Proceedings of the

Second Harvard University Forum on Islamic Finance

Islamic Finance into the 21st Century

Harvard University
Cambridge, Massachusetts

October 9-10, 1998

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<Arabic calligraphy>

IN THE NAME OF GOD, THE MOST MERCIFUL, THE MOST KIND

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Organized by

Harvard Islamic Finance Information Program
Center for Middle Eastern Studies

in association with

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The heart of these Proceedings lies in the work of the individual authors whose papers are included here. Their original contributions as speakers at the Second Forum and cooperation throughout this process are greatly appreciated. Thomas D. Mullins (Executive Director of HIFIP and Associate Director of CMES) graciously wrote the Preface and Professor Samuel L. Hayes, III (Conference Chairman) the Foreword of these Proceedings. Professor Mahmoud El-Gamal, Shaykh Yusuf Talal DeLorenzo, Dr. Muhammed-Shahid Ebrahim, and Gohar Bilal (Islamic Legal Studies Program, Harvard Law School) were kind enough to add to their own contributions to the Forum introductions for the individual sections of the Proceedings.

I would like to personally thank two individuals who made it possible for the work of these contributors to appear in print: Munir Zilanawala (Harvard College ’01 and Custodian of the Two HIFIP Conferences) for his untiring efforts from the first calling of the Forum papers to their final editing, and Gohar Bilal for her initial direction of and continuing enthusiasm for these Proceedings. I would also like to thank other staff members and friends of HIFIP who helped edit individual papers: Abdur-Rahman Syed (A.B., Harvard College), Saif Shah Mohammed (Harvard College ’02), Shahzad Bhatti (J.D., Harvard Law School), Aamir Abdul Rehman (A.M., A.B., Harvard College), Mohsin Ansari (Harvard Business School ’00), and Fatimah Iliasu (S.J.D. candidate, Harvard Law School).

These Proceedings are of course the result of the Second Forum. The considerable success of this Forum is owed in part to the institutional support of Harvard’s Center for Middle Eastern Studies, the Islamic Legal Studies Program of the Harvard Law School, and the Masters of Lowell House. Particular recognition must go to the Harvard Islamic Society, a student organization at the University whose concerned and committed members played an indispensable role in helping organize and staff the Forum. Harvard University in turn could not have hosted the Second Forum without the generous financial support of AlBaraka Investment and Development Co., with further assistance coming from American Express Company, the Islamic Cooperative Housing Corporation of Canada, Citi Islamic Investment Bank, the Gulf Investment Corporation, and Wellington Management Company.

The Harvard Islamic Finance Information Program that stands as the larger effort behind both the Proceedings and the Forum owes its own success in the past four years to a small but highly dedicated staff. I would here like to personally mention Taha Abdul-Basser (Ph.D. Candidate, Harvard GSAS), who has always seen this Program as a labor of love.

Finally, HIFIP’s success and growth has been carried on by the many Program members throughout the Islamic finance community that have believed in us and supported us. I extend my heartfelt appreciation to them all (see inside back cover for a complete list).

S. Nazim Ali, Ph.D.
Director of Operations
Harvard Islamic Finance Information Program

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Preface

It gives me great pleasure to present these Proceedings of the Second Harvard University Forum on Islamic Finance, held in Cambridge, Massachusetts, on October 9 and 10, 1998. This gathering of over 250 brought together leading academics, Islamic scholars, and financial professionals, as well as students, all united in their keen interest in Islamic financial and economic practice and theory.

The Forum is an integral component of the Harvard Islamic Finance Information Program (HIFIP), a program founded in December 1994 under the auspices of the Center for Middle Eastern Studies. Initial funding for the HIFIP program was provided by a most generous grant from the Islamic Investment Company of the Gulf, a member of the Dar Al-Maal Al-Islami group. A wide range of enlightened donors and the membership subscriptions of most of the leading Islamic financial institutions have provided subsequent funding.

From its inception, HIFIP has been dedicated to the acquisition, compilation, analysis, and diffusion of knowledge relative to the rapidly expanding field of Islamic finance. It has been our vision that this Forum serve as a meeting point for an interdisciplinary dialogue among those who study and those who practice in the field. While recognizing variations in understanding and interpretations, we have consistently tried to present, without bias, the ideas and experiences of those institutions and personalities that are both authoritative and innovative. We also seek and encourage originality and clarity of presentation in our speakers.

This Forum and the resulting Proceedings represent the coordinated efforts of the wide range of speakers whose work is presented here. Unfortunately, a very few of the papers presented at the Forum could not be included in these Proceedings, but the great majority are here and give a virtually complete picture of the range and depth of topics covered.

The Proceedings present the Forum papers in four sections: Part I – Islamic Economics, Part II – The *Shari'ah*, Part III – Islamic Finance, and Part IV – Commercial Products, Business Models, and Other. While this provides a framework to organize and locate the papers, it is true that a number of presentations overlap in content and theme, and could well be classified in different categories. The Second Forum's Program of Events, biographies of speakers, and a description of HIFIP and list of its members can be found in the Appendices at the end of the Proceedings.

Arabic words in this volume have been transliterated without macrons or other pronunciation aids. They are italicized when likely to be unfamiliar to non-specialist readers, and capitalized when appropriate.

Finally, full credit for the overall organization and direction of the Forum and these Proceedings must be given to Dr. S. Nazim Ali, Director of Operations at HIFIP, who has been the moving spirit behind this entire Program. His dedication to expanding the understanding of the Islamic financial community, its rationale and activities, and thus the Islamic faith itself, has been an inspiration to all who have had the opportunity to work with him.

Thomas D. Mullins
Executive Director of HIFIP
Associate Director of the Center for Middle Eastern Studies

Foreword

Samuel L. Hayes, III*

This is a very important time for the development of Islamic finance. In a true sense, this is a new discipline. Contemporary Islamic finance is not something that has evolved over a long period of time. The practice of Islamic finance had been suppressed until the World War II period, and only came into the public eye and at the forefront of discussion in the aftermath of oil price increases in the 1970's. Presently we are at the forefront of the creation of a practical and modern Islamic financial system.

There has been a rapid development of the literature to support the new initiative taking place in Islamic finance, and a number of people attending the Second Harvard University Forum on Islamic Finance have contributed importantly to the development of this literature. We at Harvard University have tried to make a contribution by bringing together knowledge about—and forming a central clearinghouse for—that literature, which is very important for future scholars and for the development of this discipline in years ahead. I have found as a researcher that I had to go to many different sources in many different locations in order to get information about Islamic finance. It would have saved me an enormous amount of time if we had a comprehensive clearinghouse for that information.

It is, as I indicated, true that the contemporary version of Islamic finance is in its infancy. Not only has it had only a short period of time to develop, but, in addition (and this is not surprising) there has not yet developed a consensus as to what contracts and what forms of financial activity are acceptable in Islam. It is also important to note that there is no country in the world that has fully adopted Islamic finance as the underlying basis for its system, and this is true even in Iran, Sudan, and Pakistan, which purport to have wholly and exclusively Islamic banking systems. In each of these three countries, a close scrutiny of the way they conduct their affairs indicates that they have not been able to fully implement the principles of Islam in how they do business. Partly, this is because there are not adequate contracts that will satisfy their needs, and the contracts that are available often exact substantial costs from those who use them. Only a segment of the population willingly pays that price.

I thought about what are some of the most important areas for further development in order to more effectively implement Islamic finance as a guiding principle in today's world. There are four points that I would like to make in that regard. These points are not exclusive or comprehensive but seem important to me:

1. we must develop a more comprehensive set of financial tools for those who practice their religion in the management of their businesses as well as those who are investors in other people's businesses;
2. we must see more uniformity in Islamic contracts and documentation;
3. we must re-examine the feasibility of Islamic banks' providing a comprehensive array of products and services that are competitive with conventional banks; and
4. we must deal with the failure of Islamic banks to deal adequately with problems which every business person confronts in this world of the 21st century, including the questions of inflation and hedging, and problems of liquidity.

I want to say a few words about each of these four points, with the anticipation that these and other concerns will be addressed in various papers that will follow.

As far as financial management for the Islamic business is concerned, very little attention has been directed in the literature toward the needs of Islamic business; we spend most of our time addressing the Islamic investors' needs. In societies that want to fully adopt Islamic principles, it is clear that there have to be comprehensive guidelines for businesses that want to operate in full accordance with their religious beliefs. This is not easy to do at present.

One troubling area for Islamic businesses is the financing of their working capital and, in particular, the problems of handling credit to customers. Many businesses do not have the internal capital to extend credit on a *murabaha* basis themselves. Their main alternative is to bring in a third party (that is, an Islamic bank) to act as their credit arm. But there are many businesses that don't want to turn over their credit decisions to a third party.

* Hayes is Jacob Schiff Professor Emeritus at the Harvard Business School in Cambridge, Mass. The following is the text of his Conference Chairman's Address at the Second Harvard University Forum on Islamic Finance.

They want to make those judgments themselves, since there could be strategic reasons why they might come to a different conclusion about credit extension to a customer than would be the case for a third-party provider.

The second area of concern is uniformity in contracts and documentation. Obviously this is a very important area, as it can cut down the costs that occur for both sides in an Islamic contract. In our research, we examined contracts that were drawn up early in the development of contemporary Islamic banking and then compared them to similar contracts drawn up a decade later. We found that documentation in *murabaha* contracts was shortened as experience provided more comfort as to what the essential ingredients meant. There was not the same need to spell out in elaborate detail every fine point to the arrangement being made by the two sides to the contract. That streamlining process in the case of *murabaha* contracts has not gone as far in other Islamic contracts, however. This hikes up expenses and adds time delays to the process. The time delay is particularly important in today's environment where transactions are often done almost instantaneously. Often, there isn't time to work through the fine points of an unfamiliar Islamic contract. Uniformity in contract documentation will also be very important for the future development of a secondary market for Islamic instruments.

Turning now to the capability of the Islamic banks to provide comprehensive products and services that are competitive with those of conventional Western banks, I think there is a basic problem with definitions. It is probably a mischaracterization to call the typical Islamic financial institution a "bank." They are not really banks. They could more accurately be called "finance companies" or "venture bankers," because one important principle of Islam in the area of business and finance is "partnership," not the hierarchical structure of claims of a Western bank. This historical mis-definition has resulted in much unfair criticism of Islamic banks over the past two decades. They have been held to a litmus test when that does not really describe their nature and financial mandate. We must not forget, however, that Islamic businesses have legitimate banking needs which Islamic "banks" have not been able to satisfy. An important question is: how can these be met within the framework of Islamic religious principles?

Then there is the phenomenon that most Islamic "banks" would be better characterized as de facto finance companies because the preponderance of their business volume is in the form of relatively short-term transactions. As a group they do only a modest amount of *mudaraba* or other longer-term financing contract arrangements. It strikes me that they are pulled in opposing forces on this. Their sources of capital (i.e. their profit-sharing investors, or what conventional banks would call "depositors") are often not willing to commit their money to long-term venture banking uses. They want instant liquidity and no capital risk. Thus they suffer from schizophrenia. The logical and appropriate focus for these institutions would be to act as partners with businesses to finance long-term investment needs. Participating depositors, on the other hand, are unwilling to sacrifice any liquidity or incremental risk exposure to achieve that. This has to be resolved.

Finally, I will briefly restate several existing gaps in Islamic arrangements required to meet the needs of both Islamic businesses as well as religiously motivated investors. One is inflation. A second is the problem of hedging, and a third is the problem of liquidity. These will undoubtedly be discussed in greater detail later in our conference sessions.

It is an inevitable fact of life as we move into the 21st century that there is difficulty in protecting purchasing power when dealing in multiple currencies. Any rational decision-maker, whether running a business or investing capital, will seek to preserve his/her purchasing power. The fact that the OIC *Fiqh* Academy has not yet been able to come to a consensus as to how to deal with this complex issue is understandable, although regrettable. Solving this dilemma is very important to the future of Islamic finance in the contemporary global marketplace.

I am well aware of the Islamic prohibition of "speculation." That is a worthy principle, since we have seen how speculation can cause real turmoil in the marketplace. But there are legitimate reasons why both Islamic business managers and investors—far from speculating—have a compelling need to protect themselves against unexpected movements in asset values. Some so-called Islamic hedges have been constructed, but they have shortcomings as vehicles. Either they are cumbersome and lack the necessary flexibility to respond to the variety of situations which contemporary business people confront, or they stray so far from Islamic religious principles that many *Shari'ah* boards disallow their use.

Finally there is the question of liquidity. We have already mentioned the schizophrenia among Islamic financial managers and their customers—their profit-sharing depositors—who explicitly or implicitly expect to be able to withdraw their funds on short notice, just as they can from conventional banks. That is basically inconsistent with the role of the venture banker or collaborative partner in an ongoing business. One obvious solution is to create secondary markets for such investments, as is done in Western financial markets. I am well aware of the Islamic prohibition of the exchange of existing financial instruments that are backed only by money, as opposed to real goods and assets. Obviously the development of any secondary market for Islamic financial contracts must be fully in accord with *Shari'ah* principles. Professor Vogel and I hold the view that the failure thus far to develop secondary markets for qualified Islamic instruments is not primarily attributable to withheld *Shari'ah* approval, but to the unwillingness on the part of Islamic institutions to commit the necessary capital to launch and support such markets until the volume reaches a critical mass that assures profitability. In other words, it seems to be a question of exposing capital. Expected high front-end costs of a secondary market are certainly daunting, but one way or another such markets will have to be established if Islamic finance is to thrive in the future.

I want to re-emphasize the point that we live in a world in which the Western financial model is and will continue to be dominant for the foreseeable future. Islam cannot realistically develop an economic society that is sufficiently self-contained to run it strictly according to Islamic principles, without reference to the conventional Western financial model. Islamic finance will always have to live side-by-side with the conventional Western model. Thus, the challenge that we face is to develop means by which the Islamic and Western financial modes can co-exist with some stability. I firmly believe that goal can be achieved.

PART I

ISLAMIC ECONOMICS

Introduction

Mahmoud A. El-Gamal*

The reader of this volume will no doubt be struck by the great rift between the theoretical preoccupations of the part for which this introduction is written, and the pragmatic approach of the parts dealing with the *Shari'ah*, Islamic finance, and consumer finance. This rift was best summarized at the Second Harvard University Forum on Islamic Finance, at which the papers in this volume were presented, in a casual statement made by one of the distinguished participants. During the opening session, a noted practitioner in the field of Islamic finance stated—in a matter-of-fact manner—words to the effect, "Islamic finance did not come about to prove any theory. It came about to satisfy a market demand." There is no need for the reader to ponder the dire theological implications of this statement (e.g. whose "theory" was meant by that statement, and who may have engaged in the act of "proving" it?). It is clear that the speaker was implicitly questioning (perhaps appropriately) the usefulness of the entire field of "Islamic economics" as it stands today.

There are many viable approaches for me to write this introduction. Perhaps the safest would be simply to summarize the issues and results discussed by the authors of the various papers, and to try to find some common themes. Slightly riskier would be an attempt to identify a place for those contributions in the large and growing bodies (plural intended) of literature that are self-identified as investigations in "Islamic economics." Riskier still, I may attempt to critique the papers, identifying the distance between the divergent problems posed by "Islamic economists" and the answers that are provided in the literature, as represented in particular by the papers at hand.

