in the construction of factors varies depending on the availability of data for the corresponding year. This eliminates the problem of survivorship bias in the sample.

The construction of the *global* systemic risk factors is in line with Fama and French. *MktRf* is the market risk premium, *SMB* is the size mimicking portfolio constructed each week by taking the simple average of the returns on small-sized portfolios minus returns on large-sized portfolios, and *HML* is constructed (book to market mimicking portfolios) each week by taking the simple average of the returns on high book-to-market portfolios minus the returns on low book-to-market portfolios.[41] For all three stock universes, the Dow Jones Global Index is assumed to be the benchmark stock index. The dependent variable is the average weekly portfolio return of all firms.

Preliminary diagnostics suggest that the weekly excess returns have time varying variance with volatility clustering and fat tails. To deal with this issue, weekly excess returns are estimated using the following Threshold GARCH model (Glosten, Jaganathan, and Runkle)[42] from hereafter GJR model with traditional Fama-French (Fama and French, 1992) factors

$$(2)\ r_t - r_{ft} = \beta_0 + \beta_1(r_{mt} - r_{ft}) + \beta_2 R_{t,SMB} + \beta_3 R_{t,HML} + \varepsilon_t$$

$$(3)\ \varepsilon_t \,|\, \Psi_{t-1} \sim \mathrm{N}(0,\sigma_t^2),$$

$$(4)\ \sigma_t^2 = \Omega + \sum_{i=1}^{q} \alpha_i \varepsilon_{t-i}^2 + \sum_{k=1}^{k} \lambda_k V_t \varepsilon_{t-k}^2 + \sum_{j=1}^{p} \delta_j \sigma_{t-j}$$

where $r_t - r_{ft}$ in equation (2) is the weekly excess return on the portfolio, r_{ft} is the weekly risk-free rate (one-month US T-bill), $r_{mt} - r_{ft}$ is the market risk premium, the difference between the return on a portfolio of small

Table 4. Weekly Excess Returns Are Estimated Using the Following Threshold Garch Model:

$$(2)\ r_t - r_{ft} = \beta_0 + \beta_1(r_{mt} - r_{ft}) + \beta_2 R_{t,SMB} + \beta_3 R_{t,HML} + \varepsilon_t$$

$$(3)\ \varepsilon_t \mid \Psi_{t-1} \sim \mathrm{N}(0,\sigma_t^2),$$

$$(4)\ \sigma_t^2 = \Omega + \sum_{i=1}^{q} \alpha_i \varepsilon_{t-i}^2 + \sum_{k=1}^{k} \lambda_k V_t \varepsilon_{t-k}^2 + \sum_{j=1}^{p} \delta_j \sigma_{t-j}$$

where $r_t - r_{ft}$ in equation (2) is the weekly excess return on the portfolio, r_{ft} is the weekly risk free rate (one-month US T-bill), $r_{mt} - r_{ft}$ is the market risk premium (*MktRf*), the difference between the return on a portfolio of small stocks and the return on a portfolio of large stocks (*SMB*, small minus big), and the difference between the return on a portfolio of high-book-to-market stocks and the return on a portfolio of low-book-to-market stocks (*HML*, high minus low). The intercept term is β_0 and $\beta_{1\text{-}4}$ are factor loadings on the familiar risk factors. The variance equation (4) models the conditional variance as a GJR (*p*, *q*) process where *p*, *k*, and *q* denote the lag length. Ω is the intercept term, α is the ARCH term, λ is the ARCH term that measures the asymmetric response of the time varying volatility to good news and bad news. V_t is a dummy variable that takes a value of one if past returns are negative and 0 if past returns are positive. Finally, δ is the GARCH term. The GJR specification allows us to avoid placing conditions on the α and δ terms to be positive. Portfolios are rebalanced annually.

Panel A: Benchmark Model: January 2000–April 2011

Panel A has all firms included in each universe for constructing three equally weighted portfolios. Firms are classified as conventional, Islamic, and SRI by the Dow Jones Indexes. In the conventional portfolio, there are 1648 firms. For the Islamic portfolio, we include 1024 firms. Finally, in the SRI portfolio, there are 192 stocks.

Stock Universe	Alpha	MktRf	SMB	HML	TARCH0	TARCH1	TARCH2	GARCH1	Information Ratio
Conventional	0.0027 (3.59)	0.1636 (7.41)	0.1414 (3.05)	–0.1071 (–2.16)	0.0001 (4.95)	0.0752 (1.59)	0.2720 (4.95)	0.6327 (10.75)	0.14
SC	0.0041 (5.13)	0.1826 (6.97)	0.1486 (2.88)	–0.1514 (–3.08)	0.0001 (4.59)	0.0581 (1.25)	0.2813 (4.47)	0.5792 (7.12)	0.21
SRI	0.0021 (2.87)	0.1183 (6.37)	0.0351 (0.8)	–0.0476 (–1.03)	0.0000 (4.68)	0.0611 (1.3)	0.3048 (4.69)	0.6978 (14.52)	0.03

Table 4. (continued)

Panel B: Investment Style: Values: January 2000–April 2011									
In this section, we sort firms on the basis of debt/market cap. We consider low debt ratio as an indicator of values. For each type of portfolio, we include the top 100 firms with the lowest debt/market cap ratio.									
Stock Universe	**Alpha**	**MktRf**	**SMB**	**HML**	**TARCH0**	**TARCH1**	**TARCH2**	**GARCH1**	**Information Ratio**
Conventional	0.00309 (4.36)	0.1558 (7.18)	0.1674 (3.76)	–0.1223 (–2.76)	0.0001 (5.50)	–0.123 (–0.32)	0.3809 (5.31)	0.5740 (8.56)	0.16
SC	0.0038 (4.39)	0.1937 (6.63)	0.2324 (4.00)	–0.2415 (–4.78)	0.0001 (4.83)	0.0024 (0.06)	0.3371 (4.87)	0.5348 (7.61)	0.17
SRI	0.0015 (2.10)	0.1515 (6.23)	0.0494 (1.07)	–0.0607 (–1.41)	0.0001 (4.87)	0.00844 (0.21)	0.3259 (5.25)	0.7048 (14.90)	0.07

Panel C: Investment Style: Shunned Stocks: January 2000–April 2011									
In this section, we sort firms on the basis of debt/market cap. We consider low debt ratio as an indicator of values. For each type of portfolio, we include top 100 firms with the highest debt/market cap ratio.									
Stock Universe	**Alpha**	**MktRf**	**SMB**	**HML**	**TARCH0**	**TARCH1**	**TARCH2**	**GARCH1**	**Information Ratio**
Conventional	0.0047 (4.44)	0.1443 (4.49)	0.2216 (3.50)	–0.1126 (–1.66)	0.000001 (3.87)	0.0767 (2.06)	0.2373 (4.89)	0.7451 (19.81)	0.15
SC	0.0078 (7.09)	0.1902 (5.08)	0.2038 (3.05)	–0.0967 (–1.51)	0.00004 (3.63)	0.0371 (2.02)	0.13 (4.30)	0.8464 (51.9)	0.27
SRI	0.003 (3.20)	0.1204 (6.09)	0.0723 (1.45)	–0.0389 (0.72)	0.00004 (4.47)	0.0889 (1.62)	0.2825 (4.27)	0.7010 (14.06)	0.10

Table 4. (continued)

Panel D: Investment Style: Profit: January 2000–April 2011									
In this section, we sort firms on the basis of Greenblatt ranking. The investment philosophy ranks on the basis earnings yield (EY) and return on capital (ROC) ratios. Note that high earnings yield identifies stocks that are selling cheap and the return on capital ratio identifies companies that are capable of reinvesting their earnings at a high rate. Therefore, firms with high ROC thus results in high earnings growth and are expected to have competitive advantage. Each portfolio contains top 100 firms ranked high according to the Greenblatt's profitability indicator. *Indicates the model is of type exponential GARCH.									
Stock Universe	**Alpha**	**MktRf**	**SMB**	**HML**	**TARCH0**	**TARCH1**	**TARCH2**	**GARCH1**	**Information Ratio**
Conventional	0.00499 (5.78)	0.1621 (5.64)	0.1480 (2.70)	–0.1281 (–2.45)	0.00007 (4.06)	0.1483 (2.77)	0.1936 (3.39)	0.6096 (8.83)	0.21
SC*	0.011 (17.67)	0.2830 (18.96)	–0.0526 (–1.39)	0.2036 (6.01)	–4.6678 (–21.05)	1.9153 (36.76)	0.3091 (10.33)	–0.4846 (–12.97)	0.21
SRI	0.003 (4.03)	0.1004 (5.05)	0.0403 (0.94)	–0.0217 (–0.54)	0.00004 (4.57)	0.1217 (2.10)	0.2951 (3.86)	0.6273 (11.63)	0.13

stocks and the return on a portfolio of large stocks (*SMB*, small minus big); and the difference between the return on a portfolio of high-book-to-market stocks and the return on a portfolio of low-book-to-market stocks (*HML*, high minus low). The intercept term is β_0 (alpha) and $\beta_{1\text{-}4}$ are factor loadings on the familiar risk factors. If stocks are efficiently priced, the alpha should be zero and statistically insignificant.

The variance equation (4) models the conditional variance as a GJR (p, q) process where p, k, and q denote the lag length. Ω is the intercept term, α is the ARCH term, and λ is the ARCH term that measures the asymmetric response of the time varying volatility to good news and bad news. A positive λ implies that bad news increases volatility. This is also known as the leverage effect, which suggests that future stock returns tend to have asymmetric response to past signed returns, i.e., past positive returns have a different effect than past negative returns. V_t is a dummy variable that takes a value of one if past returns are negative and zero if past returns are positive. Finally, δ is the GARCH term. The GJR specification helps us avoid placing non-negativity conditions on the α and δ terms.[43]

Panel A, Table 4 reports GARCH results for estimating a multifactor asset pricing equation assuming a passive investment strategy for the January 2000–April 2011 period. The dependent variable is the risk-adjusted return from each universe of stocks. For each model, factor loadings for global

MktRf, *SMB*, and *HML* are reported (t-stats in parentheses). We also report the estimates from the variance equation including TARCH0, TARCH1, TARCH2, and GARCH1 parameters. ARCH1 and GARCH1 terms are positive and significant at the 1% significance level. In contrast, TARCH2 terms are negative and significant, suggesting the presence of asymmetry in the effects of positive and negative residuals. Overall, TGARCH modeling provides a parsimonious representation of the data to deal with time varying volatility and non-normality.

The estimated parameters for the *MktRf*, *SMB*, and *HML* are significant in several instances. The intercept terms are all positive and significant at least at the 5% significance level. The SC portfolio has the best performance. The coefficient for *MktRf* is positive and significant for all three universes. *SMB* is significant for both shari'a-compliant and conventional portfolios. The positive sign indicates that funds are leaning more toward small caps. *HML* is also significant for both conventional and SC portfolios. The negative sign indicates that funds are leaning more toward growth than value stocks.[44] It also indicates that, during this period, value stocks were hammered hard. Both *SMB* and *HML* were insignificant for the SRI portfolio.

We calculated the Sharpe ratio as an indicator of risk-adjusted return. It is defined as the intercept term divided by the standard error of the regression. As shown in Panel A, the Sharpe ratio for each portfolio for the period is positive, with the shari'a-compliant portfolio offering the best performance. The conventional portfolio was the second-best performer, followed by the SRI portfolio. Overall, the results clearly indicate that shari'a-compliant investing offers superior performance. For subsequent models, we will concentrate mostly on the Sharpe ratio from each portfolio.

Panel B reports the investment performance of the "values" strategy, where an investor picks the top 100 stocks on the basis of low leverage (debt/market cap). The shari'a portfolio performs the best, followed by conventional and SRI portfolios, respectively.[45] This investment strategy relies on the idea that a positive debt/market cap ratio is harmful to firms because of interest expense to service debt. As noted earlier, shari'a scholars are clear in their choice of low leverage and their reasoning is based on the historical precedence of 33% leverage, as well as on the attractiveness of equity financing over debt financing, fairness, social equity, and reduced exposure to the interest rate volatility. Overall, a portfolio manager would notice that during this period, using low leverage as a stock-picking strategy would have performed quite well.

Results for the shunned stock hypothesis are reported in Panel C. Under this strategy, an investor picks stocks with the highest leverage, which is assumed to be clearly against the basic tenets of the shari'a law prohibiting excessive leverage. Note that while we also include high-leverage shari'a-compliant stocks, these stocks are still shari'a-compliant because of the upper limit of 33% on leverage. For the remaining two groups of stocks, there is no such limit on the amount of leverage. Again, the shari'a-compliant portfolio has the highest alpha (intercept term), followed by the conventional and SRI portfolios, respectively. The shari'a-compliant portfolio has the highest Sharpe ratio. It is comforting to see that while a portfolio of sin stocks (shunned stocks) performed well during this period, the shari'a -compliant portfolio clearly is a better performer on two accounts—from the perspective of highest risk adjusted returns and from the shari'a perspective of permissible maximum leverage for a firm.

Finally, how would a portfolio based upon stocks selected on Greenblatt's index of profitability perform? So a portfolio manager identifies undervalued stocks on the basis of earnings yield (EY) and return on capital (ROC) ratios. In essence, one picks stocks that are selling cheap and the return on capital ratio identifies companies that are capable of reinvesting their earnings at a high rate. Our experiment shows that, compared to the preceding results, the shari'a-compliant portfolio has the highest alpha. Notice that the coefficient of *SMB* is no longer significant; instead, *HML* is statistically significant and positive, indicating the fact that the portfolio manager is leaning more toward value stocks. Overall, our results for the values and profits motives suggest that the profit-motivated portfolios are clearly superior to shunned stocks and leverage-based strategies. Our results also indicate that the shari'a-compliant strategy comes out as the best performer with respect to excess returns.

While many of these results hinge on investment periods and the choice of the fundamental variables as a screening tool, the idea presented in this paper clearly indicates that shari'a-compliant investing is a mainstream investment strategy. We show that shari'a-compliant investing can be tailored to meet the specific needs of a diverse client base.[46] Clients who prefer low-leverage stocks earn lower returns compared to clients who prefer high-leverage stocks. But the story does not end here. The performance of the shunned stock strategy clearly demonstrates that shari'a-compliant stocks can offer the best of the two worlds: investing to maximize both values and profit. To this extent, non–shari'a-compliant stocks do not offer investors a profitable opportunity to maximize non-pecuniary objectives of investing in good companies that are acceptable by moral and religious standards.

ROBUSTNESS CHECKS

We conducted a series of additional exercises to check on the robustness of these results.[47] First, we used a shorter investment horizon (January 2000–December 2006) to observe ex post the performance (using the Sharpe ratio) of these investment strategies. This period would be categorized as a pre-crisis period when worldwide equity markets were on an upward trajectory. We expect all investment strategies to perform well during this period and the results confirm our priors. All four investment strategies (benchmark, low leverage, high leverage, and undervalued stocks) have statistically significant alphas.[48] The results show that the shari'a-compliant portfolio is ranked as the best, followed by the conventional and SRI portfolios, respectively. When stocks are picked on the basis of low leverage (values strategy), again, the shari'a-compliant portfolio dominates the other investment strategies considered here. For the shunned stock hypothesis, the shari'a portfolio is the clear winner. Finally, when portfolios are constructed using Greenblatt's undervaluation criteria as a screening device, the shari'a portfolio is ranked the best.

Second, the recent financial crisis has forced many investors to seek safe returns when markets become volatile and experience sustained declines. It would be interesting to see how these investment strategies performed during periods of great instability. We consider the period from January 2007 to February 2009 as the period during which the worldwide financial markets experienced substantial instability and loss of investor wealth. In times of such worldwide financial meltdown, which strategy performed the best?

At the outset, we note that with the exception of the shari'a-compliant

Figure 1. Annual Excess Return: Benchmark Model

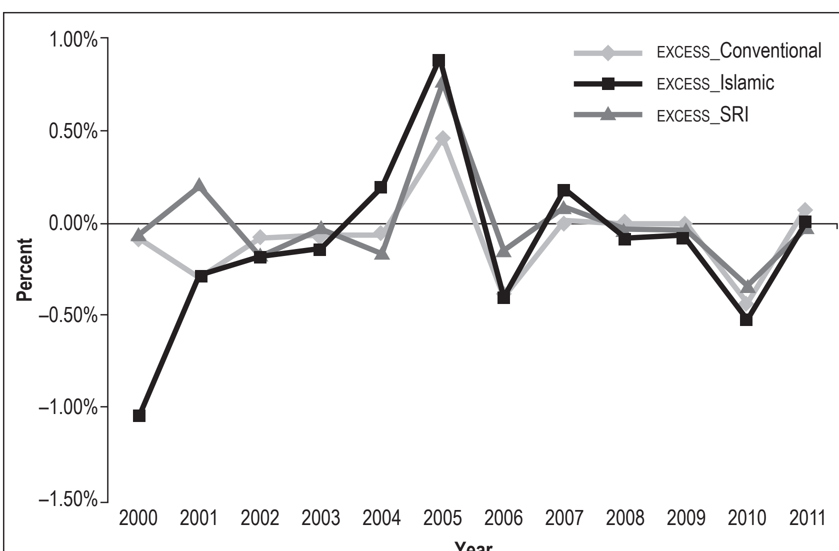


Figure 2. Annual Excess: Return Investment Strategy: Values

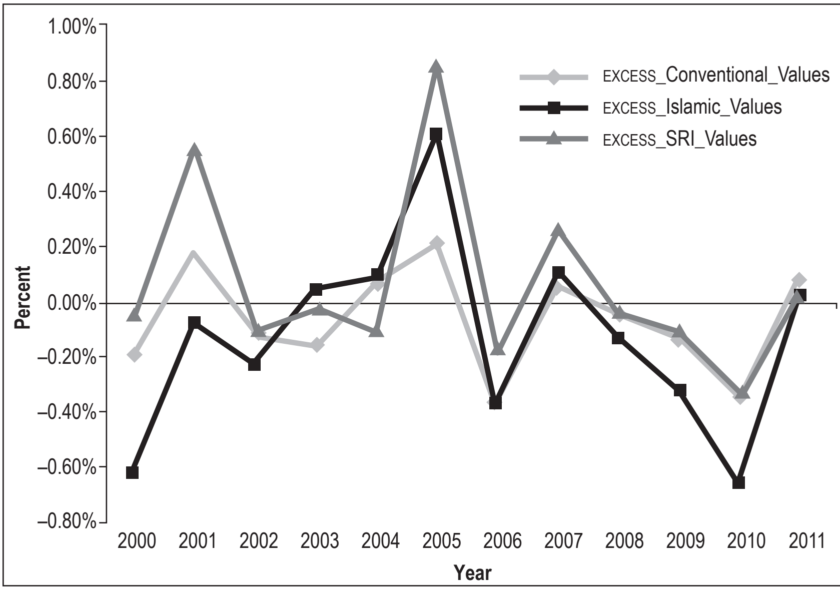


Figure 3. Annual Excess Return: Investing Strategy: Shunned Stocks

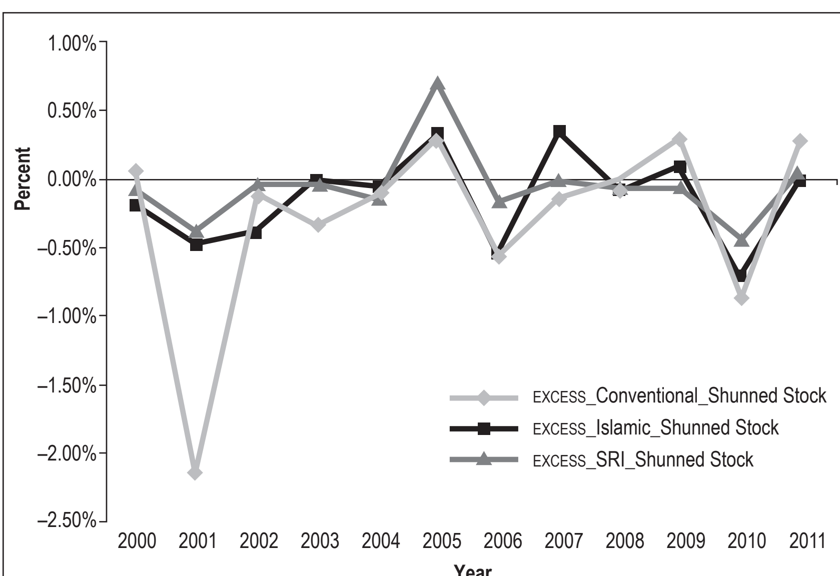
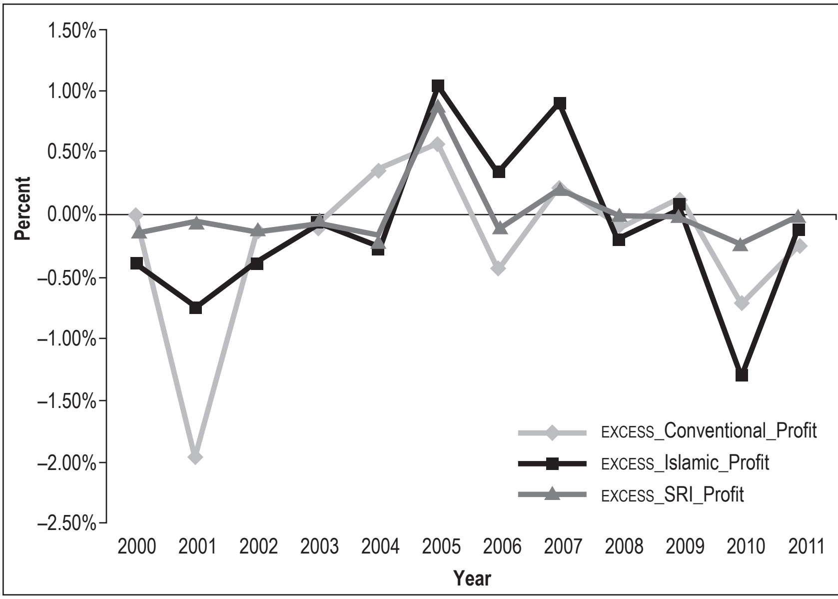


Figure 4. Annual Excess Return: Investment Strategy: Profit



portfolio constructed using shunned stocks, the alphas are insignificant and negative, suggesting that excess returns disappeared during the period. Individually, there are some interesting results. All three benchmark portfolios have negative alphas during the financial crisis, though the shari‘a portfolio does a better job in the preservation of wealth. It has the smallest negative alpha. This is a key result in this study. The interpretation of this finding is that, by not investing in non-shari‘a stocks, investors are able to weather the global financial crisis. Whether such investment outcomes are a result of shari‘a-compliant stocks having low leverage, having low exposure to the debt market, and being undervalued in general is an issue worth further empirical investigation. These results are indicative of the fact that during the financial crisis, a flight to quality strategy would involve investing in shari‘a-compliant stocks.

Next, when stocks are picked on the basis of low leverage, the conventional portfolio is the winner as it has a positive alpha. For the shunned stock strategy, the shari‘a portfolio is the clear winner with a positive alpha, which is significant at the 5% level. Finally, when portfolios are constructed using Greenblatt’s undervaluation criteria as a screening device, the shari‘a portfolio is ranked the best. Again, the reader is reminded that in most cases, alphas are negative and statistically insignificant.

Third, we also examined investment performance of these stock-picking strategies for the post-crisis period (March 2009 to April 2011). For the benchmark strategy (each portfolio has all stocks in that universe) both the conventional and shari'a-compliant portfolio perform equally well, with the SRI portfolio a close second. When stocks are picked on the basis of low leverage, the shari'a-compliant portfolio dominates other investment strategies considered here. For the shunned stock hypothesis, the shari'a portfolio is the clear winner, though the alphas are not significant. Finally, when portfolios are constructed using Greenblatt's undervaluation criteria as a screening device, the shari'a portfolio is ranked the best.

Figures 1–4 illustrate the general trends of investment performance for all strategies on an annual basis. Here, we estimate average weekly excess returns (raw returns minus predicted returns) using the ordinary least squares method (ARIMA), thus avoiding convergence issues for estimating GARCH models with only 52 weekly observations each year (for the year 2011, we have only 19 weekly observations). In Figure 1, all three stock universes have weekly excess returns that are remarkably similar. Almost identical results are displayed in the remaining tables. In all the graphs, all the strategies experience a substantial decline in performance during the financial crisis period, though shari'a-compliant strategy may have performed better by losing less than remaining strategies. Towards the second half of 2009, all strategies started to produce better returns, though SRI and conventional portfolios outperformed the shari'a-compliant portfolio.

CONCLUSION

According to Derwall et al. (2011), it is possible to discriminate among investors in terms of the personal, social, and religious beliefs guiding their investment choices. Broadly speaking, two dominant investment strategies have been identified. The values strategy suggests that values-driven investors are primarily concerned with the non-pecuniary investment objective of achieving some moral or societal goals. The financial return also exists, but as a secondary objective. For this group of investors, there are several choices of investment universes that include the SRI universe of stocks as well as stocks that are classified as being shari'a-compliant. In contrast, profit-motivated investors are primarily motivated to maximize financial return for a given degree of risk. For this group of investors, values play a minimal role in selecting the appropriate investments. Naturally, there are no restrictions as to which stock universes this group of investors picks. But regardless of the personal, social, moral, or profit motives guiding investment choices, the question of what strategy performs best is an empirical question, one that requires a careful analysis of the performances of these disparate investment portfolios.

We examine the relative performance of different investment strategies using three different universes of stocks—conventional, shari'a-compliant, and socially responsible—during the recent tranquil and turbulent periods. We find that it is possible to discriminate among various universes of stocks to identify various dominant investment strategies. The performance of these strategies using globally listed stocks varies among various universes of stocks subjected to these investment strategies. Broadly speaking, there is room for both values and profits investing using conventional, SRI, and shari'a-compliant stocks. However, the shari'a-compliant universe has a unique appeal to Muslims and non-Muslim investors. Values investors can construct portfolios by excluding stocks that do not meet strict shari'a guidelines. The most surprising result of this study is that among the three universes of shunned stocks, only the shari'a-compliant portfolio delivers superior performance. In other words, leverage is good, but only up to a certain level. Finally, our results show that profits-driven investors can also find the shari'a-compliant universe of stocks to deliver attractive returns. In essence, they offer the best of two worlds, without sacrificing returns. The results presented in this study have significant implications for making shari'a-compliant investment a mainstream investment strategy.

Endnotes

1. For Islamic investing, for example, there is the Dow Jones Islamic Market Index. The recent introduction of the STOXX Europe 600 Index has been a welcome addition to the finance industry for measuring the performance of Christian faith-based investing. For socially responsible investing, there is Dow Jones Sustainability Index.
2. Credit Suisse, *Faith-based Investing, Harmonizing Religion and Finance* (May 4, 2011).
3. Jeroen Derwall, Kees Koedijk, and Jenke Ter Horst, "*A Tale of Values-Driven and Profit-Seeking Social Investors," Journal of Banking & Finance* 35 (2011): 2137–2147. http://www.cerag.org/IMG/pdf/Derwall_atelier_finance.pdf (accessed February 5, 2014).
4. Ibid.
5. Mark. S. Latkovic, *Morally Responsible Investing: Why Catholics Must Make Every Effort Not to Fund Immoral Activity* (2004). Available at http://www.aodonline.org/aodonline-sqlimages/SHMS/Faculty/LatkovicMark/UnpublishedWritings/OnMorallyResponsibleInvesting05Nov.pdf (accessed March 2012).
6. Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Singapore: John Wiley & Sons, 2007).
7. Dow Jones & Company, *Dow Jones Indexes* (February 27, 2009). http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicStats#fund (accessed March 2012).
8. Vaishanvi Bhatt and Jahangir Sultan, *Leverage Risk, Financial Crisis, and Stock Returns: A Comparison among Islamic, Conventional, and Socially Responsible Stocks, Islamic Economic Studies* 20 (June 2012): 87–143.
9. http://ussif.org/resources/sriguide/srifacts.cfm (accessed March 2012).
10. R. Sparkes, *Socially Responsible Investment, a Global Revolution* (Chichester, West Sussex: John Wiley, 2002).

11. For example, the Sullivan Principles were largely responsible for discouraging investments in firms doing business in South Africa in the ’70s to protest against apartheid.
12. Eurosif (European Sustainable Investment Forum). European SRI Study, 2010, available at www.eurosif.org (accessed February 5, 2014).
13. The reader is cautioned that all socially responsible investing is not morally responsible. For example, SRI would permit investing in a scientific firm that does research on stem cells, or produces contraceptives, or promotes alternative lifestyles such as homosexuality, or uses animals for scientific research. All these activities would be deemed immoral according to the Catholic religion.
14. Credit Suisse, 2011.
15. At the firm level, there are a lot of instances where firms that pass the MRI screening also pass the SRI screening. For example, Microsoft, Johnson & Johnson, Intel, Proctor & Gamble, Cisco, and PepsiCo are a few firms that are also identified as both MRI and SRI compliant. Wafica Ghoul and Paul Karam, “MRI and SRI Mutual Funds: A Comparison of Christian, Islamic (Morally Responsible Investing), and Socially Responsible Investing (SRI) Mutual Funds,” *Journal of Investing* 16 (2007): 96–102.
16. Jeroen Derwall, Kees Koedijk, and Jenke Ter Horst.
17. James Angel and Pietra Rivoli, “Does ethical investing impose a cost upon the firm? A theoretical perspective,” *Journal of Investing* 6:4 (1997): 57–61; H. Hong and M. Kacperczyk, “The price of sin: the effects of social norms on markets,” *Journal of Financial Economics* 93 (2009): 5–36.
18. Report on Socially Responsible Investing Trends in the United States. 10–Year Review (Washington DC: Social Investment Forum, 2005).
19 Ibid.
20. Ernst & Young, “World Islamic Banking Competitiveness Report 2012–2013: Growing Beyond: DNA of Successful Transformation.” 2012. Available at http://www.mifc.com/index.php?ch=28&pg=72&ac=21&bb=uploadpdf.
21. What sets shari‘a-compliant investors distinctly apart from conventional or SRI investors is the fact that their investments must be shari‘a-compliant. As the divine code of law, shari‘a serves as “the guide for human action, which encompasses every aspect of human life and [. . .] operationalizes the understanding of the Divine Will in terms of human actions.” The framework of shari‘a is based on the Qur’an, the written revelation of God’s Word, and the *sunna*, which is comprised of the teachings and practices of the Prophet Mohammed. Deriving its rulings from the Qur’an and *sunna*, shari‘a is instilled with divine authority. Hence, the guidelines set forth in shari‘a become imperative to all Muslims and govern all aspects of life, whether they are of a personal, social, political, economic, or financial nature.
22. Jahangir Sultan and Milly M., “Portfolio Diversification during Financial Crisis: Analysis of Faith-Based Investment Strategies,” *Building Bridges across Financial Communities: the Global Financial Crisis, Social Responsibility, and Faith-Based Finance* (Cambridge, Massachusetts: Islamic Finance Project, Harvard Law School, 2012).
23. In this regard, it would be interesting to compare the performance of portfolios based upon sin stocks (shunned stocks) across the three universes of stocks considered in this paper. The use of SC stocks to test the shunned stocks hypothesis is unique in the sense that shunned SC stocks are still shari‘a-compliant, while the conventional and SRI stocks may not be. We will address this issue in the empirical section.

24. Also see, Jeroen Derwall, Rob Bauer, Nadja Guenster, and Kees C. G. Koedijk, "The eco-efficiency premium puzzle," *Financial Analysts Journal* 61 (2005): 51–63.
25. KLD STATS database ranks publicly traded US firms on social and environmental issues.
26. The values-driven investment strategy has its roots in Merton's incomplete information model. Accordingly, investors' inability to be aware of a particular stock causes its price to be lower in the short run; Robert C. Merton, "A Simple Model of Capital Market Equilibrium with Incomplete Information,"*Journal of Finance* 42 (1987): 483–510.
27. Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118:1 (2003): 107–155.
28. There are also some issues regarding the impact of the 1/3 rule. As El-Gamal suggests, the rule introduces pervasiveness in the way fund managers are forced to buy and sell stocks. For example, fund managers buy stocks when price is rising (implying D/market cap is low). Subsequently, an increase in the D/market cap in a falling market would prompt the firm to be excluded from the shari'a-compliant universe. This would again force fund managers to sell the stock when the price is too low; Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006).
29. Mohammed Obaidullah, *Islamic Financial Services*. Islamic Economics Research Center, King Abdul Aziz University, (Jeddah: King Abdul Aziz University, 2001; Mahmoud El-Gamal, "*Interest and the Paradox of Contemporary Islamic Law and Finance*," *Fordham International Law Journal* 27:1 (2003): 108–149.
30. Zamir Iqbal and Abbas Mirakhor; M. Nejatullah Siddiqi, "Islamic Banking and Finance in Theory and Practice: A Survey of State of The Art," *Journal of Islamic Economic Studies* 13:2 (2006): 6; Eddy Yusof, Fahmy Ezry, Jhordy Kashoogie, and Asim Anwar Kamal, *Islamic Finance: Debt versus Equity Financing in the Light of Maqasid al-Shari'ah*. Munich Personal RePec Working Paper no. 20722, 2009. http://mpra.ub.uni-muenchen.de/20722/ (accessed on February 5, 2014).
31. It is critical to note that screening firms on the basis of low debt ratio does not make stocks representing the Dow Jones Global Index and the Dow Jones Sustainibility index shari'a-compliant because these firms may be involved in activities not permissible under shari'a law. To this extent, a negative screen to exclude stocks with high debt ratio is interesting because it allows us to examine the performance of the selected stocks with very little exposure to the debt market.
32. As pointed out earlier, stocks classified as shari'a-compliant are selected on the basis of several screens employed by the Dow Jones Islamic Index Sharia Board. Excluded from the universe are stocks representing alcohol, pork-related products, conventional financial services, entertainment, tobacco, and weapons and defense. In terms of financial ratio screens, for each firm, the following ratios must be less than 33%: "Total debt divided by trailing 24-month average market capitalization must be less than 33%, sum of company's cash and interest-bearing securities divided by trailing 24-month average market capitalization, and accounts receivables divided by trailing 24-month average market capitalization. No further screens were utilized to form the universe of shari'a-compliant stocks." See http://www.djindexes.com/islamicmarket/.
33. See the appendix in Joel Greenblatt's *The Little Book That Beats the Market* (2006) for a detailed back-test performance analysis. Sultan and Milly (2011)

use Greenblatt's methodology to conduct performance tests for Islamic, SRI, and conventional investment strategies. Also see http://seekingalpha.com/article/237970–how-does-joel-greenblatts-magic-formula-investing-hold-up.

34. As Sultan and Milly (2011) report, higher EY and ROC values are better so that the highest EY stock would receive an EY rank of 1 and the highest ROC stock would get a ROC rank of 1. The EY and ROC ranks are added together—the best stocks will have the "lowest" ranking. For example, if the stock with the highest EY also had the highest ROC, its overall rank would be 1 + 1 = 2.
35. Note that while the debt ratio is capped at 33% for the shari'a-compliant firms, conventional and SRI stocks are not constrained by this limitation.
36. Söhnke M. Bartram and M. Bodnar Gordan, "No place to hide: The global crisis in equity markets in 2008/2009," *Journal of International Money and Finance* 28:8 (2009): 1246–1292.
37. This part of the discussion has been adapted from Andy Singh's "Leverage 101: The Real Cause of Financial Crisis," September 25, 2008, extracted from http://seekingalpha.com/article/97299-leverage-101-the-real-cause-of-the-financial-crisis.
38. Economic Research: Federal Bank of St. Louis. "Federal Reserve Economic Data (FRED)" available at http://research.stlouisfed.org/fred2/; We acknowledge that the use of the US risk-free rate as a proxy for global risk-free rate is arbitrary.
39. E. Fama and K. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance* 47 (1992): 427–465.
40. This is consistent with the portfolio formation procedure as suggested in Fama and French (1992). However, for the purpose of firm-specific analysis, we consider all stocks.
41. See Bhatt and Sultan for more on the construction of the risk factors.
42. Lawrence R. Glosten, Ravi Jagannathan, and David E. Runkle, "On the Relation Between the Expected Value and the Volatility of the Nominal Excess Return on Stocks," *Journal of Finance* XLVIII:5 (1993): 1779–1801.
43. In cases where a standard TGARCH model did not converge, we estimated the asymmetric GARCH model known as EGARCH, originally in Nelson (1991). The EGARCH model allows one to specifically account for the fact that good news and bad news may have differential impact on the volatility structure. Specifically, the conditional variance equation is:

$$\log(\sigma_t^2) = \omega + \sum_{i=1}^{p} \alpha_i \left| \frac{\varepsilon_{t-i}}{\sigma_{t-i}} - \sqrt{\frac{2}{\pi}} \right| + \sum_{j=1}^{q} \beta_j \log(\sigma_{t-j}^2) + \sum_{k=1}^{r} \gamma_k \frac{\varepsilon_{t-k}}{\sigma_{t-k}}$$

where α measures the symmetric impact of past innovations and β measures persistence in conditional volatility. The coefficient λ measures asymmetry (or leverage) effect. When λ is zero, the model is asymmetric (good news or bad news have same effect). When λ is negative, good news contributes less to the volatility than bad news. Finally, when λ is positive, good news increases volatility more than bad news. See Nelson (1991) for more on EGARCH models; Daniel B. Nelson, "Conditional Heteroskedasticity in Asset Returns: A New Approach," *Econometrica* 59:2 (1991), 347–370.

44. The reader is cautioned that the choice of "value" and "values" to describe our portfolios can be confusing. Values portfolios are simply portfolios that include low

debt/equity firms, while "value" refers to the traditional Fama-French portfolio of return on values stocks minus return on growth stocks.

45. We chose the EGARCH model to estimate the returns for the conventional and SC portfolios to avoid convergence issues.
46. It is important to point out that we do not purify these raw returns by purging impure returns (returns due to interest income). This would involve excluding companies with an impure income of 5% of total income or more. We recognize that this is a limitation of our paper but we hope that a portfolio manager would be able to declare this percentage to all investors in the fund, Muslims and non-Muslims alike, and it is up to Muslim investors to distribute this percentage of income as charity.
47. To conserve space, these results are not reported, but are available upon request.
48. The SRI portfolio constructed using low leverage is an exception. It has a positive alpha but it is insignificant at conventional significance levels.

Hybrid *Sukuk* for SMEs: Financing the Real Economy through Ethical Principles

Anass Patel

INTRODUCTION

After many years of practice in the capital markets, asset management, and structured financing, we came to the conclusion that there are two trends that are misleading our rational economic approach to banking and financing. On the one hand, banks, whether conventional or Islamic ones, tend to request more and more collateral or guarantees on their borrower regardless of the nature of the project to be financed, the quality of the underlying assets, and the track record of the entrepreneur-borrower. On the other hand, risk capital investors, who are more likely to take risks on the potential upside of the project with less focus on the credit history of the client, are getting involved only through more and more complex instruments; their engagements, which should supposedly be equity investments, are in practice acting more like debt instruments in the form of equity-like features such as subordinated or venture loans. This clear evolution of the financial market between "minimum risk taking" (loans with strict guarantees) and "upside-only risk sharing" (equity with debt security features) is putting a clear strain on the smaller economic players such as the small medium enterprises (SMEs), which are less capable of accessing vanilla types of financing due to their size and risk profile.

Many authors have written about the differences and issues raised by collateral-based debt or profit and loss sharing (PLS) contracts, mainly under the asymmetric information analysis framework.[1] But we believe that there has not been enough focus on the SMEs segment, which is a better image representation of the real economy in the modern world. While the debate has been hot on the nature of Islamic financial instruments, especially about the partnership format, and their resulting compatibility with the modern markets considering the lack of robust risk management systems and,

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Anass Patel, President, 570 Asset Management, Paris, France.

alternative solutions. However, project or venture financing have been less covered in those debates.

To best illustrate the disconnect between collateral-based debt and upside-only risk capital, we would like to share our experience in the French economy, where we had to find an alternative to *riba*-based bank financing with an innovative structure that had to overcome this double challenge of "no risk-taking loans" or "no risk-sharing equity." Tax considerations aside, we believe that market participants do not have the right approach when considering the appropriate allocation of equity or debt towards SMEs/asset-backed projects finance.

The assumption behind this hybrid *sukuk* model is that when structuring an SME-specific *mudaraba*-based partnership financing instrument, transaction costs will become incrementally insignificant. This is considered only if they are used properly and at such a scale, through a program issuance, for example. As such, hybrid *sukuk* does provide a credible alternative to conventional loans, which are increasingly costly and inaccessible to smaller SMEs or entrepreneurs due to the credit crunch. For the importance of developing more equity-based contracts away from simple debt-based contracts, we refer to numerous works by eminent scholars.[2]

In a nutshell, the model is neither an equity partnership where the capital investors take most if not all power and upside gain, nor a pure collateral-based debt with a pre-defined interest rate disconnected to the performance of the project. However, it is a true value-sharing instrument between an entrepreneur (*mudarib*) with their expertise and business idea, and investors (*rab al maal*) committing to a participative debt funding component (*sak*) completely modeled on the business plan and potential value of the underlying assets, making it truly a risk-sharing transaction. It is not a win-lose situation as with the classical lender-to-borrower relationship, but a participative financing method dependent on the success of the project to generate the necessary cash flow. This cash flow, in turn, gives the entrepreneur the ability to grow and be successful with the performance shared with its capital partners (*sukuk* holders). Contrary to the proposal of Bacha to have an alignment of interest through equity-kicker, which raises some shari'a issues that are yet to be resolved, the innovation of this project resides in the contractual framework with a package of partnership instruments (participative loan with no collateral but a waterfall of sharing devices acting as the *mudaraba* contract) glued together under a *sukuk* scheme that makes the relationship established on true creation of valuable assets. In our project's case, the project consists of the creation of a new restaurant with tangible assets, branding, clientele, and the track record of the entrepreneurs, who were already successful in this business.

With this perspective, we suggest the following three assumptions based on the proposal developed in this study, which is premised on the pilot project at stake:

a) Bank loans are not adapted to SMEs situation;
b) The profit and loss sharing approach for SMEs financing can work; and
c) Hybrid structure in the form of participating *mudaraba sukuk* is a credible alternative.

The paper is organized into four sections. In the first section, we discuss the SMEs market in light of the 2008 crisis and the new Basel II regulation. We will also discuss some recent empirical analyses showing that SMEs are suffering the most in terms of access to financing due to some intrinsic determinants of their structure. In the second section, we introduce our analysis to accommodate PLS contracts to SMEs in France. Then we begin elaborating on the framework prototype developed in section three. We then conclude the paper in the last section with a comparative analysis of the most recent *mudaraba sukuk* issued by one of the largest investment banks in the Gulf region, the Saudi Hollandi Bank.

WHY ARE BANK LOANS NOT ADAPTED TO SMEs?

Before we start looking at the reasons why bank loans are not adapted to the needs of SMEs, let us first provide a general view of the SMEs market, especially some background in the French context.

SMEs MARKET ANALYSIS

In most modern economies, there is a large industry of venture capital with many quasi-equity instruments in different flavors (equity-link bonds or certificates, depending on US, UK, and European legislations) and there is a large practice of subordinated loans or, better put, participative loans, the latter having the flexibility of the former but with a remuneration partly or entirely tied to the performance of its underlying assets. Yet these instruments are not well developed or are not accessible to mainstream SMEs. This concern has been the subject of our research for practical solutions considering the potential market at stake—SMEs financing in France—outlined below.

The SMEs market is indeed a very strategic segment for the French economy in terms of value creation. According to the latest panorama to the SMEs sector,[3] SMEs account for nearly two thirds of employment (63%), more than half of total added value (53%), and a little over a third of real investment (34%). Many French academic studies[4] have discussed the challenges facing this vital market segment, which can be summarized into three main issues:

a) They are affected by a lack of equity even though they suffered less from the consequences of the 2008 financial crisis;
b) They have less access to financial markets for their financing needs, making their cost of capital more expensive; and
c) They suffer from a risk rating system that takes into account mainly their historical performance, which does not really reflect their potential growth and the robustness of the economic model.

The French *halal* food market is worth more than €5Bn in annual sales, growing by 15% over the last five years according to various local surveys.[5] It is possibly the foremost sector where Muslim entrepreneurs are flourishing due to their expertise in this market and their cultural proximity to the targeted consumers. Thanks to the new mode of consumption, the targeted consumers' eating habits have been developing greatly over the years.

Another powerful trend regarding SMEs and their economic development is related to the source of financing of lenders who are constrained by the work of the Basel II Committee. This new framework highlights a disconnect between risk analysis methods and basic modes of financing (secured financing) that supposedly favor smaller borrowers. Aubier and Cherbonnier[6] have looked at corporate access to banking loans and suggested increasing difficulties for smaller companies partly due to Basel II regulatory constraints. This new risk framework is introducing a deeper credit risk analysis that depends on the lender's size in order not to bias the analysis of its risk of default. This is especially true with the retail SMEs category.

If one wants to develop a specifically designed hybrid structure for SMEs, looking from conventional loan financing to capital risk and venture loan financing, it is very likely to end up with a so-called innovative structure that refers to Islamic principles based upon its core risk-sharing principles. Hybrid securities, whether as close as quasi-equity tranche (convertible shares) or in the form of debt instruments (convertible debt), play on two crucial dimensions of time and risk. In the context of Islamic finance, if one could take the best of both worlds and design a particular type of participative loan in the form of an asset-backed structure the remuneration of which depends mainly on the underlying profit, it shall present some strong appeal in response to the vast needs of SMEs, even more so for those with high growth potential (post initial seed capital phase).

Mudaraba financing is "really a hybrid," enumerating the similarities between the Islamic instrument and conventional equity from the *mudarib* side.[7] As Bacha states in his overview of *mudaraba* in his 1997 paper called "Adapting *Mudarabah* Financing to Contemporary Realities: A Proposed Financing Structure":

a) There are no "fixed" annual payments that are due (unlike interest);
b) Payments made to the Islamic banks come from profits, much like dividends—they need to be paid if and only if there are profits;
c) The Islamic bank cannot foreclose or take legal action if there are no profits and therefore nothing to be shared; and
d) Like equity, using *mudaraba* financing does not increase a firm's risk the way debt financing does through increased financial leverage.

On the other hand, Bacha continues, *mudaraba* financing can appear to the *mudarib* as a conventional debt for the following reasons:

a) It represents a "fixed" claim by the Islamic bank on his company, being the initial amount plus whatever accrued profits (losses) that are due to the bank; and
b) Like debt, *mudaraba* financing is terminal; that is, the arrangement can be ended either by mutual prior agreement or by one party. The *mudarib* can end the relationship by repaying the principal and accrued profits to the financier.

So, unlike equity, which represents an unlimited and perpetual claim, *mudaraba*, despite the features that make it seem like equity, represents a fixed and terminable claim, much like debt, hence the earlier argument that *mudaraba* is really a hybrid in the conventional sense.

In theory, regarding SMEs in particular, the above should lead us to the examination of the scope of their financing needs and assess their ability to support quasi-equity financing and/or participative loans with the backdrop of a profit and loss sharing (PLS) contract. In practice, thanks to a pilot project (prototype) conducted in the food industry, we came up with an alternative financing method which allowed French Muslim entrepreneurs to launch a new food chain that benefited from a strong asset-backed structure with hybrid financing. This attracted individual and professional investors as *sukuk* holders who share the risks of the project.

Despite the benefits, conventional economists are adamant in arguing that debt-based contracts are preferable to PLS contracts because the lender only faces a credit default risk, thanks to the ex-ante fixed rate of return, rather than other issues related to the nature of the asset or the relationship with the borrower (asymmetric information to be detailed later). In other words, the debt contract has to be honored regardless of the state of nature, whereas the sharing contract is state-dependent. Debt has seniority over sharing contracts offering more security.[8]

Let us now observe a global view on collateral-based debt within the new capital regulation framework.

COLLATERAL IS NOT THE HOLY GRAIL OF RISK MITIGATION FOR BANKS

In a usual banking relationship between lenders and borrowers, a bank will first and foremost grant a loan to a corporate client depending on its historical financial strength, its credit rating, and through determining in some way the perspective of the potential growth of the company in the future. More often than not, the bank will request a guarantee or collateral to its client, in the form of cash collateral or on an existing asset guarantee/collateral, whether it belongs to the company (in its balance sheet) or its shareholders (their personal wealth). In this sense, it performs a normal assessment of the overall strengths and risks of the company's structure independent of the specific features of the project, meaning it does not rely on the nature of the assets/project being financed or the potential wealth generated by the project. That being said, we can see that banks are generally more concerned about the three main risk circles known as the credit risk, market risk, and operational risk.

Collaterals and guarantees are powerful tools for lenders to minimize asymmetric information, especially for conventional banks facing mainly adverse selection agency problems.[9] Better the quality of collateral, more favorable the terms offered by the financial institution to the borrower. According to Dairi, "the collateral is supposed to reduce the risk of the loan and also to proceed to recovery in the event that the borrower is defaulting on its payments."[10] Indeed, providing collateral or a guarantee is not only a pledge against default for the financial institution, but it is also a tool to reduce the informational opacity of small businesses. The lack of information might result in credit rationing or the extension of credit only on relatively unfavorable terms, especially in France.

But what collaterals and guarantees do not capture is the potential adequacy from the value creation to the strength of the project at stake. In a way, it is not meant to do so, since the commercial loans that need to be guaranteed are against the risk of default of the borrower and not from the specific project being financed. Indeed, most of the risk management practices in the finance industry are geared toward "credit risk" (i.e., the borrower risk profile; can he meet his payment obligations, regardless of external events) while focusing less on the "project/asset risk" (i.e., the robustness of the underlying asset financed; can they provide some components of economic robustness and diversification factors to influence the volatility of economic cycles). In other words, due to information asymmetry and moral hazard, bigger companies benefit from the increased odds of successfully taking out a loan from a bank (especially with large banks or investment banks). This is true despite the fact that these big businesses lack the advantages that new, highly specialized entrepreneurs demonstrate with their distinct competency in execution of their target projects. In addition, one could argue that international banks tend to specialize their team vertically, in order to better appreciate the specifics of the industry in which their clients grow and sustain their relationships for this market. This captures a potential worst-case scenario for SMEs and entrepreneurs, as these types of banks are generally investment banks with high barriers at entry and are only affordable to larger organizations.

PROBABILITY OF DEFAULT IS CERTAINLY THE MOST IMPORTANT COMPONENT OF CREDIT RISK, BUT HOW CAN IT ADAPT TO SMALLER BUSINESS UNITS?

In the context of banking regulation, probability of default (PD) is essential to the approaches foreseen by both Basel II and the Capital Requirements Directive (CRD), and is therefore the main determinant of capital reserves for banks. To understand how the risk elements interact in those capital reserve frameworks, we shall refer to the work of Ayadi and Resti[11] with particular reference to their comparison of the Basel impact on SMEs financing. According to Ayadi and Resti, "PD must be computed over a one-year risk horizon, accounting for possible deteriorations in the borrower's creditworthiness in the medium to long term. It is therefore a rather dynamic risk element and should not be taken for granted once and for all."[12]

The two authors further summarize the impact of such risk analysis for SMEs in the following points:

a) A SME can have a PD within a category or a class, for instance, between 0.01% and 10%;
b) The exposure at default (EAD) will range in general between 50% and 100% of the loan. Default often occurs soon after lending. The lower the outstanding loan, the less frequently default occurs; and
c) Loss given default (LGD) most commonly fluctuates between 20% and 100%. The worst scenario is that the bank/financial institution does not recover any of the defaulted amounts, and hence, the recovery rate is 0 and the LGD is 100%. In the best scenario, recovery rate will reach 80% of the principal outstanding; hence the LGD will be reduced to 20%.

Ayadi and Resti continue to explain how "The expected loss is a simple multiplication of PD X LGD X EAD. In conjunction with the maturity estimate of the exposure (*m*) and the diversification coefficient (*rho*), these risk parameters are used to determine capital for both economic capital and Basel II regulatory capital models. Risk weights and capital requirements would be determined by a combination of a bank, providing the quantitative inputs, and the supervisor, providing the formulas."[13]

With all the new banking regulations under the Basel framework, banks will have to develop deeper relationships with their smaller clients, as they will have to classify their portfolios into categories of risk with probability of default (PD) and the potential income impact (loss given default measure).

Interestingly enough, this may propel participative loan financing. Participative loans contain clauses and conditions under which the lender participates in the revenues of the assets. The level of participation may be calculated from the gross revenues, operating income, net income, or net cash flows of the assets. This type of financing tends to trigger other types of risk that will be discussed later.

A collateral-based (*riba*) contract creates an explicit mapping between the compensation and the input of capital. There is a disconnect between the time when the bank has to screen and allocate its capital, with potential adverse selection issues, and the lifespan of the financing contract where the borrower is tied to a lock structure with legal obligations toward its debt payments.[14] In contrast, Pressley and Sessions believe that the "incentive compatibility requires the manager to set inefficiently low levels of capital investment in bad states of the world, whilst leaving him free to set effort at the individually optimal first best level in all states. If *riba* is prohibited then the return to investors cannot be tied to the level of their capital investment and alternative compensatory arrangements will be required."

On the contrary, Pressley and Sessions state that *mudaraba* financing "ties compensation to the outcome of the project. *Mudaraba* therefore allows the contract to directly control the manager's incentive to exert effort, since this effort affects the relationship between capital investment and the outcome of the project. Under a *mudaraba* contract the manager is free to choose the individually optimal level of investment in each state contingent on his contractually specified level of effort. Such a contract permits a mean-variance improvement in capital investment—average investment is increased whilst inefficiently large fluctuations around this level are reduced."

Here we can observe, theoretically, that *mudaraba* adapts well to SME financing, but in practice there are other challenges to overcome, such as the screening phase by the financier.

NEED FOR BETTER SMEs RATING TOOLS

As stated by Ayadi and Resti, rating an SME "involves applying a statistical system that multiplies a series of descriptive ratios by a set of coefficients, which results in a certain value (a rating or score). This value allows for comparison between SMEs, establishing a sort of risk gradient: the higher the value is, the higher the probability of default. The value corresponds to a determined risk category, and this risk category is associated with a PD. Therefore, to analyze the impact of a certain rating system, one must look at the precise set of ratios used, which should be adapted to the environment at stake."[15]

In the context of Islamic banking, it is clear that all of the above must be applied carefully. This application depends on the nature of the instrument involved, and the nature and the timespan of the relationship, whether it be short to medium debt or longer-term equity-based financing.

Adapting rating tools to SMEs, especially within the context of shari'a-compliant projects, is something yet to be developed, especially in non-Muslim countries. Both from a macro-economic standpoint and from a micro level, all this depends on the parties involved, the usage of the Islamic contracts, the risk profile, its robustness in the local legal system, and other potential frictions that may occur due to the scarcity of shari'a-compliant projects (Islamic assets count for only 1% of the global market).

One alternative to collateral-based debt with a uniform grid of risk rating analysis is to refer to new works being conducted over behaviors and psychology. Indeed, new psychometric testing tools are being developed[16] current experiences such as crowd sourcing and crowd funding (with online portals such as Zopa, Babyloan, FriendsClear, etc.) are opening new avenues in terms of risk sharing.

From all the research works on the subject, we can summarize that SME financing is facing the following three major challenges in the context of agency problems:

a) The cost of financing is higher than average large corporations that have access to cheaper capital in the market or better facility conditions with the non-retail banks.
b) The structure of their balance sheet—a higher proportion of working capital than fixed assets—does not allow great flexibility for the lender to apply the usual collateral and guarantees other than personal assets.
c) The risk rating system works mainly on the supposed robustness of the borrower itself rather than the projects or assets being financed. This system provides analysis tools geared toward the risk of default of the borrower, which make them more favorable to companies providing longer historical records with smooth life cycles rather than SMEs, though Basel regulation should offer more precision in the details of parameters taken into account.

On this last point, Aubier has looked at Basel II impact on SME financing and concludes that there is a positive impact. Indeed, Basel II introduced a deeper credit risk analysis depending on the lender's size in order not to bias the analysis of its risk of default, especially with the retail SME category.[17] One of the reasons this works positively is the diversification effect of the loans portfolio for the lender, since the SME loans and their underlying assets are not correlated to its other loans and obligations. Going further, we anticipate that SME financing will be more complex to handle by existing banks as their risk culture is not geared toward understanding the intricacies of the project being financed, but only the credit risk of the borrower. This is one of the reasons why we would encourage SMEs and their financial advisors to move toward more equity-like products or PLS contracts, which offer alternative dimensions of risk and performance to the lender/investor.

To conclude at this point, it is safe to say that bank loans are not appropriate to SMEs' needs and the risk-profiling techniques operated over these small structures, lacking historical records and guarantees, does not work. As such, it is a good challenge to turn to alternative methods of financing, not dependent on the collateral offered by the borrower but favoring asset-backing structure, which provides the financiers with better access to the performance of the underlying asset and if need be to its ownership in case of default.

We shall now examine how profit and loss sharing techniques in the form of hybrid structures, a mixture of equity and debt instruments, can present sustainable alternatives for SMEs.

THE PROFIT AND LOSS SHARING (PLS) APPROACH FOR SME FINANCING

The literature on Islamic sharing contracts applicable to smaller companies is not as prolific as for large corporate entities. Indeed, most of the authors have looked at determinants that impact generic agency problems between principal and agent (the *rab-al-mal* and the *mudarib*).

It is not our objective here to do an extensive review of the literature but, in essence, most of the publications in this area allow us drawing the following summaries:

a) *Mudaraba* techniques trigger agency issues, which are regarded as the most important tools and which involve two or more parties entering into a contract with capital and entrepreneurship to undertake a joint venture (trade, business, manufacturing, etc.) to share the profit according to a predetermined ratio;[18]
b) The use of a *mudaraba* (prevalent alternative method of financier remuneration) will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of *mudaraba* to act as an efficient revelation device (Presley and Sessions, 2002);
c) Traditional theories of intermediation are based on transaction costs and asymmetric information, but the literature's emphasis on the role of intermediaries as reducing the frictions of transaction costs and asymmetric information is probably too strong;[19]
d) Debt contracts expand the set of projects funded and improve social welfare;[20]

e) A variable return scheme has a higher monitoring cost;[21]
f) When markets are perfect and complete, the allocation of resources is Pareto efficient and there is no scope for intermediaries to improve welfare;[22]
g) Ex-ante information limitations (project quality and incentive of under-reporting) explain severity of asymmetric information;23 and
h) Profit sharing ratio can be used as a screening device to avoid the adverse selection problem of *mudaraba* and to improve the profitability of a venture.[24]

In this section, we will see how these theories apply to our SME context and if we can look at alternative ways of contracting in order to overcome these issues.

IS RISKY AND COMMUNITY-BASED CAPITAL THE ONLY OPTION FOR THE MUSLIM-LED SMEs?

Going back to our pilot experience, we noticed the following situation in the French market. We had French Muslim entrepreneurs who had been successful in launching new food concepts, one as a fast food mini-chain (four units) and the other as French traditional *halal* restaurants (two main units and a state-of-the-art catering facility. The way they achieved this growth was mainly using their own equity, getting some friends and families involved in the company setup, with no real governance framework. They ended up raising some no-interest-bearing loans for working capital purposes. Once we discovered the value they created with such basic financial instruments, we discussed the potential of raising equity from a larger pool of investors and tapping into institutional funds and venture capitalists. But quickly, in the analysis, we understood that their management structure and their financials would not fit into what those institutions would require both in terms of governance and ownership, with the consequence of capital dilution and loss of control for the entrepreneurs. The latter were clearly in the sole position of leading the business thanks again to their agility and proximity to the clients and their unique mix of know-how and expertise in their local markets, without which financiers' ownership control would have derailed the dynamics of this specific business.

It was quite easy to understand that for such potential projects with great growth prospects (i.e., double digit growth figures anticipated by many market analysis firms), we would not be able to apply usual financing methods either from the banking sector or from institutional investment funds.

What we needed to do then was move away from conventional loans and from fixed return financing instruments such as *murabaha* (cost plus margin debt financing) or *wakala* (fixed fee based financing in the diverse form of contracts or mandates) structure. We had to investigate the partnership-based contracts at the core principles of Islamic finance while making sure that both the entrepreneurs and the investors in France would be satisfied with such risk-sharing alternatives.

For such reasons, we decided to explore PLS techniques and go to intermediate solutions from equity capital to senior loan financing by leveraging what Islamic finance encourages investors to do, i.e., participative structures, and what the French commercial law offers as the best alternative. We initially came across what is called participative loans (*prêts participatifs*), a not-so-used instrument that had been established in the French context in the 80s when the state had to inject more money into the economy and led by example by taking a subordinated position to private companies or public representative state bodies.

As confirmed by the literature, the *mudaraba* contract is a profit-sharing financial instrument that is neither a financial liability nor an equity instrument. Unlike equity instruments, *mudaraba* contracts are redeemable at maturity or at the initiative of their holders, but (usually) not without the prior consent of the financier.[25] On the other hand, unlike debt instruments as referred to by Archer et al. (1998), investment accounts are not a liability of the bank because they share in the profits generated from their funds, and also bear their share of any losses incurred. Thus, they have a claim on the financier's earnings or assets that ranks *pari passu* with that of the shareholders.

In our case—that of growing SMEs with entrepreneurs who could offer their track record, honesty, and business potential for new projects in the real economy—*mudaraba* setup was the way forward. But *mudaraba* contracts, strictly speaking, pose many issues as seen before in terms of agency problems and in terms of enforcement with applicable local legislation. As such, we wanted to stick to the PLS value proposition using the *mudaraba* structure but in a more flexible way in order to attract financiers concerned about lack of information as discussed before. To achieve this, we decided to provide more visibility into the structure through a *sukuk* structure issued by a dedicated vehicle setup for the sake of the project with its own governance and monitoring tools with the help of an external shari'a asset manager. This is the reason why we decided to investigate a little more about hybrid instruments and their practice in the financial world.

HYBRID SECURITIES FROM THE CONVENTIONAL ARENA TO THE ISLAMIC WORLD

Hybrid securities are a form of securities that combine elements of debt and equity at the same time. As stated in the financial literature, they are a popular method for companies to raise funds by issuing a form of hybrid debt that has both debt and equity features. The most common forms are converting preference shares and convertible notes, although there are many variations, to replicate the price movements to the ordinary shares of the issuer. Hybrid securities offer the investor an alternative asset class to the traditional fixed income securities based on interest payments with the opportunity to enhance the performance. The key to these investments is the quality of the underlying asset, which will be reflected by the credit rating and the financial abilities of the company to repay its payment obligations through the interest as well as the capital on maturity or conversion. Moreover, they do offer a lower after-tax cost of capital to the issuer, while at the same time they are a less expensive form of accessing capital than equity markets, which draw much capital dilution for issuers. It is probably an indication of the level of sophistication of our modern markets that hybrid securities, traditionally used in the wholesale end of the market, have found growing acceptance by retail investors, thanks to disintermediation platforms among other things.