Rather than venture in any one of those directions, I have decided to construct a mental model of the generic reader of this volume, and to address that reader. Since the Forum and most of its papers relate to issues in Islamic finance, as well as Islamic jurisprudence as it relates to practical matters in finance, I assume that the reader holding this volume is not particularly aware of the history and goals of Islamic economics. I further assume that the reader who is holding this volume, and who has not already skipped to the *Shari'ah* or finance sections, is reading this part out of curiosity about two main topics: 1) what is Islamic economics, and 2) what contribution does it make? Therefore, my main goal will be to discuss the field and the papers at hand within the context of familiarizing the reader with some of the different approaches within Islamic economics. In doing this, I find myself forced to alternate between all three approaches mentioned above, without regard to their respective risks.

I. The Language(s) of Islamic Economics

The astute reader will probably come to this volume with the expectation of finding writings characterized by extreme reverence not only for the divinely revealed and inspired canonical texts of Islam (the Revealed Qur'an and the Authenticated Sayings of the Prophet Muhammad (PBUH)), but also to the contributions of Muslim jurists and earlier writers on "Islamic economics." Our astute reader will also expect to suffer through many anglicized transliterations of Arabic terms, used consciously or unconsciously by the authors to lend credibility to their arguments. This reader will not be surprised along either of those dimensions. After all, the very name of the field considered in this part of the volume is "Islamic economics," with the first term "Islamic" invoking religious study with all its emphasis on etymology and semantics. Thus, whether the authors of the papers at hand agree or disagree with the writings of other Islamic economists, the need to derive credibility through occasional reference to earlier—and therefore "more authentically Islamic"—texts, is inevitable.

What the reader may, perhaps, find more surprising is the reverence with which some ideas proposed by contemporary writers continue to be endorsed. This, more than any other factor, contributes to the rift between "Islamic economics" and "Islamic finance," as represented by various papers in this volume. To give but one example, which will be discussed in greater detail later in this introduction, consider the obsession in the field of Islamic economics with the notion of "profit- and loss-sharing" being the "true Islamic ideal for finance." All the papers in this part illustrate this obsession to varying degrees. Contrast this emphasis on profit- and loss-sharing with the following facts: First, silent partnership (to use a transliterated term, *mudaraba*) is better characterized as profit sharing only, since the entrepreneur does not share in any financial losses. Second, the vast majority of

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transactions currently used by Islamic financial institutions are based on a fixed mark-up through cost plus (*murabaha)* and leasing (*ijara)* contracts. Finally, ignoring some of the sticky juristic issues regarding intention to circumvent the law, there are no grounds to argue that cost-plus contracts are any less "Islamic" than profit- and loss-sharing partnerships.

This divergence between reality in jurisprudence and market practice on the one hand, and the maintained hypotheses of writings in Islamic economics on the other, forces me to oscillate between an apologetic tone and a critical one. The apologetic tone is necessary since "Islamic economics," in its quest to distinguish itself as a distinct area of study, often requires an exaggeration of the differences between practices permitted in Islamic law and those that are used in societies deemed to be "un-Islamic." The critical tone is necessary due to the inevitable questions whether there is any need for a distinct field of study called "Islamic economics," and whether the literature at hand satisfies that need.

II. Historical Origins and Present Manifestations

In this short introduction, I can only provide a very brief historical background on Islamic economics, mainly intended to explain the field's preoccupation with the themes discussed in this volume. Two excellent overviews of Islamic economics as a field, one historical and one forward looking, are, respectively, Siddiqui (in Ahmad and Awan, 1992), and Chapra (1996). An in-depth study of some of the earliest predominant writers in the area is provided in Haneef (1985).

Detractors of the field of Islamic economics (e.g., Kuran (1995, 1996)) were quick to point out—correctly—the coincidence of the birth of contemporary Islamic economics (with the writings of Mawdudi (1947, 1978), who coined the term) in the Indian subcontinent with the nationalist-religious movement in that region. There was, it is argued, a need to define "our economy," in the same manner that "our nation" and "our religion" were distinctly defined by Pakistani independence from Britain (nationalist) and then India (religious and nationalistic). Thus, the quest to establish a new Islamic identity "neither of the East nor of the West" [Qur'an, 24:35] extended to the area of economics. Consequently, much of the early writings of the area focused on comparative economic systems, emphasizing the aspects of Islamic property rights, tax systems, and financial transactions, which distinguished it from both camps. This much is historical fact, which may be used as ammunition for or against Islamic economics as it emerged. The emphasis of the field was historically summarized in a positive light by Mannan (1986, p. 18): "Islamic economics is a social science which studies the economic problems of a people imbued with the values of Islam."

A. Islamic Worldview

This approach to "Islamic economics" can be witnessed by the reader of the current volume in M. Umer Chapra's references to the "Islamic vision" and Masudul Alam Choudhury's "*Shari'ah*-based worldview." Usamah Uthman professes this view of Islamic economics as the study of economic problems in the ideal Islamic society: "Islamic economics is part of that integrated system, the purpose of which is the betterment of life on the basis of the teachings of the Lord." The three authors cited here represent the line of Islamic economics that refuses to divorce positive economics from its normative counterpart (as stated by Professor Uthman). Two of the authors go further to declare that Islamic economics is not within the realm of economics per se, as it must be multidisciplinary (see Chapra's use of a multi-disciplinary model, and Professor Choudhury's call for a paradigm shift). Professors Uthman and Choudhury are also quick to highlight the shortcomings of "mainstream" or "western" economics, especially with respect to its inability to provide acceptable definitions of money. In the process, those three authors criticize the study of economics in its various labeled forms: "mainstream," "western," "capitalist," "positive," "neoclassical," "Keynesian," etc., as insufficient, not only in terms of content, but also in terms of method. Thus, not only is Islamic economics professed to be the study of an ideal Islamic society, the study of economics per se is viewed as insufficient to address the relevant human problems.

B. The Economics of Islamic Economies

A somewhat more practical version of this line in Islamic economics is represented in this volume in the papers by Abdul Aziz and Mahmud Rahman, and Abdel-Hameed M. Bashir. They follow in a long line of studies that apply the tools of traditional economics and finance to a theoretical "Islamic economy," which they define—in accordance with early writings in the field—as "interest-free." Thus, the first author investigates a *zakat*-based alternative for the riskless rate of return used to determine risk-return relationships. The theoretical motivation for this paper ignores the fact that government-guaranteed riskless rates are indeed offered by some governments in accordance with Islamic law (e.g. the Jordanian Central Bank's use of *murabaha* contracts to deal with the Islamic

Bank of Jordan). The second author investigates the effects of "interest-free" government expenditure financing and monetary policy on economic growth. The motivation for this paper also ignores the recently developed Islamic alternatives (most notably Sudan, Iran, and Malaysia), none of which is equity-based. Those new instruments give Islamic governments virtually the same macroeconomic policy tools available to any other government. This line of Islamic economic studies, therefore, agrees with the first one in its goal of providing an analysis of the "economics of an ideal Islamic society" (ideal in a particular sense), but identifies itself as a separate approach by using standard economic modeling tools to achieve this end.

Some of the purist adherents to the first view of Islamic economics criticize this research agenda vigorously. In this regard, we may quote Nasr (1991, p.388), who concludes that researchers in this area have "failed to escape the centripetal pull of western economic thought," and therefore finds that this program "has been caught in the intellectual web of the very system it set out to replace." This critique of using even the technology of mainstream neoclassical economics lies at the heart of Choudhury's call for a paradigm shift, which echoes earlier calls of the same nature by Naqvi and others. In defense of this approach, which places Islamic economics squarely as a sub-field of economics while replacing some of the "western" assumptions of economic models with their "Islamic" counterparts, Siddiqi (1994) argues, "The craving for a *de novo* discipline of Islamic economics is ill-conceived. No such thing is possible. The key to Islamic economics lies in positioning the Islamic vision in place of the Anglo-Saxon economic vision."

C. The Economics of "Islamic Economics"

The first group of papers discussed above represents a concerted effort to provide a distinct "Islamic political economic" or "multidisciplinary" analysis of economic problems in a "perfect Islamic society" from an "Islamic worldview." The second set provides a contemporary "positive economic analysis," using standard economic tools, of a theoretical "Islamic economy." We now consider a third set of papers (Dar et al. and El-Gamal), which are best described as "an economic analysis of the economic consequences of Islamic jurisprudence as interpreted in 'Islamic economics.'" Both papers are motivated by two facts. First, there is a wide range of financial contracts that are endorsed by Islamic jurists, some equity-based and some debt/liability-based. Second, it is widely believed in Islamic economic circles that among those contracts, the ones that do not provide a fixed rate of return (*mudaraba* and *musharaka*) are in some sense "more Islamic" than those that do (*murabaha*, *ijara*, etc.). Without arguing whether such a preference is warranted, the two papers proceed to analyze the economic consequences of favoring the first set of contracts over the second. Dar et al. find that various agency problems that are exacerbated by firm size make the variable-profitability contracts more viable for smaller firms. El-Gamal finds that in order to compete with fixed-return financial institutions, the use of the less preferred Islamic financial instruments is necessary and sufficient for long-term survival. In a sense, these two papers fit under a category we may call "economic analysis of 'Islamic economics'" since they attempt to quantify the economic losses and gains associated with adopting the models of "Islamic economics."

III. Concluding Remarks

Needless to say, the authors of the papers in this part may not agree with my description of their goals and methods. In fact, if my categorization is correct, I should not expect them to agree with my views. As the field of "Islamic economics" tries to find its place (within economics, social science, Islamic studies, or any other field), not only must we continue to differ in opinion about the nature of the field, but we must also continue to misunderstand each other. Without a common set of maintained hypotheses (beyond our belief in the One God, and acceptance of His Law), we cannot have a unified field of inquiry within which we can agree on what contribution was made by any given written work.

One thing is certain: the speaker in the first session of the Forum was correct about the theories of Islamic economists and their relevance to Islamic finance. As the resources of Muslims continue to pour into the area of Islamic finance, the need for practical contributions from Islamic economics continues to rise. This increased demand can only lead to one of three outcomes. First, we may witness a rebirth of Islamic economics as a well-defined science with testable predictions. Second, Islamic economics may dissolve into economics proper as "the economic study of Islamic law," along the lines of "law and economics." Third, Islamic economics may receive a continued and final rejection from the ranks of social scientific inquiry.

This author is anticipating and hoping for the second outcome to materialize, but it is easy to imagine how other researchers in the area can continue to hope for the first outcome while dismissing signs of the third as anti-Islamic bias by some, and intellectual defeatism by others. My reason for taking the side I chose is quite clear: Islamic sciences prospered within their domain. Despite resistance by those who viewed building on Greek knowledge to be un-Islamic, Muslims managed to make many contributions to scientific inquiry in cooperation and harmony with non-Muslims. In this regard, Islamic economics can perhaps make its greatest contribution if it can contribute to the field of economics an understanding of the economic objectives, costs, and benefits of Islamic law.

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Capital Budgeting and Project Financing in Equity-based Economies

Abdul Aziz and Mahmud Rahman*

ABSTRACT

A framework for determining the required rate of return for project financing in Islamic or equity-based finance is suggested. The *zakat* requirement is used as a proxy for the risk-free rate in the security market line of modern corporate finance. An Islamic version of the security market line is proposed, which facilitates the estimation of required rates of return for project financing using the security market line concepts of modern corporate finance. In equity-based finance, compared to conventional finance, riskier projects are discouraged, while safer projects are encouraged. These results are consistent with the Islamic philosophy of discouraging risk shifting and encouraging risk sharing, the essence of equity-based financing.

I. INTRODUCTION

The prohibition of usury (*riba*) in Islam led to the development of interest-free banking and finance, also known as Islamic finance, or equity-based finance (EBF). Although it is evolving, EBF is widely practiced in many countries. If EBF is a special case of modern corporate finance (MCF), as it arguably is, the practitioners of EBF can benefit from the tools and techniques of MCF. However, some adjustments are called for. EBF must use only instruments approved by *Shari'ah* boards. This prohibits use of any debt instruments. Financing and working capital decisions in EBF must overcome the absence of debt instruments or devise a satisfactory alternative to fully benefit from the advances in MCF. Before the benefits of MCF can be reasonably integrated into EBF, a few fundamental issues must be resolved. One of them is the choice of securities in the absence of debt instruments. Only then can practitioners of EBF proceed with decisions about capital structure, the cost of capital, capital budgeting, and project financing.

II. THE SECURITY MARKET LINE

The security market line (SML) of MCF establishes a risk-return relationship between projects, assuming beta is a reliable measure of risk. The SML connects the yield of a risk-free security to the market return, plotted on the risk domain described by beta. Thus, the SML provides a linear relationship between risk and return:

$$k_j = k_{RF} + (k_M - k_{RF}) \times b_j \qquad (1)$$

where k_j = required return
k_{RF} = risk-free security
k_M = market return
b_j = beta or relative risk of a security j compared to the market

Under EBF, there are no debt securities, let alone a risk-free security (k_{RF}), since governments are not allowed to borrow. Therefore, the SML relationship that MCF describes is impossible in EBF. The SML relationship changes to:

$$k_j = k_M \times b_j \qquad (2)$$

Therefore, without a SML, the required return on projects becomes a risk-multiple of market returns. The resulting required return (hurdle rate) will be much higher in EBF, resulting in a very high rejection rate for even relatively risk-free projects. One solution is to find an equivalent proxy for a risk-free security that is acceptable

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under EBF. The lower hurdle rate that results is more realistic, and will allow more projects in Islamic countries to be accepted.

III. Risk-Free Security

The risk-free security in MCF is defined as a short-term debt instrument with no probability of default. The rate varies among countries, depending on, for instance, the supply and demand of funds and inflation rates. However, the attributes of this money-market instrument include liquidity, safety, and an opportunity cost for idle funds. While invested capital is exempt from *zakat*, income from such investments is not. With that fact in mind, the non-invested or idle wealth, which in Islam is subjected to *zakat*, results in a cash outflow of 2.5%. Putting aside the charitable aspects of *zakat*, the opportunity cost of idle funds is -2.5%. This is a riskless rate, since for idle funds there is neither any uncertainty about this rate, nor are there any exemptions from paying it. *Zakat* is usually paid in the form of liquid or short-term assets, such as cash.

The inflation rate could be a strong contender for a risk-free security in EBF. After all, the risk-free rate in MCF includes the real rate, plus the inflation rate. But because earning a real rate through lending is forbidden, the only alternative is to use the inflation rate to preserve the purchasing power of idle money. However, variable returns indexed to uncontrollable indices are also not allowed in Islam. Therefore, *zakat* seems to be the only viable proxy for the risk-free rate.

IV. The Islamic Security Market Line

Under Islamic finance, one can argue that *zakat* qualifies as a proxy for the risk-free rate by constructing the Islamic security market line (ISML). The ISML relationship can be described as:

$$\begin{aligned} k_j &= -Z + (k_M - (-Z)) \times b_j \\ &= -Z + (k_M + Z) \times b_j \end{aligned} \tag{3}$$

The ISML has several noteworthy attributes:

The intercept is now lower [$(-Z) < k_{RF}$].
The slope is now steeper [$(k_M + Z) > (k_M - k_{RF})$].
There can be a conflict in the ranking of projects under the SML and the ISML, depending on the beta of the projects.

a. when beta = 1,
   SML: $k_j = k_{RF} + (k_M - k_{RF}) \times b_j = k_{RF} + k_M - k_{RF} = k_M$ (4)
   ISML: $k_j = -Z + (k_M + Z) \times b_j = -Z + k_M + Z = k_M$ (5)
   The required return is same under both methods.
b. when beta > 1,
   [SML: $k_j = k_{RF} + (k_M - k_{RF}) \times b_j$] < [ISML: $k_j = -Z + (k_M + Z) \times b_j$] (6)
   The required return under the ISML is greater than that under the SML.
c. when beta < 1,
   [SML: $k_j = k_{RF} + (k_M - k_{RF}) \times b_j$] > [ISML: $k_j = -Z + (k_M + Z) \times b_j$] (7)
   The required return under the ISML is less than that under the SML.

Projects that are riskier than the market have higher hurdle rates under EBF than under MCF (equation 6). Similarly, projects that are less risky than the market have lower hurdle rates under the EBF than under MCF (equation 7).

V. Conclusion

Zakat is a universal rate. Therefore, the use of *zakat* as a proxy for the risk-free rate provides a global model for uniformity, particularly for multinational enterprises. Projects in the many Islamic countries can be more readily evaluated and ranked when the Islamic SML is applied in capital budgeting.

The use of ISML lowers the cost of capital compared to all other equity approaches to the calculation of the cost of capital. This model incorporates the opportunity cost of idle cash. The result is a lower cost of capital, and a higher net present value in project appraisal.

In EBF, compared to MCF, riskier projects are discouraged, as their net present values decline due to higher hurdle rates. Similarly, safer projects have a better chance of being accepted due to their relatively higher net present values as lower hurdle rates are applied. These results are consistent with the Islamic philosophy of discouraging risk shifting and encouraging risk sharing, which is the essence of equity-based financing.

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Monetary Policy and Economic Growth

An Islamic Perspective

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ABSTRACT

The role of monetary policy in determining long-run economic growth from an Islamic perspective is explored. The monetary authority regulates the financial sector to allocate resources and finances its budget through seigniorage and *zakat* revenue. It is shown that, in an environment in which financial institutions use capital-augmented technologies to transform resources into output and private agents maximize intertemporal utility over consumption and money balances, a rise in inflation hampers growth and reduces welfare, while financial innovation (or equivalently financial regulation) promotes growth and improves welfare. Therefore, the injunction against fixed interest payments induces the monetary authority in an Islamic economy to develop and innovate alternative financial instruments that do not have fixed nominal values and do not bear predetermined rates of interest.

I. INTRODUCTION

The Islamic injunction against fixed interest payments implies that most of the conventional monetary policy tools are not available to the monetary authority. Consequently, the framework under which macroeconomic policies can be formulated to create a stable economic environment is yet to be addressed.[1] Meanwhile, many important and tenacious questions remain unanswered. For example, how can the government commit to the optimal rate of inflation? What are the welfare costs of inflation? What are the welfare effects of financial innovation? In addition, what is the impact of fiscal and monetary policy on the rate of growth of the economy?

Since many of these questions are not answered, critics argue that the ban on fixed-return securities will force the government to resort to the inflation tax to finance its deficit. Such a policy is believed to exacerbate high inflation and permit large-scale financial repression. On the other hand, the proponents of the Islamic model argue that the ban on fixed return does not necessarily mean that the monetary authority in an Islamic economy is powerless. In a model exemplifying the principal characteristics of an Islamic financial system, Khan and Mirakhor (1987) concluded that there are no fundamental differences between the conventional and the Islamic economic system in the way monetary policy affects economic variables. The central bank would continue to control the supply of high-powered money and the reserve ratios on different types of liabilities and to exert substantial influence on the financial system. Meanwhile, the model did not address a number of issues. First, it did not examine how monetary policy stimulates economic growth. Second, it did not explain how the budget deficit is financed in the absence of fixed-return securities. Third, the model did not address the role of *zakat* in an Islamic economy.[2]

The purpose of this paper is to examine the impact of monetary policy on long-run growth. The model differs from previous models in many ways. First, no previous study, to the author's knowledge, has investigated the relationship between money and growth in Islamic economics.[3] Second, it addresses the issue of deficit financing in Islamic economics. Third, it analyzes the welfare effects of inflation and financial innovation. Section II contains a general equilibrium model of growth with *zakat* and profit sharing features. The monetary authority intervenes in the financial sector to allocate resources, while financial institutions use capital-augmenting technologies to transform these resources into output. Sections III and IV investigate the welfare effects of financial innovation and inflation respectively. The main result is that given the capital stock, financial innovation improves welfare, while inflation reduces both growth and welfare. Section V concludes the study.

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II. THE MODEL

We begin with an economy inhabited by infinitely lived, identical agents, financial institutions known as banks (firms) and the government (monetary authority). Agents, who are endowed with capital at the beginning of their lives, derive utility from consumption and real money balances, and can hold their savings in terms of deposits or real balances.[4] All deposits in banks are profit- and loss-sharing (PLS) deposits that do not guarantee a fixed return, and the bank does not guarantee their nominal values. Each bank has access to an investment project that requires specialized evaluation and monitoring technology with a large fixed cost. The government issues and distributes high-powered money at the beginning of the period, and usually intervenes in the market to direct monetary policy toward specific goals. Specifically, the monetary authority alters the profit-sharing ratios between banks and their depositors, as well as the reserve ratios on different types of liabilities (see Khan and Mirakhor, 1987). We assume that the marginal utility of money is decreasing in the level of government intervention in the financial markets. Building on Sidrauski (1967), and closely following Roubini and Sala-i-Martin (1992), preferences are modeled over per capita consumption and real balances by:

$$U = \int_0^\infty e^{-(\rho-n)t} u(c_t, m_t) dt \tag{1}$$

where $\rho>0$ is the rate of time preference, and n is the exogenous growth rate of the population. Both consumption and real balances are assumed to be normal goods, so per capita utility function $u(c_t, m_t)$ is strictly concave. To achieve closed-form solutions, we assume utility to be of the following form:

$$u(c_t, m_t) = \alpha \ln c_t + \beta(\theta) \ln m_t \tag{2}$$

where θ, $0<\theta<1$, is a policy variable (e.g., profit-sharing ratios between the financial institution and its depositors) while α and β are elasticities of consumption and money respectively. $\beta'(\theta)<0$, which indicates that higher values for θ reduce the marginal utility of holding money.[5] The government alters θ as a monetary policy tool to allocate resources in the economy. Strict regulation of the financial system will give the monetary authority better control over the money supply. Since the policy variable θ represents government regulatory policy in the financial market, without loss of generality, θ becomes an index of how an individual can be induced to invest (see Persson and Tabellini, 1991).

Individuals are assumed to maximize the lifetime utility function (1) subject to the budget constraint:

$$\frac{\dot{K}}{N} + \frac{\dot{M}}{NP} = (1+r)(1-z)K - c \tag{3}$$

where K is capital (PLS deposits), M is money stock, P is the price level, and N is the total number of persons in the economy. The rate of return per unit of investment r (defined below), is endogenously determined, and z is the rate of *zakat* on capital.[6]

Equation (3) states that per capita saving equals per capita investment plus money accumulation. Note that households can hold either money or capital (deposits at banks and capital are the same) or both. Denoting the per capita asset holding by $x_t = k_t + m_t$, the budget constraint (3) can be rewritten in terms of an asset-accumulation equation of the form:

$$\dot{x}_t = (1+r)(1-z) x_t - n x_t - R_t m_t - c_t \tag{4}$$

where $R_t= (1+r)(1-z)+\pi$ is the nominal rate of return per unit of investment, π is the inflation rate, and the dot denotes the time derivative. The maximization problem is now given by the current value Hamiltonian:

$$H = e^{-(\rho+n)t} [\alpha \ln c + \beta(\theta) \ln m] + \lambda_t [(1+r)(1-z)x - nx - c - Rm] \tag{5}$$

The optimal allocation optimizes (5) at each date t, provided the implicit price λ_t is correctly chosen. Maximizing with respect to c_t and m_t(5) gives the money demand function:

$$m_t{}^d = \frac{\beta(\theta)c_t}{\alpha R_t} \tag{6}$$

The money demand function depends negatively on the nominal rate of return (i.e., the opportunity cost of holding money), and positively on the level of per capita consumption. The accumulation equation (4) and the first order conditions imply that the per capita growth rate of consumption equals

$$\gamma_c = \frac{\dot{c}}{c} = (1+r)(1-z) - \rho \tag{7}$$

The first term in the right-hand side of (7) is the after-*zakat* (real) rate of return of investment, while the second term is the rate of time preference. Given z and assuming certain parameter value to ρ, θ can be chosen such that γ_c will be positive, indicating that sustained per capita growth is feasible. Equation (7) also reveals an important result of the endogenous growth model. The long-run growth rate is determined by the saving and investment decisions of private agents, or equivalently, by factors that influence saving and investment. These include the rate of return on investment (or equivalently, the profit sharing ratio θ) and the *zakat* rate. The rate of growth of the money supply is then defined as:

$$\gamma_m = \frac{\dot{m}}{m} = (1+r)(1-z) - \rho - \frac{\dot{R}}{R} = \gamma_c - \gamma_R \tag{8}$$

Equation (8) indicates that the growth rate of consumption is equal to the growth rate of the money stock plus the growth rate of profits, i.e., $\gamma_c = \gamma_m + \gamma_R$. In general, r is variable and so is Π^*, the level of profit in the economy. However, competition between firms and government control over θ will tend to equalize profits and rates of return across firms. Only then would the nominal rate of return be constant. A necessary condition for balanced growth is that the growth rates of consumption and money equal a common rate, i.e., $\gamma_c = \gamma_m = \gamma$ (no transitional dynamics).

A. The Firm

To further analyze production and growth in this context, banks are now brought into the model. Banks operate production technologies that are linear in a broad measure of capital, i.e., include physical and human capital (see Barro, 1989). As in Ireland (1994), there may be decreasing returns in either type of capital when applied separately, but there are constant returns in both when applied together. To achieve tractability, we assume that the following process governs production:

$$Y = F(\phi(\theta), K) = \phi(\theta)K \tag{9}$$

where y is the per capita level of output and $\phi(\theta)$ is an intermediation technology (or the state of knowledge).[7] The intermediation technology is increasing in the profit-sharing ratio, i.e., $\phi^{/}(\theta)>0$. The linearity of the production function in (9) is rationalized by the fact that K_t is regarded as a composite of human and physical capital. Under such conditions, a constant rate of investment can result in an ever-growing capital stock, and thus steady-state growth. Any policy that raises saving would be sufficient to raise the rate of growth. This certainly rationalizes government intervention in the production process to raise the marginal product of private capital. I assume here that government actions will only influence private production and enhance property rights (i.e., enforce the Islamic laws of contracts).

Alternatively, higher profit-sharing ratios offered to the customers (depositors) will enable banks to mobilize more funds. The more funds they mobilize, the more they invest in R&D and the more intermediation knowledge and techniques they acquire. If this learning process spills over into the economy, banks will be able to collect and analyze information that will allow investors' resources to flow to their most profitable uses. The high incomes generated through risk pooling and efficient resource allocation will feedback and promote economic growth. In an equilibrium with active R&D activity, the expected rate of return for R&D must reflect the opportunity cost of capital [see Grossman and Helpman (1990)]. If we assume the rate of depreciation of capital is zero, then profit maximization will yield the usual condition equating marginal productivity with the rate of return on capital:

$$1+r = \phi(\theta) \tag{10}$$

Substituting equation (11) in equation (8) gives:

$$\gamma_c = \phi(\theta)(1-z)-\rho \tag{11}$$

Equation (11) implies the superneutrality result derived by Sidrauski (1967). Furthermore, equation (11) shows the direct influence of the policy variable θ on the growht rate of the economy. That is, a higher sharing ratio fixed by the monetary authority will boost growth. Equivalently, an improvement in the level of financial innovation, which raises the average and marginal productivity of capital, also raises the growth rate of the economy.

B. The Monetary Authority

In order to complete the model, we assume that the government controls the supply of high-powered money by setting the nominal growth rate of the money supply $\frac{\dot{M}}{M} = \mu$, and follows a time-consistent monetary policy that prevents jumps in the price level.

The government relies on two revenue sources to finance its expenditures: seigniorage and *zakat* revenue. The consolidated government budget constraint is $g_t = \frac{\dot{M}}{P} + Z$, where $\frac{\dot{M}}{P}$ is the revenue from seigniorage and $Z = (1+r)zk$ are the proceeds from *zakat*. Since the issue of interest-bearing securities is not allowed, and no transfers are assumed, the government's budget constraint can be rewritten as:

$$g_t = \dot{m} + m(\Pi + n) + (1+r)zk \tag{12}$$

Rearranging and using the agent's budget constraint (4) and the government's budget equation (12), the equation for capital accumulation can be written as:

$$\dot{k} = (\phi(\theta) - n)k - c - g \tag{13}$$

Since we are assuming that there is no depreciation, breakeven investment is nk and actual investment is $\phi(\theta)k-c-g$. That is, the capital stock accumulates as the difference between net per capita real output and private and public consumption gets larger (i.e., the larger the saving). Given the government budget constraint (12), equation (13) shows that the rate of capital accumulation varies with the rate of inflation. Specifically, it shows that inflation would slow the rate of capital accumulation. Using the nominal growth rate of the money supply $\mu = \frac{\dot{M}}{M}$, and substituting for the per capita demand for real balances, the government budget equation becomes:

$$g_t = \frac{\beta(\theta)c_t}{\alpha R_t}\mu + \phi(\theta)z k_t \tag{14}$$

Substituting (7) into (14) reduces the budget equation to $g_t = m_t\mu + \phi(\theta)zk_t$. The first term in the right-hand side of (14) shows the amount of seigniorage that the government can collect from its inflation tax, which equals the consumer's cost of holding money. The second term in (14) is the proceeds from imposing *zakat* on output. The results further show that by adhering to the optimum quantity of money rule, the government can raise the revenue it requires at a lower tax rate. When the government adopts the optimum quantity of money rule, it can satisfy its budget constraint with any combination of monetary and fiscal policies. This is possible if θ is chosen such that the expected revenue is equal to the expected expenditure.[8] However, given the marginal utility of holding money, any government action to increase θ would decrease the demand for real balances and reduce the revenue collected from the inflation tax. On the other hand, since the revenue generated from *zakat* is increasing in income, any government action to reduce θ (i.e. the profit-sharing ratios) would decrease output and, hence, the *zakat* revenue. Thus, a tradeoff exists between the welfare cost of inflation and the welfare cost that can be ascribed to decreasing income. To balance these two effects, the monetary authority should adjust its instrument to control the amount of revenue generated from both sources.

III. The Welfare Effects of Financial Innovation

This section analyzes the welfare effects of varying θ on consumption, money demand, and government spending at the steady state equilibrium. As shown by De Gregorio (1991), there are multiple equilibrium paths for such an economy, but the only (bubbleless) equilibrium is where $\dot{k} = 0$. Then for a given k, the steady-state level of consumption is given by:

$$c = (\phi(\theta) - n)k - g \tag{15}$$

Thus equations (7), (14), and (15) will characterize the steady state general equilibrium. In particular, the goods market equilibrium requires c +g = y-nk, where nk is the amount of capital needed for the new generation. The asset market equilibrium has already been implicitly assumed in the preceding discussion. Since the economy is always in the steady state and both c and m enter the utility function, we need to analyze the effects of θ on both consumption and real balances in order to understand how θ effects welfare.

Proposition 1. For a given level of capital stock and inflation, the welfare effect on consumption of increasing θ is positive.

Proof: see Appendix A.