On the other side, hybrid securities are beneficial to investors because they provide investors with protection during bankruptcy as compared to common stock. That is, hybrid investors are eligible to be paid before common stockholders in bankruptcy cases. Consequently, hybrid securities generally provide a higher rate of return than typical debt instruments, though they are not treated as speculative instruments or high yield bonds. Although there is a risk element attached to these securities, the risk is usually diminished if the securities are held to maturity. At maturity a hybrid may convert to ordinary share, cash, or a mixture of both.

In our globalized economies, the main attraction toward hybrid securities is their tax treatment, as what has been developed in Luxembourg, for example, one of the European financial hubs that develops advance financial instruments for the markets including shari'a-compliant instruments for Islamic investors. Below are the different financial instruments offered in Luxembourg:

a) Simple bonds
b) Profit participative bonds
c) Convertible bonds
d) Equity/participant bonds
e) Equity loans
f) Tracker-certificate
g) Preferred equity certificates (PEC)
h) Convertible preferred equity certificates (CPEC)

They can easily be mapped out as illustrated in Table 1 below, showing the width of these hybrid securities from end to end, from equity to bond.

Table 1. Spectrum of hybrid securities

		Convertible preferred			Convertible debt			
Instrument	Shares	Mandatory convertible	Convertible preferred	Hybrid preferred security	Convertible debt	Premium/ discount convertible debt	Zero coupon convertible debt	Bond
Conversion probability	Certain	Certain/high		High/medium		Medium	Low	Zero

Source: "Luxembourg Vehicles for Islamic Finance," Luxembourg in Finance's brochure

Islamic finance specialists would probably argue that one can structure similar instruments in a shari'a-compliant manner, but the economic rationale is biased, as this would tend to replicate conventional techniques in an Islamic wrap. On the other hand, the idea is to reflect on Islamic ethics and principles and build a suitable alternative from this base. This has been the challenge of our project in the specific context of French law.

APPLYING PROFIT AND LOSS SHARING (PLS) TECHNIQUES IN THE FRENCH SYSTEM

The principle of profit and loss sharing, being a consequence of the prohibition of *riba*, is one of the key distinguishing features between Islamic and conventional finance. In Islamic finance, instead of lending money with an (usually fixed) interest rate, the parties will form a partnership and share the profits and losses "according to a formula that reflects their respective levels of participation."[26] This basic principle of PLS also exists in the French law as described thus:

a) Firstly, similar to the *mudaraba* and *musharaka* structures, a partner in a French company is entitled to part of the profits and has to contribute to losses (Art. 1844-1 of the French Civil Code).[27] Secondly, the participative loan, which is governed by Articles L313-13 through L313-20 of the French Monetary and Financial Code, is also similar to these two Islamic finance contracts. Indeed, at the crossroads of long-term loans and stockholdings, the participative loan is a credit agreement by which an authorized body provides financial assistance to a company. Its uniqueness lies in two distinctive features:

   i) If the borrower's company is put into liquidation or receivership, the lender agrees to be ranked for repayment only after all of the borrower's secured and unsecured creditors; and

ii) The lender charges a fixed fee (legally called interest but not necessarily understood as *riba*), usually increased by a profit-sharing system.[28]

b) Secondly, in addition to the participative loan, French law includes participative securities (*titres participatifs*). Addressed in Article L228–36 of the French Commercial Code, participating securities are debt securities of undefined duration. They are redeemable only in the event of the company's winding-up. For this reason, they are considered "quasi equity." This has some advantage to the issuer, as he can strengthen his (quasi) equity without changing shareholders or the control power. Reflecting the duality of such securities, the compensation of underwriters must include both a fixed component and a variable one.[29]

c) Moreover, Islamic finance requires that every financing should be backed by a tangible asset. This principle, which reinforces the potential of Islamic finance in terms of stability and risk management, is also present in French law; for example, the shares of mutual funds, representing co-ownership of the underlying debt. These mutual funds, governed by Article L214-43 and subsequent ones of the French Monetary and Financial Code, are a co-ownership, without legal personality, whose sole purpose is to acquire debt held by credit institutions or the Deposit and Consignment Office (*Caisse des Dépôts et Consignations*), in order to issue shares representing such debts. The shares of the mutual funds are securities.

From all these findings in French law, we were tempted to innovate with a small SME fund in the form of a mutual fund wrapper, which would grant participative loans to SMEs based on a very selective origination process and financial discipline in terms of risk-return analysis. But quickly, we were facing the mounting complexity of such a structure, requiring special authorization from the French regulators, not only at the vehicle level but also regarding all sorts of requirements in terms of shareholders, governance, and the management company. All put together, we then decided to launch an ad hoc project vehicle to prove the business case and the market appetite for such equitable instruments in the form of a *mudaraba sukuk*.

In fairness, contracts, whether in a conventional or Islamic law context, provide the framework for a complex set of interactions between the parties to economic relationships. As reminded by Sarker (2000), the "agency problem" is an important determinant of reward-sharing in a production process which may be solved through efficiency attained in allocation of resources and putting a package of incentives in reward-sharing structure."[30] The goal is to reduce the impact of such agency problems with its numerical aspect being "transaction cost" as described by the famous Jensen and Meckling four categories including monitoring, bonding, structuring, and residual loss costs. Drilling down on these costs in our case, it covers end-to-end aspects of the transaction, screening, allocating, and monitoring costs. Some would argue that bankruptcy costs in debt contracts are similar to monitoring costs in PLS structures, but this is not essential for our case.[31]

In our appreciation of the French market dynamics, we think it is important that complex and engineered shari'a-compliant products are nurtured locally and are justified by local demand. Providing Islamic finance products for the French SMEs market is a perfect example of a long-term challenge that, in the first step, needs to address the right financing contracts but at the same time anticipate its winding-up issues. Exploiting the depth of the Islamic finance market is not just a promise but a necessity nowadays, especially for real economy needs, being commercial or professional loans, in the momentum of true asset-backed securities (ABS), thanks to the growth of the *sukuk* market.

In fact, most Islamic finance players agree with Sarker's position, viewing *sukuk* as a way to "grant the investor a share of the underlying asset or business venture along with the cash flows and risk commensurate with such ownership. Investors should note that, while all conventional ABS (based on the cash flow only, disconnected to the ownership of the asset) may not be *sukuk*, a true asset-backed *sukuk* should be accessible to the vast universe of conventional ABS investors and not just Muslims."

A CREDIBLE ALTERNATIVE: HYBRID STRUCTURE IN THE FORM OF PARTICIPATING *SUKUK* (*MUDARABA*)

Asset-Based vs. Asset-Backed: Is There a Difference from a Risk Pricing Perspective?

Sukuk are a combination of "nominate contracts," including *mudaraba, salam, ijara*, and *musharaka*. They can be structured in different ways in order to obtain a fixed income instrument or an equity-type product. While there are fourteen types of *sukuk* specified by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), only *ijara* and *murabaha* (non-tradable) have formed the volume of the issuance thus far. To summarize, *sukuk* are notes or certificates that represent ownership of a pool of underlying assets; hence, *sukuk* holders should be entitled to the ongoing cash flows and proceeds of sales from those assets. *Sukuk* are not a completely new asset class requiring different financial analysis tools, but rather these securities employ existing financial engineering techniques to create 'asset-backed' or securitization structures that are also shari'a-compliant.

If we refer to Moody's analysis for such structures, *sukuk* fall under two categories:

a) Asset-backed *sukuk*, for which the ratings are primarily dependent on a risk analysis of the assets; and
b) Unsecured (repurchase) *sukuk*, for which ratings are primarily dependent on the riskiness of the borrower/sponsor/originator/lessee.

According to Moody's analysis, due to the nature of *sukuk*, all transactions are likely to involve a set of underlying assets. Both parties—the issuer and the investors—share the risks in the transaction. Where investors enjoy asset-backing, they benefit from some form of security or lien over the assets, and are therefore in a preferential position over other unsecured creditors. In other words, in the event that the issuer were to default or become insolvent, the *sukuk* holders would be able to recover their exposure by taking control of, and ultimately realizing the value from, the underlying asset(s). In such a case, the transaction may achieve a higher rating, compared to the unsecured issuer rating of the originator, subject to certain conditions.

"Where the transaction is asset-based (which has been the case for the vast majority of *sukuk* so far), the originator undertakes to repurchase the assets from the issuer at maturity of the *sukuk*, or upon a pre-defined early termination event, for an amount equal to the principal repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the *sukuk* holders, as the amount is defined to be equivalent to the notes. In this case, investors in *sukuk* rely wholly on the originator's creditworthiness for repayment. This class of *sukuk* is identical to unsecured lending from a risk perspective and hence attracts a similar capital charge."

According to Patel many of the current *sukuk* are essentially a sale and leaseback or *ijara* structure with lease payments providing regular income stream. In such structures, the originator seeking financing "sells" the asset to the *sukuk* special purpose vehicle (SPV) for a value equal to the financing provided, then the SPV leases it back to the originator. Lease payments provide the fixed income stream, which may be indexed to a benchmark. The underlying asset can be a single asset or a portfolio of assets. *Sukuk* principal repayments can be bullet or amortizing, but the critical difference is in how such repayments are processed. The most prevalent practice is to use a "purchase undertaking" from the originator or an affiliate to repurchase the asset at maturity (or upon early termination) for an amount equal to the principal repayment(s) due.

The asset itself can be a plot of land, a building, or anything else tangible and lease-able. If the *sukuk* is a "true sale" securitization, then there will be a correspondence of the income streams with the actual rental and market value of the asset(s), except when a reserve fund is constituted to smooth periodic distributions. If not, then it is an unsecured exposure and the asset only exists in the structure to facilitate its shari'a compliance. The payment streams to investors are only nominally linked to the underlying asset cash flows and value. In either case, the *sukuk* notes represent an equity share in those assets.

However, most *sukuk* are conducted on a non–true sale basis, so repayment and risk/performance are not asset-based but originator-based. Notable exceptions to this are Tamweel and Sorouh PJSC, both UAE transactions. In both cases, the property/land titles were registered in the name of the investors and any losses on those cash flows are passed on to *sukuk* holders. There is no recourse back to the originators; these *sukuk* should survive upon an event of default (typically bankruptcy) affecting the originator. In addition, it is refreshing to see that few *musharaka* or *mudaraba sukuk* are issued in the market, not as widely as we would like it to be. Two recent examples shed some light on this initial trend: the first UK private *musharaka sukuk* issued by a local med-tech company for Dubai Islamic Bank and the Saudi Hollandi *mudaraba sukuk* issued from the Saudi market to investors (more details are given later).

As a matter of fact, the commercial real estate industry has paved the way for investors to penetrate the French market with already €3Bn worth of shari‘a-compliant property investment.[32] This suggests that alternative financing can meet the market opportunities, especially regarding asset-backed project financing in different flavors using the variety of contracts offered by Islamic finance in this regard.[33] One of the key messages of French professionals given throughout the period of 2008 to 2011[34] is that the introduction of Islamic finance—the moral and socially responsible dimension of which classifies it as ethical finance—into France would meet the growing demand of the local population for ethical financial instruments, respectful of social, environmental, moral, and religious convictions, both in terms of Muslim and non-Muslim individuals, entrepreneurs, professionals, and corporations. This led to the situation in which we really had to do something at least for the SME market, an original way of servicing the great potential of Muslim entrepreneurs and professionals. *Sukuk* is certainly the best point to start with, adding some true partnership features in order to capture the best of what the entrepreneurs can deliver in terms of performance without diluting its control. At the same time, *sukuk*, if designed in such a way that it can be distributed to the different customer channels, not only to institutions, is a great way to tap into the large investors network accessible through incentivized tax wrapper or collective investment schemes. In this regard, France is clearly at the forefront of the distribution of mutual funds to the large public, with an estimated 2,656 billion Euros of assets under management at the end of 2010.[35]

HOW TO IMPLEMENT HYBRID *SUKUK* AS A QUASI-EQUITY STRUCTURE FOR FRENCH SMEs*?*

The basic framework required for the issuance of *mudaraba sukuk* in our participatory model is the establishment of a trust or its equivalent, say SPV. The investors pay money to buy *sukuk*, which provide them ownership in an underlying asset and thus the corresponding right to the income generated by that asset. The relationship between the SPV and the investors is a *mudaraba* partnership. The investors provide capital and the SPV is the manager. Then the money received from investors is used to buy shari'a-compliant assets from the originator (government or company), which thus gets the cash it requires.

As said previously, *ijara* structures are widespread in the Islamic markets simply because they can be tailored to replicate as best a secured type of fixed income. But what is interesting about SMEs, especially with entrepreneurs who have many good ideas in their mature business, is their ability to provide simple business propositions and impactful development tools for their economic growth and job creation. On top of the different elements discussed earlier regarding participating loans, *sukuk* can be enhanced in France using different schemes. According to the Paris Europlace *sukuk* guidebook,[36] the following can be the basis of the reflection of a *sukuk* issuance in France:

1. Choice among the following instruments:
   a) Subordinated bonds (French Commercial Code, article L. 228–97);
   b) Subordinated instruments (French Commercial Code, article L. 228–37);
      i) Ability to provide for an index-based remuneration (articles L. 112-2 and L. 112-3 of the French Monetary and Financial Code, which allow for the indexation to the performance of the issuer of the interest paid to bondholders);
      ii) Implementation of a Fiducie, (i.e., a French equivalent to Anglo-Saxon trust);
   c) Participatory certificates could be structured as equity-linked bonds (*obligations donnant accès au capital*) under French law, allowing the investors to require the conversion of their bonds into shares and then become the shareholders of the SPV issuer;
      i) The effective return paid by the SPV issuer to the investors on the participatory certificates, after the payment by the SPV issuer of the management fee to the management company, will be economically similar to the return received by regular bondholders; and

ii) It will specify that for French legal and tax purposes, the participatory certificates will be subject to the French provisions applicable to bonds.

2. *Sukuk* regulation under AMF guidelines:
   a) Recommendation of the AMF on July 2, 2008, for listing of the *sukuk* on Euronext Paris:
      i) *Sukuk* are assimilated to debt instruments and not equity;
      ii) Acknowledges that *sukuk* issues may be structured either as asset-backed or asset-based;
      iii) Provides information on level of disclosure to be set out in offering circulars;
      iv) A target remuneration ("expected profit rate") is indicated to the *sukuk* holders;
      v) Practical guide issued by NYSE-Euronext (July 2, 2009) regarding the listing of *sukuk* on Euronext; and
      vi) Practical guide issued by AMF (October 2010) regarding the format of a *sukuk* prospectus.

3. Tax treatment of *sukuk* transactions and assimilated debt instruments such as indexed loans or bonds (Tax Instruction of August 24, 2010):
   a) *Sukuk* are assimilated to debt instruments for tax purposes provided that they comply in particular with the following four requirements:
      i) *Sukuk* must rank senior to any shareholders of the SPV;
      ii) *Sukuk* must not entitle the holders to any shareholders' rights like voting rights in the SPV, right to liquidation surplus, etc.;
      iii) Remuneration under *sukuk* must be based on the assets' performance or on the results of the SPV and must be subject to a predetermined cap (Euribor, Libor), plus margin; and
      iv) When the value of the financed assets exceeds the par value of the *sukuk* or the amount of the loan, the repayment may exceed the amount of the principal pursuant to the indexation rule provided for in the contract.
   b) As a result thereof, the remuneration under *sukuk*:
      i) Is deductible from the taxable result of the SPV under similar conditions as conventional interests (at an expected profit rate based on market index); and
      ii) Is exempted from withholding tax when paid to non-French tax residents (except in case of payment to non-cooperative territories).

These guidelines come from Paris Europlace *sukuk* guidebook issued in 2010 with some translation as needed for this study.

With all this on the table, it was important to thoroughly select a niche market where the first pilot hybrid *sukuk* structure would be conducted. A good argument to sustain this view is the *halal* meat market, which was still unknown ten years ago. When *halal* meat initially appeared in France, almost nobody bought it and it was very hard to find, especially in supermarkets. Today, in France, annual consumption of *halal* meat is some 400,000 tons, which represents 10–15% of bovine, ovine, and poultry consumption. Many Muslims, who did not previously eat *halal* meat, influenced by imitation of their neighbors, now do so on such a level that the French *halal* market is estimated at 5.5 billion Euros, growing at more than 10% annually.[37]

It is pertinent indeed to start with the food industry thanks to the momentum of new retail chain concepts nurtured by entrepreneurs in the shade of the large multinational food chains, like McDonalds, tapping into the *halal* market.

The same phenomenon could occur with Islamic financial products once some banks start seriously marketing such products. If a Muslim has the opportunity to purchase a home through either conventional financing or Islamic financing, he probably will opt for the latter. Today's Muslim community consists of consumers. It enjoys strong purchasing power and it is unfortunate that it cannot access adequate banking products, corresponding to its needs, to invest its money.[38] This is further assessed thanks to a survey conducted by the French specialist statistical agency IFOP in 2008, reflecting that 47% of the 3 million people in the potential Muslim market are interested in a shari'a-compliant mortgage while 55% are waiting for *halal* savings alternatives.[39]

FRENCH SME HYBRID *SUKUK* PROTOTYPE BASED ON A *MUDARABA* STRUCTURE WITH TOTAL ALIGNMENT OF INTEREST

Armed with all these clarifications from the French government, and in the absence of *sukuk* issuance by institutional funds in France, we decided to launch a simple structure for our entrepreneurs willing to put their efforts and responsibilities into a profit and loss sharing setup. The *mudaraba sukuk* contract was fit for this purpose, as the entrepreneurs were well known, already in the food business, and running multiple existing restaurants.

It is true that at this stage, it was more important to dedicate a lot of engineering work and effort to the transaction, which we can say is like a Rolls-Royce for an SME.

Indeed, and to summarize, the pilot project was put in place after more than a year of consultations, thanks to the dedication of and lengthy discussions with many Islamic finance experts, advisors, financial intermediaries, etc., all working wholeheartedly with no financial commitments at this prototype phase. This structure reflects the will of many entrepreneurs, not only on the food business but also on the financial engineering side, especially thanks to the trust relationship of a partner from a shari‘a asset management company and a partner from a financial advisory firm who is an expert in legal structuring with more than twenty years of practice.

From a shari‘a point of view, it is completely a new structure in the French market. It has never been used before (this is arguably the first time ever), and again it is the result of fruitful discussion with a prominent shari‘a scholar born and educated in France who now specializes in this industry under a not-for-profit organization called ACERFI.[40]

All in all, the features of this innovative product can be summarized in the following salient points in addition to the term sheet given below (aside from the usual risk factor assessment, events of default, winding-up procedures, etc.):

a) Truly partnership-based
b) Strongly asset-backed
c) Simply accessible

Sukuk program of circa 5 million Euros for "MasterCookCo" to be drawn up by tranche of 0.5 million Euros based on the opening of point of sale (restaurant) by each SPV FoodCo 1 to 10.

Overall structure	*Mudaraba* agreement between the issuer MasterCookCo (as *mudarib*) and the *sukuk* holders (as *rab al maal*) represented by the *sukuk* holders' agent. The proceeds of the issuance of the *mudaraba sukuk* will be applied to invest in the opening of a new restaurant as the *mudaraba* asset held under SPV FoodCo.
Nature of the securities	• Participating certificates completely indexed on the value of FoodCo. • *Mudaraba sukuk* constitutes undivided beneficial ownership interests in the *mudaraba* assets and will rank *pari passu,* without any preference or priority among themselves. • The *mudaraba sukuk* will be issued on a subordinated basis. • The effective return paid by MasterCookCo to the investors on the participatory certificates, after the payment of the *mudaraba* fee, will be economically similar to the return received by regular bondholders. • *Mudaraba sukuk* ranks senior to any shareholders of FoodCo and does not entitle *sukuk* holders to any shareholders' rights like voting rights, right to liquidation surplus, etc.
Target remuneration of *sukuk*	• Remuneration under *sukuk* must be based on FoodCo performance established under the business documents with a predetermined cap (market industry return rate). • If the annual *mudaraba* income exceeds the target amount, the amount of any surplus shall be retained by MasterCookCo in its remuneration reserve account.
Redemption of the *sukuks*	The aggregate value of the *mudaraba sukuk* payable upon the redemption of the *mudaraba sukuk* by MasterCookCo upon the term of the agreement, less any loss relating to the *mudaraba* assets not covered by the reserve account. The obligation of the issuer to pay the redemption amount is a subordinated payment obligation of the issuer.

This summarized term sheet is aimed at showing that the hybrid structure can work in France for SMEs, and, on top of that, it can take the form of a true *mudaraba sukuk*. This solves a lot of financing issues for smaller organizations that usually do not have the collateral profile required for such indebtedness or are simply not interested in conventional loans.

For confidentiality reasons, we cannot disclose the whole setup here, but it is again a rather sophisticated product with a double-tier structure allowing for the best features from the venture capital industry, asset management practice, and tax efficient solutions. Thanks to this successful prototype, completely closed in late June 2012, it is our aim now to standardize the process and make it an accessible solution for all organizations and institutions: small, medium, and large corporate.

We strongly believe that thanks to this simple yet innovative alternative, many of the agency problems and the resulting layer of costs will be reduced in a *sukuk* program for SMEs operated by a platform leveraging on new technologies (i.e., Cloud Computing and SaaS: Software as a Solution) and emerging crowd-sourcing techniques (the "wisdom of the crowd"[41]).

CONCLUSION

Having been working on this project since 2011, and in someway writing up a new page for SME financing, we were happy to execute this first step and provide a working solution for both entrepreneurs and individuals who are eager to invest their capital in a way that complies with their ethical values, together with all the transparency required by such innovative financial setup.

Our modest experience in this pilot project of a *mudaraba sukuk* SME did not aim at reshaping the banking industry or the fund management world. Far from that, we simply tried to empirically design a fair financing structure that should propel entrepreneurs to develop their talents and do what they do best, i.e., put capital to work, and allow financiers or *sukuk* holders to deploy their capital in a fair and equitable way, sharing some capital risks but being able to capture the value creation at work.

The positive result of this tentative experiment is to prove that this new type of hybrid *sukuk* financing is a primer, maybe in any Western market, with this simple fact: this model is not dependent on the credit risk scoring of the SMEs conducting the project, but on the quality and robustness of the project itself with its underlying assets that keep their value in case of the borrower's default—in this case, a physical restaurant with its know-how, clientele, and commercial position in the market.

In case of default of the borrower, the investor will have access to the underlying assets not as hypothetical collateral but as part of their co-ownership backdrop assets related to its capital commitments, making him the ultimate owner. In fact, our structure went a little further thanks to three innovative features:

a) A secured Trust entity that prevents fraud, negligence, or misreporting of the entrepreneurs under the supervision of the shari‘a asset manager;
b) A cash trap mechanism that gives incentives to the entrepreneur to meet its business plan with annual profit payments and capital reimbursement; and
c) A downscaled ownership of the *mudaraba* assets held by the trustee if the entrepreneurs do not perform as expected under normal circumstances (using the technique of diminishing *mudaraba*).

While we were finishing up our structure and ready for the fundraising in early 2012, we learnt that a major *mudaraba sukuk* was being closed as well, the Saudi Hollandi deal in the Saudi market. Based on our experience, it was inspiring to read the comments of Mohamed A. Elgari,[42] which clarify how to understand the *mudaraba* assets and the fact that the issuer, whether it is a Muslim corporation or not, makes no major difference. He refers to the positioning of *sukuk*, a flexible security that enables investors and issuers to commingle assets in order to produce a reduced level of risks and income. "This need of Islamic issuers and investors is now met by the current structure of *sukuk*. However, we appear to have overlooked a much simpler structure based on *mudaraba* which can meet the said need, yet retain the salient quality of the Islamic system of finance, including the interlink between real and monetary sectors."[43] It is probably also worth looking at some key points of the Saudi Hollandi *mudaraba sukuk* issued in late 2011 (from the offering circular):

The *Mudaraba Sukuk* Are Unsecured Obligations of the Issuer

The sole recourse of the *sukuk* holders will be against the issuer to pay the redemption amount under the *mudaraba* agreement and otherwise perform its obligations. The *sukuk* holders will otherwise have no other recourse to any assets of the issuer.

Subordination

Subordinated payment obligations will be subordinate in right of payment upon the occurrence of any winding-up proceeding of the issuer to the prior payment in full of all deposit liabilities and all other liabilities of the issuer, except, in each case, to those liabilities which by their terms rank equally in right of payment with or subordinate to the subordinated payment obligations.

Payments Relating to the *Mudaraba Sukuk*

Prospective *sukuk* holders should note that the periodic distribution amount or partial distribution amount on the relevant payment date will be paid on the basis of a constructive liquidation of the *mudaraba* on the relevant payment date based on the issuer's management accounts (based on an audit review of the Islamic business portfolio). The capital of the *mudaraba* to be invested by the issuer (acting as *mudarib*) formed the Islamic business portfolio. The issuer shall be entitled to commingle its own Islamic assets with the *mudaraba* assets.

Credit Risk: The Bank May Suffer Loss Due to a Defaulting Counterparty

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. The bank carries provisions to cover for possible credit losses. These provisions are made up of two components, namely specific provisions and portfolio provisions.

The objective of this study was not to provide an academic view on PLS contracts, but to share some practical elements and highlight new avenues of research. Going back to our initial assumptions, this pilot project has proven that bank financing cannot appreciate value creation outside of its risk analysis grid, which has been designed to reward low profile risk of the borrower regardless of the robust economic profile of the underlying project.

We can indeed clearly state that bank loans are not always adapted to SMEs' needs. And we can anticipate that things will not improve with the current global crisis given the drain on equity consumption for banks due to their capital adequacy ratio constraints.

On the contrary, too, pure venture capital is not necessarily the solution for SMEs, as their capital base does not allow them to prevent all their value creation from being taken by the financier, a non-operational partner. We can surely elaborate on that, but since this road is not the best illustration of a fair alignment of interest between risk sharing and risk rewards, we would like to encourage further development routes that mix co-ownership of the assets being financed (including financial, immaterial, etc.) and flexible instruments that allow an equitable share of the success of the venture. This is what represents hybrid structures that can be used by companies—not only Muslim-owned as the company starts with a sound business plan or develops itself with a mature business model.

Now considering the development of this prototype and the research related to this study, we are convinced that new approaches are needed when smaller structures such as micro, small and medium enterprises are concerned. In particular, we have shown that the risk profile is something to appreciate not only through the prism of conventional bankers focusing on downside risks regardless of the nature of the quality of the project and the nature of the underlying assets as provided by credit rating systems. Future directions of our pilot hybrid structure will aim at developing a systematic approach to reducing asymmetric information by standardizing the screening, allocation, and monitoring processes in order to reduce agency and transaction costs. Further, alternative risk assessment will need to be developed with alternative credit scoring that is not looking only backward; current progress on psychometric testing and crowd-sourcing is interesting to follow.

One other aspect we did not cover in this paper is pricing issues, as again this is a first pilot project that was built for a purpose and with some confidentiality. We aim at developing more data points and practice on this kind of hybrid shari'a-compliant structure in order to design a more systematic pricing process. The pricing model should nevertheless reflect the usual mode of pricing but also, very importantly, integrate what technologies offer at their best, which is data crunching and forecasting. Crowd-sourcing techniques made available thanks to wide Internet access and its related openness are again a good avenue to explore.

Finally, this project, just being launched and yet to be performing as forecasted, has convinced us that an SME hybrid *sukuk* could be an ethical source of financing for all French entrepreneurs and not only for Muslim entrepreneurs. By expanding into these larger markets, the wish is to develop true ethical finance that shares some form of risks in the deployment of capital over talent work, allowing diversification of risks, thanks to robust projects and the underlying assets. This should create a new relationship between the parties, with different levels of obligations for entrepreneurs, and allow for better subordinated instruments for investors.

Endnotes

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by the firm, or is released from the whole of the losses, and/or the one by which a member is excluded in whole from the profit or is liable for the whole of the losses shall be deemed not written." Available at www.legifrance.gouv.fr.

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Faith and Financial Development

Séamus P. Finn

INTRODUCTION

The earliest commercial centers of activity were located in the ordinary gathering places of local communities and therefore operated under the guidance and supervision of the prevailing beliefs and values of the day. The laws that were codified in the Hebrew Scriptures reference nearly all the aspects of ordinary commercial activity and recorded the standards whereby various activities should be conducted. The foundation for all these principles and laws was deemed to be an expression of the divine will and was grounded in the justice of God whereby God's relationship with and design for His people was revealed, described, and defined.

Over the course of history numerous arrangements and systems would emerge to build out the working framework for commercial activity and to define the relationships between individuals, communities, institutions, and professional actors in the sector. These developments would take place within the context of a vibrant exchange and conversation with prevailing religious traditions and beliefs. The history of the development and organization of the temple-based bank, the city-state structure, the monastic enclosure, the bazaar culture around the mosque, and the mercantile and feudal systems are all reflective of this iterative process.

Since activities in the banking and financial services sector were neither a physical asset like a commodity or a herd of animals or specific skills that the guild system relied on, they would call for the development of a unique set of principles, arrangements, rules, and operational criteria. The formulation and definition of these principles, codes, laws, regulations, and prohibitions engaged many of the leading religious and secular leaders of the time and would draw on the insights of different theological, philosophical, and legal centers and schools. Later the emergence of independent financial centers and banking powers that were of an entirely secular origin, operating alongside or in tandem with the frameworks that were either based on a

Séamus Finn, Director, Justice, Peace and Integrity of Creation, Missionary Oblates, Washington, DC.

religious tradition or operated within an entirely religious culture, would introduce a powerful parallel and competing organizing set of principles and operating practices into the debate about acceptable financial and commercial activities.

In this paper I want to review the process whereby the foundational principles of economics and economic theory emerged and evolved within a culture and context that was rooted in faith traditions. Secondly, I will look at how basic teachings about ownership, wealth accumulation, interest, usury, and partnership were understood, organized, and refined in a process of interaction that included religious and secular leaders, philosophers, and practitioners. Finally I want to identify some of the elements of the faith traditions that may have been bypassed or ignored by the theory and practice of contemporary capitalism and explore which of them might be appropriately retrieved and make a contribution to the reform of the prevailing capitalist system.

CUSTOMS, RULES, AND REGULATIONS IN ANCIENT COMMUNITIES

Ancient communities were organized and emerged around the experience and teaching of specific religious leaders and the scriptures and holy books that recorded the stories and captured the teaching, laws, and rules of each tradition (EX 22:25, DT 23:19–20, EZ 18:8). These books and stories focused on the relationship of human beings and the transcendent and human beings and the earth but also, especially in commercial and economic affairs, on the relationships between human beings. In broad strokes and concepts they articulated and defined all these relationships within a creator-creation-creature framework and set forth the appropriate boundaries, responsibilities, and hoped-for outcomes of each relationship.

The evolving practice of commercial transactions and financial activities would become common in local communities and would therefore necessitate the articulation and the establishment of sets of rules and regulations to govern these activities. They were generally grounded in the belief that “right” relationship was the cornerstone concept around which God intended his creative handiwork to be organized, governed, and operate and were understood to take place within a vision of life and activity that was both harmonious, sustainable, and destined to reflect the will of the divine.