That is, other things being equal, an increase in θ will increase welfare. The effects of increasing θ on money demand are apparent from the following equation:

$$\frac{\partial m}{\partial \theta} = \frac{1}{(1 + \frac{\mu\beta}{\alpha R})}[(\frac{\beta' m}{\beta} - (1 - z)\mu\phi' \frac{m}{R} + \frac{\beta}{\alpha R}(1 - z)\phi' k] \tag{16}$$

The first two terms in square brackets on the right-hand side of (16) are negative while the third term is positive, indicating the ambiguous effect of θ on money demand.

Proposition 2. For a given level of consumption c, increases in θ reduce the demand for real balances.

Proof: Straightforward from Appendix A.

The intuition here is that an increase in θ is interpreted as financial innovation, which allows people to require lower money balances to carry the same amount of transactions.

Proposition 3. Given the steady state levels of consumption and capital stock, increasing θ has an ambiguous effect on g.

Proof. Assuming a given k, then from equation (14) we have:

$$\frac{\partial g}{\partial \theta} = \mu \frac{\partial m}{\partial \theta} + \phi'(\theta) zk \tag{17}$$

Given c, the first term on the right-hand side of (17) reduces to $\mu[(\beta^{/}/\beta)m-(1-z)\phi^{/}m/R]<0$. Since $\phi^{/}(\theta)>0$, the second term is positive. The overall effect of θ on g depends on whether the decline on seigniorage dominates the increase in *zakat* revenue. A government that prefers levying an inflation tax (to finance its deficit) will increase the per capita demand for money by reducing θ, thus reducing the incentives to invest (i.e., hold a PLS deposit). Such behavior will certainly reduce the level of output and hence hampers growth. Moreover, since the economy will grow at a lower rate, both the revenue from *zakat* and the revenue from money creation will decline. By contrast, a forward-looking government will increase θ to mobilize more resources and increase the level of income. By doing so, it can lure the non-productive resources to the financial system and promote growth. In short, one would say that a government that prefers to collect an inflation tax to finance its deficit would tend to reduce the profit-sharing ratio, and hence depress the incentives to hold PLS deposits. Financial institutions would then spend less on R&D activities and become less innovative in attracting and disposing of funds. Since holding money is a close substitute for holding PLS deposits, the per capita demand for money increases. Such behavior will be inflationary and eventually hampers growth.

IV. THE WELFARE EFFECTS OF INFLATION

To investigate the welfare costs of inflation, we first need to characterize the effect of inflation on the policy variable θ. Note that the steady state equation (6) can be rewritten as a function of θ and π. Specifically $\beta(\theta)c/\alpha m = R^*$, where R* is the optimal rate defined above.

Proposition 4. *For a given nominal rate of return R, an increase in the rate of inflation reduces θ.*

Proof. Rewriting the steady-state equation (6) and differentiating with respect to π we get:

$$\frac{d\theta}{d\Pi}=\frac{1}{\dfrac{\beta^{/}}{\beta}R^{*}-\phi^{/}(\theta)(1-z)} \tag{18}$$

The right-hand side of (22) is negative (since $\beta^{/}<0$ and $\phi^{/}>0$). This result indicates that inflation is harmful to innovation and/or to government regulation since it adversely affects θ.

The next step is to use this result to investigate the effects of inflation on consumption, money demand, government spending, and growth. To do this, we use equilibrium equation (6) and the following propositions:

Proposition 5. (*i) For a given capital stock, inflation affects consumption negatively.*
(ii) For a given capital stock, increases in the rate of inflation affect money demand negatively.

Proof: See Appendix B.

The utility function u(c, m) can now be used to show how higher rates of inflation reduce consumers' welfare. To see this, note that $\frac{\partial u}{\partial\Pi}=u_c\frac{\partial c}{\partial\Pi}+u_m\frac{\partial m}{\partial\Pi}<0$, and $\frac{\partial m}{\partial\Pi}<0$.

Proposition 6. *Given the levels of consumption, real money balances, and capital stock, higher inflation rates reduce growth*.

Proof. Differentiating equation (11) with respect to π to get

$$\frac{\partial\gamma}{\partial\Pi}=\phi^{/}(1-z)\frac{d\theta}{d\Pi} \tag{19}$$

Using equation (18) and $\phi^{/}(\theta)>0$ proves the result.

This result shows the traditional tradeoff between inflation and output growth. More specifically, policy measures that are set to finance government spending by seigniorage may end up hampering growth. Countries that use seigniorage to finance their deficits have the difficult job of targeting output growth and financing government spending (using an inflation tax) at the same time.

V. CONCLUSION

The model presented above demonstrates that the injunction against fixed interest payments induces the monetary authority in an Islamic economy to develop and innovate alternative financial instruments that do not have fixed nominal values and do not bear predetermined rates of interest.[9] The model also proves that financial innovation is welfare enhancing, while inflation reduces welfare and hampers growth. The model further proves that the government in an Islamic economy can effectively implement fiscal policy using *zakat*. The fact that the *zakat* rate is fixed reduces the distortion created by variations in the tax rate.[10] Revenues from *zakat* and from money creation can be used to finance public sector programs and/or to finance the budget deficit. To boost growth, monetary and fiscal policies should be closely coordinated.

APPENDIX A. PROOF OF PROPOSITION 1

Differentiating equations (15), (14), and (6) with respect to θ:

$$\frac{\partial c}{\partial \theta} = \phi\_(\theta)k + (\phi(\theta) - n)\frac{\partial k}{\partial \theta} - \frac{\partial g}{\partial \theta} \tag{A1}$$

$$\frac{\partial g}{\partial \theta} = \mu \frac{\partial m}{\partial \theta} + \phi\_(\theta)zk + \phi(\theta)z\frac{\partial k}{\partial \theta} \tag{A2}$$

$$\frac{\partial m}{\partial \theta} = \frac{\beta\_(\theta)}{\beta} m + \frac{\beta(\theta)}{\alpha R}\frac{\partial c}{\partial \theta} - \frac{\beta c}{\alpha R^{*2}}\frac{\partial R^*}{\partial \theta} \tag{A3}$$

where R* = ϕ(θ)(1-z)+π is the optimal nominal rate of return per unit of investment. If we assume the government will choose θ to determine the optimal demand for real balances, equation (A3) can be rewritten as:

$$\frac{\partial m}{\partial \theta}\frac{\theta}{m} = \frac{\theta}{m}[\frac{\beta\_}{\beta} m + \frac{m}{c}\frac{\partial c}{\partial \theta} - m\,OVERR^{*}\frac{\partial R^*}{\partial \theta}] \tag{A3$^{/}$}$$

The expression in (A3$^{/}$) reduces to $\eta_{m\theta}=\eta_{\beta\theta}+\eta_{c\theta}-\eta_{R^*\theta}$, which are gross elasticities that take into account the total effect of changing θ on the demand for real balances.

Substitute (A1) and (A2) in (A3) to get:

$$\frac{\partial c}{\partial \theta} = (\frac{1}{1+\frac{\mu\beta}{\alpha R}})[(1-z)\phi^{/}k + \frac{(1-z)\mu\phi^{/}m}{R} - \frac{\beta^{/}(\theta)m}{\beta}] \tag{A4}$$

Given the assumptions on the marginal productivity of capital and the marginal utility of holding money, the right-hand side of (A4) indicates the positive externalities of increasing θ.

APPENDIX B. PROOF OF PROPOSITION 5

(i) Differentiating the steady-state equations (6), (14), and (15) and using the envelope theorem:

$$\frac{\partial c}{\partial \Pi} = (\frac{1}{1+\mu\beta/\alpha R})[(\phi^{/} k(1-z) - \mu\beta^{/} m/\beta) + \mu\phi^{/}(1-z)\frac{m}{R}]\frac{d\theta}{d\Pi} \qquad \text{(B1)}$$

Using equation (18) and the fact that $(\mu\beta^{/}m/\beta)<0$ proves the result. The model also predicts an inverse relationship between inflation and output, as can be seen from the production function (9) and equation (18).

(ii) Differentiating (6) with respect to π we get:

$$\frac{\partial m}{\partial \Pi} = [\frac{\beta^{/} c}{\alpha m}\frac{m}{R} - \phi^{/}(1-z)\frac{m}{R}]\frac{d\theta}{d\Pi} + \frac{\beta}{\alpha R}\frac{\partial c}{\partial \Pi} - \frac{m}{R} \qquad \text{(B2)}$$

Given equation (22), the first term in equation (B2) (in the square brackets) cancels out with the third term. Applying equation (B1) proves the negative effects of inflation on the demand for real balances.

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[1] See the Proceedings of "Policies for Long-run Economic Growth," *A Symposium sponsored by The Federal Reserve Bank of Kansas City*, Jackson Hole, WY, 1992.

[2] *Zakat* is a 2.5% annual wealth tax paid on non-working capital, profits, saving, and all types of wealth in excess of an exempt minimum known as *nisab*. Although *zakat* is supposed to be given to a designated group in the society, it can also be spent in public programs.

[3] See M. Arif (1982), *Monetary and Fiscal Economics of Islam*, and the papers cited there.

[4] Real balances enter the utility function because money reduces transaction costs.

[5] If θ is interpreted as reserve ratio against bank deposits, then $\beta^{/}(\theta)>0$.

[6] The rate of return per unit invested is calculated using the formula $r = \theta(F(K^*)-K^*)/K^* = \theta\Pi^*/K^*$, where K^* is the optimal level of investment, and $\Pi^* = F(K^*)-K^*$ is the optimal profit at that level of investment.

[7] The knowledge here is about financial intermediation techniques, which accumulates as a by-product of government intervention to correct market imperfections (effective enforcement of contractual agreements), or by private firms investing on R&D to introduce new mechanisms to raise and disperse funds, (see Grossman and Helpman, 1990, Romer, 1990).

[8] The budget deficit is equal to the difference between real government expenditures and real *zakat* revenue at time t.

[9] The monetary policy tools available to the monetary authority in an Islamic economy include the reserve ratio against bank deposits, and the profit-sharing ratios between banks and their depositors and/or borrowers (Khan and Mirakhor, 1987).

Variations in these rates will enable the monetary authority to control the amount of funds channeled into the investment process. The central bank in an Islamic economy can also issue and regulate high-powered money.

[10] King and Rebelo (1990) showed that, raising income tax rate from 20% to 30% results in welfare loss in excess of 60% of consumption.

Islam and Economic Development

A Discussion within the Framework of Ibn Khaldun's Philosophy of History

M. Umer Chapra[*]

ABSTRACT

Islamic finance is closely related to Islam's vision of economic development, which gives primary importance to the realization of socioeconomic justice and the well being (*falah*) of all humans. Although one can quote at length from the Qur'an and the *Sunna* to indicate the kind of well being that Islam envisions, it is useful to explore why the Muslim world is unable to realize the Islamic vision now when it could in earlier centuries. A helpful model to guide analysis is Ibn Khaldun's, for it offers a dynamic, multifaceted, and Islamic perspective on human society. Though the Muslim world has languished into poverty and drifted away from democracy and accountability, the future prospects for realizing the Islamic vision of economic development seem bright.

I. INTRODUCTION

The subject of Islam and economic development raises a number of questions, one of which is about the relevance of the subject to a discussion forum on Islamic finance. This question is not difficult to answer because finance and development are very closely interrelated. Finance is not an end in itself: it is one of the essential means to development, which in turn leads to a rise in financial resources for accelerating development. The juxtaposition of Islam and economic development in the title also raises some other questions. One of these is whether Islam is an asset or a liability for development and whether Islam and development can coexist without hurting each other. If Islam is capable of promoting development, then the second and third questions are about the kind of development that Islam visualizes, and the reasons for the failure of Muslim countries to realize development of this kind.

The first question, about Islam's being an asset or a liability for development, acquires importance only because Western news media try to paint an unsavory image of Islam. Nevertheless, I will not try to answer this question because most scholars of Islamic history agree that Islam played a positive role in the development of the Arab bedouin society and transformed it to such a remarkable extent that it not only overcame its own handicaps but also brought about a revolutionary change in the societies that came under its influence.[1] Consequently, the Muslim lands became the most advanced parts of the world at that time and enjoyed supremacy in the world of science and technology for almost four centuries, from the middle of eighth to the middle of twelfth centuries. Even after the loss of their leadership, they continued to make valuable contributions for at least two more centuries.[2] There is no reason to assume that Islam is not capable of bringing about once again a revolutionary change in the Muslim world to help its inhabitants accelerate development.

The second question about the kind of development that Islam visualizes is very closely related to the vision of Islam. Every society has a vision, and Islam is no exception.[3] Its vision gives primary importance to the realization of socioeconomic justice and the well being (*falah*) of all humans. Why? They are all vicegerents (*khalifat*) of God and brothers unto each other. Islam also places a balanced emphasis on the material and the spiritual aspects of life, in step with some other major religions and in sharp contrast to the materialist worldview that dominates conventional economic philosophy. While economic development is indispensable, it is not sufficient to realize human well being. It is also necessary to have mental peace and inner happiness of the individual, human dignity, brotherhood and socioeconomic justice, family and social harmony, and minimization of crime and anomie. All religious worldviews emphasize that these can be better achieved if a spiritual dimension is injected into human life. Any society in which wealth and consumption have been maximized but where there is poverty amidst plenty, where people do not have mental peace and satisfaction, where families are disintegrating, and where crime and hopelessness are rising, cannot be said to have attained well being in the true sense of the term.

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II. WHY IBN KHALDUN?

I can quote at length from the Qur'an and the *Sunna* to indicate the kind of well being that Islam desires. However, the limited time at my disposal does not allow me to do so. I will, therefore, concentrate on answering the third question of why the Muslim world is unable to realize the Islamic vision now when it was able to do so in earlier centuries. Why are Muslim countries faced with excruciating poverty alongside affluence, a state of affairs that corrodes the fabric of brotherhood and social solidarity and serves as one of the prime causes of crime, social unrest, and political instability? Why are they also beset with macroeconomic imbalances and a rising debt-service burden? Why is there as much crime and anomie in Muslim countries as in the rest of the world? The failing on the part of Muslim countries is all the more serious because of Islam's uncompromising emphasis on human dignity, brotherhood, and socioeconomic justice, which will remain empty slogans as long as all the essential elements of well being are not ensured for all members of society.

A number of efforts have been made by scholars to explain the rise and fall of a society or civilization. These include those of Ibn Khaldun (d. 1406) and Gibbon (d. 1794) in the past, and those of Spengler (1947), Schweitzer (1949), Sorokin (1951), Toynbee (1935), North (1973 and 1990), Kennedy (1987), and several others in modern times. While all of these scholars provide valuable insights into the rise and fall of civilizations, I intend to utilize the model that Ibn Khaldun presented in his *Muqaddima*, which is the first or introductory volume of his seven volume history called *Kitab al-'Ibar*, or the *Book of Lessons [of History]*.[4] Even though I will modify his model to some extent to reflect the change in historical circumstances, one may still wonder why I prefer the model of a person who lived 600 years ago when more recent models are also available.

There are a number of reasons for this preference. First, his model is directly related to Muslim society, which was in a process of decline during Ibn Khaldun's own lifetime. The Abbasid caliphate had ended after the pillage, burning, and near-destruction of Baghdad and the surrounding areas by the Mongols in 656 A.H./1258 C.E., around three-fourths of a century before Ibn Khaldun was born in 732 A.H./1332 C.E. In addition, the Circassian Mamluks (784-922 A.H./1382-1517 C.E.), during whose reign Ibn Khaldun spent the last one-third of his life, were corrupt and inefficient and were following policies that could not but accelerate the decline.

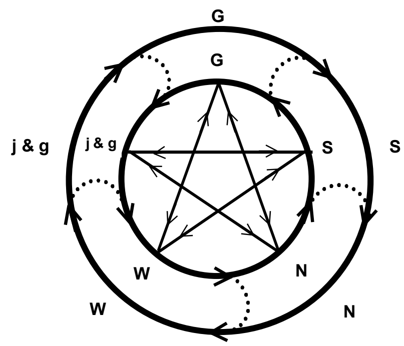
Second, his model is multidisciplinary and dynamic. It is multidisciplinary because it does not attribute the development and decline of a society to a single cause, but rather to a number of factors, including moral, psychological, political, social, demographic, and historical ones. Together they determine the quality of the individuals, the families, the society, the market, and the government, and thereby influence the overall performance of a dynasty or civilization. Even though only one of the crucial factors may serve as the trigger mechanism, other factors tend to be affected over time. Accordingly, it is not possible to talk of just economic decline within the framework of this model. When a society starts decaying, it decays in practically everything: economic decline becomes a part of the overall deterioration. This creates the effect of circular causation. The model is also dynamic because Ibn Khaldun takes into account three generations, stretching over a period of 120 years. However, he was talking of a dynasty, while we are talking of a civilization and the period involved may therefore be much longer. Over such a long period of time, none of the variables remains constant. Every variable affects every other, and in turn do they influence itself, until it becomes difficult to distinguish cause from effect.[5]

III. DEVELOPMENT AND DECLINE IN IBN KHALDUN'S MODEL

The centerpiece of Ibn Khaldun's analysis is the human being himself (N). He or she is the end and means of development. He is the end because it is his well being that is desired. He or she will not be efficient or creative until it is ensured. Societies in which the common man is unable to reap the fruits of his hard labor are not likely to grow rapidly. The human being is also the means because nothing can work effectively until he is right. He is the input of the market, the government, the family, and the society. The market and the government may not operate efficiently and equitably, the family may disintegrate, and the society may be soulless and uncaring if the human input of all these institutions and organizations does not have the moral and mental qualities needed for their successful operation. If the human being is not right, the market may not serve the social interest, the government may be corrupt, ineffective, and unjust, husbands and wives may not be able to get along with each other, families may fall apart, children may not get the needed care and upbringing, and the society may be unable to secrete the glue of mutual care and cooperation necessary for social solidarity and all-round development.

FIGURE 1. IBN KHALDUN'S MODEL OF SOCIOECONOMIC AND POLITICAL DYNAMICS

(Circular Causation in the Development and Decline of Societies)



G	=	Political authority
S	=	*Shari'ah* (values and institutions or rules of behavior)
N	=	People (individuals, families, groups, and society)
W	=	Wealth (the economy)
j	=	Justice
g	=	Development (not just economic but overall)

This is perhaps the main reason all the prophets of God concentrated on the reform of human beings (N) and the institutions (S, G, and W) that affect them. They struggled hard for their education and socioeconomic uplift. This is the reason the Qur'an says: "God does not change the condition of a people until they change their own inner selves" (Qur'an, 13:11; see also 8:53). If human beings are reformed in a way that makes them willing and able to render their best in service of their own interests as well as those of their society and mankind, then the market, the government, the family, and the society may all tend to operate effectively in a way that leads to the well being of all.

All the other variables in Ibn Khaldun's model (G, S, W, g, and j) affect human beings (N) and determine their willingness and ability to do their best for themselves and their society. The two factors that affect them most are development (g) and justice (j). These two elements affect the well being of all. If there is no development (g), then there may be paucity of the resources needed for well being and to render justice to all. Moreover, a society does not generally remain stagnant: it moves either forward or backward. That is why Iqbal, the poet-philosopher of the Indo-Pak sub-continent, says, "I am, as long as I move. Not moving, I am not."[6] This is truer of societies than of individuals. The development (g) referred to here is not just economic development but all-encompassing development, which incorporates all aspects of society, including moral, institutional, intellectual, social, economic, and political. If even one of them lags behind, it may affect the quality of the human being (N) and thus retard development in the future.

While development (g) is important, justice (j) is indispensable. It induces people to work hard and be conscientious, honest, and creative. It also promotes cooperation and social solidarity, and reduces socially harmful behavior. Human societies cannot function effectively and develop without justice. Absence of justice may weaken the effective operation of incentives and deterrents, lead to discontent, crime, anomie, social unrest, and ultimately to a decline in development. However, when we talk of justice, we have to take it in a broad sense. Fulfillment of promises, obligations, and contracts is as much a part of justice as is giving everyone his or her dues. A society in which contracts are not fulfilled and people are unable to get their rights may accentuate uncertainties and hurt incentives for people to do their best. Moreover, all sectors of society must receive their rights, whether they are rich or poor, white or colored, male or female, adults or children, powerful or ordinary.

This is perhaps why the Qur'an makes the establishment of justice the primary reason for which God sent His prophets to mankind (Qur'an, 57:25). It also says that a society that perpetuates injustice ultimately gets destroyed (Qur'an, 20:111). The Prophet Muhammad, may the peace and blessings of God be on him, equated injustice with absolute darkness because the greater the injustice in a society, the greater may be the discontent and the lesser the development.

This stress on justice in the Qur'an and the *Sunna* has been reflected in the writings of almost all prominent scholars in Muslim history, including Abu Yusuf (d. 182 A.H./798 C.E.), al-Mawardi (d. 450 A.H./1058 C.E.), Ibn Taymiyyah (d. 728 A.H./1328 C.E.), and Ibn Khaldun (d. 808 A.H./1406 C.E.). Ibn Taymiyyah considers justice an essential outcome of *tawhid* (belief in One God).[7] To him, justice is a wide concept. "Everything good is a component of justice and everything bad is a component of injustice and oppression. Hence, justice toward everything and everyone is an imperative for everyone and injustice is prohibited to everything and everyone. Injustice is absolutely not permissible irrespective of whether it is to a Muslim or a non-Muslim, or even to an unjust person."[8] Accordingly, he zealously upheld the adage prevailing in his times: "God sustains a just society even if it is not Muslim, but does not sustain an unjust society even if it is Muslim."[9]

Ibn Khaldun reflects the same philosophy when he states unequivocally that it is impossible for a country to develop without justice,[10] something that has now been belatedly recognized by the pundits of development economics after a long flirtation with injustice.[11] He goes to the extent of emphasizing that "oppression brings an end to development"[12] and that a "decline in prosperity is the necessary and inevitable result of injustice and transgression."[13] He elaborates that "oppression does not consist merely in taking away wealth and property from its owner without cause or compensation. It has rather a wider connotation. Anyone who seizes the property of others, forces them to work for him against their will, makes unjust claims on them, or imposes on them burdens not sanctioned by the *Shari'ah* is an oppressor."[14] He also emphasizes that "confiscation of people's pecuniary reward reduces the incentive for earning and acquisition" and that "a loss of incentive leads to abstinence from effort and enterprise."[15] These ideas permeate the thinking of practically all classical Islamic writers.

Justice (j) is, therefore, the most important criterion for judging the degree of Islamization of a Muslim society. Justice, however, cannot be realized without certain rules of behavior or values and institutions (S). Every society has these rules of behavior. In a Muslim society, the *Shari'ah* serves as the basis for them. These rules of behavior in general require people to fulfil their obligations toward each other and abstain from harming others.

The rules of behavior (S) are, however, meaningless if they are not enforced. Some people may act upon them on their own volition, but others may violate them. If the violators are able to get away unscathed, the circle of such people may gradually expand and the violation of laws may become a part of the social mood through path dependence and self-reinforcing mechanisms. Incentives and deterrents are what help their enforcement. A balanced religious worldview, such as that of Islam, emphasizes the role of both material and moral incentives to encourage the right behavior and discourage the wrong. The moral factor is indispensable because it induces people (N) to abide by the rules of behavior (S) on their own volition and thereby reduces the costs of enforcement.

In Ibn Khaldun's model, it is the job of the government (G) to ensure the enforcement of the rules of behavior and the effective operation of incentives and deterrents. The rules or the *Shari'ah* must be reflected in the laws and constitution of a country. The government must also establish effective machinery to detect violators and impartial judicial and police machinery to punish them promptly. If the rules of behavior are not implemented, then the *Shari'ah* (S) cannot be effective. That is why the Prophet, may the peace and blessings of God be upon him, said, "God restrains through the sultan what He does not restrain through the Qur'an." The Qur'an can only give the rules: be honest, fulfil contracts, do not cheat, do not be unjust, do not hurt others. It cannot by itself enforce them. The government (G) has to do so, and if it does not perform this task fairly and impartially, then it will impair the realization of both justice (j) and development (g).

This raises the question of when a government (G) enforces the *Shari'ah* (S). This happens best when it (G) is accountable before the people (N), and they are able not only to participate in decision-making but also to elect and remove important functionaries of the government. If this is not ensured, then government functionaries may be able to get away with corruption, inefficiencies, and inequities. This may give rise to an ineffective use of scarce resources. This is where Muslims have lagged behind. One of the major causes of their problems is the existence of illegitimate governments, unaccountable to the people. It is impossible for the people to question or check them.

Islam laid down a democratic structure for the government (G) in the form of *khilafah* and *shura*. This was, however, too radical a reform for the bedouin society of the early days of Islam. After the undoing of the *khilafah* by Mu'awiyah in 41 A.H./661 C.E. and the hereditary succession of his son, Yazid, to the caliphate in 60

A.H./679 C.E., Muslim societies moved more and more toward greater authoritarianism and away from the political accountability that Islam stands for. There were a number of efforts to undo the illegitimacy and to restore the system of *khilafah* and *shura*, but they did not succeed. As a result, most Muslim countries today have undemocratic governments controlled by powerful landholding families, armed forces, and bureaucracies. There is little freedom of expression, and the judicial system is not truly free from political pressures. The Western world needs to be complemented for having established effective democracy to ensure accountability of political authority.

The absence of democracy has led to a misuse of public resources for the private benefit of the rich and the powerful. Inadequate amounts are hence available for moral and technical education, health, infrastructure construction, expansion of employment opportunities, and the general well being of the people (N). While moral education has to some extent continued to be provided through *madrasas*, mosques, families, and reform movements, technical education, which was supported in earlier centuries by governments, has suffered considerably because a substantial proportion of resources are absorbed by defense, corruption, unproductive spending, and debt servicing.

This brings us to what may stand not just for wealth but for the economy as a whole. The market system is one of the best ways of effectively utilizing the resources of society. Throughout Muslim history, markets operated to a great extent within the disciplinary framework of the *Shari'ah* (S). Ibn Khaldun and many other scholars opposed government ownership and running of businesses.[16] Nationalization of industries and businesses, therefore, is a concept alien to Islam. However, a number of Muslim countries, including Algeria, Syria, Iraq, Egypt, and Pakistan, resorted to it under the influence of socialism. This policy has brought nothing but tears to the Muslim world. Fortunately, political illegitimacy and socialism are both losing ground among Muslims. It may be hoped that the emergence of true democracy, along with land reforms, a free press, a strong and independent judiciary, and the growth of effective and impartial institutions for detecting and punishing corruption and inefficiency, will promote the use of public resources for the development of the economy and the well being of the people.

IV. The Financial System

The financial system, which is an integral part of the economy and the main theme of the Harvard Forum, has an important role to play in the mobilization and efficient and equitable use of an economy's resources for furthering development (g) with justice (j). Unfortunately, this is not yet taking place in the Muslim world. One of the defects of the conventional financial system is that it promotes living beyond means by both the public and private sectors. Combined with political corruption, loans are extended to political favorites without proper scrutiny of the projects or the projected cash flow, and often without adequate collateral.

Pakistan is a clear example of this. Its government has been borrowing excessively in domestic as well as external financial markets. Consequently, 46% of total government spending were absorbed by debt servicing in the 1998/99 budget. Since another 24% were allocated to defense, only 30% remained for all other purposes.[17] Given that at least half of this balance was used to meet administrative expenses, the remaining half is absolutely inadequate for supporting education, health, infrastructure, and other nation-building activities. This leads to a low-level development equilibrium, hurts the poor people, and accentuates social and political unrest. If Pakistani governments had been serious in their commitment to Islam, and in particular to the prohibition of interest, they would have tried to reduce their budget deficits by streamlining the tax system and curbing corruption and unproductive spending. A reasonable amount of financing needed for productive investment and other essential expenditures could also have been raised, without significant difficulty, through Islamically permissible modes of financing. This would have helped reduce the resort to inflationary financing as well as excessive interest-based debt, which has now become a burden.

Moreover, reform of the banking system to remove corruption and promote development as well as socioeconomic justice does not seem to have received significant attention. The result is a highly inequitable financial system. In 1994, 56% of the resources that 28 million depositors provided to the banking system were lent out to a little over 4,000 privileged borrowers.[18] This is certainly not going to help promote an equitable distribution of income and wealth, which is an imperative within the framework of the *Shari'ah* (S). The inequity will also slow down development and worsen social unrest, particularly if the resources provided to the rich and the powerful are not used productively. This tends to happen in a corrupt political system in which loans extended by nationalized banks to influential people are often written off, meaning that there is little compulsion for their productive use.

V. Conclusion

Unless all the factors incorporated in Ibn Khaldun's multidisciplinary, circular causation model function effectively to make their potential contribution, it may be difficult for any society to attain and sustain economic development, let alone realize the Islamic vision. Fortunately for the Muslim world, future prospects seem bright. All Muslim nations have gained independence from foreign domination after having been colonized in the 18th and 19th centuries. Progress in the democratization of these countries is steadily gaining momentum. The revival of Islam is taking place and people are becoming more educated about Islamic values, thereby raising the hope that their future behavior will conform to Islamic norms. Technical education is also becoming more and more accessible. This should help raise the productivity and income of the poor. Female education is spreading, and their participation in the affairs of their societies is steadily rising: both are in step with Islamic teachings. *Fiqh*, which had become stagnant over the last several hundred years and was, therefore, responsible for blunting the dynamism of the *Shari'ah*, has now started to respond to the challenges faced by the *umma* by gradually becoming more liberal and realistic. Democracy will force political parties to moderate their views to make themselves acceptable to broader sectors of the population. In other words, all indicators point toward the reversal of the cycle of circular causation, from the negative to the positive direction. This should help ensure justice and social harmony, and promote spiritual as well as material development, of Muslim societies in the future.

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[1] See, for example, Toynbee (1957), Hittle (1958), Hodgson (1977), Baeck (1994), and Lewis (1995).

[2] See Sarton, 1927ff; and Sezgin, 1983ff.

[3] The Qur'an says "Every nation has a direction [or vision] toward which it turns; you therefore try to excel in everything that is good" (al-Qur'an, 2: 148)

[4] The full name of the book (given in the References) may be freely translated as "The Book of Lessons [derived from] the Record of Cause and Effect in the History of Arabs, Persians and Berbers and their Powerful Contemporaries." Several different editions of the *Muqaddima* are now available in Arabic. The one used by me in the writing of this paper is that published from Cairo by al-Maktabah al-Tijariyyah al-Kubra without any indication of the year of publication. It has the advantage of showing all vowel marks, which makes the reading relatively easier. The *Muqaddima* was translated into English in three volumes by Franz Rosenthal. The first edition of this translation was published in 1958 and the second edition in 1967. Selections from the *Muqaddima* by Charles Issawi were published in 1950 under the title, *An Arab Philosophy of History: Selections from the Prolegomena of Ibn Khaldun* (1332-1406).