The salvation-restoration-blessing oracles that are found in the Hebrew Scriptures, for example, are representative of this view and intended to serve as a guide for the leaders of the community when they consider what to do about the surplus of corn, oil, and wine that had been bestowed on them by God. The discovery, understanding, and articulation of both the framework and the rules for the disposition of such realities as a surplus at harvesttime is an example of one of the presenting circumstances in which faith communities worked out a set of operating principles and rules that were consistent with their respective beliefs.[1]

CREDIT AND ITS EVOLUTION THROUGH THE MIDDLE AGES

Judeo-Christian Teaching

Evidence establishes that credit preceded the coining of money by over two thousand years and it was based on "loans of grain by volume and loans of metal by weight."[2] Primitive credit may only have consisted of the loan of a seed until harvest or of an animal or of a tool for a while and could be classified as gifts, loans, or loans at interest depending on the arrangement accepted. The evolution of certain criteria or mediums for repayment was also in evidence until money became the common denominator for all repayment of loans. Cattle, grain, dates, olives, and figs were among the original items used for conducting commercial transactions and were followed by the use of inanimate commodities such as copper, gold, silver, and bronze.

In view of the foundational principles that guided the faith traditions in their teachings about the human-divine, human-human, and human-earth relationships, rules and commandments emerged both to approve and govern all financial and commercial transactions. These were frequently organized according to whether or not the party to the transaction was a member of the local faith community, of the same faith tradition, or a complete stranger. Different sets of rules were also developed and applied according to the type of transaction or activity that was anticipated or practiced.

Much of the early data suggest that the legal codes that emerged and were established in the financial sector were primarily focused on prohibiting the use of credit or its abuse, especially if it was deemed harmful or onerous to the poor.[3] The Israelites did not permit lending at interest and the Iranians felt it dishonored a man. The Romans permitted it but limited the rate of interest and the Greeks seemed to encourage credit without limit. The earliest historical accounts of practices and customs present us with a collage of the challenges that were faced by those who sought to define and regulate the complex set of relationships that existed between debtors and creditors.[4]

Over time, when various institutions and associations were organized to serve the credit and saving needs of peoples and communities, the rules for each of these practices evolved. Some of these institutions would evolve into financial service houses that arranged credit and financing for activities like shipping and exploration as well as the transport of people and commodities. The prevailing tools that were being developed by these institutions and used to measure the amount of risk that was being assumed in any transaction would subsequently be examined and analyzed according to accepted religious principles and doctrines.

The Roman Catholic Teaching

The Catholic Church entered this debate in a powerful fashion when in 325 C.E. the Council of Nicea passed a canon prohibiting usury by clerics by citing Psalm 15, which asks, “O Lord, who may lodge in thy tabernacle?” and responds “Who does not put his money out to usury.”[5] The fact that the Psalm admits no exceptions and is cited by the first ecumenical council made Psalm 15 a favorite reference text in the usury debate for centuries. Leading churchmen of the day, like St. Jerome, argued that the prohibition of usury among brothers in Deuteronomy had been universalized by the prophets and the New Testament.

Pope Leo the Great would extend the prohibition by declaring that laity who practiced it were guilty of seeking “shameful gain.” This was the most formal prohibition on usury enunciated by papal authority before 1179 C.E. It would also be cited in secular legislation. It would continue to be extended and enforced intermittently by church and state authorities until the eleventh century, when the revival of European learning and trade would present the occasion for a more detailed examination of the practice by scholars and a more nuanced articulation of the specific elements of its prohibition by the church.[6]

The related teaching of the church on the accumulation of wealth seems to be based squarely on the stories and the cautions that are elaborated in the Hebrew and Christian scriptures. There are, however, few direct prohibitions on the accumulation of wealth in the tradition, but numerous warnings about the blindness and dangers that wealth can bring. This is articulated, for instance, in the teachings about how difficult it is for the rich person to enter the kingdom of heaven or to be open and hospitable to the will and call of the divine.

The Teaching of Islam

Islam, like the other Semitic systems (Christianity and Judaism), is both a religious and a political system. The rules that were therefore elaborated in the banking and commercial sector emerged from a context that saw the two as inseparable. Any notion that was predicated on a separation of the sacred and the secular, the religious and the profane, would be considered untenable.

Property ownership and the accumulation of wealth are seen within the Islamic tradition in a way that is very similar to what is found in the Hebrew and Christian traditions. God is the source and creator of all and the destiny of all and therefore the true owner of all. Thus any kind of human ownership is relative, whereby man is seen as “a trustee (i.e., a custodian) appointed by God, a Vice-Regent where god is the Regent, in respect of property.”[7] Their ownership then is to be exercised with the recognition that God is the original and true owner and their stewardship must be exercised according to the divine will as revealed in the Holy Qur'an.

Wealth is not seen as an end in itself but rather a means to assure that family and dependents are cared for and do not become dependent on the community. "Nothing in Islam as a religion or a legal system discourages the acquisition of wealth, nor places a restriction—a quantitative limit—on the amount of wealth that can be acquired through lawful means."[8] Hard work, self-assertion, and dedication without falling into illegal or immoral activity that is coupled with a profound appreciation that wealth is ultimately a gift from God is deemed essential.

There is general agreement in the tradition on the prohibition against *riba* and there are many shari'a sources cited in support of it (Qur'an, supra 2:275–79: 3:130; 4:160; 2:188; 4:29; 9:34). *Riba* or the dealing in interest-bearing transactions is distinguished from trade because in the latter activity people are deemed to work and earn a living whereas in the former earning money through interest does not involve any self-exertion by the lender. There is also present in the mind of some scholars a distinction to be made between interest and usury. Usury is deemed to involve an injustice, an unreasonable and unearned excess. Holy Qur'an chapter 2 speaks on 'interest' while chapter 3 uses the term 'usurious interest,' and chapter 4, verse 161 and chapter 30, verse 39 employ the word 'usury.'"[9]

The concept of partnership has a long history in Islamic law and is found integrated into a number of operating practices. "To do business in accordance with Islamic Law is to establish, or work with an existing, form of association that is a partnership . . . Islamic legal and religious scholars, coupled with merchant practice, have developed many specific kinds of partnership entities."[10] These different kinds of partnerships enabled members of the community to extend and receive credit, to engage in economic transactions, and to do so within a framework that was consistent with Islamic law.

The period of the Abbasid Caliphate saw great advancement in Islamic civilization and this was accompanied by the growth of an extensive network of prosperous cities and international trade. This was made possible not so much by military success but through trade, commerce, and agriculture in a single political empire that linked the two great sea basins of the civilized world, the Mediterranean and the Indian Ocean. This was accompanied by the development of "An internationally recognized monetary system . . . using the Abassid dinar as the primary instrument of exchange."[11]

The disintegration and ultimate decline of the Abbasid dynasty, however, came about through the disintegration of its most fundamental institutions. The empire "came to a political end because of the crisis of the caliphate, the military, the bureaucracy and the economy . . . The centrifugal forces in the provinces proved stronger and led finally to a multiplicity of regional rulers."[12] The sacking of Baghdad by Mongol forces in 1258 and the nomadic orientation of the Mongols dealt a terrible blow to the prosperity that had emerged in both rural and urban life. By that time, however, the foundational teachings of Islam in the finance and commercial sector were well established and while no longer defined by geographic boundaries and political power, it was grounded "by a common set of religious beliefs, a uniquely Islamic culture, and an elaborate system of law and practice."[13]

THE SCHOLASTICS AND A THEORY OF ECONOMICS

When we look at how the scholastics engaged the concept and practice of usury it "reveals much about the relation of religion, reason and economic facts in the West."[14] It likewise reveals aspects of the concept that are at once theological, legal, and economic. Most importantly, however, it shows that their theory of usury is the beginning of the development of a theory of economics.

There is no evidence of a coherent body of thought that could be considered a theory of economics, neither in the ancient philosophers nor in any other writers of antiquity. At the most there is a theory of money. "To classify economic activities, to determine the nature of money and the factors affecting its price, to essay a theory of economic value, and to develop a theory of interest, are original scholastic achievements. In this way, the scholastic analysis of usury is the midwife of modern economics."[15]

The scholastics were intent on grounding their case against usury "on the nature of man and on the nature of things in themselves."[16] They are in this way consistent with the practice of Catholic theology, which in most instances sought to demonstrate the rational basis for a duty that was commanded by God. Though their work had its origins in the effort to explain and apply what was the positive teaching of the Church about usury, their theory evolves predominantly from a natural law analysis.

Their discussion of usury would lead to a much-nuanced consideration of the conditions under which the charging of interest might be acceptable. They readily accepted the Roman law sense of "interesse," which was based on damages due because of default on a contract, and recognized the right to an increment on a loan in a number of exceptional cases. While eventually they accepted a number of different extenuating circumstances wherein interest was acceptable, "the risk inherent in lending was not recognized as a title to interest."[17]

The scholastic consideration of "societas" or partnership, which enters largely in the form that was given it by Roman law, is essential to complete the account of their contribution to economic theory. Societas is the union of the money and or skill of two or more persons for the common purpose of profit. They become joint owners of the goods contributed and the loss of the property of the partnership will normally be borne equally by both parties. The scholastic analysis and acceptance of this practice was grounded in their analysis of the same basic principles that lead to their prohibition on the practice of usury; the limited notion of ownership, various categories of risk, and the sterility of money.[18]

EVOLVING TEACHING IN THE WEST POST–MIDDLE AGES

The religious, historical, and political developments of the 16th, 17th and 18th centuries would lead to greater degrees of acceptance of various principles and practices in different jurisdictions. These emerged from the interaction of theological and philosophical insights and the demands that certain commercial activities and financial transactions made on prevailing practices. In the Christian tradition these practices were also influenced by the political and theological developments that emerged during the Reformation debates and the subsequent religious and political reorganization and operation. John Calvin, for example, marked a new approach in the following ways: "First in denying an absolute divine prohibition of all usury; secondly, in suggesting that money be identified with the goods it buys."[19] In addition, a variety of practices in the sector would emerge as a result of different political and commercial relationships and conflicts.

A series of decrees from the Holy Office in Rome between 1822 and 1836 effectively ended all doubts and major questions "by publicly declaring that the interest allowed by law may be taken by everyone."[20] Earlier prohibitions were explained as pertaining only to excessive usury and the insights of the reformers and more contemporary thinkers pushed forward new interpretations that were able to accommodate the quickening pace of economic life. The pressure of the Industrial Revolution on economic life in England would soon make its way to the continent and continue the demand for more innovative and flexible commercial and financial tools and mechanisms.

The path of this transition in church teaching is in evidence when we look at the teaching of Pope Leo XIII on usury in 1891 and an address given by Pope Pius XII in 1950 on banking. In the encyclical letter Rerum Novarum, when commenting on the exploitation of workers, Pope Leo XIII declared, "A devouring usury, although often condemned by the Church, but practiced nevertheless under another form by avaricious and grasping men, has increased the evil."[21] In 1950, Pope Pius XII, in an address to the employees and directors of the Bank of Rome, thought it necessary to "define clearly" his view on an oppressive opinion which held that "the banking system was by its nature stained with guilt" and that the profession exposed one to the loss of eternal salvation and to excessive attachment to material things. The Holy Father went on to state that he found no inherent inequity in the system and that "bankers earn their livelihood honestly." He emphasized that he approved of the banking system and that it is necessary to society and has power, utility, and responsibility.[22]

EMERGING CONCEPTS OF CAPITALISM

Among the core concepts of the economic system of capitalism are free markets, competition, private property, credit, interest, collateral, motivation for productivity and creativity, legal protection of property, contracts, and profit. The system is grounded on the unique features that transparency, price discovery, capital allocation, and the laws of supply and demand bring to the marketplace while delivering stability and accountability to the greatest number of regions, countries, and communities.

This system has evolved and been adapted to accommodate many different constitutional agreements and political frameworks over the last three hundred years and in some instances has been rejected as inadequate or significantly modified to accommodate specific visions and values adopted by societies. The faith traditions have wrestled with various aspects and elements of the system and over time judged particular practices and operations to be inconsistent with their traditions and doctrines. This conversation continues today. The teaching of the traditions on the issues of ownership, wealth accumulation, interest, usury, or risk continue to be priorities for large numbers of believers and the system is still judged through the teachings of the faith traditions and the moral compass of their values and rules.

FAITH TRADITIONS/PRACTITIONERS AND CONTEMPORARY CAPITALISM

Each of the different waves of development in social organization and in societies—whether the temple banking system, the agrarian economy, the feudal system, the mercantile system and the epoch-making changes in economic life and social conditions that came to be the Industrial Revolution—presented their own set of challenges to the teachings of the faith traditions about basic financial activities and commercial transactions. The traditions were consistently seeking to understand new proposals and developments in light of their teaching while at the same time committed to the development of a more humane economic system that was consistent with the broader vision of their beliefs.

An economic and financial system, like the one that exists today, that operates at regional and global levels on a 24/7 cycle can immediately serve to undermine the personal and relational foundations, communities, and associations that espouse and practice the teachings of their respective faiths. The continuous development of innovative tools and mechanisms like derivatives, short selling, securities lending, hedge funds, and private equity are further examples of instruments that present challenges to the teaching and culture of faith traditions. Faith communities that in the past provided the space for the incubation and testing of new types of commercial and financial relationships and transactions are further threatened by the speed and complexity of a globally integrated financial system.

TOPICS FOR A CONVERSATION

Given the foundational principles of the Abrahamic faith traditions about the origin and the ultimate destination of all of creation and therefore the goods of the earth, one immediately realizes the challenges that this vision faces when confronted with the concepts and principles of capitalism and its prevailing operational practices. In this final section I want to look at the opportunities that the faith traditions have to participate in the debate about the limits of the prevailing financial system and shape the framework for the establishment of a more sustainable system.

1) The foundational and social purpose of any financial system is immediately raised by the Abrahamic faith traditions. It flows directly from their understanding of God as the creator and source of all and therefore the ultimate owner of all. A reintroduction of this foundational belief and value into an evaluation of the prevailing system that prizes short-term profit over sustainability while privatizing profits and socializing all the risk is urgently needed. A system that has as a priority serving the needs of all communities before enriching executives, traders, and shareowners will also be judged as consistent with the vision of the faith traditions.
2) At the macro level the faith traditions must engage a system that is founded on a continuous expansion and growth model that is perpetually looking for comparative advantage in resources and labor at a global level. This model is also inherently dependent on advances in transportation and technology and politically guaranteed trade agreements. The integration of a religious perspective of one world created by God and destined for God without distinction by geography, ethnicity, or religion immediately presents a number of challenges. Living wages, environmental security and safety, and natural resource exploitation that respects human rights and is equitable and safe are among those that come immediately to mind.
3) The issue of climate change and global warming, for instance, crystallizes the debate about the extent of the costs of the prevailing system on the environment. It immediately opens up the question of development, growth, and investment that is primarily focused on short-term gain without measuring the long-term impact. The faith traditions must be, along with others in the investment community, like pension funds, proponents of a long-term view that incorporates their beliefs about the destination of the goods of the earth.

4) Governments or secular authorities have usually been placed in the position of authorizing the framework and approving the rules and regulations whereby a financial system is organized and adapted to varying political and cultural environments. In Western societies especially, religious leaders and authorities have often been sidelined or absent from this debate or allowed themselves to be ever so slowly and determinedly pushed away from the table. The religious vision and moral compass that is grounded in their sacred books and traditions, including the basic principles of economics that emerged from their traditions, must be included in the ongoing conversation and evaluation of the framework and laws of any financial system if both the social purpose and the common good are to be respected.
5) The faiths can be an advocate for the inclusion of this perspective when governments organize or reform financial systems so that the social and environmental costs that have been too readily externalized are included in the system. Is there room for a conversation about "partnerships" being the safest and most stable form of ownership, for instance, in the banking sector? Does this model that is deeply rooted in the faith traditions offer a more desirable framework and structure in a sector that constitutes something akin to a global circulatory system that nearly everyone relies on?
6) While finding themselves in most places coexisting within the larger dominant financial and commercial systems, faith communities may also want to establish an alternative operating space and system that will allow their followers to more faithfully integrate their beliefs into the management of their financial and commercial affairs. In this innovative space, many faith traditions have established funds and innovative credit mechanisms that reflect more faithfully their foundational principles on the practice of credit, borrowing, and lending while preserving wealth and fostering stability. They have done this successfully in the past through instruments and mechanisms that are more appropriate to the needs of communities, offer stable and accountable delivery systems, and promote sustainability.
7) In the interfaith space the Abrahamic faiths share some of the following basic principles that serve to evaluate any financial system: responsible ownership, duty, community, charity, partnership, compassion, justice, economic independence, and achievement. In their respective traditions they have very detailed prohibitions of usury, models for partnerships, and warnings about excessive speculation. The faiths working together can draw on the principles they hold in common to promote a more humane system and reform the dominant financial system. By working together, they can bring the values of sustainability, social responsibility, solidarity, and subsidiarity into a vibrant debate and conversation about the kind

of economic model that is consistent with the vision of their beliefs. In the post–World War II period, for instance, we have examples of the modification of a free market individualistic capitalism to a more social market economy in some societies.

8) The faiths can also work with allies who are concerned about the growth of "empty ownership" that has been fostered through investment in derivatives, to examine the impact of such practices. An active and engaged ownership is a dimension of the responsible ownership and responsibility that faith traditions espouse and teach. The development and promotion of a system that recognizes these values can find common ground with the "stewardship codes" that are being developed in some jurisdictions.
9) Finally, the faiths can likewise find common ground with others in the ongoing process of evaluating the tools and innovations that are introduced into any financial system by using the wisdom in their traditions and the environmental, social, and governance criteria that have been established. The approach of the precautionary principle that states that if an action or policy has a suspected risk of causing harm to the public or the environment, then the burden of proof that it is not harmful falls on those taking the action, can also be useful.

CONCLUSION

In our review of how the customs, rules, and regulations of financial and commercial transactions emerged in early communities and traditions, we were able to see how they were a response to lived experience and its evolving questions. As these rules were written down and codified in religious communities they were scrutinized in terms of their consistency with the accepted understanding of God and concepts such as being in "right relationship" with God, the earth, and one's fellow human beings.

In each of the successive periods these basic teachings and beliefs were tested both by the emerging understandings and uses of money and collateral and the questions that surfaced through engagement with communities that were more diverse both culturally and religiously. In addition, the challenges that securing financing and apportioning both the potential profits and losses for such activities as merchant shipping presented would necessitate further study and examination of the teaching of the traditions for guidance and rules that were consistent and appropriate.

The recent near-meltdown of the prevailing financial system has resulted in an extensive analysis of many of the specific laws and regulations that have regulated that system. In the last section of this paper I have identified a number of the ways and areas where the faith traditions can participate in and contribute to this analysis. This type of engagement and examination has been a part of their lived tradition for centuries and the principles and values that they can bring to the conversation are important and necessary.

Integrity, stability, and sustainability must be the cornerstones of a global financial system that impacts the lives of billions of people across the world, if it is to be consistent with the long-term vision and horizon of the faith traditions. A system and its institutions must be consistently reminded of their social purpose to provide financial services and facilitate commercial transactions that advance human well-being, promote the common good, and respect and protect the environment. The faith traditions are uniquely positioned to bring these priorities to the ongoing dialogue.

Endnotes

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PART III

Case Studies: Islamic Finance and Grassroots-Oriented Development

Relevance of Islamic Finance to the Nigerian Economy: The Regulatory Challenges

Abdulqadir Ibrahim Abikan and Is-haq O. Oloyede

INTRODUCTION

Economic development is the process by which the productive capacity of an economy is enhanced by using available resources to reduce risks and remove impediments that are capable of lowering costs and hindering investment. It is about promotion of more intensive and more advanced economic activity through such means as education, improved tools and techniques, more available financing, better transportation facilities, and creation of new businesses.[1] To achieve the ideals of economic development, the significance of the roles to be played by a nation's financial system cannot be overemphasized. The financial system serves as a catalyst for economic development by vigorously seeking to attract the reservoir of savings and idle funds and allocate same to entrepreneurs, businesses, households, and government for investment projects and other purposes with a view of returns. It plays a key role in the mobilization and allocation of savings for productive use and provides structures for monetary management, which is the basis of managing liquidity in the system. It also assists in the reduction of risks faced by firms and businesses in their productive processes, improvement of portfolio diversification, and the insulation of the economy from the vicissitudes of international economic changes. Additionally, the system provides linkages for the different sectors of the economy and encourages a high level of specialization expertise and economies of scale.[2]

For decades, many Nigerian banks were not engaged in strict banking business in terms of savings intermediation. They were trading in foreign exchange, government treasury bills, and sometimes in direct importation of goods through phony companies. A group of people would secure a banking

Is-haq O. Oloyede, Former Vice Chancellor, University of Ilorin, Nigeria.

Abdulqadir Ibrahim Abikan, Former Acting Dean, University of Ilorin and Legal Practitioner, Supreme Court of Nigeria.

license, use their connections to garner some billions of Naira in deposits from one or two parastatals, and use the deposits to trade in government treasury bills, foreign exchange, and open letters of credit for importers. With such a move, a bank could declare billions of Naira in profit.[3] The effect of this scenario is that financial institutions, particularly banks, have not been keen on mobilizing funds from low- and middle-income savers, thereby leaving a high percentage of currency in circulation in the informal sector. The mobilized funds are not allocated to the productive sector or small- and medium-scale entrepreneurs, thereby exacerbating the unemployment rate, poverty level, and infrastructural decay.

At different times, the regulatory authorities wade in to redirect the focus of the financial players toward economic development.[4] In 2004, the Central Bank of Nigeria (CBN) embarked on financial sector reform with the aim of strengthening and consolidating the banking system to ensure a diversified, strong, and reliable banking sector, which would ensure the safety of depositors' money, play an active developmental role in the Nigerian economy, and serve as a competent and competitive player in the African regional and global financial system.[5] The first phase of the exercise pruned the number of commercial banks in Nigeria from 89 to a relatively stronger 24 banks. While that recapitalization may have helped to build and foster a competitive and healthier financial system, it is debatable if the structure of their investments portfolio has the capacity to support the desired economic development objective of the reformers.[6]

Although there was a rapid increase in lending, the share of production sectors of the economy, especially agriculture and mining, was fluctuating between progression and decline over time, suggesting that the new monies were channeled into miscellaneous activities.[7] The banks are still unable to mobilize much of the cash outside the banking system,[8] thereby limiting the impact of the CBN's efforts at price and economic stabilization. Interest rates and poverty levels also remain high and a sizable percentage of the population is excluded from financial services.

Another phase of the reform was started by the CBN in 2009, which was aimed at ensuring that the financial sector contributes to the real economy. The reform was commenced after it was revealed that the investment portfolios of a number of the banks were more of diversionary and miscellaneous than productive. The reform led to the sacking of eight chief executive officers of banks and the subsequent injection of N620 billion (3,856,942.00 USD)[9] to avert the imminent collapse of the banking institutions. The development was followed by a drastic decline in confidence in the existing banking system[10] and gave popularity to and placed high expectations on the Islamic banking system initiated by the regulator in 1998 but fully introduced and licensed in June 2011.[11]

The financial system's avoidance of interest and a number of popular products it parades—like *murabaha* (cost-plus financing); *bay bithaman ajil*

(BBA) (deferred sale); and *sukuk* (Islamic investment certificates)—have played significant roles in the achievements it has recorded so far. While adoption of such products is desirable for macro-economic prosperity, this paper identifies a number of Islamic financial products like *muzara'a* (sharecropping), *musaqah* (irrigation), *musharaka* (partnership financing), *mudaraba* (profit sharing), and *sukuk* (Islamic investment certificate) as those peculiar to fair allocation of the nation's resources and to her real economic development needs. Successful introduction of Islamic finance in Nigeria is not without challenges. The challenges include deep-rooted religious bigotry, which hampers its acceptability, and the difficulty of putting an appropriate regulatory framework in place. The endemic corrupt business environment prevalent in the country is also a matter of serious concern.

This study therefore examines the present state of economic development in Nigeria, the impact of finance thereon, the possibility of Islamic finance improving the situation, and the challenges to be faced in the process. The work is carried out in six parts. Following this introduction, part two looks into the background of the Nigerian economy. In part three the impacts of the existing financial system on the economy as well as the level of financial exclusion in the country are examined. Part four examines the Islamic finance option, while investigation of the regulatory challenges is carried out in part five. The work ends with a conclusion and recommendations in part six.

BACKGROUND OF THE NIGERIAN ECONOMY

Nigeria is richly endowed with human and natural resources. It has a total of about 98 million hectares of landmass, out of which 82 million hectares are arable. The Food and Agriculture Organization of the United Nations (FAO) concluded that most of the country's soil would have medium to good productivity if this resource were managed properly.[12] It has an estimated 37.5 billion barrels of oil reserves, constituting 2.69% of the world's oil, and is the sixth-largest exporter of petroleum products in the world. It has other natural resources like coal, columbite, bitumen, natural gas, tin, iron ore, limestone, niobium, lead, and zinc, most of which are untapped. Based on this endowment, the Constitution of the Federal Republic of Nigeria obliges the government to direct the nation's economic objectives and policies toward ensuring:

a) The promotion of a planned and balanced economic development;
b) That the material resources of the nation are harnessed and distributed as best as possible to serve the common good;
c) That the economic system is not operated in such a manner as to permit the concentration of wealth or the means of production and exchange in the hands of a few individuals or of a group; and

d) That suitable and adequate shelter, suitable and adequate food, reasonable national minimum living wage, old age care and pensions and unemployment, sick benefits, and welfare for the disabled are provided for all citizens.[13]

The Nigerian economy has had a truncated history. In the period 1960–70, the gross domestic product (GDP) recorded 3.1 percent growth annually. During the oil boom era (1970–78), GDP grew positively by 6.2 percent annually—a remarkable growth. However, in the 1980s, GDP had negative growth. In the period 1988–1997, which constitutes the period of structural adjustment and economic liberalization, the GDP responded to economic adjustment policies and grew at 4.0 percent. The boom in the oil sector lured labor away from the rural sector to urban centers.[14] In the last four decades, oil has accounted for not less than 80% of the Nigerian government's revenue and not less than 95% of the country's export earnings.[15]

Nigeria has continued to experience progressive economic growth in the past decade, with an annual average of 7.4 percent. Yet the growth has not been inclusive and transformational. The implication of this trend is that economic growth in Nigeria has not resulted in economic development. The desired structural changes that would make manufacturing the engine of growth, create employment, promote technological advancement, and induce poverty alleviation have not been achieved.[16] Available data has put the national poverty level at 54.4 percent. Similarly, there has been rising unemployment, with the current level put at 23.9 percent by the National Bureau of Statistics (NBS).[17]

Many national economic programs and policies put in place have not been able to change the tide. The first was the National Development Plan, 1962–68, introduced to put the economy on a fast growth path with agriculture, industrial, and manpower development as priority areas. The second National Development Plan, 1970–74, targeted reconstruction and rehabilitation of infrastructure that was damaged during the civil war. The Indigenization Decrees of 1972 and 1974 attempted to put the Nigerian economy in the hands of Nigerians within the context of nationalism. While the third National Development Plan, 1975–80, immensely enjoyed the benefits of the huge oil revenues of the mid-1970s, the execution of the Fourth National Development Plan, 1981–85, was adversely affected by the collapse of international oil prices.[18]

The government adopted a structural adjustment program (SAP) sponsored by the IMF in 1986 for a better market-friendly environment with measures and incentives that would encourage private enterprise and more efficient allocation of resources. However, the program failed to realize the goals of creating wealth and promoting sound economic development as a result of policy reversal. The National Economic Empowerment and Development Strategy (NEEDS) was launched in 2004 with the goal of wealth creation, empowerment, poverty reduction, and value reorientation.[19] The strategy expected to be a catalyst for meeting the Millennium Development Goals (MDGs).

If any factor is common to all of the above economic development plans, it is gross mismanagement and policy reversals by successive governments. Corruption coupled with profligate spending has made it impossible to channel the resources to profitable investments to bring about desired economic benefits. As a result, the Nigerian economy has been bedeviled by unemployment and poverty.[20]

The biggest economic problem for Nigeria is infrastructural decay. Virtually all known indices of infrastructure are negative: electricity supply is erratic, taps are dry and the ones that run are sporadic, the level of security provided does not make one secure, most roads are barely motorable, etc. Most people, therefore, make private provision of infrastructural facilities so as to live a decent life. This might be in whole or in part, such as the employment of security guards, making use of fueled power-generating sets, the sinking of wells or boreholes, etc. Knowledge of the cost of provision of infrastructure by individuals, or fixing cars and other automobile engines frequently damaged by bad roads, will enable one to ascertain the amount of money that would otherwise be used either for investment or to improve the standard of living.[21]

David King captured the prevailing economic scene when he observed that Nigeria might be the most challenging and important developing country in the world today. It is by far the world's most populous extremely poor country,[22] but is its sixth-largest oil exporter. It has the smallest manufacturing sector of any large economy in the world, and the greatest concentration of export and government revenue dependence on a natural resource commodity. It is a country of spectacularly failed economic policies, whose GDP per capita is no higher than it was forty years ago. It is a country of rising poverty and return to subsistence. Its social problems are enormous, with half of the adult population illiterate, gender disparities in education, and league-leading infant, under-five, and maternal mortality rates. Public utility services are among the worst in the world, with at least two-thirds of households not connected to electricity, access to water extremely limited, and impossible urban transportation.[23] This observation still suits the current description of the Nigerian economic development as well as it did in 2003.

Impact of the Financial System on Development

Studies have shown that there is a strong and positive relationship between economic development and the financial system. Goldsmith was of the view that financial institution development is of prime importance for real development because the financial superstructure, in the form of both primary and secondary securities, accelerates economic growth and improves economic performance to the extent that it facilitates the migration of funds to the best user.[24] The best user here refers to the sector of the economy where the funds will yield the highest social and financial returns. Goldsmith was quoted to have empirically calculated the values of the financial interrelation ratio (FIR), the ratio of all financial instruments at a given time, to the value of the national wealth. He found that the ratios for developing countries were far lower than those of developed countries and concluded that because the development of financial institutions affects development, the low level of development of the financial superstructure affects development negatively.[25]

Goldsmith's analysis typifies the Nigerian banking sector. Before the 2004–05 reform of the sector, the Nigerian commercial banks were no better than rent-seekers. There were 89 deposit money banks operating in the country, comprising institutions of various sizes and degrees of soundness. Structurally, the sector was highly concentrated, as the ten largest banks accounted for about 50 percent of the industry's total assets/liabilities. Most banks in Nigeria had a capitalization of less than US$10 million. The largest bank in Nigeria had a capital base of about US$240 million. The small size of most of the banks, each with expensive headquarters, heavy fixed costs and operating expenses, and with many branches in few commercial centers, led to a very high average cost for the industry. This in turn has implications for the cost of intermediation and the spread between deposit and lending rates, and puts undue pressures on the viability of the banking industry. Some of the banks were not engaged in strict banking business in terms of savings intermediation; rather, they turned to trading in foreign exchange, government treasury bills, and sometimes even direct importation of goods through phony companies.[26]

The reform resulted in 24 "stronger" banks capable of undertaking funding of large ticket projects and engendering improved customer confidence. The number of bank branches increased from 3,247 in 2003 to over 5,837 in 2010 and employment in the sector rose from 50,586 in 2005 to 71,876 in 2010. Also, the capital market received a boost as several banks recorded successes in their initial public offers (IPOs). The consolidation exercise also impacted the payment system positively as the lower number of banks made it easier to deploy the new automated clearing systems and reduced the length of time spent on the clearing floor.[27] This result appeared so impressive that an observer would hazard a conclusion that it is the level of financial institution development Porter referred to as the best indicator of general economic development.[28]

However, it was discovered shortly after that Goldsmith's condition precedent "facilitating the migration of funds to the best user" was missing. Rather than advancing the funds to productive sectors, some of the banks engaged in subprime lending, margin loans, and other high-risk investments.

According to Balogun, despite the increase in lending to the economy by the financial institutions, propelled by their larger size, the share of the priority sector of the economy, particularly agriculture, solid minerals, exports, and manufacturing, was low and continued to fluctuate between progression and decline over time. Table 1 below depicts distribution of funds to different sectors of the economy.

Table 1. Deposit Money Banks Share of Credit to the Core Private Sector, 2007–11 (Percent)

	2007	2008	2009	2010	2011
1. Priority Sector	**25.9**	**26.2**	**25.2**	**30.4**	**36.1**
Agriculture	3.2	1.4	1.4	1.7	3.5
Solid Minerals	10.7	11.3	12.7	15.3	17.7
Exports	1.4	1.0	0.5	0.6	0.5
Manufacturing	10.4	12.5	10.6	12.8	14.4
2. Less Preferred Sectors	**41.2**	**42.0**	**46.9**	**47.8**	**45.8**
Real Estate	6.2	6.2	8.3	8.7	6.2
Public Utilities	0.6	0.6	0.8	0.7	0.9
Transport and Communication	6.8	7.2	8.3	10.7	17.3
Finance and Insurance	9.4	9.5	13.1	11.3	4.1
Government	3.7	1.9	3.7	4.9	6.8
Imports and Domestic Trade	14.4	16.4	12.8	11.7	10.3
3. Unclassified	**32.9**	**31.8**	**27.9**	**21.8**	**18.1**
Total (1+2+3)	**100**	**100**	**100**	**100**	**100**

Source: CBN[29]

The Nigerian brand of the financial crisis of 2008, which coincided with the global financial meltdown, gave credence to the view that the capital gains of the consolidation exercise were channeled more toward miscellaneous activities.[30] Channeling appropriate funds to agricultural and production sectors will have a positive impact on the nation's economic development.

Financial Exclusion

According to the United Nations Capital Development Fund (UNCDF), inclusive financial sectors are defined by a continuum of financial institutions that together offer appropriate financial products and services to all segments of the population. To operate effectively, inclusive financial sectors need to be supported by sound policy, legal, and regulatory frameworks. They are characterized by:

a) Access at a reasonable cost of all households and enterprises to a broad range of financial services including savings, short- and long-term credit, leasing and factoring, mortgages, insurance, pensions, payments, and remittances;
b) Sound institutions guided by appropriate internal management systems, industry performance standards, performance monitoring, institutional transparency, accountability, and sound prudential regulation;
c) Financial and institutional sustainability as a means of providing access to financial services over time; and
d) Multiple providers of financial services, wherever feasible, so as to bring a wide variety of cost-effective alternatives to customers.[31]

The term “financial exclusion” was conceived in 1993 by geographers who were concerned about limited physical access to banking services as a result of bank branch closures.[32] But it was in the work of Kempson and Whyley in 1999 that it seems first to have been used in a broader sense to refer to people who have constrained access to mainstream financial services.[33] According to a report prepared for the European Commission, financial exclusion refers to a process whereby people encounter difficulties accessing and/or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in the society to which they belong.[34]

The number of Nigerians who have no access at all to financial services better explains the situation. A survey conducted by Enhancing Financial Innovation and Access (EFInA) group in 2008 put the adult population of Nigeria who should ordinarily have access to financial services at 86.6 million. Of this, 72% of the population lives in a rural area, with the remaining 28% of the population residing in urban areas. Of this, only 20% and 13% of the total adult population engage in subsistence and commercial farming, respectively. On the whole, 21% of adults are currently banked and 5% are previously banked, while 74% of adults are unbanked.[35] Banks credit thus constitutes only 30% of GDP while just 8% of those who have access to financial services own about 90% of the available deposits.[36] By this survey, about 65% of the cash in circulation in the Nigerian economy is outside of the banking system and its attendant implication for price and economic stabilization is *res ipsa loquitor*.

Some of the reasons adduced for lack of access to financial services are illiteracy, poverty, and other factors, which include avoidance of interest-based banking.[37] These factors have been shown by empirical research to be more prevalent among Nigerian Muslims than people of other religious affiliations.[38] Thus, going by a survey conducted by the PEW Research

Institute in 2009 that put the total population of Muslims in Nigeria at 78 million (51.4%),[39] it is only logical to conclude that more than 50% of the unbanked are Muslims.

The extent of economic deprivation Nigeria is suffering as a result of the financial exclusion of its population, particularly rural settlers, will be better appreciated by putting the percentage of the total rural dwellers, shown above, against the percentage of those who engage in farming, which is 45.8%.[40] No level of financial system reform will produce the desired economic development result unless financial resources are channeled toward engaging those idle men and women.

RELEVANCE OF ISLAMIC FINANCE TO NIGERIAN ECONOMY

Islamic finance emerged on the global financial scene about four decades ago.[41] The first modern experiment of Islamic interest-free banking was made in Mit Ghamr, Egypt, in 1963. The Mit Ghamr project was by and large successful from 1963 to 1966. At about the same time, Muslim Bank of West Africa was operating in Nigeria in accordance with Islamic principles before its license was revoked by the then minister of finance, the late Obafemi Awolowo, in 1967.[42] The Islamic Development Bank and Dubai Islamic Bank were both established in 1975. Since then, Islamic banking and finance have made serious inroads to various parts of the world, covering not only the Islamic world but the secular and developed world too. The 2010 survey of financial institutions practicing Islamic finance reveals that shari'a-compliant assets (SCA) rose by 8.85% from $822bn in 2009 to $895bn in 2010. Islamic finance has held a compound annual growth rate (CAGR) of 23.46% from 2006 to 2010.[43] It has also proved to be resilient in the face of the global financial meltdown.

A number of Islamic financial products have been developed over the years to give a variety of choices to users of financial services. They include *murabaha* (cost plus financing),[44] *bay bithaman ajil* (BBA) (deferred payment sale),[45] *bay tawaruq*,[46] *ijarah wa iqtina'* (lease purchase),[47] *bay'al-salam,*[48] *kafalah* (guarantee),[49] and *wakalah.*[50] However, some of the products have inbuilt mechanisms for financial deepening which are peculiar to Nigerian economic development needs and are as such the focus of this study. They include *muzara'a* (sharecropping) and *musaqah* (irrigation), *musharaka* (active partnership), *mudaraba* (profit sharing financing) and *sukuk* (security certificate). *Muzara'a* and *musaqah* products are capable of engaging about 67% of Nigerian rural dwellers, who are still unproductive, in agricultural activities, thereby doubling the input of agriculture to the GDP. *Musharaka* and *mudaraba* products are capable of giving financial access to nearly 74% of the total adults who are unbanked. *Sukuk* is also a veritable product for reversing the nation's infrastructural decay and deepening economic development.

Muzara'a and *Musaqah* (Sharecropping and Irrigation)

Muzara'a and *musaqah* are commercial transactions in which a party commits a particular plot of land belonging to him or to which he is beneficially entitled to another to cultivate or maintain for a specified period of time in return for a share in the produce.[51] These contracts have their validity in the *hadith* of the Prophet Muhammad narrated on the authority of 'Ibn Umar that "the Prophet Muhammad dealt with the people of Khaybar for a specific portion of their output of fruits."[52] Relying on this *hadith*, the majority of Muslim jurists, including Imam Malik, Ahmad, and the famous disciples of Abu Hanifah and Dawud al-Zahiri, render the contract as permissible in analogy to *mudaraba.*[53] *Muzara'a* can function as a contract or lease of land, or the gift of land and its farm implements and hiring only the service of the farmer in cultivating it. Unlike jurists of other schools, the Malikis insist that in *muzara'a,* both the landlord and the farmer must jointly provide the seeds and other inputes.[54]

These modes are suitable for commercial relationships with people in rural areas, especially farmers. In adopting this mode, the bank allocates land and economic trees in its possession to farmers and in addition provides other necessary inputs like seeds, fertilizer, pesticides, implements, and means of production and transportation.[55] If it has insufficient lands, it may use its corporate recognizance to procure agricultural lands from governments under agricultural development programs for allocation. An agreed share of the produce is the bank's return on investment.

Islamic banks have designed *musaqah* as an irrigation scheme, especially in Southeast Asian countries like Malaysia and Indonesia and parts of Africa like Nigeria, where farming has proved to be a vital source of national income. Its use, especially in Nigeria, would be more fortified by the fact that, unlike other schools, the Maliki *madhab* recognizes the operation of *musaqah* in both trees and other agricultural plants.[56] Its practice as such in Iran and the claim of success of similar experimentation by Faisal Islamic Bank, Sudan,[57] is a clear departure from the practice of many Islamic banks that are still finding it difficult to deal with a large percentage of "unbankables."[58]

Bay'al-salam (forward sale) also provides an ideal opportunity by which a bank makes an advance purchase of future crops with its *musaqah* partners. Apart from encouraging rural dwellers to deposit their surplus funds in the bank, the *salam* arrangement also helps them out of marketing problems and protects farmers from price fluctuations during the harvest season.[59] However, it is advisable that the bank have a ready buyer engaging in a *salam* contract to avoid non-salability.[60] Upon finding a ready buyer, which preferably would be a large commercial enterprise using farm produce as their raw material, it is permissible for the bank to contract a parallel *salam* and use the first *salam* in the discharge of its obligation to the third party in a separate contract.[61]

Musaqah products can be developed to create an irrigation system that would improve productivity and change the preset seasonal farming in Nigeria and many parts of the developing world to year-round farming. The two products have the potential to enhance productivity and increase agricultural yield. This in turn improves the per capita income of the partners, encouraging them to save with the bank and improve the contribution of agriculture to the GDP of the nations. Through these factors, employment will be created and the problem of urban migration and congestion will also be mitigated to a reasonable extent.[62]

Musharaka (Partnership Financing)

Musharaka has been acclaimed as the Islamic financial contract most suited to Islamic banking, especially in satisfying the maxim "right follows responsibility."[63]

Adopting this mode in converting its liabilities to assets, an Islamic bank partly funds projects, sometimes financing commodity trade or industry working capital, submitted to it by a client/partner after a thorough evaluation of the project's technical and economic feasibility. The other partner contributes his share either in cash or in kind. In practice, the partner is always allowed to manage the project, giving collateral for good management while the bank reserves the right of supervision and, if necessary, intervention.[64] It is also agreed in advance to compensate the partner's management with between 20 percent and 35 percent of the net profit before the leftover is shared according to the agreed-upon ratio that is always in favor of the partner. The profit ratio is usually up to 45 percent of the profit after management allowance, even though the partner actually contributed about 15 percent of the project capital.[65]

Islamic banks may either adopt a continuing or diminishing *musharaka.* In the former, the bank participates in the equity and receives an annual share of the profits on a pro rata basis. The period of termination of the contract is not specified. The latter culminates in the ownership of the asset or the project by the bank's partner. In this case, the bank participates as a financial partner, in part or in full, in a project with a given income forecast. An agreement is signed by the partner and the bank through which the bank receives a share of the profit if any is made.

However, the agreement also provides for payment of a portion of the net income of the project as repayment of the principal financed by the bank. The partner is entitled to keep the rest. In this way, the bank's share of the equity is progressively reduced and the partner eventually becomes the full owner on completion of repayment of the principal project capital. The Jordan Islamic Bank has successfully practiced this diminishing mode of financing in the construction of a commercial market in Irbid, a community college in Jerash, and a hospital in Zerqa.[66] This product is capable of turning around the fortunes of the small and medium scale enterprises (SMEs), which are viewed by conventional banks as volatile establishments with low chances of survival and thus a high investment risk.[67]

Mudaraba **(Profit Sharing)**

The profit sharing arrangement sometimes referred to as trust financing, trustee profit sharing, equity sharing, and sleeping partnership is another age-old trade arrangement prevalent in the pre- and post-Islamic Arab states. It is a kind of partnership where one partner, called *rabb al-mal* (capital provider), provides the necessary financial capital and the other, called *mudarib* (entrepreneur), supplies the human capital. The two types of capital are invested in commercial enterprise for an agreed-upon general ratio of the net profit. All losses are borne by the capital provider while the entrepreneur loses his efforts. [68]

An Islamic bank acting as the entrepreneur accepts deposits into investment account through this arrangement. In Faisal Islamic Bank, Sudan, the customer signs an undertaking authorizing the bank to invest the deposit in *al-mudarabah al-mutlaqah* (unrestricted investment).[69] Exercising this authority, an Islamic bank, in turn, invests the fund with another entrepreneur by means of second-tier *mudaraba.* Meanwhile, the bank makes the second *mudaraba* a restricted or recursive one—that is, *al-muqayyadah*[70]—which enables the bank to dictate the type of investment to which the fund shall be engaged. The bank provides the 100% capital to the second *mudarib*, retaining the power to monitor the progress but not to interfere in the management of the project.[71] Although the Malliki school of law, where *mudaraba* is required to be unrestricted,[72] is the predominant school in Nigeria, the level of risk involved in *mudaraba al-mutlaqah* will justify adopting the *muqayyadah* type. This product is significant to Nigeria economic development because of its capacity to improve financial inclusion for the great majority of youth who are skilled laborers and who have hitherto been excluded from financial access.

Sukuk **(Islamic Investment Certificates)**

Sukuk are investment certificates issued by a special purpose investment vehicle (SPV). Usually the owner of an asset who desires to raise capital leases the asset on the principle of *al-ijara muntahia bittamlik*. The rent paid by the obligor is distributed to the certificate holders. On the certificate due date, the obligor buys back the asset, the proceeds of which are used to redeem the investment certificates, which may also be traded in the market before the redemption date.[73]

Aside from raising funds for capital projects that can translate to economic development, sovereign *sukuk* are useful to governments because the cost of financing does not fluctuate along with the financial condition of the issuing sovereign. This is because the value and yield of the *sukuk* is derived from the performance of its underlying asset. The issuing sovereign enjoys flexibility in making financial decisions without external influence, as the fund raised is the equivalent of a private sector fund.[74]

REGULATORY CHALLENGES

As part of the ongoing reform of the financial sector, the CBN has adopted an Islamic banking system. It issued a fairly comprehensive framework for the regulation and supervision of institutions offering non-interest financial services in Nigeria in January 2011, which is analyzed later in this section.[75] It also gave full approval to the first full-fledged Islamic bank (Jaiz International Bank Plc) and an Islamic window for Stanbic IBTC Bank in June 2011. The adoption is a policy focused on enabling economic growth and ensuring that the financial sector contributes to the real economy.[76]

However, the adoption has also generated a heated debate arising from the religious tensions prevalent in the country. Some non-Muslims, including the umbrella body of Christians, criticized the policy as a ploy to Islamize the country. Other pitfalls, too, have plagued the project, including an insufficient legal and regulatory framework, inadequate manpower on both the operation and regulatory sides, and a low level of awareness about the workings of the financial system.

Religious Rivalry

Religious rivalry in Nigeria predates the establishment of Islamic banking. Similar debates came up when Nigeria joined the Organization of Islamic Conference (OIC) in 1986, and when some states in northern Nigeria adopted a shari‘a penal code in 1999–2000. The argument always centers on the different interpretations of the provisions of Section 10 of the Constitution of the Federal Republic of Nigeria. The section states that: “The Government of the Federation or a State shall not adopt any religion as State Religion.” Some argue that the provision makes Nigeria a multi-religious state, while others view it as secular state. The proponents of secularity of the Nigerian state thus declared the introduction of Islamic law as unconstitutional and discriminatory.[77] In introducing Islamic financial tools, the CBN has been viewed by some leading figures among Nigerian non-Muslims as using a public institution to promote religion, for which reason they have mounted strong opposition.[78]

Robust Enabling Law

The substantive laws that have direct bearing on the activities of Islamic banks in Nigeria include: the Banks and Other Financial Institutions Act, 1991 (BOFIA) (as amended), and the Central Bank of Nigeria Act, 2007. While Section 9(2) of BOFIA recognized profit and loss sharing (PLS) banks as one of the categories of banks that can operate in Nigeria, the law does not have sufficient provisions for the day-to-day operations of Islamic banks.[79] Furthermore, the provisions of BOFIA 1991 as they relate to PLS banking are so scanty that they only define and recognize PLS banking in matters of interest and unspecified peculiar products.

Rather than enlarging the scope of operations, the subsequent amendments up to 1999 became highly stringent on banking products other than *musharaka* and *mudaraba.* Additionally, no particular product of the banking system was specifically defined nor were provisions made for its internal regulatory control to ensure compliance of its operations with the object of the bank's establishment. Therefore, the existing banking laws in Nigeria are essentially lacking in the requisite comprehensiveness and would as such require amendments. The enactment of a complete set of comprehensive laws for the new system would be a better option.[80]

In the meantime, the CBN, subsequent to the initial general framework, has continued to issue guidelines to ensure the smooth operation of Islamic financial institutions in the country. These include: *Guidelines on Shariah Governance for Non-Interest Financial Institutions in Nigeria* and *Guidelines on Non-Interest Window and Branch Operations of Conventional Banks and Other Financial Institutions*. It has also issued Guidelines on Corporate Governance for Non-interest (Islamic) Financial Institutions in Nigeria,[81] while it indicated ongoing efforts to issue operational, product compliance, risk management, and capital adequacy guidelines.[82]

It is still premature to examine the efficacy of these regulations and guidelines at the moment because they are just being implemented. Yet there have not been any complaints, to the knowledge of these authors, about their implementation, despite the continued opposition by some groups. For instance, the initial Guideline on Shariah Governance was seriously challenged by public commentators for establishing a shari'a advisory council for the CBN and committee for all non-interest financial institutions (NIFIs) in its section 4. The complaint was that the composition of the council and committee was discriminatory against non-Muslims.[83] Some groups have even declared the introduction of non-interest banking an attempt to Islamize Nigeria.[84] This probably necessitated the change in its nomenclature to *Guidelines on the Governance of Advisory Committees of Experts (A.C.E.) for Non-Interest (Islamic) Financial Institutions* in Nigeria.

The efforts of the CBN may also have prompted the proposition of the *Draft Framework for Non-Interest Deposit Insurance Scheme* by the

Nigeria Deposit Insurance Corporation.[85] The framework makes provisions to accommodate the peculiarities of Islamic deposit money banks in terms of shari'a compliance of their activities and governance structures.[86] However, the differential premium assessment system (DPAS), which focuses on the risk profile of each non-interest financial institution it seeks to adopt in the determination of their contribution to the scheme, would need reexamination in view of the existing distribution pattern of return on investment of the fund.[87] Similar steps have been taken by the Nigerian Security and Exchange Commission by proposing amendments to their rules and regulations. The rule, which will govern the administration of *sukuk*, provides for the establishment of a shari'a advisory council for the commission and board for fund managers. It also made prescription of the content of a trust deed; includes a shari'a adviser in the composition of the investment committee; and insisted on sharia-compliant investment in portfolio management.[88]

The latest guideline issued for the regulation of Islamic finance in Nigeria is the one by the National Insurance Commission of Nigeria (NAICOM)[89] These guidelines appear comprehensive but have yet to take effect and, when they do, they cannot take the place of substantive law. Thus, it is easy to do away with them by successive administration of the apex bank.

Conflict of Making Regulations and Making Laws for Islamic Finance

Attempts by the CBN to enlarge the scope of the statutory provisions enabling Islamic banking through guidelines and regulations could pose serious challenges. Although the framework and regulations made by the CBN governor are within the powers vested in them under the law,[90] such delegated powers do not extend to assuming the law-making powers of the legislators.[91] What appears to be usurpation of legislative powers presents on Section 10 of the framework[92] shown below:

> 10.1 Branding: In line with the provisions of Section 39 (1) of BOFIA 1991 (as amended), NIFIs shall not include the word "Islamic" as part of their registered or licensed names.
>
> Whereas section 39 (1) BOFIA provides:
>
> 39. (1) Except with the written consent of the Governor
> (a) No bank shall, as from the commencement of this Decree, be registered or incorporated with a name which includes the words "Central," "Federal," "Federation," "National," "Nigeria," "Reserve," "State," Christian," "Islamic," "Moslem," "Quranic," "Biblical."

The apparent contradiction in the two provisions is that, while the substantive law gives rights to the citizens, subject to the discretion of the governor, to use "Islam" or "Islamic" as part of a bank's name, the regulation foreclosed the possibility of even applying for the use at all and this cannot be the correct position of the law. This point was directly made to the CBN governor at a colloquium in June 2011[93] and the contradiction was removed in the revised edition of the framework issued the same month.[94] Nonetheless, just as it was easy for the CBN to amend the framework to comply with the substantive law, it would be as easy for any new administration of the Bank to do away with all of the guidelines and the framework.

Another contradiction is evident in the designation by CBN of non-interest banks in Nigeria as specialized banks under what it called the "new banking model,"[95] pursuant to Section 66 of BOFIA.[96] Although the law empowers the governor to so do, it does not exclude any specialized bank from charging interest in its operations. The only category of banks excepted by BOFIA from operating on an interest base are profit and loss sharing (PLS) banks,[97] which were envisaged by the law as a distinct category of banks in Nigeria.[98] Thus, making non-interest banks into specialized banks is not within the contemplation of the law.

The challenges of the CBN in sponsoring an executive bill to the National Assembly for a comprehensive law on Islamic banking will be appreciated by the following scenario. On May 25, 2005, while the operating license of Jaiz International Bank Plc. was awaiting approval, some Muslim members of the National Assembly entered a motion at the House of Representatives for a resolution of the House urging the federal government of Nigeria to facilitate the nation's membership in the Islamic Development Bank (IDB).[99] This was to encourage IDB to invest in the Islamic banking system of the country.[100] Because of the religious divides between members of the House, the motion attracted a heated debate, which nearly resulted in a physical challenge. The federal government had to endorse the nation's membership in the Bank on June 8, 2005, unilaterally subscribing to 250 units of its shares.[101] The foregoing notwithstanding, the CBN will still need to take necessary steps to have a new set of laws passed for effective regulation of Islamic banking in the country.

Challenge of Raising the Initial Share Capital

The 2004–05 bank reforms put a daunting challenge in the path of the establishment of Islamic banking in Nigeria and still constitute a clog in the promotion of other Islamic banks after the issuance of the first license. The reform had raised the minimum capital base for banks from 2 billion to 25 billion Naira.[102] The reform took off at a time when the promoters of Islamic banking had fulfilled all the requirements and were expecting the operating license by the CBN. The promoters had thought that since the dateline for the new capital base was the end of 2005, the license being applied for in December 2003 would first be issued. Then the new banking system would be allowed, like other existing banks, to struggle and raise more capital to comply with the new requirements.[103]

However, the CBN, which was interested in getting rid of the low portfolio banks from the system, would rather grant partial approval to the promoters subject to their raising the balance of N23 billion from the capital market.[104] This gave the promoters a daunting task, which seemed almost impossible. This is against the background fact that virtually all the banks that met the N25 billion capitalizations had to go through merger or acquisition processes to raise the capital despite their existing assets and capitals. It is on record that nine banks had to merge to form the new Unity Bank Plc.,[105] while the new Springbank Bank Plc. is made up of six old banks merged together.[106]

The lead author herein had done a sufficient critique of the legal implications of the reforms for contravening BOFIA's banks categorization policy.[107] The law and its various amendments had categorized banks with different capital base commensurate to their size, coverage, and kind of operation.[108] The reform removed the categorization by "legislating" equal capital base for all banks and, by that act, it took the first Islamic bank eight years to raise the minimum required capital. The Senate attempted to foil this usurpation of legislative powers by attempting to amend BOFIA to restore the categorization policy,[109] but her efforts were aborted by political maneuvering which ensured that the amendment suffered from the requisite concurrent passage by the lower legislative House of Representatives.[110] The CBN has started taking steps to amend the law along the lines earlier proposed by the senate, by which banks will be categorized according to paid-up share capital as follows: (a) Mega banks with minimum share capital of N25 billion; (b) Medium banks with minimum paid-up share capital of N10 billion; and (c) Small banks with minimum paid-up share capital of N5 billion.[111] If this is achieved, it will go a long way toward encouraging more promoters to seek license and operate more Islamic banks.

CONCLUSIONS AND RECOMMENDATIONS

This study explored the state of the Nigerian economy and the impact of the Nigerian financial system on the country's developmental efforts. It was shown that the nation is richly endowed in human and natural resources that should have a positive impact on the Nigerian people if properly managed. It was also shown that for much of the nation's history, the financial system was not able to properly mobilize funds for best productive purposes. In the absence of such opportunities, the bankers were rather trading in foreign exchange and government treasury bills, and sometimes engaging in the direct importation of goods through spurious means. Despite the various financial reforms experimented with by the country, the great majority of its citizens are still excluded from the mainstream financial system. The distribution of bank capital is extremely disproportionate to the number of banked individuals. All these factors account for the high level of poverty and deprivation in the country despite the impressive level of economic growth achieved in recent years.

Regulatory authorities embarked upon several financial sector reforms that were supposed to ensure that financial institutions deployed funds to the real sectors of the economy. The desired result has not been achieved, leading to the adoption of the Islamic financial system. Of the various products of Islamic finance, *muzara'a, musaqah*, *musharaka*, and *sukuk* are uniquely suited to reviving Nigerian economic developmental efforts. The absence of robust enabling laws for Islamic financial institutions, including those for *takaful* and an Islamic stock market, are among the other initial challenges facing the regulatory authorities.

Based on the foregoing conclusions, the following recommendations are presented for a development-driven Islamic finance system in Nigeria:

1) Religious and social organizations should intensify efforts to raise awareness of the working and benefits of Islamic banking, not only to the Muslim population but also to the general public.
2) The CBN and other regulatory authorities should provide incentives to motivate the emerging Islamic banks to give priority to *muzara'a*, *musaqah*, *musharaka*, *mudaraba*, and *sukuk* as suitable products for remedying the current economic situation.
3) Necessary steps should be taken to sponsor a bill in support of Islamic banking in Nigeria. Such a bill ought to make clear the peculiar features of Islamic finance in terms of product development and internal regulatory needs. This step will also free CBN from the dangers of assuming lawmaking powers in the name of issuing regulations and guidelines.
4) The CBN, along with other regulatory authorities, commercial banks, and educational institutions, should work closely to address the human resource needs of the emerging Islamic financial system.
5) The CBN should be cautious about issuing operating licenses to commercial banks until it is satisfied that they have sufficiently trained personnel to run the system. Alternatively, it should launch a pilot project of Islamic finance giving approval to selected commercial banks until required human capital is made available.
6) BOFIA should be amended to restore the categorization policy and allow medium and small sized banks to attract particular segment of the market by providing services to the customers fulfilling their peculiar needs.

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36. Charles Chukwuma Soludo, "Making Finance Work for the Poor," paper delivered at the convocation lecture of Federal University of Technology, Oweri, Imo State on 15 February, 2008, 5.
37. Ibid., 18.
38. I. A. Abdulqadir, "Islam in Nigeria by the Year 2020: Awakening a Collective Consciousness," *Al-Asaalah Journal of Arabic and Islamic Studies* 3:2 (2012): 170–177.
39. T. Miller, ed., "Mapping the Global Muslim Population: A Report on the Size and Distribution of the World's Muslim Population," *Pew Research Center Report,* October 2009, accessed on March 8, 2011, and available at http://pewforum.org/newassets/images/reports/Muslimpopulation/Muslimpopulation.pdf.
40. Agricultural sector has consistently contributed an average of 40% to the GDP, and it contributed 41.59% to the GDP in Q2, 2011; see National Bureau of Statistics, accessed on September 14, 2011, and available at http://www.nigerianstat.gov.ng/.
41. For further details on earlier operations of Islamic finance, see W. J. Fischel, *Encyclopedia of Islam* 2 (1992): 382–3; I. A. Abdulqadir and J. Zainudin, "Islamic Financial Services: The Way Forward for the Financial Regulatory Authorities," *University of Ilorin Law Journal* 1:1 (2006): 147–148; I. A. Abdulqadir, "Islamic Banking as Non-Interest Banking: Fact or Fiction?" *Shariah Law Report* 1 (2012): 49.
42. A. K. Musa, "The Need for Islamic Banking in Nigeria," paper presented at the International Conference on Islamic Banking and Finance, organized by Crescent University, Abeokuta, March 19–22, 2010, 3 (although there is no detailed evidence of its operational modus yet).; O. A. Ajayi, *Law and Practice of Banking* (Ibadan: Andy-P Corporate Bureau, 1999), 57, reported two decided cases involving the bank and its customers viz: *Nigerian Breweries Ltd. v. Muslim Bank of West Africa* (1963) and *United Nigerian Insurance Ltd. v. Muslim Bank of West Africa* (1972).
43 *The Banker*, accessed on August 8, 2011. http://top500islamic.thebanker.com/index.cfm?fuseaction=top500.home&CFID=1277573&CFTOKEN=93128769.
44. *Murabahah*: Lit. "Cost plus financing"; Tech.: Sale of goods with an agreed-upon profit mark-up on the cost. Islamic financial institutions operate the product either to the purchase order of the customer or without purchase order.
45. This is also called *bay al-muajjal*: Lit.: "Deferred payment sale"; Tech.: This transaction is a sales contract whereby an immediate delivery of goods purchased is made while postponing the payment of the price to a later date. It refers to sale of goods purchased by a bank for a customer at a price agreed to by both parties on a deferred payment basis or by periodic instalments. See Glossary, *Journal of Islamic Banking and Finance* 28:3 (July–September 2011): 127. This product was widely used in Malaysia along with *bay al-inah* (buyback sale) and was for a long time, before *sukuk* became popular, the leading product despite the enormous criticism it attracted for being very close to lending on interest. See for instance Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer International, 1998), 139; and Muhammad Anwar, *Islamicity of Banking and Modes of Islamic Banking* (Malaysia: IIUM, 2002), 4. The practice has also attracted a number of court cases. See for instance, *Bank Islam Malaysia Berhad v. Adnan Bin Omar* [1994] 3 CLJ 735; *Dato' Haji Nik Mahmud Bin Daud v. Bank Islam Malaysia Berhad* (1996) 1 CLJ 737; *Bank Islam Malaysia Berhad v. Shamsuddin Bin Haji Ahmad* [1999] 1 LNS 275; *Bank Kerjasama Rakyat Malaysia*

v. Emcee Corporation [2003] 1 CLJ 625; *Malaysian Merchant Bank Bhd v. Silver Concept Sdn Bhd* [2005] 5 AMR 381; and *Affin Bank Berhad v. Zulkifli Bin Abdullah* (2005) MLJU 568.