[5] Ibn Khaldun, *Muqaddima*, p. 40.

[6] Iqbal, 1954, p. 150.

[7] Ibn Taymiyyah, *Majmu ' al-Fatawa*, 1961, vol. 18, p. 165.

[8] Ibn Taymiyyah, *Minhaj al-Sunnah*, 1986, vol. 5, p. 127.

[9] Ibn Taymiyyah, *Al-Hisbah fi al-Islam*, 1967, p. 94.

[10] Ibn Khaldun, *Muqaddima*, p. 287.

[11] See Chapra, *Challenge*, 1992, pp. 143-56 and 168-9.

[12] Ibn Khaldun, *Muqaddima*, p. 288.

[13] *Ibid*, p. 288.

[14] *Ibid*, p. 288.

[15] *Ibid*, p. 286.

[16] Ibn Khaldun, *Muqaddima*, p. 19. See also al-Dimashqi (d. after 570/1175), who is against the direct involvement of the state in business and says: "Some wise men have asserted that if the ruler participates with the subjects in their businesses, they are ruined." (Al-Dimashqi, *al-Isharah ...,* 1977, p. 61).

[17] The percentages are based on the budgetary data given in the *State Bank News,* 16 June 1988, p. 5.

[18] These figures are based on data given in the State Bank of Pakistan, *Statistical Bulletin*, July 1995, pp. 32-33 and 46-47.

Resource Mobilization and Development Goals for Islamic Banks

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ABSTRACT

A critical evaluative study of Islamic economic thought that has gone into the theory of money, finance, and market exchange is undertaken. Such economic reasoning influences the operations and financial perspectives of Islamic banks and financial institutions. Yet it has remained oblivious to the paradigmatic substance of Islamic political economy, wherein human futures incorporating markets, money, finance, institutions, and the economy are studied via an interactive process-based worldview that makes institutions, policies, and preferences endogenous entities. The epistemology of Divine Unity that generates unification of knowledge in a web of systemic complementarity and diversity becomes the essential foundation of the new paradigmatic shift. Viewed in this light, the corresponding goal of social well being, substantively explained, is presented for Islamic banks and financial institutions. An empirical study of Islamic banks points out that such a *Shari'ah*-based worldview remains to be realized. Policy directions are thereby suggested.

I. OBJECTIVES

This paper has three objectives. First is to critically assess whether the type of resource mobilization that Islamic banks throughout the world presently undertake can eventually lead to the formation of a viable Islamic capital market and the Islamic socioeconomic transformation. Second, along with major questions and perspectives appearing in global political economy and on the threshold of new thought, it is also time now to evaluate whether the evolution of Islamic banks and their future prospects points to a substantive contribution in these directions during the new millennium. Together with these questions, one must also examine the philosophy behind Islamic financing and money in their relationships to the Islamization process, particularly of the Islamic political economy. An alternative worldview on paradigmatic shift is provided. Third, an empirical analysis is done to evaluate the performance of Islamic banks and financial institutions during the last decade. This is followed by recommendations to standardize the scope of Islamic banks and financial institutions globally, in light of the analysis in the first and second objectives of this paper.

II. REVIEW OF LITERATURE

A. Keynesian and Neoclassical Orientations

A brief review of the literature on Islamic finance, money, and macroeconomics shows that one or the other of the received economic doctrines, particularly of the Keynesian and neoclassical genre, has been thoroughly rationalized and used. Within these main areas, the models of Tobin and Brainard (Khan and Mirakhor, 1989), moral hazard and information asymmetry (Khan, 1985), and risk aversion and the principal-agent game (Bashir, 1990) are the main ones adopted. The neoclassical doctrine of optimality, marginal analysis, the existence of exogenous preferences, and the derivation of financial rules with the tradeoff between money and goods, all of which are found in consumer utility analysis, have become the building blocks of Islamic economists in treating decision-making with altruistic values in them, and in making money an exogenous instrument of exchange and valuation (Metwally, 1990; Khan, 1991). Even where various cooperative instruments of financing joint ventures have been invoked and interdependent utility functions used, as in the case of explaining the principal-agent problem, the preferences of agents are held to be exogenous.

Social decision-making that should truly configure the cooperative venue in the sense of interactions, organizational behavior, and the process of dynamic change within systems are treated non-substantively. Thus a Beckerian neoclassical analysis of altruism, with risk aversion and the marginal substitution hypothesis entrenched in the prescribed utilitarian behavior of agents, is used to explain the nature of altruism in the Islamic economic attitude toward risk and return by individuals and collectives (Becker, 1989; Khan, 1992). There is an endorsement of such neoclassical methodological approaches in the understanding of the relationship between money and goods

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and the risk-return behavior behind financing and resource mobilization in the neoclassical economic framework (Naqvi, 1994).

There are at least two problems with both the Keynesian macroeconomic orientation and the Tobin-type neoclassical treatment of the liquidity preference theory of the relationship between money and goods. First, a macroeconomic approach to this relationship hides the ethical and moral nature of the relation between money and goods, institutions and preference formation—essentially a matter of microeconomics. Thus a macroeconomic policy analysis on the quantity of money is methodologically carried out in the absence of the intrinsic nature of microeconomic interrelationships (Thurow, 1983). Here, for example, one can think of information sharing, which configures the decision-making relating to a relationship between money, goods, prices, and factors of production. The Keynesian theory cannot offer such perspectives.

Second, Tobin's liquidity preference theory of money and goods in utility analysis assumes agent-specific preferences to be exogenously given (Tobin, 1958). A utility maximum and an optimal allocation of resources are assumed to be attainable. Optima that are attained by a cogent realization of the first-order conditions of the utility maximization problem are of the long-run type. The implication is that the assumed optimal relationship, and with it the underlying equilibrium resource allocation, are permanent structural conditions of the model and methodology. Given exogenous consumer preferences, targeted utility-maximization problems, and the steady state equilibrium methodology, any substantive issue of interactive, cooperative decision-making under the continuous impact of an evolutionary process of information flows (learning) loses relevance. The importance of novelty is subdued by inert learning states (Shackle, 1971; Simon, 1960).

B. Non-Neoclassical Evolutionary Approaches

Islamic economists have sparingly ventured in the direction of the rational expectations hypothesis, which tries to lay a microeconomic foundation for macroeconomics (Lucas, 1983). Few works in this area of methodology applying to Islamic political economy have looked at the social contractarian issues with economy/institution interrelationships (Choudhury, 1993a; Mehmet, 1990). The missing methodological area for explaining the dynamic nature of interrelationships between monetary issues (seen as an institutional category) and goods (seen as a market phenomenon) has resulted in the absence of an explanation of endogenous interrelationship in such economy/institution interlinkages. Contrarily, the methodological and applied understanding of the inhering interactive and evolutionary interrelationships within a consensual framework of economy/institution social contracts becomes central to the microeconomic (i.e. market-based) preference formation in concert with the flow of information from public authority (polity).

Even in the case of the rational expectations hypothesis (REH), such a dynamic concept has not been possible. Expectations based on an existing stock of knowledge are assumed to be adaptive. Hence, despite the REH's introducing probabilistic processes, the adaptive nature of information flows assumes a linear history and its exogenous influence on present and future preference formation. This is nothing but a property of linearity in models of behavior and change. Indeed, if we apply such Markovian models to the stock market volatility of recent times, the result would be chaotic to investors' well being (Kolb, 1994; Yong, 1994). In essence, the moral dimensions of money, finance, and their relations to the market exchange, through an endogenous treatment of institutions, policy, and interrelations in the political economy, cannot depend upon time-forecasting models for directives. Instead, structural models of behavior are used to guide prediction and change. Such models are simulated by information flows using evolutionary knowledge, not by sheer dependence on linear time.

In earlier works on money and finance in Islam, certain instruments were invoked under the claim of the *Shari'ah* (Siddiqi, 1985; Chapra, 1985). Most prominent among such instruments, in the absence of interest transactions, are *mudaraba* (profit sharing) and *musharaka* (equity participation). Thereafter, other forms, such as trade financing, *murabaha* (cost-plus pricing), and secondary-market financial instruments (e.g., unit trusts, co-financing, and Islamic bank portfolios), are linked with joint ventures. Financial loans are treated as grants having no interest rate attached (*qard hasana*) (IDB, 1997).

While such financial instruments are at face value *Shari'ah*-based, there remains the deeper question whether the way they are currently used helps interlink the goods and money markets (i.e. economy and institutions, as mentioned above). In fact, a prime objective of the *Shari'ah* (*maqasid as-Shari'ah*) is to attain social well being through complementarity among opportunities that the moral law allows. Such a complementarity rule attained by means of *Shari'ah* rules (*ahkam as-Shari'ah*) emanates from the Qur'an: "Of every kind He made in pairs, two and two … Behold, verily in these things there are signs for those who consider" (Qur'an 13:3). The principle of complementarity is causally related to the diversity of the creative order: "And in the earth are tracts diverse through" (Qur'an 13:4). Such universally causal relations are shown as the medium of dynamically evolving creative processes: "It is He who begins the process of creation, and repeats it" (Qur'an 10:4). These principles, taken together, bestow social well being that is reflected by the Divine attributes of balance and justice: "that He may reward with justice those who believe and work righteousness"(Qur'an 10:4). There are many other Quranic verses to establish this inference (Choudhury, 1994). The precepts of universal complementarity, diversity, and the creative evolution of opportunities therefrom become the permanent characteristic of the Islamic worldview, with its epistemological premise of Divine Unity. The creative actualization of Divine Unity is found in the emergent unification of knowledge within Islamic world systems, in the present case of money and markets, institutions, and the economy. The unification of knowledge is the manifest essence of the principle of complementarity.

The issues of economy and institution, and hence of the causal relationship between money and markets, and all the methodological ramifications of these concepts are thus premised on the overarching implication of the *Shari'ah*. From our Quranic derivation it follows that the *Shari'ah* is based on systemic complementarity among the diversity of permissible possibilities evolved by the creative synergy of human presence. Besides, the complementary essence is seen by the Qur'an to be endowed in nature. Its observation is open to discovery through human effort, discourse, and interactions.

Complementarity among the diversity of *Shari'ah*-based opportunities is discovered as the basis of the goal of attaining social well being. When money, markets, and financing instruments are taken up within such a systemic methodology, their *Shari'ah* relevance cannot be limited to isolated segments of the society or its sectors, markets, agents, and enterprises. In other words, the *Shari'ah*-based money, markets, and financing instruments, with endogenous interactions and preferences, novelty and discovery, must evolve ever new possibilities for dynamic expansion. Besides, the ever-increasing sets of interactive instruments and methodology enable such systemic expansions to occur and be sustained. The implication here is not that *Shari'ah*-based possibilities are to link up with those inimical to Islam. *Shari'ah*-based opportunities must replace the latter, not merge with them.

In the end, we find that the treatment of money, goods, markets, and their causal interrelations has not been advanced in Islamic economics in a strictly Quranic view of such politico-economic realities. The undue reliance of the Islamic economic methodological approaches in this area is one of several mainstream adaptations and has crried with it the epistemology of such other systems. The substantive methodology of endogenously incorporating the Divine Unity worldview, along with its precepts of complementarity, diversity, and the evolutionary model of unification of knowledge could not be incorporated. This debility has partly been because of the very ethically neutral or ethically exogenous nature of the economic theory on which Islamic economic methodology and methods have been premised. The new methodology to explain causal relations among money, markets, and financing, and thereby among institutions and markets, will now be briefly expounded (Choudhury, 1997).

III. METHODOLOGY

We commence this section by noting the premise of Divine Unity that endogenously establishes a knowledge-induced process worldview of interactions among diverse *Shari'ah*-based opportunities with complementarity and creative evolution as the essence. These processes take place in the human world in institutional and organizational forms. The Qur'an refers to them as the systemically pervasive consultative organization called *shura*. Consensual evolution of such organizational behavior implies the unification of knowledge based on the tenets of the *Shari'ah*. In the physical world including markets, the worldview arises from inherently complementary interlinkages. Such is the attribute of unification realized by means of the essence of Divine Unity (*tawhid*) in the order of things (Choudhury, 1991; Faruqi, 1982).

A. Social Well Being Criterion

With the two complementary sides of social reality—the human world and the natural world—we now define the social well being function as the evaluative criterion of complementarity and balance reflected by institutional rules and market preferences and between them. Complementarity thus becomes pervasive. It annuls both the tradeoff nature of marginalism and the concept of limited complementarity in neoclassical economic theory. It also replaces the Keynesian concept of macroeconomic aggregation, the neoclassical microeconomic foundations of macroeconomics, and social contacts based on public choice theory (Buchanan, 1971) by the criterion of social well being. From this criterion are then derived the interrelationships between money and goods, prices, financing instruments, and factors of production, and economy-wide linkages among real economic activities. The *Shari'ah* rule of interest-free financing eliminates financial speculation and promissory monetary notes from capital markets.

The concept of such a social well being criterion that captures the overarching precept of complementarity and thereby unifies diverse *Shari'ah*-based opportunities is similar to the precept of a public purpose based on *Shari'ah* rules. Imam Shatibi formulated one such theory as *al-Maslaha wa l-Istihsan* (Shatibi, undated; Masud, 1984; Choudhury, 1993a).

The attributes of social well being in *Shari'ah* terms are:

1. upholding the law of Divine Unity (*tawhid*);
2. just balance (*mizan*);
3. dispensing equality with justice (*'adl*). This attribute comprises the Divine purpose of justice in the *Shari'ah*;
4. protecting property rights, entitlements, security from insolvency, and guaranteeing the basic needs of all. This comprises the attribute of certainty, or *haqq al-yaqin* in the social domain;
5. and dynamic reproduction of knowledge of the Divine Unity (*khalaqa thumma yu'id*).

These attributes are entrenched in Islamic political economy by injunctions of the Qur'an. They are not initiated by human "rationalism." The great Islamic philosopher Fakhruddin Razi thought of such attributes of the *Shari'ah* in his epistemological works (Noor, 1998).

For instance, money in the social well being function becomes a complementary entity with real economic transactions. The monetary authority creates it as a quantity equivalent to the value of transactions of real goods and services in market exchange. The link between exchange prices and the quantity of money occurs primarily from the market side to money, not vice versa.

In the first round of interactions, money responds to the exchange value of real goods and services. This marks the market determination of value and its monetary assignment. With this direction of relation from goods to money, prices determine the quantity of money required for the valuation of real transactions. We note that the discursive process underlying *Shari'ah* modes of financing and of establishing permissible enterprises initially determines the nature of exchange transactions. The consumption preferences and production and distribution menus, changed by interactive knowledge induction through discourse, give social legitimacy to the *Shari'ah*. Goods thus affect the quantity of money. Money then responds for purposes of valuation to the real exchange.

In the second round of interaction, when an existing quantity of money from a previous time period (i.e., the moment of shuratic discourse) has already entered the markets and has valued a market exchange in process, there comes about a simultaneous income multiplier caused by such a valuation. Money affects a second round of economic activity. This is the reverse of the first round of interaction, in which goods determined the quantity of money for exchange valuation. Yet such an effect of money on goods, incomes, and thereby prices occurs by the continuing organizational interactive process of market-institution *shura*. It is this form of interrelationship at every stage of choices that determines where money is to be mobilized and by what instruments in order to make the creation and use of money acceptable in *Shari'ah* perspectives and link it with real transactions.