46. A sale of commodity to a customer by a bank on deferred payment at cost plus profit; the customer then sells the commodity to a third party on a spot basis and gets instant cash. Ibid., 132.
47. A contract by which an Islamic bank finances equipment, building, or other facilities for a client at an agreed rental together with an undertaking from the client to make additional payment on an account which will eventually permit the client to purchase the equipment or the facility. The rental as well as the purchase price is fixed in such a manner that the bank gets back its principal sum along with some profit which is usually determined in advance. See Mohammad Akram Khan, *Islamic Economics and Finance: A Glossary* (New York: Routledge, 2003), 85–86.
48. Lit. "Advance sale," also called *salaf*. The variation in the name relates to what the same transaction is called in different locations; while s*alaf* is of Iraqi origin, the same transaction is known as *salam* in Hijaz and they are now synonymously used. See M. A. H. Umar, *Shariʿah Economic Framework of Bai' al-Salam in the Light of Contemporary Application* (Jeddah: Islamic Development Bank, Research Paper No. 33, 1995), 17. Tech. it is a sale agreement which involves advance payment for specifically described goods that are to be delivered at a later but definite date; it is an exception to the general rule of Islamic law against the sale of any good not existing at the time of bargain (Mohammad Akram Khan).
49. *Kafalah*. Lit. "Guarantee." Tech.: Contract or assurance made by financial institution to third parties that its customer would fulfill his obligations towards the said third party, thereby assuming liability of its customer in the event of default or breach of contract by its customer. See I. A. Abdulqadir, "Contract of *Kafalah* (Guarantee): A Veritable Product of Islamic Financing?" *University of Ilorin Law Journal* 3–4 (2007–08): 209–210.
50. *Wakalah*. Lit. "Representation, agency." Tech.: Contract of agency by which a person delegates his business to another and substitutes the other in his own place, the latter is called the *wakil*, or agent, and the former is called *muwakkkil*, or principal. See Moahmmad Akram Khan, *Islamic Economics and Finance,* 192.
51. Ibn Qudamah Abd ʻAllah, *Al-Mughni - al-Shar' al-Kabir,* reprt. (Beirut: Dar al-Kitab al-ʻArabi, 1983), vol. 5, 555 and 581; see also Articles 71 and 74, "Regulation Relating to the Granting of Banking Facilities," Tehran (1984).
52. Reported by the six major narrators of *ahadith* as authentic, see *Sahih Muslim,* vol. 3 (1978 ed.), 810.
53. Wahabah Al-Zuhayli, *Al-Fiqh al-Islami wa-Adillatuh*, Mahmoud A. El-Gamal, trans., vol. 1 (Damascus: Dar al-Fikr, 2003), 522–523.
54. Ahmad Al-Dardir, *Al-Sharh Al-Kabir* (Egypt: Matbaʿah Al-Babi Al-ʻalabi) vol. 3, 372.
55. See Articles 72 and 75, Iranian Regulation, 1984.
56. See Al-Dardir, *Al-Sharh Al-Kabir,* n. 58, 713–714.
57. A. R. Hamdi, "The operation of Faisal Islamic Bank Sudan," in A. Hoque, ed., *Readings in Islamic Banking* (Bangladesh: Islamic Foundation, 1987), 296.
58. News Item, "Why banks withhold N28b SMEEIS fund, by SMEDAN boss," *The Guardian,* Wednesday, February 23, 2005, 34. The term originally belonging to the conventional banks has crept into the practice of Islamic banks, referring to the

inability of the poor segment of the community to benefit optimally from banking facilities for having no collateral security.

59. M. Azizul Huq, “Islamic Banking and some Possible Impacts,” in *Thoughts on Islamic Banking,* edited by M. A. Rasheed (Dhakka: Islamic Economics Research Bureau Publication, 1982), 169–170. It is also a commonplace in Nigeria that a lot of farm produce, especially the perishables, get destroyed or farmers are forced to sell them at a giveaway price during the harvest period for lack of means of transporting them to the cities or preserving the excess.
60. M. Kahf and Tariqullah Khan, *Principles of Islamic Finance (A Survey)* (Jeddah: Islamic Research and Training Institute, Research Paper No. 16, 1992), 18.
61. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), “*Salam* and Parallel *salam*,” *Shari'ah Standards 2003,* clause 6/2 (Manama: Bahrain, 2003), 167.
62. L. A. Abdulqadir, *Islamic Banking under the Existing Laws in Nigeria: Problems and Prospects* (Kuala Lumpur: International Islamic University Malaysia, 2007), 215.
63. A. M. Yaacob and H. Ibrahim, eds., *Islamic Financial Services and Products* (Kuala Lumpur: Institute of Islamic Understanding, 1999), 3. The legal maxim found its root in the *hadith* of the holy Prophet narrated by Abu Hurairah, in which the former was reported to have said: “The mortgage is not closed on the mortgagor who mortgages it, its benefit is for him as much as its responsibility.” See Al-Naisaburi, Muhammad Ibn Abdullah, *Al-Mustadrak 'ala al-Sahihain* (Beirut: Dar al-Kitab al-ʿilmiyyah, vol. 2, 1990), 58.
64. The collateral here does not secure the business risk inherent in the partnership which cannot be secured under the Islamic law and, unlike in conventional banking, the partner’s satisfaction of financial requirements through collateral is not enough to cause an Islamic bank to finance a project having no prospect of profitability. See A. R. Hamdi, “The operation of Faisal Islamic Bank in Sudan,” in Hoque n. 61, 292.
65. Ibid., 290–291.
66. M. A. Shahadah, “Experiences of Jordan Islamic Bank,” in *Investment Strategy in Islamic Banking: Applications, Issues and Problems* (Amman: The Royal Academy for Islamic Civilization Research, 1987), 11.
67. Seun Adesida, “How Banks Frustrate Entrepreneurs,” *Daily Sun*, Thursday, February 8, 2007, 24.
68. Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (The Hague: Kluwer Law International, 2002), 13; Bank Islam Malaysia Berhad (BIMB) offers distribution in a ratio of 70 percent to the customer and 30 percent to the Bank and the ratio may also vary from time to time. See Bank Islam Malaysia Berhad (BIMB), *Islamic Banking Practice from Practitioner’s Perspective* (Kuala Lumpur: 1994), 32.
69. (Hamdi, in Hoque n. 61, 297).
70. The practice of restricted *mudarabah* is based on the Abu Hanifa and Ahmad Ibn Hanbal’s classification of *mudarabah* into restricted and unrestricted types by which *rab al-mal* can determine the extent of the use of the fund, see Al-Kasāni ʿAla` al-Din Abu Bakr, *Bada‘iu al-Sana‘i' fi Tartib al-Shara‘iu*, (Beirut: Dar al-Kitab al-ʿArabi. 1982), 5, 62–63; The Malikis and Shafiʿis, on the other hand, require all *mudarabah* to be unrestricted to give an entrepreneur unfettered freedom to search for the most profitable opportunities in the market. See Ahmad Al-Dardir, *Al-Sharh Al-Kabir* (Egypt: Matbaʿah Al-Babi Al-Halabi,), 3, 521.

71. (Vogel and Hayes).
72. Ahmad Al-Dardir, *Al-Sharh Al-Kabir* (Egypt: Matbaʿah Al-Babi Al-Halabi) vol. 3, 521.
73. Simon Archer and Rifaat A. Abdel-Karim, *Islamic Finance; Innovation and Growth* (London: Euromoney Books, 2002), 204; K. Owens and Y. Thompson, "Sovereign *Sukuk*: A Way to Revive the Celtic Tiger," *Accountancy Ireland* 43:2 (April 2011): 34.
74. Ibid.
75. Central Bank of Nigeria, *Framework for Regulation and Supervision of Institutions offering Non-Interest Financial Services in Nigeria* (CBN: Abuja, Circular No. FPR/DIR/CIR/GEN/01/010) issued on 13 January, 2011. The initial framework was updated and reissued in June 2011 following expression of concern by this lead author to the CBN governor the same month on a contradiction between S. 10 of the framework and S. 43 BOFIA, 1991 (as amended) relating to the use of "Islamic" as part of a bank's name; some structural changes were also made based on opposition to the system, particularly by Christians.
76. L. S. Sanusi, *Banks in Nigeria and National Economic Development*, n. 30, 8.
77. Emmanuel Addeh, "CAN Opposes Islamic Banking," *The Punch*, Friday, June 24, 2011, 8.
78. For instance, the opposition of the Christian Association of Nigeria (CAN) was voiced in a press release published in the Nigerian *Daily Trust* of October 19, 2011, page 60; see also CAN President, "Islamic Banking is a plot to Islamize Nigeria," *PM News* of July 25, 2011, accessed August 11, 2012 (*http://pmnewsnigeria.com/*); and A. A. Abdul-Razzaq, *Non-Interest Banking,* op. cit. page 141.
79. Apart from S. 9, only sections 23 on exemption from interest charging, 39 on name clauses, and 61 on the definition of PLS are specifically related to Islamic banking.
80. I. A. Abdulqadir, "Islamic Banking under the Existing Laws in Nigeria: Problems and Prospects," (Malaysia: IIUM, 2007), 354.
81. Central Bank of Nigeria, Circular No. FPR/DIR/CIR/GEN/01/010, issued on 13 January, 2011, Abuja.
82. Central Bank of Nigeria, "Guidelines for the Regulation and Supervision of Institutions offering Non-Interest Financial Services in Nigeria," issued June 2011; this was a revised edition of the Framework issued in January 2011.
83. See, for instance the editorial, "Sanusi's Many Controversies (2)," *Business Day,* Wednesday, August 3, 2011, accessed on December 3, 2012, and available at http://www.businessdayonline.com/NG/index.php/analysis/columnists/25492-sanusis-many-controversies-2.
84. Christian Association of Nigeria President, "Islamic Banking is a plot to Islamize Nigeria," *PM News*, July 25, 2011, accessed on March 15 2013 at *http://pmnewsnigeria.com/;* For a detailed analysis of the controversy, D. O. Alao and E. M. Alao, "Islamic Banking: The Controversy over Non-Interest Banking in Nigeria," *Arabian Journal of Business and Management Review* 1:1 (2012): 70–74.
85. Copy on file with the authors and is available at the corporation website: http://www.ndic.org.ng/draft-framework-for-non-interest-deposit-insurance-scheme.html published in September 2011, accessed January 3, 2012.
86. See SS. 4-8 of the Draft Framework; the provisions are a clear departure from the interest-based orientation of NDIC Act 2006 (as amended) which has been criticized as not being sufficient to accommodate non-interest deposit money banks. See Abdulqadir I. A., "Islamic Banks' Participation in Deposit Insurance Scheme: A Legal Appraisal," *NDIC Quarterly* 21:1 (March, 2011): 17–38.

87. Ibid., 33.
88. SS. 1, 2, 3, 5, and 6 of the Proposed Amendments to the Rules.
89. A. Sola, "NAICOM Issues Guidelines on Islamic Insurance," Daily Independent, Friday, April 12, 2013), electronic version accessed on May 15, 2013 and available at http://dailyindependentnig.com/2013/04/naicom-issues-guidelines-on-islamic-insurance/. A copy of the guideline is available at: http://www.google.com.ng/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&ved=0CEUQFjAE&url=http%3A%2F%2Fwww.proshareng.com%2Fnews%2Fdownload.php%3Fitem%3DUNLISTESECURITIEAUG.pdf&ei=AI3pUdiOGMuO7QbR14DYDQ&usg=AFQjCNEZm81mofsM36o189PhX4fjVSAe6A&sig2=iNt2hh2nv_JFB8ZWwvFXkw&bvm=bv.49478099,d.ZGU.
90. See S. 57 BOFIA 1991 (as amended), Cap. B3, Laws of the Federation of Nigeria (LFN), 2010.
91. For a detailed reading on the extent of the lawmaking powers of the CBN governor, see I. A. Abdulqadir, "(Il) Legality of the 200–2005 Reform of the Nigerian Banking Sector," *University of Maiduguri Law Journal* 8 (2010): 330–334.
92. The Framework for the Supervision and Regulation of Institutions offering Islamic Financial Services in Nigeria issued on January 13, 2011.
93. A colloquium on Islamic Banking: Challenges and Prospects organized by Nigerian Institute of Advanced Legal Studies on June 6, 2011, at the Institute.
94. The new section 10 now subjects inclusion of "Islamic" in the name of a bank to consent of the CBN governor in line with the substantive law.
95. CBN: S. 1, Guideline for the Regulation and Supervision of Institutions offering Noninterest Financial Services in Nigeria, issued in June 2011.
96. (S. BOFIA).
97. (S. BOFIA).
98. (S. BOFIA) For a critique of the change in the categorization by the CBN without amendment of the law by legislators, see I. A. Abdulqadir, (Il)Legality of 2004–2005 Reform," 103, 328–330.
99. I. Ibanga, "Reps suspend debate on Nigeria's membership of Islamic Bank," *The Punch,* Thursday, 26 May, 2005, 1–2.
100. One of the crucial responsibilities of Islamic Development Bank is to be closely associated with the establishment and development of Islamic banks by way of assistance in the mobilization of new and additional resources in member countries. See Islamic Development Bank, *30th IDB Annual Report 1425H (2004–2005)*, 93.
101. Y. Kabiru, "FEC Approves Nigeria's Membership of IDB," *Daily Triumph,* Thursday, June 9, 2005, 1–2.
102. C. C. Soludo, "Consolidating the Nigerian Banking Industry to Meet the Development Challenges of the 21st Century," An address delivered to the Special Meeting of the Bankers' Committee, held at the CBN Headquarters, Abuja, on July 6, 2004, page 7.
103. Idowu Sowumi, "Islamic bank to get license by December—Adegbite," *This Day,* Tuesday, August 10, 2004, 4. The late Dr. Abdullateef Adegbite was the secretary general of the Nigerian Supreme Council for Islamic Affairs, under whose auspices the Islamic banking system was being promoted.
104. Yusuf Kabiru, "CBN Okays Islamic Banking, JAIZ secures approval," *Daily Triumph,* Tuesday, May 31, 2005, 1 and 2.
105. These are the former New Africa Bank, Tropical Commercial Bank, Centre-Point Bank, Bank of the North, NNB, First Interstate Bank, Intercity Bank, *Societe*

Bancaire and Pacific Bank. See CBN, "Component members of the consolidated banks," *Banking Supervision: Bank List 2,* issued January 27, 2006.

106. These are the former Guardian Express Bank, Citizens Bank, Fountain Trust Bank, Omega Bank, Trans International Bank, and ACB (Ibid.).
107. For detailed readings on this, see I. A. Abdulqadir, "(Il)Legality of 2004–2005 Reform," n. 103, pages 323–335.
108. (BOFIA)
109. M. Jamiu, F. Adetutu, and O. Mumeh, "Senate dares CBN, categorizes banks," *Daily Independent,* Friday, February 4, 2005, 1 and 2.
110. Honourable Usman Bugaje, former chairman, Nigerian House of Representative Committee on Foreign Affairs, confirmed that the executive worked on the leadership of the House to ensure that the BOFIA and CBN amendment bills were not given concurrent passage as same would frustrate its recapitalization policy. Interview by the author at International Islamic University Malaysia, Al-Tabari Conference Room, on February 14, 2006.
111. See M. Jamiu, F. Adetutu, and P. Mumeh, "Senate dares CBN, categorizes banks," *Daily Independent,* Friday, February 4, 2005, 1 and 2.

Products and Infrastructure—Saudi Arabian Achievements and Ambitions: A Glance at the Past and Future

Craig R. Nethercott

INTRODUCTION

Saudi Arabia has experienced a rapid phase of project development in the last fifteen years. The significant projects financed by Islamic finance institutions and other finance providers have principally been in the industrial infrastructure sectors (mainly in the core areas of power [electricity] and oil and gas, with some activity in the metals and mining sector and the telecommunications sector). At the beginning of this period (circa 1995) project development practitioners (sponsors, lawyers, and bankers) were doubtful as to the practicality of completing a shari'a-compliant project financing in Saudi Arabia within the confines of jurisprudence founded on the Hanbali *madhab* and where government institutions were perceived (rightly or wrongly) to be a roadblock to necessary legal structuring solutions.

However, with the assistance of the super-corporates of the Saudi economy, Saudi Aramco and SABIC (amongst others), and enthusiastic finance institutions, a path has been found to include shari'a-compliant financing in development projects. Starting from a place of pessimism, we have arrived at a situation today where Islamic project finance is a common feature of project financings in Saudi Arabia. Shari'a-compliant project financing in Saudi Arabia is reported to total US$14.8 billion (or SAR55.5 billion) between 2004–12 with US$795 million (SAR2.9 billion) in 2011 and US$1 billion (SAR3.75 billion) in 2012 alone.[1] Indeed, shari'a-compliant debt financing is arguably the more common form of financing in the small to medium development projects and is an important part of the large projects (where debt capacity exceeds available shari'a-compliant debt capacity). The *istisna'a* and *ijara* combination is seen with respect to physical assets without contention in numerous project financings and the

Craig R. Nethercott, Partner, Latham & Watkins LLP, London, United Kingdom.

commodity *murabaha (tawarruq)* makes frequent appearances in everything from straight corporate facilities and working capital facilities to project financings where the underlying project structure might present challenges to other shari‘a-compliant structure alternatives.

However, the next wave of project development, in addition to the customary oil and gas and power transactions, involves important social infrastructure projects, including airports, houses, roads, and railways. Governments throughout the Middle East region have pledged substantial support for the overhaul of the region's infrastructure. Saudi Arabia alone awarded US$24.93 billion worth of construction projects in 2011 and committed US$44.6 billion and US$39 billion for construction and infrastructure projects respectively in 2012.[2]

The transport sector is one of the main areas of expansion in the Middle East. More than US$100 billion of rail schemes are planned or underway in the Gulf Cooperation Council (GCC).[3] In Saudi Arabia, the government is developing two main railway lines, namely the Saudi Landbridge Project, linking Saudi Arabia's main cities from east to west, and the Haramain High Speed Rail linking the cities of Mecca, Medina, and Jeddah.

Middle Eastern governments have flirted with the involvement of the public private partnership (PPP) model or other forms of private sector involvement in public infrastructure. In Saudi Arabia we have seen partial engagement with private sector participation in public infrastructure development. In 2006, The General Authority for Civil Aviation (GACA), advised by the International Finance Corporation, embraced the PPP model for the Hajj Terminal expansion in Jeddah. Again in 2011, GACA awarded the redevelopment and expansion of Medina airport to a consortium led by Turkey's TAV Airports Holding pursuant to a build, own, operate, and transfer long-term concession. In 2008, The Saudi Rail Authority (SRO) abandoned the proposed involvement of the private sector in the Saudi Landbridge (East West Railway project) after initially contemplating a build-transfer-operate scheme. The SRO was the biggest infrastructure client in 2011, awarding contracts on a procurement basis worth more than $9 billion for its Haramain Rail Project. Similarly, the Saudi Electricity Company (SEC) has used a combination of a self-procurement and private sector development strategy.

The government in Saudi Arabia remains the dominant construction client in the Kingdom, having awarded 91.7% of the total contract awards. It is unclear whether the Saudi Arabian and other Middle Eastern governments will continue to publicly fund the vast majority of the next wave of public infrastructure projects, but to the extent that the private sector is involved it is interesting to examine whether the structures for shari‘a-compliant debt utilized to date are suitable and can accommodate the public infrastructure development wave.

With an increased focus on public infrastructure and other non-industrial civil development, this paper will review the structures used in Saudi Arabia to date and the ability to adapt such structures to the development of public infrastructure.

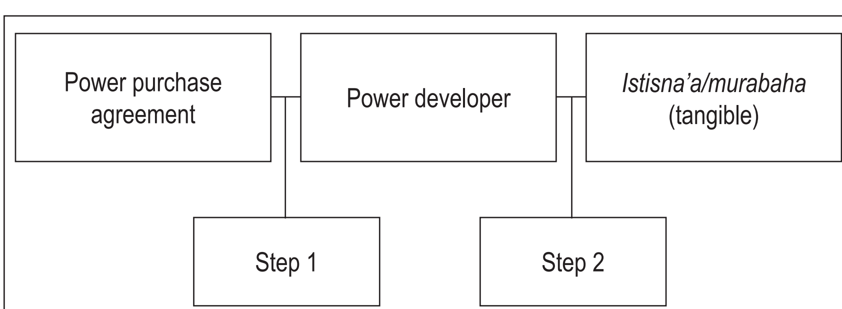
INFRASTRUCTURE DEVELOPMENT MODELS

BOOT – Power

The Saudi Electricity Company (SEC) has deployed private sector participation to meet in part the power supply demands in the Kingdom, reported to top 77 GW by 2020.[4] The SEC, like Abu Dhabi Water and Electricity Authority in Abu Dhabi, chose the "build-own-operate-transfer" model (the "BOOT model") for four independent power projects (IPP) to date, namely Rabigh IPP (1.2 GW) (2009), Riyadh PP-11 (1.7 GW) (2010), Qurayyah (2 GW) (2011), and Rabigh 2 IPP (1.8GW) (2013). The first three of these IPP projects were successfully financed and are at different stages of operation (or construction) and the last (Rabigh 2) is in the tender stage.

Each of the Rabigh IPP ($1.45 billion), the Riyadh PP-11 IPP ($2.1 billion), and the Qurayyah IPP ($1 billion) power projects in Saudi Arabia involved shari'a-compliant debt. The BOOT model is well suited to the application of an *istisna'a/ijara* structure—with the generator (the owner of the power plant) able to obtain shari'a-compliant financing on a procurement and lease basis. The compatibility of the BOOT model with the *istisna'a/ijara* structure is not controversial. The power purchase agreements in these transactions require the development of tangible greenfield assets that easily form the underlying assets of the *istisna'a/ijara* structure.

Figure 1. *Istisna'a/Ijara* – BOOT Power Structure



Step 1 – Power developer signs long-term power purchase agreement with the Saudi Electricity Company (or its affiliate).

Step 2 – Power developer is obliged under the terms of the power purchase agreement to procure the development of the power generation assets. The power developer enters into an *istisna'a/ijara* to finance the power generation assets.

BTO – Airports and Rail

With respect to the public transport infrastructure, some Saudi Arabian government agencies have for policy reasons chosen the "build-transfer-operate" concession model (the "BTO model"). Under the BTO model the concessionaire constructs the relevant assets and transfers title to the grantor of the assets on completion. In return for completion of the assets the concessionaire holds the rights to operate the concession assets under the concession agreement for an agreed-upon period, but not the title to the physical assets. Consequently, the concessionaire's asset base for a potential project financing consists of only the "intangible rights" under the concession agreement—the right to operate the relevant asset on completion.

As already mentioned above, the BTO model was favored by GACA for the Hajj Terminal expansion project (see case study below) and for the Medina Airport redevelopment project recently awarded to the TAV/Saudi Oger consortium.

The Tangible and Intangible Asset Conundrum

Whilst it is uncontroversial for tangible assets such as those underlying the BOOT model to form part of an *istisna'a* and *ijara* arrangement, the question has arisen in practice whether intangible assets, namely the rights under the concession agreement in the BTO model, form a legitimate basis for a shari'a-compliant financing.

Before considering this question it is useful to look at case studies of:

a) Tangible assets *istisna'a and ijara* combination (as seen in the Petro-Rabigh transaction and Riyadh PP-11 independent power projects);
b) The intangible asset *ijara* (as seen in the Hajj Terminal expansion project); and
c) The Sipchem *sukuk mudaraba* (which had intangible rights forming the underlying structure of the *sukuk*).

CREATING THE MOLD IN SAUDI ARABIA

Petro-Rabigh (Greenfield, Tangible Assets) – 2006

The Petro-Rabigh project, a 50/50 joint venture between Saudi Aramco and Sumitomo Chemical, involved the construction of a world scale petrochemical complex (capable of producing high-value petroleum products and ethylene- and propylene-based petrochemical derivatives) and the upgrade of an existing refinery complex to a 400,000 bpd refinery. The total project cost was estimated at US$9.9 billion and involved an approximately US$5.8 billion financing, part of which (US$600 million) was provided by investors in an Islamic tranche using an *istisna'a/ijara* combination.

At the time, the Petro-Rabigh Islamic financing was the first Islamic project financing in Saudi Arabia and the largest ever in a project financing. Prior to the Petro-Rabigh transaction there was enormous skepticism as to the doability of a shari'a-compliant project financing in the Kingdom. Whilst today the *istisna'a/ijara* structure looks uncontroversial,[5] the legal hurdles involved in deploying the structure at that time (2006) in Saudi Arabia were significant. At the time, it was difficult to receive Ministry of Commerce approval for special purpose companies to hold the financed assets; the Saudi Arabian Monetary Authority (the financial regulator) did not readily approve financial institutions using special purpose companies; the taxation treatment of the *istisna'a/ijara* cash flows was unclear; and the conventional lenders (the traditional providers of financing) were concerned as to intercreditor arrangements on enforcement and bankruptcy when the *istisna'a/ijara* assets were owned by the participants in the Islamic financing (and not by the borrower in the general pool of assets available to creditors). Although the *istisna'a/ijara* model had been seen elsewhere in the region, the *shari'a* boards of many institutions in Saudi Arabia had not encountered the documentation for an *istisna'a/ijara* as a part of a complex multi-tranche financing in Saudi Arabia.

A PERIOD OF REPLICATION TO A SETTLED MODEL (2006–2013)

Following the Petro-Rabigh transaction, the market readily adopted the *istisna'a* and *ijara* combination to obtain Islamic finance institution participation in projects. We saw US$635 million in the Saudi Kayan project (2008), US$1.138 billion in the Maaden Aluminum smelter transaction (2009), and US$990 million in the PP-11 IPP project (2010). In 2010 we also saw 1.075 billion from an *istisna'a* and *ijara* combination in the SATORP petrochemical transaction (the first large project financing by Saudi Aramco since Petro-Rabigh) and a later $1 billion (3.75 billion SAR) *sukuk* issuance by the same project (2011). Most recently (2013), we have seen a US$2 billion *sukuk* and US$520 million provided under an *istisna'a* and *ijara* combination in the Sadara Project (a US$20 billion joint venture between Saudi Aramco and Dow). Today the *istisna'a* and *ijara* combination with respect to physical assets is commonly seen and uncontroversial in Saudi Arabia.

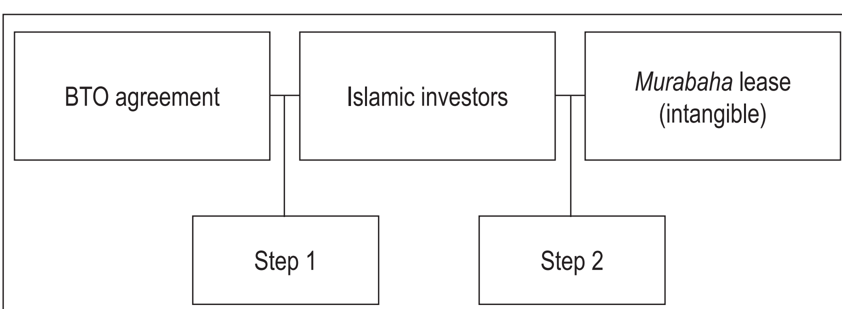
REPLICATION AND EXTENSION

Hajj Terminal Case Study (Intangible Asset) (2007)

Whilst the Petro-Rabigh transaction and its successors involved the Islamic financing of tangible assets by way of an *istisna'a* and *ijara* combination, the US$205 million Hajj Terminal Islamic financing in 2007 was structured around an *ijara* in connection with intangible assets only.

The Hajj Terminal project required the refurbishment, extension, and operation of the Hajj Terminal at the King Abdulaziz International Airport in Jeddah, Saudi Arabia. The Hajj Terminal is one of the principal transport nodes for the arrival of *hajj* and *umrah* pilgrims in Saudi Arabia. The Hajj Terminal project was founded on a BTO model basis by GACA, meaning that following construction of the terminal assets by the concessionaire, ownership was transferred to the grantor of the concession, GACA. Following the transfer of the assets, the concessionaire held the right to operate the terminal for the term of the concession; however, the concessionaire held no tangible rights in the physical assets of the terminal constructed by it. This presented a challenge to the concessionaire (the Hajj Terminal Development Company, principally owned by the Saudi Binladen Group) and the Islamic investors (Bank AlJazira, Credit Suisse, and the Islamic Development Bank) in that the only valuable rights held by the concessionaire were the rights under the concession agreement—intangible rights only.

Figure 2. Hajj Terminal Structure – Intangible Asset – BTO



Step 1. BTO agreement between GACA and concessionaire. Rights under the agreement are sold to a third party. Islamic investors purchase BTO agreement rights from third party.

Step 2. Islamic investors enter into a forward lease agreement of the rights under the BTO with the Hajj Terminal Development Company.

Recognizing the modern value of intangible rights, and similar to the concept of sub-leasing under an *ijara,* the Islamic investors purchased for

US$205 million the concessionaire's rights (sold to a third party by the concessionaire) and leased such rights to the concessionaire under an *ijara.* In return for the lease of the rights under the *ijara,* the concessionaire (HTDC) pays rental payments to the Islamic investors. Critical commentators have not universally supported the Hajj Terminal Islamic structure. The structure continues to cause debate; such debate is focused on the "intangible assets" comprising the bundle of concession rights and the applicability of the *ijara* to such assets.

SHARI'A-COMPLIANT FINANCING OF INTANGIBLES

International Accounting Standards 38 describes an intangible asset as "an identifiable non-monetary asset without physical substance." Rights under concession arrangements are obviously intangible rights. The AAOIFI Shari'a Standards provide that a relevant state may grant a concession (a right of regulation) and can transfer such a right to another party.[6] The question then arises as to whether these rights are assets that can form the basis of a shari'a-compliant financing.

For an object to qualify as property (*mal*) in classical Islamic law it should have two characteristics:

a) The possibility of physical possession; and
b) Have potential for beneficial use. Intangible assets, such as the rights under aconcession agreement (the usufructs), clearly fail the first test of physical possession.[7]

The Hanafis did not consider usufructs (*manfa'a*) as property (*mal*),[8] although the Hanafis recognized certain types of property (including services) that constitute intangibles as eligible property for a lease. Article 125 of the *Majallat Al Akham Al Adliya* defined owned property as "things of which man has become the owner, whether it be the things themselves or whether it be the use."[9] The Hanafis thus recognized the ownership of intangible assets, albeit those derived from physical assets.

Other schools have recognized usufructs as property (*mal*), based on "the apparent ground that the existence and custody of the underlying thing suffices as a token for the existence and custody of the usufruct."[10]

Contemporary scholars have challenged the validity of other intangible rights such as intellectual property on the basis that ownership of property is confined to tangible property only.[11] However, modern transactions have been established on the sale of a usufruct, which is in itself an intangible right, and now numerous transactions have been banked with intangibles as the underlying asset.[12]

OTHER NON-BTO INTANGIBLE FINANCINGS IN SAUDI ARABIA

We have seen increasing use of intangibles underlying financing structures (outside of the pure infrastructure sector in Saudi Arabia). The recent offering and sale by Saudi International Petrochemical Company (Sipchem) of SAR1.8 billion publically listed *mudaraba sukuk* represents an example of the use of intangible assets forming the foundation of a shari‘a-compliant debt issuance.

Whilst Sipchem's operating company subsidiaries owned assets which theoretically could be used to fund a potential issue of *sukuk*, many of those operating companies were party to existing secured loan arrangements with encumbered assets being unavailable for use in any meaningful capital-raising exercise (see Figure 3).

The Sipchem structure drew upon a previous market development, namely the Saudi Hollandi *sukuk mudaraba*. The Saudi Hollandi Bank *sukuk mudaraba,* which closed at the end of 2008, offers interesting background to the development of the Sipchem *sukuk*. With relatively few tangible assets to form the basis of the financing, the *mudaraba* assets under the Saudi Hollandi issuance comprised intangible rights being: "An undivided interest of each *sukuk* holder in the present and future business operations of the issuer."

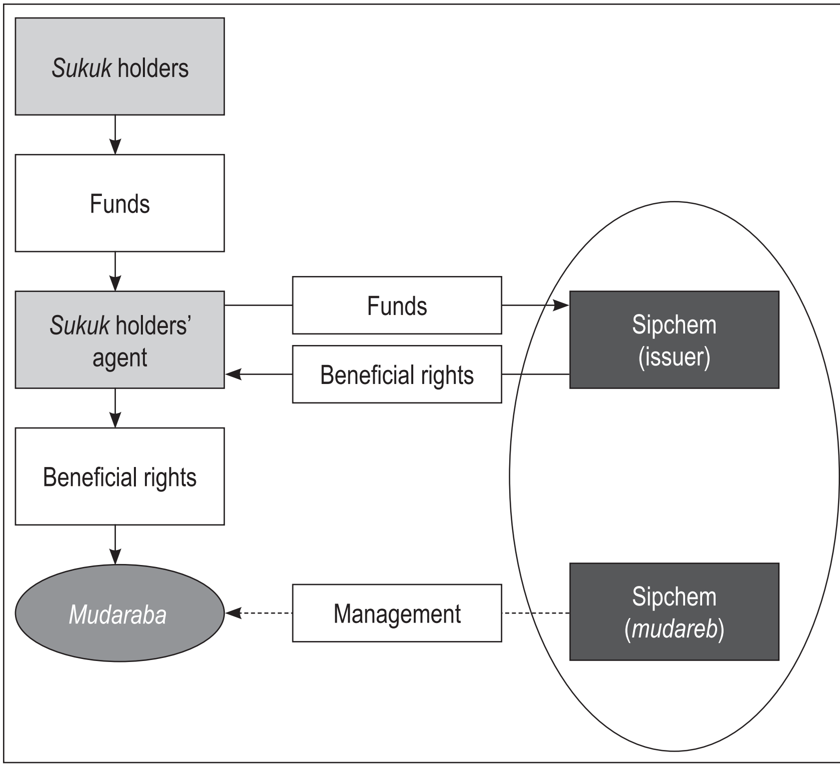
This structure has since been replicated in the Saudi market (with the documents often being used as a negotiating reference point by lead managers and issuers alike).