On both sides of the above-mentioned interrelationship between money and real economic transactions permissible under *Shari'ah*, knowledge formed through the underlying shuratic (of the essence of *shura*) process becomes the only determining factor. In the absence of such a primacy of knowledge formation in the interrelationship between money and exchange value, speculative transactions would enter exchange. Promissory monetary notes would be supplied. These would cause interest rates to become endemic in transactions. All *Shari'ah* rules would be annulled. The circularity of interrelationships between money and goods in rounds of creative evolution between institutions and markets being determined by the primacy of knowledge formation based on *Shari'ah* rules makes the models of knowledge-based dynamics among money, output, value, prices, costs, and factors of production to be determinate. The problem of logical tautology in a circular dialectical process, found in Marx (Carchedi, 1991), and of non-convergence of decisions, in Rawls' infinite social games (Wolff, 1977), are resolved by the presence of endogenous knowledge derived in the specific issue from the epistemology of fundamental Unity.

The type of money in Islam we have defined here is endogenous with respect to its knowledge-based interactive, complementary, and dynamic interrelationships with real sectoral transactions. Its valuation is carried out through financial instruments. All these are determined by *Shari'ah* rules. Consequently, because both financial speculation and promissory monetary notes become irrelevant in and by the above interrelationships, interest rates cannot have any bearing on such real economic transactions. Exchange value is measured by market-driven prices. Consequently, price instability is reduced. Thereby, costs of production and factor payments remain stable as well.

In case market imperfections inevitably appear in such processes of Islamically ethicizing market transformations, probabilistically expected interrelationships would be generated. But such expected values are simulated by means of knowledge-based rules and directions emanating from interactions. They are therefore not based on time-dynamic forecasting and predictive methods alone. The evolution of complementarity opportunities based on the realization of rich diversities among goods and services achieves product and risk diversification continuously. In the evolutionary framework of analysis of Islamic political economy of money and goods, institutions, and markets, such incompleteness of information flows must always exist and be improved on. Consequently, imperfections in market-institutional and money-goods interrelationships must always exist. By simulation of the social well being function, we have replaced optimal methods of analysis in neoclassical economic theory in relation to knowledge-based socioeconomic variables, including money, output, prices, costs, and factors of production with *Shari'ah*-based policies (*ahkam as-Shari'ah*).

IV. A SIMPLE FORMULATION

A simple formulation of the knowledge-induced social well being function, SW, and its subsidiary relations is:

$$SW = SW(M, X, p, F, P(r)) \tag{1}$$

The social well being function is simulated in terms of its inherent knowledge production by interactions among the following relations:

$$M = f_1(X, F, p, P(r)) \tag{2}$$
$$X = f_2(M, F, p, P(r)) \tag{3}$$
$$F = f_3(M, X, p, P(r)) \tag{4}$$
$$p = f_4(M, X, F, P(r)) \tag{5}$$
$$P = f_5(M, X, F, p) \tag{6}$$
$$r = f_5(M, X, F, p, P) \tag{7}$$

SW, the social well being function, is based on complementarity among the following variables:

M: quantity of money
X: output
F: services of factors of production
p: exchange price
P(r): *Shari'ah*-based policy, as indicated by its dependence on the profit-sharing rate r in *Shari'ah*-approved opportunities
P_-: previous policy impact on r in a recursive sense

Furthermore, as the circular causation of interrelationships among markets and institutions, and among socioeconomic variables, as explained earlier, continues, attained levels of (M, X, F, P(r)) determine SW, which in turn determines simulated values (denoted by +) of $(M, X, F, P(r))_+$, and so on. Each time, the continuous evolution of underlying knowledge values (implicitly implied here) causes the evolutionary causation to occur. See Figure 1.

Next, we can explain the nature of the above forms of interrelations among (M, X, F, P(r)). Note that the principle of complementarity implies that with respect to the simulation of the underlying knowledge variable realized in the interactive process, we obtain $dSW > 0$. This implies that all the knowledge-induced variables change together and in the same direction.

Expression (1) means that in the knowledge-induced sense, as money increases (or decreases) with market transactions, X increases (or decreases). This relationship automatically stabilizes prices from the demand and supply sides. Now increased mobilization of M across increasing X stabilizes the growth rate of the quantity of money. Since the existing quantity of money assigns values to goods in exchange, therefore, the rates of change in money and prices remain equal. Thereby, inflation is avoided; price stability is maintained.

With the attainment of increased output (X), factor use (F) increases as well. But since p remains stable, factor payments are also stabilized. Consequently, the yield on profit-sharing ventures, denoted by r, increases in the midst of such stability and productivity growth. Such yields manage to augment the factor payments with dividends. In the developmental sense across the economy, markets in the microeconomic sense generate the aggregate quantity of money for circulation among complementary activities, as explained here.

The endogenous effect of prices and output on the quantity of money is transmitted essentially by knowledge formation through interactions. This is instrumental in causing the stability of the relationship (1). Otherwise, any other effect of prices on the quantity of money can be inflationary. Besides, with the neoclassical marginal substitution among factors of production, F, the stability of incomes by such factors would not be maintained. This would adversely affect income distribution, which would show up on the profit-sharing side. The marginal substitution between factors as a cause and effect of the inequitable distribution of incomes now becomes a de-link in the otherwise complementary chain required in the Islamic economy.

The implication of such differences between Friedman's (1989) concept and ours, regarding the "quantity equation" relating to money, income and prices, as in (1), is that the knowledge-centric institutional relations cause stabilization in (1). However, leaving this same expression to Friedman's quantity equation of exchange can cause speculation and inflationary pressures to occur randomly (Laidler, 1989).

Expressions (2) through (7) give the reverse relationship in the circular causation between money and socioeconomic variables, as we explained earlier. In such a circular causation evolutionary process, the implications of stability among the variables are maintained by the presence of knowledge formation in the interactive processes that ensue (i.e. P(r)). In their absence, any other form of increase in money creation will inflate prices and destroy the balance of interrelationships among the variables as shown.

The implication of stability is also in accord with the dynamic basic needs regimes (X, F) of change that essentially characterize development in Islamic political economy (Huq, 1997). Here price stability (p) keeps unison between moderation in income (X) and in spending (money). Moderate factor payments are thereafter augmented by profit-sharing (r).

In the end, social well being improves along a stable trajectory of complementary variables, all being induced by knowledge formation in the underlying interactive process. Such a social well being function must then have multiplicative and non-linear variable types. Since the social well being function now becomes a non-linear aggregation of the microeconomic social well being indices, as implied by group-specific, enterprise-specific, and economy/institution-specific interactive preferences, we have the implication of a microeconomic foundation of politico-economic interrelationships. Here, preferences and policies become endogenous due to continuously generated knowledge and their circular cause-effect interrelationships among the socioeconomic variables.

V. Islamic Banks and Endogenous Money

The implication of expressions (1)-(7) for Islamic banks is that such financial institutions are now intertwined with socioeconomic development issues in Islamic political economy. Their objective criterion, as guided by the social well being function, is to generate and sustain intersectoral linkages among real transactions as prescribed by the *Shari'ah* and using *Shari'ah*-based financing instruments. The focus on such intersectoral linkages, while they are based on P(r), increases resource mobilization and reduces all kinds of speculative financial transactions. In an Islamizing political economy with the role of Islamic banks as development institutions, the ratio (interest rate (i) /profit-sharing rate (r)) thereby progressively decreases to zero. Risk diversification, followed by increasing r and decreasing i, is complemented by product diversification, indicated by an increase in real output (X), along with stability in the growth rates of M and p.

As Islamic banks get increasingly coordinated in an Islamic political economy, a positive Islamic capital market can arise. This is an evolutionary process of the type explained above. Islamization of the financial sector is meant here to evolve even from an initially a non-*Shari'ah* venue to increasing acceptance and application of the *Shari'ah* in society. In such an evolutionary process, banks and financial institutions would increasingly cease to issue promissory monetary notes. The quantity of money created would be determined in concert with representatives of the commercial enterprises, clients, their Islamic banks, and the central bank. The central bank would then create and constrain the quantity of money in accordance with the direct transaction needs of the agents. Any excess money, apart from the requirement to service loans and debts outstanding with interest-bearing sectors, would be neutralized.

Clients hold vouchers, just like checks, which they can fractionally liquidate across the bank counter after spending in direct transaction needs, just as bonds are liquidated. They would then hold vouchers of residual value. The unused monetary holding would be neutralized. A transformation to 100% reserve requirements at the central bank would be engendered in such monetary regimes.

In a 100% reserve requirement monetary regime, the central bank does not "supply" money. It simply produces money at a cost, like any other commodities created in real economic transactions. It then lets commercial banks, entrepreneurs, and clients hold it on the basis of a widely systemic form of cooperative ventures. In these ventures, the central bank, commercial banks, entrepreneurs, and households (represented, say, by consumer guilds) all become participants.

This is precisely the idea of the economy-wide and globally interlinked participatory ventures in light of *Shari'ah* rules, wherein profit sharing, equity-participation, and other instruments cease to be restricted to narrow domains of actions. Systemic expansions of intersectoral and global linkages are generated and sustained. Once again, the central principles of complementarity, diversity, and creative evolution function in such interrelationships between money and real transactions.

It is no wonder that after World War II, the demise of the gold standard and the fixed exchange-rate regime were caused by the cunning of capitalist financiers to monetize the post-war debts of many countries. The Bretton Woods agreements institutionalized the holding of the U.S. dollar or the British pound as paper money. Such holding of paper money caused hyperinflation around the world and ended the stability that the gold standard stood for and realized. Today, the same game of supplying paper money (promissory notes) has caused speculation and an excess supply of dollar-denominated money to be held by entrepreneurs at high risk of uncertainty in capital markets. The Southeast Asian stock market crashes proved the volatile and uncertain consequences of currency swaps and derivative markets, where money as promissory notes held in convertibility to U.S. dollars did not link with real sectoral transactions.

A. Loanable Funds

In the case of loan capital, the usually accepted notion of lending as grants—because interest-based transactions are avoided—raises questions relating to the sharing of participatory costs and benefits. Risk must be equally shared in appropriate ways among partners. A borrower of money is indeed a partner with other risk takers, though with a different mode of financing.

We suggest that the cost of loanable funds in an Islamic participatory joint-venture scheme be computed by holding it against a productive venture. For example, if an Islamic bank makes a loan on a car, the cost of the loan is not an interest charge on it. Rather, it is a payment equivalent to a proportion of the market value of the car, over a period of time, as the loan is progressively liquidated. The payment would be against the period-wise income accrued, in the production of which the car was an intermediate input. The payment of the decreasing proportion of the loan outstanding continues until the liquidation of the loan by market valuation. Such a market valuation helps avoid an interest capitalization of the loan.

In the case of a loan to a poor or asset-less person, the focus must be on the productive use of such loans, rather than on issuance of loans for sheer consumption purposes. For example, cooperative joint ventures by the poor in an economy-wide sense and their effective product selection and development must become the target. Loanable capital would then be linked with a productive return on such enterprises. Only in adverse cases can loanable capital be financed as a grant from developmental funds held by financial institutions. But here, too, the loanable funds would be combined with the 2.5% mandatory Islamic wealth tax on the accrual of the fund to meet the immediate consumption needs of the poor and needy. This Islamic charitable outlay is called *zakat*. *Zakat* is not to be repaid by its recipients.

Boulding and Wilson's theory of the grant economy points out that a good deal of resource mobilization can be integrated with the productive economy (Boulding and Wilson, 1978). For example, homemakers generate an impressive informal economy by responding to flyers and catalogues distributed free. Such ads bring forth a substantial amount of spending. Similarly, at the grassroots levels of the Islamic political economy, the interface among interest groups, Islamic banks as development institutions, market opportunities, and the *Shari'ah* polity can generate wide intersectoral linkages. In such situations, any loanable capital should be linked with returns on the productive outlets for which the loan will be used in direct or indirect ways.

At the end, we see that whether it is for investment or consumption purposes, resource mobilization becomes the target for Islamic bank portfolios. Loans are converted into resources if they pay returns in the absence of interest rates. The very absence of interest rates or its progressive phase-out increases the speed of resource mobilization and spending capacities of the Islamic economy. *Shari'ah* institutions launch their efforts in this direction by being catalysts for knowledge generation, that is, interactions and guidance. It is only in the interest-based loanable system that the poor are adversely affected, spending remains costly, joint ventures are limited by the constraint on spending; and productive returns remain low due to the presence of high or uncertain commercial interest rates and financial collateral.

VI. Islamic Financial Index

From our discussions on the nature and modus operandi of Islamic financial instruments, it is clear that participatory joint ventures stand out as the singular aspect of Islamic enterprise. This acquires its significance in the midst of the universally interconnected epistemological worldview of unity and unification afforded by the *Shari'ah*. The complementary and interactive perspective is holds on matters of money and real transactions in ethical markets and between the economy and institutions on the side of polity, organization, and social contracts. The narrow concept of participatory instrumentation has thus been extended to the overarching case of systemic interlinkages in the economy-wide and global sense. We will now formulate the index of Islamic financial instruments that can effectively realize such extensive systemic interlinkages among real sectoral activities permissible under the *Shari'ah*.

A. Definition of an Islamic Financial Instrument

What then is the idea of an Islamic financial instrument, I, in the above sense? "I" is an index of ways to realize the monetary goal of valuation in the sense of extensive linkages among *Shari'ah*-based enterprises. Formally we proceed as follows:

Note the relationship that holds in the Islamic political economy,

Commerce $\rightarrow_{I}$ Valuation $\rightarrow_{I'}$ Commerce (8)

(as opposed to the M-C-M cycle of the capitalist order) (Heilbroner, 1985).

We write I(Commerce) = Valuation, and I'(Valuation) = Commerce. This comprises a pair of recursive relationships. Interrelationships of this type were shown by expressions (1) through (7).

Next, we will specify some specific kinds of "I" that could be candidates in expression (8). For reasons of space, only *mudaraba*, *musharaka*, unity trust, and foreign trade financing will be considered in formulating the index. *Mudaraba* is profit sharing under economic cooperation; *musharaka* is equity participation. We will generalize for secondary financial instruments.

B. *Mudaraba-Musharaka*

For the valuation of intertemporally and intersectorally linked profit sharing and risk sharing in participatory cooperative joint ventures, we can write:

valuation of $[(p_{ij,t}.X_{ij,t} - C_{ij,t}).\rho_{ij,t}]$ = monetary value of returns. (9)

Here, i and j denote sectors, i,j=1, 2, …, n. C denotes the cost of production allayed in productive factors. ρ denotes the profit and loss shared over time t. The suffixes denote sectoral interlinkages over time.

$(p_{ij,t}.X_{ij,t} - C_{ij,t})\rho_{ij,t}=\pi_{ij,t},$ (10)

is the usual profit-share function that is intersectorally linked and intertemporally valued. In each case, the underlying knowledge value affecting all variables is implicit. The nature of the exact model of valuation remains to be answered in an important component of the nature of the Islamic financial indices developed below. In this regard, we have rejected the time-discounting method of valuation because of its neoclassical leaning on intertemporal costing and marginal substitution of resources (Choudhury, 1993).