In Sipchem's *mudaraba sukuk*, the key financeable asset was the right to receive distributions and other payments from its subsidiaries. The *mudaraba* assets were defined as follows: "An undivided interest in Sipchem's existing and future business (including, amongst others, the right to share in distributions and any other payments made by any subsidiary to Sipchem once received by Sipchem but excluding the shares of any subsidiary of Sipchem or any interests in such shares or any votes attached to them)."

Stripping out the intangible rights associated with the equity in such a way and using it as the basis of the *mudaraba* underlined a real progression among shari‘a scholars in their acceptance of intangible assets as the basis for Islamic capital markets instruments, and it is indicative of the growing sophistication of the Saudi Arabian market.

The recent GACA *sukuk* issuance (2012), whereby GACA raised SAR15 billion for a ten-year term, provides another example of an intangible asset underlying a debt issuance. The structure underlying the GACA *sukuk* was a combination of a *murabaha* and a purchase of the following intangible rights pursuant to a benefits purchase agreement: "The benefits that are owned by the Issuer which entitles it to charge and collect fees from airlines . . . such fees being for: (i) the landing aircraft at King Abdulaziz International Airport in Jeddah, King Fahad International Airport in Dammam and King Khaled International Airport in Riyadh; and (ii) the parking aircraft at King

Figure 3. Sipchem *Sukuk* Structure



Abdulaziz International Airport (which, for the avoidance of doubt, shall exclude rights relating to the Hajj Terminal), King Fahad International Airport and King Khaled International Airport."

IS FURTHER INNOVATION NECESSARY?

With wider practical application of the financing of intangibles, it is worth revisiting the model of the Hajj Terminal transaction (*ijara* with respect to intangible rights) and examining whether the *ijara* is the most appropriate vehicle for the financing of projects pursuing the BTO model. The BTO model involves the grant of rights with respect to the use of an asset for an agreed return for an agreed period. The concessionaire under the BTO model therefore holds a basket of rights akin to a usufruct. The *ijara* agreement itself representss the transfer of a usufruct with respect to an underlying asset and in the classical form requires the retention of the corpus of the leased properties and certain obligations with respect to, among other items, risk, damage, and maintenance focused on the tangible natures of assets.[13]

The classical *ijara* is therefore not designed to accommodate the transfer of a usufruct of an underlying asset of an intangible nature (in the case of a concession agreement, itself a usufruct). This is not surprising given the relatively recent economic prominence of the intangible asset. Looking at the developments in the financing of intangibles subsequent to the Hajj Terminal financing, there are now possible structural alternatives to the *ijara* for financings involving the BTO model. Following the structure of the Sipchem *sukuk mudaraba*, the Islamic investors could, for example, purchase the rights of the concessionaire under the BTO model (as under the Hajj Terminal financing) and the Islamic investors could then grant a sub-usufruct of such rights to the operator of the concession. This sub-usufruct would avoid the tortuous rationalization of the *ijara* model to suit intangible assets.

CONCLUSION

The product suite in Saudi Arabia is well settled with respect to the financing of greenfield tangible assets pursuing the BOOT model. With respect to the BTO model, whilst the *ijara* has been utilized for the financing of projects, the *ijara* structure generates questions as to the suitability of this classical concept to intangible assets. Reviewing the developments in the Saudi Arabian market with respect to the financing of intangible assets, the evolution of other structures with respect to intangible assets now presents solutions with greater simplicity that do not require the rationalization of a classical structure designed for tangible property in an age where intangible assets were of less relevance.

The financial crisis in the Western economies has compressed the available debt capacity, is driving appetite for alternative funding sources, and is once again driving the further development of shari‘a-compliant debt structures. Sponsors of development projects are embracing (and indeed investing in) the further enhancement of products (and the addition of new products) in the marketplace. The demand for shari‘a-compliant financing in Saudi Arabia is poised to again deliver another round of advancement in meeting market demand.

Endnotes

1. KIEP World Economy Update, May 31, 2013, Vol. 3 No. 24.
2. J. Dare, “Rail industry on track in the Middle East,” *MENA Infrastructure*, Issue 7.
3. “Global Focus—2012—The Year Ahead,” Standard Chartered Bank.
4. Saudi Arabian Monetary Agency, Forty-Sixth Annual Report, The Latest Economic Developments 1431 (2010 G), Research and Statistics Department.
5. The Islamic investors in the project entered into an investment agency agreement whereby the Islamic investors agreed to provide US$600m in aggregate to the

investment agent (Gulf International Bank) for the purpose of investing in the *istisna'a* and *ijara* arrangements relating to specific components of the refinery. Petro-Rabigh, as procurer, entered into an *istisna'a* with the SPV, as purchaser, with respect to the purchase of a vacuum distillation unit and a VGO hydrotreater unit (hereafter the Islamic Assets), being integral parts of the project process. The Islamic Assets were to be delivered no later than the final completion date. At the same time as Petro-Rabigh entered into the *istisna'a* with the SPV, the same parties entered into an *ijara musufah fi al dhimmah* (forward lease) with Petro-Rabigh, as lessee and the SPV as lessor. Under the *ijara* Petro-Rabigh agreed to lease the Islamic assets from the SPV from the date of delivery of the Islamic Assets under the *istisna'a.* The Islamic tranche was provided by APICORP, Bank Al Bilad, Credit Agricole (then known as Calyon), Citibank, the Islamic Development Bank, Gulf International Bank, Riyadh Bank and Saudi British Bank.

6. See AAOIF Shari'a Standard No. 22, Appendix B: Basis of Shari'a Rulings, Management Contracts, page 408. AAOIFI Shari'a Standard No. 22 also recognizes the validity of a concession contract for the utilization, construction or management of contracts, provided there is no *riba, gharar*, or other prohibited practice.
7. Mahmoud A. El Gamal*, Islamic Finance Law Economics and Practice* (Cambridge, Cambridge University Press, 2006): 36.
8. Muhammad Wohidul Islam, "*Al-Mal*: The Concept of Property in Islamic Legal Thought," *Arab Law Quarterly* 14:4 (1999): 361–368.
9. *The Mejelle, being an English Translation of the* Majallah el-Ahkam-I-Adliya *and Complete Code of Islamic Civil Law,* translated by C. R. Tyser, D. G. Demertriades, and Ismail Haqqi Effendi, with a foreword by S. A. Rahman (Kuala Lumpur: The Other Press, 2007).
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11. Muhammad Taqi Usmani, *Copyright According to Shari'a*, at www.albalagh.ne/qa/copyright.shtml.
12. Mahmoud A El Gamal, 2006.
13. Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi, Maktaba Ma'Ariful Qur'an, 2007): 60.

Ethnographic Approaches to Understanding Client Versus Institutional Priorities for Islamic Microfinance in Bangladesh

Bridget Kustin

INTRODUCTION: ANTHROPOLOGY AND ISLAMIC MICROFINANCE

During 2010 and 2011, I conducted approximately five months of anthropological field research in urban and rural Bangladesh on the relationship between an Islamic finance industry that has rapidly expanded from small and uncertain beginnings, and the increasing social, political, and economic prominence of Islam.[1] My fieldwork concentrated upon the Islami Bank Bangladesh Limited (IBBL), the country's oldest and largest Islamic bank, established in 1983 with the assistance of the Islamic Development Bank (IDB). The IDB has maintained robust investment in IBBL and several members of the IBBL's board of directors are from the IDB and other Gulf-based institutions. Within the broad range of IBBL's finance and charitable activities, I focused upon its Islamic microfinance program, the Rural Development Scheme (RDS), as a tool for poverty alleviation based on shari'a principles. My qualitative research methods included: (1) Full-time participant-observation among the women of one semi-rural village's RDS collective, whereby I shadowed the collective's leader and assistant leader as they conducted daily activities; (2) Extensive interviews of IBBL bank officials at the Dhaka headquarters and the local branch servicing the village; and (3) The collection of reports, training materials, and contract templates.[2]

In this paper, I first present an overview of RDS as an Islamic microfinance case study. The IDB has paid close attention to the progress of this program as a potential model for its other member countries.[3] Indeed, with the support of the IDB, IBBL has already offered Islamic microfinance trainings to Nigerian and Sri Lankan delegations. Next, I draw upon my

Bridget Kustin, Doctoral Candidate, Johns Hopkins University, Baltimore, Maryland.

ethnographic field research to examine challenges and benefits of RDS's current use of *bay-mu'ajjal* (a credit sale utilizing a contract to establish deferred payment terms between a buyer and a seller) and *qard hasan* (an interest-free loan, often disbursed for welfare or charitable purposes), including their potential for replication in different national and cultural contexts.

Finally, I examine slippages and convergences between client versus IBBL understandings of the "Islamic-ness" of RDS. This matters because the way that clients and the IBBL distinguish RDS as an alternative to the widespread non-Islamic conventional microfinance sector in Bangladesh suggests particular advantages and disadvantages to the potential expansion of the program and its ability to provide meaningful assistance to its poor clients.

Dividing my field research between bank officials and RDS clients serves to implicitly question who has the authority to determine what makes Islamic microfinance distinctly Islamic and uniquely suited (or not) to the needs of the poor. Aside from quantitative customer satisfaction surveys, client perspective is generally overlooked in the now-substantial field of economic and theological studies of Islamic finance. This literature tends to focus more on how institutions develop new products and services, rather than on how these products and services come to life in the hands of clients. And yet, the broader future of global Islamic consumer finance is entwined with the question of whether or not Islamic microfinance and small-medium enterprise financing can attend to the financial and development needs of millions of poor, unbanked Muslims. The contributions of an anthropological approach to understanding the broader cultural, religious, and ethical dimensions of Islamic microfinance are most explicit here: rather than delimiting client perspective to "feedback" on a predetermined set of questions in a manner suited for market research or institutional quality control, multi-year, free-form engagement with clients allows for nuanced perspectives on money, poverty, and religion to unfold. This approach allows the client to determine the contours of relevant challenges, successes, and concerns—rather than the bank.

THE RURAL DEVELOPMENT SCHEME (RDS): A CASE STUDY

Bangladesh is a deeply impoverished nation of over 163 million people, approximately 89.5 percent of whom are Muslims. Just over 70 percent of Bangladeshis live in rural or semi-rural areas outside of the three main urban centers and nearly 57 percent of the population over age 15 cannot read or write.[4] Out of Bangladesh's 48 total banks, six are wholly Islamic, with two additional conventional banks attempting full conversion to Islamic banking. Additionally, 15 conventional banks have opened Islamic branches or windows. In 2012, Islamic banking accounted for approximately 18.5

percent of total bank deposits.[5] The IBBL is by far the most prominent, having over 276 branches with about two-thirds located outside the main urban centers—a testament to its mission statement to "encourage the socio-economic development and financial services to the low-income community particularly in the rural areas."[6]

Established in 1995, RDS requires members to open *mudaraba* savings accounts, and most commonly offers small business investment through *bay-mu'ajjal,* hire purchase *shirkatul milk,* and less frequently *musharaka* and *bay-salam*. *Qard hasan* is offered less frequently and on a more contingent basis, and will be discussed later in this paper. According to IBBL's 2012 Annual Report, out of IBBL's 276 total branches, 197 operate RDS programs in surrounding districts, dispensing services to 733,520 members in 15,507 villages—a 21 percent growth in membership from 2011. Cumulative disbursement stood at nearly USD 730 million, with nearly USD 134 million in outstanding investment.[7] The IBBL has listed its loan rate of recovery as 99 percent for several years, and continues to publish this rate on its website. IBBL collects a 10 percent flat annual rate of return, although this can be reduced by 2.5 percent for long-term members who consistently pay on time. This can be more attractive to poor clients than the 11 percent flat interest rate charged by Bangladesh's most well-known microfinance provider, the Nobel Peace Prize–winning Grameen Bank.[8]

According to my interlocutors at the IBBL, RDS will not open new collectives in areas serviced by other microfinance groups, which removes RDS from direct competition with other microfinance programs, which are abundant in Bangladesh. Additionally, RDS collectives must be located within 10 kilometers of an IBBL branch office, which disadvantages potential clients in remote areas located far from a branch. RDS clients are taught to sign their names if they cannot read or write, and are required to occasionally visit the branch office, helping familiarize them with mainstream banking. Each collective is comprised of 10–40 clients subdivided into two to eight groups of five members each. Clients are visited in their village by field officers collecting weekly repayments. Akin to the Grameen Bank, members of a group bear liability for each other's weekly repayments. Unlike Grameen, however, RDS bases its group liability model upon a Qur'anic injunction to engage in "mutual consultation."[9] Also unlike Grameen, RDS does not currently provide access to microfinance for the poorest Bangladeshis. Rather, a steady stream of income or land ownership up to 0.5 acres is a baseline requirement for membership. The decision to limit RDS clientele to a more financially solvent poor demographic supports a key goal of the program: client transition into the separate small medium enterprise investment program. RDS also emphasizes the spiritual education and social development of its clientele. During weekly collective meetings, field officers lecture for 10–15 minutes on topics ranging from sanitation and maternal health, to the importance of fasting during Ramadan, to proper ways to perform *salah*, or prayer, and *Wudhu*, or ritual ablutions before prayer (although I observed that in practice, these lectures occur sporadically, due largely to time constraints upon over-stretched field officers).

I spent my time in a semi-rural coastal village serviced by RDS, studying how the leader and assistant leader of one collective conceptualized money management, poverty alleviation, and religious practice, and how Islamic criteria might enter into monetary calculations and flows. I shadowed these women in their daily lives, tracking how money and Islam were discussed. Notably, the district possesses a high population of Hindus and Buddhists, and the local IBBL branch counts numerous non-Muslims among its clientele. IBBL frequently comes under the current, secular government's scrutiny for perceived ties to Jamaat-I-Islami, rendering IBBL's decision to encourage Islamic banking among the poor and to target women as recipients of weekly spiritual lessons a deeply politicizing project. No doubt, IBBL is the only bank in Bangladesh required to have an observer from the central bank sitting in on board of directors meetings.[10]

FLEXIBILITY IN MICROFINANCE AND THE LIMITATIONS OF *BAY-MU'AJJAL* AND *QARD HASAN*

RDS currently offers *qard hasan*, or interest-free loans, for constructing latrines or tube wells for the collection of underground water. According to IBBL's 2012 Annual Report, over USD 100,000 was disbursed to 1,543 RDS clients. Individual members can also apply for *qard hasan* in times of economic distress, although according to both RDS field officers and program administrators, this happens infrequently. According to these interlocutors, this is likely due to the fact that *qard hasan* in this instance is offered on an *ad hoc* basis; it is neither widely advertised nor are members encouraged to partake of these loans.

Recent research in Bangladesh on the financial habits of the poor suggests that in times of need, small, readily available interest-free loans are often sought from relatives and neighbors. However, this can create negative social and financial entanglements. Collins et al. (2009) found that these loans fill temporarily gaps in income flow for critical needs, such as food for the day, and are repaid quickly. These informal, interest-free loans are the most frequently used borrowing instrument in Bangladesh, constituting 88–92 percent of all borrowing. An expansion of *qard hasan* could reduce reliance upon family and neighbors, thereby expanding the options of the poor in times of need, and institutionalizing an informal process that, according to the authors of this study, can leave borrowers vulnerable to humiliation, harassment, anxiety, and unclear expectations.[11]

Among the members of the rural microfinance collective with whom I conducted fieldwork, I spent the most time with the collective's elected leader and assistant leader—two sisters, raising children with absentee husbands. Short-term interest-free loans were constantly being given and repaid between the two, for expenses ranging from the quotidian and small (groceries) to the more rarely occurring and substantive (motorized rickshaw fare and the services of a *kobiraj*, or traditional healer). One critical gap in existing research is qualitative and quantitative explorations into the relationships engendered and obligations wrought by different kinds of interest-free loans, e.g., regularly occurring and quotidian loans, versus more anomalous loans. Loans for different purposes, such as food, medicine, business development, education, or festival/ritual expenses, might also carry different resonances. A further question is how to schematize the place of *qard hasan*, the interest-free loan, against IBBL fee-bearing investment products, and IBBL's *zakat*-financed charitable initiatives organized by its philanthropic arm, the IBBL Foundation. As Banerjee and Duflo (2011) note in *Poor Economics*, the amount that the poor must financially contribute to particular development initiatives or products can impact their use, efficacy, and sustainability.[12] Potential relationships between the success of products and services designed to promote financial stability or poverty alleviation and the amounts that clients pay into such products and services can be quantitatively assessed.

Collins et al. (2009: 25) further explain that understanding how the poor manage their money and increase net worth comes from tracking borrowing and lending cash flows, rather than measuring or analyzing limited balances or assets. The lack of consistent income streams sufficient to meet critical needs renders the poor uniquely susceptible to emergency. Conventional probabilistic models of risk and uncertainty do not capture the unique risk and uncertainty of poverty. Without solidly built homes, for example, assets are uniquely vulnerable to weather that would not otherwise cause harm, or theft that could not otherwise occur. What remains similarly unclear is how to conceptualize "moral hazard" for the poor as potential clients of Islamic finance. This is particularly salient given that RDS program officers prided themselves on their willingness to accommodate late weekly payments due to unforeseen events. This *ad hoc* approach certainly makes RDS highly sensitive and responsive to the immediate needs of its clients, but any attendant moral hazards this might engender have not been adequately theorized.

In their multi-year, multi-country study, Collins et al. (2009: 59) emphasize that "the demand for microcredit extends well beyond the need for just *microenterprise* credit. The poor . . . seek loans for a multitude of uses besides business investment." This represents one crucial shortcoming of RDS: the emphasis upon the development of businesses and the purchase of assets does not assist the poor in amassing funds for medical emergencies, education, or wedding expenses. Meeting these expenses constituted some of the most pressing financial emergencies of my informants. Equally critically, the fact that the poor meet expenses by compiling sums from multiple sources imperils the shari‘a compliance of funds obtained from Islamic microfinance: money is not fungible in Islamic finance. If a *bay-mu'ajjal* contract provides money for the purchase of a cow on Thursday, those funds cannot be diverted on Tuesday toward the payment for a doctor's visit and purchase of medicine. Nor can a temporary loan from an uncle on Wednesday be used to replace the *bay-mu'ajjal* funds and purchase the cow. Money in this context is not fungible, otherwise the potential for *riba* can exist. In this sense, Islamic microfinance places more constraints on the daily economic decision-making of the poor, who often "[show] creativity in devising arrangements to fit their circumstances, taking a standard product. . . . but bending it to make it work for other ends."[13] Thus, one central challenge for Islamic microfinance is development of an all-purpose investment fund not tied to the purchase of an asset, akin to how the Grameen Bank, for example, has already taken this step to respond to the needs of its poor borrowers.

This still presupposes that the funds obtained would be used to purchase a good or service, even if it is outside the *bay-mu'ajjal* contract. However, microfinance loans are often used to pay down other loans in Bangladesh—an oft-levied critique of conventional microfinance. Moreover, Collins et al. (2009: 109) found that "where lump sums can be raised cheaply relative to other means it makes sense to arbitrage . . . borrowers quickly lend their capital to others who not only repay and service the loan but pay additional interest." While I did not encounter this during my fieldwork, it remains an issue of unique concern for Islamic microfinance. Such a profit-making opportunity for a poor microfinance client would, of course, constitute *riba*.

I asked RDS field officers as well as officials at the Dhaka headquarters how the IBBL mitigates the unique risks of *bay-mu'ajjal* in the context of Islamic microfinance. All uniformly cited frequent and substantive monitoring and evaluation as key. However, all also acknowledged that an extremely high ratio of field officers to clients makes this impossible. Most recently, one field officer attends to an average of 359 clients.[14] Despite continuing to lower even higher ratios following an internal report's recommendation, RDS officers still face the nearly impossible task of gaining individual client trust and possessing a working knowledge of the financial needs and situation of hundreds of clients. The RDS budget is already stretched thin: RDS does not garner much profit for the IBBL. RDS is separate from IBBL's philanthropic Islami Bank Foundation, and does not receive funds from IBBL's *zakat* spending.[15] The fact that the program has endured and continued to expand over the past 18 years despite its lack of high profitability was an obvious point of pride both for local branch officers and high-ranking officials in Dhaka. It indicates, I was repeatedly told, the depth of the IBBL's commitment to Islam and to social justice—even when this commitment is not profitable.

The current RDS model of the IBBL thus holds three competing claims in tension: the need to attempt to not operate at a loss or an untenably low rate of profit; the need to offer services to as many people as possible to enact its mission statement of poverty alleviation; and the need to prioritize shari‘a compliance, given the unique risks inherent in the economic precariousness of poverty. Current evaluation and monitoring efforts focus upon client repayments to ensure loan recovery. If robust shari‘a compliance is a priority, enhanced monitoring capacity must be factored into the cost of the program—whether the cost is borne by the bank or passed down to clients as a higher service fee. For the poor, the line between high "service fees" and usury can seem blurry. Microfinance will never "solve" poverty, but at best can be a valuable part of a poor client's portfolio, which is comprised of particular lenders and products to suit different economic needs. As Collins et al. (2009: 22) note, it is in this sense that the extremely high interest rates of moneylender loans, for example, can be conceptualized as fees for the immediacy of the service, rather than an annualized interest rate, since the loans are meant to be repaid quickly. Accordingly, it is inaccurate to compare the annualized interest rates of longer-duration microfinance loans against moneylender loans. In the case of Bangladesh, this rethinking of interest rates versus fees along the axis of loan duration raises possibilities for enhanced shari‘a compliance of microfinance *bay-mu'ajjal* contracts.

During my fieldwork, I observed that RDS provided one innovative, although informal and perhaps accidental, way to help reconcile the inflexibility or non-fungibility of money disbursed through Islamic microfinance with the irregular and uncertain cash flow of the poor. Field officers and the local branch director of RDS told me that individuals who can't meet their weekly repayments are excused without penalty. This non-standardized approach requires trust and intimacy between field officers and clients. It does not compromise the overall integrity of the repayment schedule, perhaps because it is a contingent accommodation, rather than a firm policy. However, the field officers and program administrators stressed that this willingness to forgive delay in loan repayment is precisely what distinguishes RDS from other microfinance institutions. To paraphrase a sentiment repeated on numerous occasions: RDS has heart and loves its clients. Islam was also frequently invoked when explaining why these exceptions are made: the poor must be afforded this generosity and extra consideration. This is what distinguishes the IBBL from non-Islamic banks.

CLIENT PERCEPTIONS OF ISLAMIC-NESS IN ISLAMIC MICROFINANCE

IBBL is perhaps unique among Islamic banks for its explicit dual emphasis upon devotion to shari‘a compliance and poverty alleviation.[16] In conversations with village RDS clients as well as townspeople unaffiliated with IBBL, two sentiments were consistently expressed: first, the IBBL is a popular institution because it is perceived as uniquely friendly to the poor, rural, and/or those with minimal literacy. Indeed, beyond RDS, the 2012 Annual Report notes that over 46 percent of total IBBL investment is in its small medium enterprise (SME) scheme. This unusually high SME investment places the IBBL on the crest of a wave of research regarding SME investment as a critical but underutilized tool to strengthen developing economies.[17] The second commonly expressed sentiment was that Bangladeshis are deeply religious and prefer Islamic institutions when the option is available.

What is interesting is the infrequency with which the particularities of the IBBL's Islamic-ness were of concern to clients. If clients are inconsistently concerned with *how* Islamic and/or shari'a-compliant the IBBL might be, this suggests that the onus for shari'a compliance rests on the bank. For example, in my village field site, one RDS client described the program to me in the following terms: "they give us *takaful*,[18] we get income." The transformation that occurs is not of "secular" money into money-with-religious-benefit, but of money-as-investment into money-as-profit. Islam is absent as this client describes what IBBL provides. The absence of interest and the low rate of return collected by IBBL is valuable from an economic rather than a religious standpoint. In other words, Islamic banking is desirable because it extracts less money from the client. As one woman explained, "Islam is free from interest—this is Islamic finance. Other banks must take a lot of money, but Islamic banks do not have this kind of interest. We love our Islamic bank."[19]

According to another client, obtaining Islamically permissible income ("*halal labh*") is the main reason for banking ("*prodhan karun'ta*"). When asked what constitutes Islamically permissible income, this client and others either deferred to the bank to make this determination, or mentioned the absence of interest. In a neighboring village, I was told that profit acquired through RDS is not meant to be stockpiled, but should go toward the purchase of commodities. The point, I am told, is to increase savings accounts such that a client can invest in more, or more valuable capital, enabling a shift from, for example, vegetable to mango cultivation.[20] Again, the absence of Islam is notable here: the client presents this as a sensible business strategy rather than an Islamic guideline for appropriate money use. In other words, the practicality of Islamic banking strategies is emphasized by clients, rather than adherence to textual Qur'anic guidelines.

One key slippage is thus that what the IBBL understands as Islamic principles of banking and finance might not necessarily be known by or shared with clients. The religious value of Islamic finance for the RDS clients with whom I worked was generally present only nominally (the fact that IBBL was an Islamic bank was sufficient proof of its Islamic-ness), or was attributed to the idea that extracting less money—whether as interest or as fees—was as an Islamically sanctioned concession for the poor.

Where Islam was present for these RDS clients was in the religious lessons delivered by field officers during the weekly collective meetings.

According to one RDS administrator with whom I spoke, these religious pedagogical lessons occur because "we want to try to give an idea about Islamic modes of investment. Most of the people are illiterate, so we try to provide some education on various issues [and] some basic information on issues in Islam. RDS motivates them to follow the right way and Islam." Villagers consistently praised the Qur'anic discussions ("*Qur'an allochona*") as balanced and fair ("*sharbik*") and instructive in the correct ways to pray, for example. While this educative component could be adapted to local contexts, it places high importance on the field officer, thereby rendering the utility or effectiveness of these lessons highly contingent. For example, in my village, the collective's leader and her assistant were vocally displeased with their current field officer, and did not pay attention to his lectures. However, they frequently referred to the words and pleasant demeanor of the previous field officer, who was to them a better representative of the IBBL. This limitation was also pointed out in an Islamic Development Bank (IDB) report comparing Islamic microfinance projects in IDB member countries.[21]

Finally, both Islamic and conventional microloans in Bangladesh are overwhelmingly disbursed to women. As of 2013, 88 percent of RDS clients are women. Decades of scholarship have explored microfinance as a signature women's empowerment initiative, and contemporary critical accounts are complicating notions regarding women's ostensible access to and control over money.[22] However, according to multiple RDS officials over numerous interviews, RDS is committed to the economic uplift of families, as opposed to women. Officials cited this perspective as more in accordance with Islam. However, the absence or delinquency of men in the female-headed families I observed challenged IBBL's notion of the "family" as an intact, bounded, and mutually supportive unit.[23] Female RDS clients whose husbands had taken other wives without their consent, or were deserted by husbands who would sporadically return home to take money, were unable to protect and maintain control of their money, and unsure about how they might do so in the future.

CONCLUSION

Islamic finance is often presented as the religious alternative to what Tripp (2006: 5–6) describes as the capitalist "model of rationality [that] colonizes the ethical world" by insisting upon a "circle of capital-market-exchange-profit-capital."[24] My interlocutors at the IBBL and other Islamic financial institutions in Bangladesh consistently echoed this view. However, setting Islamic and conventional finance up as religious and non-religious opposites subjects Islamic finance to lines of inquiry more concerned with whether it is quantifiably Islamic, or whether its products and services are marketing "tricks" seeking to capitalize on a potential market base of one billion Muslims globally. Such suspicions help explain why the forays of conventional financial institutions into Islamic finance through Islamic windows, indexes, and other semi-autonomous operations remain contentious and subject to scrutiny.[25]

Approaching Islamic finance as either "true" or "false" forecloses the possibility of clients' participation in Islamic finance as a novel way of constituting, reflecting, or shaping individual Islamic piety, subjectivity, or selfhood—which several recent cultural anthropologists have demonstrated to be dynamic processes.[26] To finance practitioners, this might seem like an overly academic or theoretical concern. But the stakes become high when the clients under discussion are deeply poor. Bringing the unbanked poor into the fold of formal finance gives financial institutions, developed markets, and wealthy countries opportunities for engagement with the poor, newly reconfigured into market opportunities. As a result, the rise of microfinance as an answer to global wealth and opportunity disparities raises urgent questions about how to prevent the creation of a formal, stratified geography of (valuable) finance participants versus (marginal) microfinance participants. Such stratification would keep underlying inequalities firmly intact. Qualitative, sustained inquiry into the experiences, needs, and challenges of poor Islamic microfinance clients is a first step toward taking the subjectivity and knowledge of the poor seriously, rather than just superimposing new institutions and products upon them. This in turn is a first challenge to norms privileging the experiences, desires, and knowledge of the wealthy.

Perhaps most importantly, insisting on the primary site of difference between Islamic and conventional finance as religion risks diminishing the importance of social justice in distinguishing the two systems from each other. The key tenets of Islamic finance (particularly the prohibition of *riba*, encouragement of risk sharing, mutual assistance, and asset-backed over equity-backed transactions) exist to promote what numerous scholars describe as "social justice."[27] Products and services are structured to encourage repudiation of self-interest in favor of a more equitable distribution of God-given resources. For this reason, the Qur'an, *hadith* (collected sayings and acts of the Prophet Muhammad), and juridical interpretations of shari'a offer extensive guidance regarding economic activities and distributions of wealth, meant to mitigate the most egregious differences in economic status. The individual is only a temporary trustee of his assets; all wealth ultimately belongs to God.[28] Beyond just providing the poor with access to credit or immediate liquidity, or reconfiguring the poor as a domain of untapped growth for banks, the inherent emphasis in Islamic microfinance on social justice signals the nascent industry's potential to be more attentive to undoing broader, pernicious structures of economic inequity than conventional microfinance—a critical area for further inquiry and exploration.

Endnotes

1. This research was conducted with grants from the National Science Foundation's Graduate Research Fellowship Program; the American Institute for Bangladesh Studies; the Johns Hopkins Institute for Global Studies; and the Johns Hopkins Program for Women, Gender, and Sexuality.
2. Unless otherwise cited, all information in this paper is derived from firsthand observation and interviews conducted during this fieldwork.
3. Mohammed Obaidullah, *Role of Microfinance in Poverty Alleviation* (Jeddah: Islamic Research and Training Institute [Member of the Islamic Development Bank Group], 2008).
4. "South Asia-Bangladesh," in *The World Factbook 2009*, Washington, DC: Central Intelligence Agency, page updated July 13, 2013, available at https://www.cia.gov/library/publications/the-world-factbook/geos/bg.html.
5. Jebun Nesa Alo, "Conventional banks looking for a piece of the Islamic banking pie," Dhaka Tribune, June 27, 2013, available at http://www.dhakatribune.com/business/2013/jun/27/conventional-banks-looking-piece-islamic-banking-pie.
6. Islami Bank Bangladesh Limited, *Annual Report 2012* (Dhaka: Islami Bank Bangladesh Limited, 2012).
7. These statistics take into account the particulars of the Rural Development Scheme as well as the Urban Poor Development Scheme, a new program launched in 2012 that offers the same Islamic financing and savings facilities as RDS, but to an urban clientele.
8. The 99 percent repayment rate was listed as occurring from 2006–10 in: *Annual Report 2010* (Dhaka: Islami Bank Bangladesh Limited, 2010,) 105. Currently, this rate is published on the website "Rural Development Scheme," (Dhaka: Islami Bank Bangladesh Limited), accessed August 2, 2013, available at http://www.islamibankbd.com/prodServices/rdsScheme.php. Regarding IBBL service fees, see *Rural Development Scheme: An Islamic Microfinance Model,* (Dhaka: Islami Bank Bangladesh Limited, 2006), 12, available at http://www.islamibankbd.com/rds/. Grameen Bank possesses four flat interest rate levels: eight percent for housing loans, five percent for student loans, and interest-free loans for "Struggling Members," or beggars. See: Grameen Bank,"Grameen Bank At A Glance," accessed August 2011, available at http://www.grameen-info.org/index.php?option=com_content&task=view&id=26&Itemid=0.
9. According to a 2006 IBBL pamphlet on RDS, "The cardinal principle of the Scheme shall be the 'Group Approach.' Allah loves those 'who conduct their affairs by mutual consultation' (Al-Quran 42:38)." *Rural Development Scheme* (Dhaka: Islami Bank Bangladesh Limited Public Relations Department, October 2006), 8–9.
10. Daily Star Business Report, "BB warns Islamic Banks," Dhaka: *The Daily Star* (Business Section), July 22, 2011. The presence of Islam in institutional, corporate, and political spheres exists in relation to, and yet distinct from, the myriad ways that individuals are creatively manifesting and/or engaging with their faith. For more on this topic, see Samia Huq, "Women's Religious Discussion Circles in Urban Bangladesh: Enacting, Negotiating and Contesting Piety," Dissertation, Brandeis University, Waltham, Massachusetts, 2011; and Elora Shehabuddin, *Reshaping the Holy: Democracy, Development, and Muslim Women in Bangladesh* (New York: Columbia University Press, 2008).

11. Daryl Collins, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven, *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (Princeton, NJ: Princeton University Press, 2009), 46–49.
12. Abhijit Banerjee and Ester Duflo, *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty* (New York: PublicAffairs, 2011).
13. Collins et al., page 59.
14. "Rural Development Scheme," Dhaka: Islami Bank Bangladesh Limited, accessed August 2, 2013, available at http://www.islamibankbd.com/prodServices/rds Scheme.php.
15. According to the IBBL's 2012 Annual Report (page 218), *zakat* is "paid at a rate of 2.58 percent . . . and calculated on the closing balances of Share Premium, Statutory Reserve, General Reserve and Dividend Equalization Accounts."
16. The IBBL's mission, as stated in its 2012 Annual Report, is "To establish Islamic Banking through the introduction of a welfare oriented banking system and also ensure equity and justice in all economic activities, achieve balanced growth and equitable development through diversified investment operations particularly in the priority sectors and less development areas of the country. To encourage socio-economic uplift and financial services to the low income community particularly in the rural areas."
17. Mansoor Durrani and Grahame Boocock, *Venture Capital, Islamic Finance, and SMEs: Valuation, Structuring and Monitoring Practices in India* (New York: Palgrave MacMillan, 2006).
18. The *taka* is the Bangladeshi currency.
19. In Bengali: "*Islam shudh mukhto—sheta Islamic finance. Onno banks'ke onek taka dorkar—Islamic bank'e ei rokom'er shudh nai. Amadair Islami bank'ke bhalobashi*."
20. In Bengali: "*Capital establish korte chai. Torkari kash kore, pore aam*."
21. (M. Obaidullah, 2008).
22. Beatriz Armendáriz and Jonathan Morduch, *The Economics of Microfinance*, 2nd edition (Cambridge, MA: MIT Press, 2010); Beatriz Armendáriz and Nigel Roome, "Gender Empowerment in Microfinance," in *Microfinance: Emerging Trends and Challenges*, edited by Suresh M. Sundaresan (Cheltenham, UK: Edward Elgar, 2008); Lamia Karim, *Microfinance and Its Discontents: Women in Debt in Bangladesh* (Minneapolis, MN: University of Minnesota Press, 2011); Aminur Rahman, *Women and Microcredit in Rural Bangladesh: Anthropological Study of the Rhetoric and Realities of Grameen Bank Lending* (Boulder, CO: Westview Press, 1999). For information about the gender of RDS clients, see "Rural Development Scheme," (Dhaka: Islami Bank Bangladesh Limited), accessed August 2, 2013, available at http://www.islamibankbd.com/prodServices/rdsScheme.php.
23. This is also at odds with an orientation common in conventional microfinance as well, despite the rhetoric of "female empowerment" frequently employed in that sector. Armendariz and Morduch (2010: 220) and Banerjee and Duflo (2011: 124) explain that microfinance tends to rely on the "efficient household" model of financial management championed by economist Gary Becker in 1981, whereby family members are not in economic competition with each other, but seek to maximize collective financial gains and are tied together for the long term.
24. Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (Cambridge: Cambridge University Press, 2006).

25. Arab News, "Religious leaders scrutinize Goldman's *sukuk*," February 2012, http://www.arabnews.com/node/4060178; Anjuli Davies, "Goldman faces new controversy over Islamic bond," Reuters, January 11, 2012, http://uk.reuters.com/article/2012/01/11/goldman-sukuk-controversy-idUKL6E8CB2IM20120111; Haider Ala Hamoudi, "Legal Lip Service," Forbes, April 21, 2008, http://www.forbes.com/2008/04/21/islamic-religious-banking-islamic-finance-cx_hh_islamicfinance08_0421spirit.html.
26. Some of the most notable examples include: Charles Hirschkind, *The Ethical Soundscape: Cassette Sermons and Islamic Counterpublics* (New York: Columbia University Press, 2006); Naveeda Khan, *Muslim Becoming: Aspiration and Skepticism in Pakistan* (Durham: Duke University Press, 2012); Saba Mahmood, *Politics of Piety: The Islamic Revival and the Feminist Subject* (Princeton, New Jersey: Princeton University Press, 2005); Stefania Pandolfo, "The Burning: Finitude and the Politico-Theological Imagination of Illegal Immigration," *Anthropological Theory* 7:3 (2007): 329–363; Elora Shehabuddin, *Reshaping the Holy: Democracy, Development, and Muslim Women in Bangladesh* (New York: Columbia University Press, 2008).
27. See Hamoudi (2008); Muhammad Baqir Al-Sadr, *Iqtisaduna* (*Our Economics*), Vol. 1 and 2 (Tehran: World Organization for Islamic Services, 1994 [1981]); Al-Sadr, "What do You Know about Islamic Economics?" translated by Yasin T. al-Jibouri (Lanham, MD: Imamia Center, Inc., 1990), available at Ahlul Bayt Digital Islamic Library Project, http://www.al-islam.org/what-do-you-know-about-islamic-economics/.
28. Al-Sadr (1990); Wael Hallaq, *The Impossible State: Islam, Politics, and Modernity's Moral Predicament* (New York: Columbia University Press, 2013).

Glossary

awqaf — See entry for *waqf.*

bay' al-mu'ajjal — Deferred payment sale, credit sale; a sale in which payment is delayed and delivery of the contracted goods is immediate.

bay' — Sale; an agreement between two parties (the seller and the buyer) that transfers ownership of the sale item from the seller to the buyer in exchange for a price.

bay' al-salam — Purchase with deferred delivery.

fard kifayah — An obligation on the Muslim community as a whole, from which some are freed if others take it up, such as funeral prayers.

fiqh al-mu'amalat — The ethics and laws of financial transactions.

gharar — Lit. peril, excessive risk, uncertainty.

hadith — Lit. report; historical account of a saying, act, or omission of the Prophet Muhammad or, secondarily, of an esteemed figure among his companions and early Muslim generations.

halal — Permissible, lawful; said of a deed that is not prohibited in Islam. Opp. *haram*.

hiyal — (sing. *hila*) legal artifices or stratagems to circumvent or avoid legal principles and rigid constructs.

ibadah/ibadat — Obedience, submission, and devotion to God along with the ultimate love for Him.

ijara — Operating leasing (lit. "letting to lease").

ijarah wa iqtina' — Agreement by customer to buy item after leasing it.

iman — Islamic conviction, faith, or belief.

istina'a (istina') — Contract for manufacturing or construction in Islamic law.

itlaf — Destruction of property.

kafala — Contract of guarantee in Islamic law. Assumption of the responsibility for debt repayment; a standard Islamic financial transaction where X (the *kafil*) agrees to assume responsibility for the debts of Y (the *makful 'anhu).*

khairat — Charity.

khums — Religious obligation to contribute one-fifth of a certain type of income to charity.

madhhab — Lit. "way of going." A jurisprudential school of thought in Islamic law. A *fiqh* school or orientation characterized by differences in the ways certain source texts and the resulting shari'a rulings deduced from them. There are four well-known *madhahib* among Sunni Muslims. Their names are associated with the classical jurists who are said to have founded them — Hanafi, Maliki, Shafi`I, and Hanbali.

mafsadah — Harm.

mal — Wealth, money, property; any valuable thing that can be possessed.

manfa'a — lit. benefit, usufruct) The use of an asset, especially in the context of leasing/renting (*ijarah*) transactions.

maslaha — (lit. welfare, benefit) The consideration of general welfare is recognized by some schools of traditional Muslim legal theory as an independent basis of the Shari`ah. According to some schools of legal theory, on the basis of the consideration of maslaha (i.e., whether or not such an act is in the interest or enhances the welfare of an individual or group), a traditional legist can conclude that an act is prohibited or permissible, particularly in cases in which such a determination is not indicated by Qur'an, Sunnah, or qiyas (analogy). Traditional Muslim legal schools hold a variety of positions as to the validity, scope and authoritativeness of of such reasoning.

maysir — Gambling or speculation prohibited by Islamic law.

mudaraba — (also called *qirad*) A form of partnership to which some of the partners contribute only capital and the other partners only labor (some schools do not treat it as a partnership but as a contract *sui generis*).

mudarib — In a *mudaraba* contract, the partner contributing labor.

muqayyadah — Restriction in delegated powers.

murabaha — Sale at a percentage markup; one of the sales (*bay*) in which the price is stated in terms of the sale object's cost to the seller, the others being sale at cost (*tawliya*) and sale at discount (*wadi'a*).

musaqah — Irrigation.

musharaka — Equity participation contract.

mutanaqisa — Diminishing.

muzara'a — A share-cropping transaction in which one party (the landowner) permits another party (the sharecropper) to cultivate and harvest on a defined subset of the former's land in return for a defined fraction of the agricultural yield.

nisab — The exemption or threshold limit for the payment of *zakat*. A Muslim who possesses wealth below the *nisab* is exempted from paying *zakat*, while a Muslim who possesses wealth at or above this exemption limit is obliged to pay *zakat*. The *nisab* differs depending on the type of wealth in question.

pari passu — Equal footing.

qard hasan — Goodwill or benevolent loan with no compensation whatsoever.

Qur'an — Lit. "The Recitation." According to Muslims, the word of God as revealed to the last Prophet, Muhammad, via the Archangel Jibril (Gabriel). The Qur'an, Islam's most sacred text, is considered the most authoritative source of Islamic law.

rabb al-mal — Lit. "the owner of the property"; a partner who contributes capital.

riba — Usury as forbidden in the Qur'an; interpreted in classical *fiqh* as including interest and various other forms of gain in contract.

rizq — Livelihood, subsistence, blessing of God.

sadaqat — Charitable giving.

salam — Forward sale. A type of sale where the full price of the goods is paid in advance and the goods are delivered at a specified date in the future.

shari'a — The divine law known from the Qur'an and *sunna*.

sukuk — (sing. *sakk*) Islamic bonds and certificates.

sunna — The Prophet Muhammad's normative example, as known from the *hadith*; one of the four roots (*usul*) of *fiqh*.

takaful — Lit. "mutual support." Islamic insurance; based on the concept of mutual financial support, an Islamically acceptable alternative to conventional commercial insurance.

tawarruq — A practice in which a person buys something on credit and at once sells it for cash to a third party in a separate transaction.

tzedakah — Righteousness, fairness, or justice.

umma — Muslim community.

wa'd — Promise.

wakala — Agency; a standard Islamic practice wherein X (the *wakil*) acts as the agent of Y. In this capacity X may execute the affairs of Y. A widely applicable phenomenon in Islamic practice, *wakala* is often used in financial transactions. Whenever a party cannot personally supervise a given affair, it deputizes another party to execute it on its behalf.

waqf — (pl. *awqaf*) Lit. "cessation." A standard Islamic transaction where one "freezes" one's property such that it is considered to have been arrested in perpetuity and can neither be sold, inherited, nor donated. The term *waqf* frequently refers to the property itself. The use of a *waqf* (e.g., a park) is often reserved for the relief of the poor, for the public at large, or for other charitable ends.

zakat — (Var. *zakah* or *zaka*) The third pillar of Islam; obligatory alms-giving that every well-off Muslim is required to relinquish to the Islamic authority for distribution to the poor and needy. In the absence of an Islamic authority, well-off Muslims must themselves distribute their alms among the poor and needy, as prescribed by shari'a. The payment of *zakat* is prescribed for all persons having wealth above an exemption limit (*nisab*), as described in the *sunna*.

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Guide to Contributors

ABIKAN, ABDULQADIR IBRAHIM

Former Acting Dean, University of Ilorin and Legal Practitioner, Supreme Court of Nigeria

Abdulqadir Abikan is advocate at the Supreme Court of Nigeria. He has teaching, research, and consulting experience, primarily in corporate management, Islamic banking and finance and business law. Abikan received his Bachelor of Laws degree from Bayero University Kano, and his Master of Laws from Obafemi Awolowo University, Ile-Ife, Nigeria. He obtained his PhD in Islamic Banking and Finance Laws from International Islamic University Malaysia. He has taught at universities in Nigeria, International Islamic University Malaysia and University Brunei Darussalam. He is currently a Senior Lecturer at the University of Ilorin, Nigeria. Abikan has written on Islamic banking and finance and constitutional law. He has published more than twenty articles in local and international refereed journals. He has also contributed chapters to books and has completed two books, *Law, Practice and Regulation of Islamic Finance* and *Financial Institutions and Freedom of Opinion under the Islamic Law: A Comparative Approach*. He also edited *The University of Ilorin Law Journal.* He has presented research papers in several international conferences.

ALI, S. NAZIM

Director, Islamic Finance Project, Harvard Law School

S. Nazim Ali is Founding Director of the Islamic Finance Project (IFP) at Harvard Law School, Harvard University. For the last thirty years, he has focused his research efforts exclusively on the field of Islamic finance, giving particular attention to lines of inquiry that seek to examine and interrogate the frontiers of the Islamic finance sector, facilitate research within the sector itself, and encourage dialogue among the sector's stakeholders as well as between the sector and various external discussants. He has played a lead role in organizing several conferences, workshops, and symposia, including the Harvard University Forum on Islamic Finance and the annual workshop at the London School of Economics. He led the effort that resulted in the publication of the world's first academic software database covering the Islamic finance sector, the IFP DataBank (http://ifp.law.harvard.edu). Dr. Ali has published half a dozen books and numerous research papers and articles.

BHATT, VAISHNAVI
Assistant Professor of Finance, Ramaiah Institute of Management Studies, Bangalore, India
Vaishnavi Bhatt is currently a faculty member at Ramaiah Institute of Management Studies, Bangalore, India. She received her MBA (specializing in finance) from Gujarat University, India and PhD (in finance) from Jain University, India. She teaches security analysis and portfolio management, international finance, and corporate finance at the undergraduate and graduate programs. Her research interests include topics such as asset pricing and international portfolio diversification.

FINN, SÉAMUS P.
Director, Justice, Peace and Integrity of Creation, Missionary Oblates, Washington, DC
Reverend Séamus Finn has been the Director of the Justice, Peace and Integrity of Creation Ministry, Missionary Oblates of Mary Immaculate, in Washington, DC, since 1986. The office supports the mission of the congregation and is also responsible for the socially responsible investment program both for the US province and for the general administration of the congregation. This program includes an active screening process as well as shareholder activism and a robust program of engagement with the managers of major US and European corporations. Finn has represented the Oblates at the Interfaith Center on Corporate Responsibility in New York since 1988. He also represents the Oblates on the executive committee of the International Interfaith Investment Group. Finn believes that the active integration of the faith and values of the religious community into their advocacy efforts and into their financial investment decisions can be a leaven for promoting sustainable human communities.

HASSAN, M. KABIR
Professor, New Orleans University, New Orleans, Louisiana
Kabir Hassan is a financial economist with consulting, research, and teaching experience in development finance, money and capital markets, Islamic finance, corporate finance, investments, monetary economics, macroeconomics, and international trade and finance. He has provided consulting services to various governments and multilateral development agencies. Hassan received his BA in Economics and Mathematics (Phi Beta Kappa) from Gustavus Adolphus College in Minnesota and his MA in Economics and PhD in Finance

from the University of Nebraska–Lincoln. He is now a tenured professor in the Department of Economics and Finance at the University of New Orleans. He has published more than 100 papers in peer-reviewed academic journals. Hassan is editor of *Journal of Islamic Economics, Banking and Finance*, and co-editor of *Journal of Economic Cooperation and Development.* He is co-editor (with M. K. Lewis) of *Handbook of Islamic Banking* and *Islamic Finance, The International Library of Critical Writings in Economics* (Edward Elgar, 2007), and co-editor (with Michael Mahlknecht) of *Islamic Capital Market: Products and Strategies* (John Wiley and Sons, 2010). He is co-author of *Islamic Entrepreneurship* (Routledge UK). Hassan has lectured and presented his research papers at numerous international conferences.

IQBAL, ZAMIR
Lead Investment Officer, World Bank, Washington, DC
Zamir Iqbal works as lead investment officer in the Treasury of the World Bank in Washington, DC. He earned his PhD in International Finance from George Washington University. His research interests include Islamic finance, financial engineering, structured finance, and risk management. He is co-author of several books on Islamic banking and finance. He also serves as professional faculty at the Johns Hopkins Carey Business School, where he teaches graduate-level courses on investments and portfolio management and risk of financial institutions.

KAYED, RASEM
Associate Professor, Arab-American University, Palestine
Rasem Kayed received both his undergraduate degree as well as his MBA degree from Jacksonville State University and obtained his PhD in Development Studies from Massey University in New Zealand. His doctoral thesis explored the entrepreneurial phenomenon from an Islamic perspective and argued for Profit and Loss Sharing (PLS) contracts as viable alternatives to conventional interest-based financing instruments. Kayed is the co-author of *Islamic Entrepreneurship* (Routledge UK, 2011) and *Islamic Banking and Finance: Principles and Practice* (Pearson, 2012). He has published many papers in peer-reviewed international academic journals and a number of chapters in edited books. He has also participated in several seminars, forums, and workshops and has presented various academic and research papers at high-profile international conferences. Kayed's research activities are currently focused on exploring the developmental role that entrepreneurship could play in advancing the well-being of individuals, communities, and nations at large. Kayed has over 25 years of work experience both in the commercial and the academic world in the USA, New Zealand, Saudi Arabia, and Palestine.

KUSTIN, BRIDGET S.
Doctoral Candidate, Johns Hopkins University, Baltimore, Maryland
Bridget Kustin is studying theologies of money, specifically Islamic banking and finance in Bangladesh and Saudi Arabia. With the assistance of Bangladesh's largest Islamic bank, she is currently examining Islamic micro-investment against broader questions of development, capitalism, nationalism, and notions of social justice and risk in Islam. Previously, she served as the South Asia researcher for the US Commission on International Religious Freedom, a federal bipartisan agency providing foreign policy recommendations to the President, Congress, and Secretary of State. As a 2005–06 Fulbright Islamic Civilization Award recipient and Fulbright scholar to Bangladesh, Kustin studied US-funded initiatives to increase the participation of Islamic religious leaders in community development programs. She was a 2006–07 Bengali language fellow of the American Institute of Indian Studies, and her graduate work and field research in Bangladesh has been supported by a National Science Foundation Graduate Fellowship, the American Institute of Bangladesh Studies, and the Johns Hopkins–based Institute of Global Studies and Program for Women, Gender, and Sexuality. In 2012, she was an Irmgard Coninx Foundation research fellow in residence at the Social Science Research Center, Berlin. Kustin received her BA from Whitman College.

MILLER, NEIL
Global Head of Islamic Finance, Linklaters, Dubai, United Arab Emirates
Neil Miller was a partner and global head of Islamic finance at KPMG. Prior to this he was global head of Islamic finance at Norton Rose LLP. He has been actively involved in the Islamic finance industry for over seventeen years and is a regular speaker and writer on Islamic financial topics. Now based in Dubai, Miller is establishing the KPMG Centre of Excellence for Islamic Finance. Miller was a member of the UK Treasury Islamic Finance Experts Group and a member of the FSA committee on Islamic finance, and has worked closely with the Muslim Council of Britain and other bodies to promote and develop Islamic finance in the UK. In July 2009, his contribution to the cause of Islamic finance was acknowledged by the organizers of the ICG Sukuk Summit Awards with an award for his "Outstanding Contribution to Islamic Finance in the UK." He was a panelist in the opening session "Innovation and Authenticity" at the Eighth Harvard University Forum on Islamic Finance in 2008.

MIRAKHOR, ABBAS
Distinguished Professor, INCEIF, Kuala Lumpur, Malaysia
Abbas Mirakhor received his PhD in Economics from Kansas State University in 1969. After teaching at various universities he joined the staff of the Research Department of the IMF in 1984. He was an executive director

of the IMF from 1990 until his retirement in 2008. At the IMF he represented the countries of Afghanistan, Algeria, Ghana, Iran, Morocco, Pakistan, and Tunisia. He is the author of a number of articles and books on Islamic economics and finance. His areas of interest include economic theory, Islamic finance, and economics. Mirakhor also served as an economist in the Research Department of the IMF and was a professor of economics at the Florida Institute of Technology. He has published widely in areas like microeconomic theory, mathematical economics, and Islamic economics. He has co-authored *Essays on Iqtisad: Islamic Approach to Economic Problems* (1989) and *Theoretical Studies in Islamic Banking and Finance* (1987). Dr. Mirakhor is the recipient of several awards, including the Order of Companion of Volta, conferred for service to Ghana; the Islamic Development Bank Prize in Islamic Economics, shared with Mohsin Khan in 2003; the Quaide Azam star for service to Pakistan and various others.

NETHERCOTT, CRAIG

Partner, Latham & Watkins LLP, London, United Kingdom

Craig Nethercott is a partner at the international law firm Latham & Watkins LLP. He is the co-chair of the firm's Global Islamic Finance Group. He specializes in project finance and Islamic finance with a primary focus on the Middle East, and in particular Saudi Arabia. Miller has been intimately involved in many of the ground-breaking Islamic finance transactions in Qatar, Oman, the UAE, and Saudi Arabia, such as his work as lead counsel to Saudi Aramco on the development of *ijara/istisn'a* structure for the Rabigh Refinery project in 2006; as counsel to the lenders (Credit Suisse/AlJezzera Bank and the Islamic Development Bank) with respect to the *istisn'a/ijara* (intangible asset) financing of the Hajj Terminal expansion in Jeddah, Saudi Arabia; and as lead counsel to Mobily (the mobile telecommunications operator in Saudi Arabia) with respect to its $5 billion innovative Airtime Sales Facility. Nethercott is currently advising the Saudi Binladen–led consortium with respect to its bid for the Madinah Airport BOT project in Saudi Arabia. Craig is the co-editor of the practitioners' publication *Islamic Finance, Law and Practice*, published by Oxford University Press in December 2011.

NIENHAUS, VOLKER

Visiting Professor, ICMA Centre, Henley Business School, University of Reading, United Kingdom

Volker Nienhaus was professor of economics at the German universities of Trier and Bochum from 1989 to 2004. He was the president of the University of Marburg from 2004 to 2010. He holds an honorary professorship at the faculty of economics and business administration of the University of Bochum and has been a visiting professor at the University of Reading since 2010. He is an adjunct professor at the International Centre for Education in

Islamic Finance (INCEIF) in Kuala Lumpur where he has also been a member of the Governing Council since 2006. He was consultant to the Islamic Financial Services Board from 2006 to 2010, was a visiting scholar at the University of Malaya under the Securities Commission Malaysia Islamic Capital Market Programme in 2010 and 2011, and was a visiting professor at the Qatar Faculty of Islamic Studies in 2011. He has published numerous articles, essays, and books on Islamic economics and finance since the 1980s.

NISAR, SHARIQ
Senior Visiting Fellow, Islamic Legal Studies Program, Harvard Law School, Harvard University
Shariq Nisar holds PhD in economics specializing in Islamic banking and finance from Aligarh Muslim University, Aligarh. He is among the senior most professionals of Islamic finance in India and is closely associated with both academia as well as the industry. He has pioneered shari‘a screening of stocks in India and has been associated with most of the shari‘a-compliant deals structured in the country. In his academic activities, Nisar focuses on Islamic finance education, research, and training. He has structured Islamic finance courses for various universities and colleges and has participated in over a dozen international seminars and conferences on Islamic finance in America, Europe, the Middle East and the Far East. Nisar is visiting faculty at many Indian universities and has published over 50 research papers and articles. He is also director of research and operations at India’s premier shari‘a advisory firm, Taqwaa Advisory and Shariah Investment Solutions Pvt Ltd. (TASIS) in Mumbai.

OLOYEDE, IS-HAQ OLANREWAJU
Former Vice Chancellor, University of Ilorin, Nigeria
Is-haq Olanrewaju Oloyede obtained his BA in Arabic from the University of Ilorin, Nigeria. In 1991, he obtained his doctorate degree in Islamic studies from the same University. In 1982 he began his academic career at University of Ilorin as an assistant lecturer in the Department of Religions and become a professor of Islamic studies in 1995. Before his appointment as the vice chancellor of the University in October 2007, he was the director of the Academic Planning Unit of the University from 2001 to 2003, the academic deputy vice-chancellor from 2003 to 2005, and administrative deputy vice-chancellor from 2005 to 2007. Oloyede was appointed as co-secretary of the National Political Reform Conference in 2005, and in 2006 he was appointed a consultant on education reforms in Nigeria by the National Universities Commission. Currently Oloyede is the executive secretary of the National Inter-Religious Council (NIREC) and a board member of the International Association of Universities (IAU). He has authored and co-authored several books and articles in reputable local and international journals.

OSENI, UMAR A.
Assistant Professor, Faculty of Law, International Islamic University Malaysia, Kuala Lumpur
Umar Oseni received his LLB (Hons) in Common and Islamic Law from the University of Ilorin, Nigeria; and Master of Comparative Laws and PhD from the International Islamic University Malaysia. He was a resource on Islamic microfinance at the UN-Habitat Workshop on Land Development in Islam jointly organized by UN-Habitat, International Islamic University Malaysia, and the University of East London in 2009. His areas of interest include the law of Islamic finance, contemporary issues in Islamic law, alternative dispute resolution, arbitration, comparative law, and international commercial arbitration. He is a member of: the Chartered Institute of Arbitrators UK; the International Centre for Dispute Resolution Young & International (ICDR Y&I); the Young International Arbitration Group (YIAG); the London Court of International Arbitration; the Nigerian Bar Association; and the Association of Professional Negotiators and Mediators. Umar is co-author (with Kabir Hassan and Rasem N. Kayed) of a textbook on Islamic finance (Pearson Publishing Company, 2012). He co-authored a textbook on Islamic Finance, (Pearson 2013). He is also a contributing editor of *Essential Readings in Legal and Regulatory Issues in Islamic Finance* (Kuala Lumpur: CERT Publications, 2014).

PATEL, ANASS
Managing Partner, 570 Asset Management, Paris, France
Anass Patel specializes in Islamic finance structuring. Patel was previously the director of investment and strategy of DTZ Asset Management, where he was in charge of business development and strategic relationships. He has built key management accounts with GE Asset Management, Dubai Islamic Bank, AMP Capital with the Global Direct Property Fund, and the Hexagone fund, a co-developed French property fund with Aviva Investors. He previously worked at GE Capital as an investment specialist and later as a risk specialist in Europe and the US. He also worked for the international property developer HRO as head of the research department. Anass has a postgraduate degree from Ecole Centrale Paris and is a graduate of ESC Lille Business School. Patel is also the founder-president of AIDIMM, a non-profit organization that promotes Islamic finance in France and French-speaking countries. He has published many papers and co-authored different books on Islamic finance, both in French, such as *La Finance Islamique à la française: un moteur pour l'économie, une alternative éthique* (Secure Finance 2008), and in English, such as *Islamic Investment Banking* (Euromoney, 2010) and *Growth of Sukuks* (Euromoney, 2011).

SHAH, SAJJAD
Assistant Vice President, Wellington Management Company, Boston, Massachusetts
Sajjad Shah is a financial industry practitioner involved in information technology and financial investment management with eighteen years of industry experience. He is currently the assistant vice president of the Wellington Management Company in Boston, Massachusetts. Shah recently completed a quantitative finance MBA degree from Stern Business School of New York University. His areas of interest are community development via innovation in financial and technology fields and in Islamic financial management.

SULTAN, JAHANGIR
Gibbons Professor of Finance, Bentley University, Waltham, Massachusetts
Jahangir Sultan was appointed the Gibbons Professor of Finance at Bentley University in 2007. He received his BA from Eureka College, his MS from Western Illinois University, and his PhD from Arizona State University. Sultan currently teaches fixed income and international financial management in the undergraduate and graduate programs at Bentley University. He conducts education seminars on topics such as treasury risk management, currency trading, international investment, financial liberalization, and modeling volatility. Sultan conceived and established the Bentley University Trading Room in 1997, a multi-million-dollar state-of-the-art facility for teaching financial analysis and risk management to finance and non-finance students. The first working trading floor on an American university campus, the facility offers real-time data feed from major equities, options exchanges, and over-the-counter markets in the US and overseas and is also used for conducting corporate training seminars. Sultan was the recipient of the 1999 Bentley University Scholar of the Year award.

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ISLAMIC FINANCE AND DEVELOPMENT

Islamic finance derives its parameters from the basic values and concepts founded on an understanding of shari'a and proceeds on these bases to work out an alternative model of development. The emergence of Islamic finance has raised expectations of faster development in the Muslim world, especially because of its focus on justice and equity in distribution of wealth among people and for its emphasis on strong linkages between finance and real economy. The strong growth achieved by Islamic finance since its modest beginning in the mid-1970s encouraged the Islamic Finance Project to organize the Tenth Biennial Harvard University Forum on Islamic Finance (2012) on the theme of Islamic finance and development.

This book comprises 11 papers presented at the biennial Forum and covers the theme of Islamic finance and development from a variety of perspectives. The first four papers focus on the role of Islamic finance in economic development. The next four papers examine the need for alternative ethical financing and strategies to spur the development of the global economy. The final three papers provide specific case studies from three different countries in their quest to enhance grassroots-oriented developments through Islamic finance.

Contributors contend that to be more successful, the Islamic finance industry needs to have its own developmental plan, one that conforms to the requirements of shari'a and meets the local needs of the community it proposes to serve.

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