But in the perspective of the simulative social well being function with money in it (the one proposed here), the following expression holds: $\pi_{ij,t} = \alpha_{ij,t} . \pi_{ij,t-1}$. $\alpha_{ij,t}$= (1 + the rate of change in $\pi_{ij,t-1}$). Underlying this adjustment relation is the interactive process of simulation of knowledge values. The important attribute of the re-contracting possibility in participatory joint ventures will be reflected in $\rho_{ij,t}$. In this way, over T time periods the net valuation of shares will be:

$M = \Pi_{t=1}{}^{T}\, \pi_{ij,t}$, i,j=1, 2, …, n, (11)

with cumulative information flows in the system arising from interactions, complementarity, and evolution. The yield rates in this case are never predetermined. It is the simulated value of yields at a given point of time that evaluates the shares. If, for instance, the profit shares were declared at the end of "s" periods of time, then the stored-value of money in the economy according to this instrument is M_t. Given such money creation, since the shareholder can opt to liquidate or fractionally hold shares, no additional money enters the economy beyond what is required for actual transactions. Thus there can be no multiple creation of money through deposits, as would be the case with promissory notes. Each M_t attains its value at specific time periods through simulation and not through additive cumulating.

The important point to note here is the extensively intersectorally linked characteristics of the profit-sharing instrument. Such an approach to participatory joint venture is quite different from the way *mudaraba* and *musharaka* are treated in Islamic economics. There, the view of these instruments is one of a sleeping partnership between the contracting partners, with no particular attention paid to intersectoral linkages. In our case, the "I" instrument is seen to be linked with a vastly cooperative joint venture financing system, with profit sharing replacing the interest rate, and endogenous money in 100% reserve requirement prevailing.

In this extended sense, the above-mentioned adjustment expression can be spread out intersectorally as follows, for a given time period t:

j \ i	1	2	3	…	n	Averages*	
1	π_{11}'	π_{12}'	π_{13}'	…	π_{1n}'	$\Sigma_j \pi_{1j}' \rho_{1j} / \Sigma_j \rho_{1j} = \pi_{1.}'$	
2	π_{21}'	π_{22}'	π_{23}'	…	π_{2n}'	$\pi_{2.}'$	(12)
3	π_{31}'	π_{32}'	π_{33}'	…	π_{3n}'	$\pi_{3.}'$	
.	.	.	.	…	.	.	
n	π_{n1}'	π_{n2}'	π_{n3}'	…	π_{nn}'	$\pi_{n.}'$	
Averages	$\pi_{.1}'$	$\pi_{.2}'$	$\pi_{.3}'$	…	$\pi_{.n}'$	$\pi_{..}'$ = economy-wide weighted profit-rate	

*Here, $\pi_{1j}' = (p_{1j}.X_{1j} - C_{1j})$; $\rho_{1.} = \Sigma_j \rho_{1j} < 1$. Likewise, for all i, j = 1, 2, …, n, horizontally and vertically. This suggests that average amounts of profit sharing equal the intersectoral profits.

The above formalism importantly points out that the overall profit rate, $\pi_{..}'$, can be used as the equivalent of macroeconomic policy developed from the microeconomic roots of profit sharing. That is,

$$\pi_{..}' = \Sigma_i\Sigma_j \pi_{ij}'.\ \rho_{ij} / \Sigma_i\Sigma_j \rho_{ij} = \Sigma_i\Sigma_j \pi_{ij}'.\ \rho_{ij}, \text{ since } \Sigma_i\Sigma_j \rho_{ij} = 1. \qquad (13)$$

Hence the profit rate equals the aggregate profit-sharing rate, both being taken up with respect to a change in knowledge values rather than time. This is due to the complexity of the knowledge-induced processual system of Islamic political economy, as opposed to the linearity of a sheer time-dependent system.

Islamic financial intermediaries, microenterprises at the grassroots, the private sector, and governments all cooperate to develop appropriate policies of the types mentioned in order to make intersectoral linkages possible in a profit-sharing system. Such linkages establish endogenous money and realize endogenous economic growth through a vast web of socioeconomic participation. Siddiqi (1983) mentions such a transformation process. Vanek (1971) gives a serious theory of the participatory economy.

The above results mark important departures in theory. They transform the instruments of *mudaraba* and *musharaka* into sectorally interactive and integrated dynamic forms of participatory joint ventures for mobilizing resources directly into (X, p, F, P(r)) toward realizing higher levels of social well being. Simultaneously, M appears as the store of value of transactions for purposes of valuation of exchange. Money thereby has no intrinsic exchange value; it simply reflects the exchange value of real socioeconomic activities. Hence, we again return to the expression M = I(X, p, F, P(r)).

C. Unit Trust (*Amana Saham*)

The next financial instrument to examine in light of endogenous money in Islam and the 100% reserve requirement monetary system is the unit trust. Unit trusts can provide an easy and well-diversified portfolio for investments by small-scale shareholders (Wilson, 1993). They thereby becomes an avenue through which microenterprises can access established stock markets. Large investors can count on a large amount of public shares being bought and floated in stock markets with a minimum of management problems, as might otherwise arise in the case of preferred shares. In this way, several of the important attributes of appropriate financial instruments to back up a progressive transformation to endogenous money in a 100% reserve requirement monetary system are present in a unit trust financing instrument. These comprise the special focus that unit trusts can give to microenterprise development. They diversify risk by expanding the portfolio base and focus on specifically integrated markets where stability of yields can be maintained, as must be the case with microenterprises governed by *Shari'ah* rules on interest-free financing and specific outlets.

The foregoing formalism gives a general framework for analyzing all kinds of Islamic financial instruments in light of the attributes of the interactive worldview applied to money, output, intersectoral linkages, prices, and social well being. The study of unit trusts in an Islamic framework would therefore invoke all the attributes of the model so far propounded.

Yet we find today that unit trusts, such as the *Amana Saham* in Malaysia, have run into the problem of floatation in risky ventures with high yield volatility. For example, the legitimization of derivatives as *Shari'ah* instruments among many Islamic economists has caused unit trusts to be mobilized in this direction. The result has been an utter liquidation of the unit trust shares during the recent stock market crashes in Southeast Asia.

Furthermore, in the absence of any evident and planned Islamization process of the Malaysian political economy, taken up within the nation's development plan, the systemic framework of financial mobilization could not be done. Consequently, risk diversification remained low, and the otherwise intersectoral linkages of unit trusts for generating real economic activities also remained low. In Malaysia, money creation has mostly remained the domain of commercial banks. Consequently, the holding of unit trusts meant buying bonds rathr than participatory shares. The extent of the decision-making process was thus removed by a capitalistic managerial presence. Interest rates could not be phased out of the economy in the process of creating an increasingly healthy equities market. Integrated markets of diverse products, on which Islamically financed microenterprises could flourish, could not be secured. Hence, they failed to compete in global capital markets.

It is therefore suggested that a combination of *Amana Saham* and *mudaraba/musharaka* forms of joint venture financing, in the economy-wide participatory sense that was explained earlier, should become mutually reinforcing instruments. These instruments would complement each other toward gaining product and risk diversification and widely productive linkages intersectorally. All other policy instruments necessary for backing up a conscious Islamization of Malaysian political economy must be addressed, as in the case of realizing endogenous money in Islam.

A joint index of the two instruments, rather than a dissociate way of using them, is essential. This is because the capital and goods markets financed by the instruments must not compete with each other if they are to be integrated. Such a compound index would be premised on the principle of universal complementarity and the diversity of possibilities in real economic activities. Once again, knowledge induction plays the central role in all such dynamic evolutions.

One form of such an integrated index, II, is,

$$II = I_m^a \, . \; I_u^b, \tag{14}$$

where I_m denotes the *mudaraba/musharaka* instrument in the sense we have re-defined it with respect to economy-wide participatory joint ventures. I_u denotes the unit trust instrument. The "a" and "b" coefficients denote the intensity (elasticity) of interlinkages among these instruments by the force of the inherent knowledge values derived from the underlying discourse within and among institutional, organizational, and policy frameworks, as explained by the interactive worldview.

Thus, through such universal complementarity, all the knowledge-induced socioeconomic and policy variables and preferences become interactive, complementary, and evolutionary between the indices, I_m^a, I_u^b, and II. The neoclassical notion of marginal substitution is totally replaced by the principle of universal complementarity, signified by economy-wide intersectoral and capital-goods market linkages. The usual conclusion on productivity, price stability, and the endogenous relationship between money and goods is reinforced.

D. Foreign Trade Financing

In this case, the index "II" is extended to include foreign trade financing (FTF) for establishing extended complementarity among the individual indices. FTF has a strong potential to interlink microenterprises and other businesses and groups through low-risk trade-related ventures and thereby to establish appropriate market and sectoral linkages. For this to be effective, policy and institutional support and good coordination of the instrument with others within a national development plan and integrated markets are essential. Such steps can make FTF a positive instrument of Islamic change (Choudhury, 1989). The very international trade feature of the instrument has the potential to generate extended market linkages, risk and product diversification, and a regime of improved terms of trade and export revenues in terms of the role that endogenous money can play in Islamic economic integration (*umma*).

Thus, all the arguments made earlier respecting money and economy-wide real sectoral activities are now extended to the international economy, keeping fixed the objective target of Islamizing the monetary and financial sectors toward a 100% reserve requirement with endogenous money in Islam. FTF plays a catalytic role in such an ummatic globalization process.

The compounded international integrated index, III, is given by:

$$III= I_m^a.I_u^b.I_f^c. \tag{15}$$

The various results obtained with respect to "II" are now extended to the case with FTF. But this should not be viewed as a mechanical step, even after the institutional, policy, organizational, and developmental perspectives are linked up with FTF.

The thesis on universal complementarity and diversity of possibilities characterizes the FTF markup in the following way:

Let $X_{ij}(r_{ij})$ denote the export of the i^{th} country to the j^{th} country under FTF with a markup of r_{ij}.
Let $X_{ji}(r_{ji})$ denote the export of the j^{th} country to the i^{th} country under FTF with a markup of r_{ji}.

Total trade between the countries with endogenous economies of scale—say, those caused by a cooperative development fund established from the proceeds of the markups and concessional financing goodwill between the countries—will be given by the compound function

$$X = X_{ij}(r_{ij})^{e1}.X_{ji}(r_{ji})^{e2}. \tag{16}$$

The implications of such a geometric aggregation on factor markets are based on endogenous economies of scale. The coefficients e1 and e2 are of types "a" and "b", earlier analyzed with respect to the underlying knowledge values that primarily cause endogenous benefits and interlinkages to occur.

Since the X's are complementary to each other between the trading countries in the product and risk diversification cases of goods and services, the r's will move in the same direction—once from the demand side (imports) and next from the supply side (exports). In a regime of trade and capital market liberalization within ummatic globalization, the markup rates (r's) will tend to decline and stabilize. Accordingly, the X's will increase. This establishes an inverse relationship between markup and trade and capital flows. The profitability of participatory joint ventures that emanate from transactions in goods and services will move in tandem and stabilize. This marks a trend of the profit rate toward a normal profit rate, wherein all revenues are distributed to productive factors. Such a state of distribution of output implies that no surpluses can exist, as all resources are mobilized into productive directions away from saving as a leakage.

The concept of profit sharing and profit rate as the microeconomic foundation of macroeconomic policy in an Islamic participatory joint venture system is now generalized to inter-country sectors and partners in the *umma*. If "r" is a rate developed as a geometric average from a spectrum of similar rates by projects, then the return on X is positively related to r (Choudhury, 1993b). In other words, with increased trade and capital flows in the *umma*, r_{ij} and r_{ji} tend to have a positive relationship with r, which then dominates. Over collective discourse in the interactive framework, as the knowledge-centered worldview promotes the limiting value, say r' of the r's, the markup in FTF is estimated from the limiting value of profitability derived in inter-country and intersectoral real transactions. Thus, r'=f(r) is the estimating expression for the markup in the midst of a development financing perspective of FTF. Together with this, all other institutional concessional factors can coexist.

It is evident that in the case of capital flows, the returns to them are reflected in the r's, and the markup on these are reflective of the same profit-rate. Finally, the unit trust discussed above becomes an important instrument to productively utilize the capital resources flowing through FTF. In perspective, the important implication of the Kuala Lumpur Stock Exchange as a financial institution that can articulate a definite Islamizing agenda with unit trusts, participatory joint ventures, and ummatic trade and capital flow linkages using FTF becomes pronounced.

E. Islamic Secondary Financial Instruments in General

Unit trusts and the various issues revolving around participatory kinds of joint ventures in the absence of interest rates and with the use of FTF are one kind of secondary financial instrument. Just as the creation of markets with diversity is important for product diversification, the development of secondary capital markets where a diverse range of complementary instruments can be issued to link up with integrated markets of goods and services is necessary for risk diversification. Product and risk diversification are essential for achieving stability, security, and distributive equity in the milieu of interest-free financing. They are also those that promote participatory enterprises, particularly at the grassroots.

Yet the temptations of derivatives, bonds, and speculative financial outlets must be avoided. Even shares issued must be of the participatory type and should be causally connected with economy-wide and ummatic (of the essence of the *umma*) interactions, integration, and evolution in them. The shares at the grassroots must be complemented by those issued by more mature enterprises and corporations. While ummatic cooperation in these will of course be the logical priority, it need not exclude other joint venturers, provided the essence of the Islamic contracts and objectives are preserved. In all kinds of financing with a large diversity of secondary instruments, complementarity among them and with integrated markets must prevail. Hence, an index of secondary financial institutions should be the guiding light for the direction and valuation of capital resources.

With these points in view, the overall financial index of capital market instruments ("FI") is given by Figure 1:

FIGURE 1: THE OVERALL ISLAMIC FINANCIAL INDEX FOR ATTAINING SOCIAL WELL BEING IN THE *UMMA*

FI = $\Pi_s I_s^{es}(X, p, r, P)$,		
and consequently,	← ←	↑
		↑
$\downarrow_{FI}$		↑ R
		↑ E
FI = $\Pi_s M_s$		↑ C
= valuation	↑ U	
with complementary recursive	↑ R	
relationships among		↑ S
	↑ I	
(M, X, p, F, P(r))		↑ V
		↑ E
↓		↑
	↑	
Simulation {θ} W(M, X, p, F, P(r))	→	↑

VII. EMPIRICAL ANALYSIS

It now remains to examine to what extent Islamic banks have performed their task as developmental financial institutions in the perspective of complementary across *Shari'ah*-based intersectoral activities and in the global sense across the Muslim world. Tthe consolidated balance sheets and resource mobilization of Islamic banks will be used in this study. The cases of some Islamic banks will be used sparingly. Data are available for 1988 and 1996, and as an average between 1985 and 1996. This time span enables examination of how, if at all, the direction of Islamic banks in resource mobilization and socioeconomic development has changed.

Table 1 shows sectoral investment for selected Islamic banks in 1988. Table 2 provides data on sectoral investment for the aggregate of all Islamic banks in 1996. Between the two, note that the declining trend in the financing of sector projects has been reinforced. The notable exception is the case of the Islamic Bank of Sudan, whose portfolio appears to be well balanced across sectors. It is noted elsewhere that despite the overly agricultural nature of Bangladesh economy, the Islamic Bank Bangladesh has overly financed manufacturing projects, particularly of garments (Hassan, 1997). The same picture appears in the case of Islamic Bank Malaysia. This proves to be in tandem with the general substitution of the industrial sector for the agricultural sector in Malaysia by the Government Development Policy (Alias and Choudhury, 1996; Bank Islam Malaysia Berhad, 1994).

TABLE 1. SECTORAL ALLOCATION OF INVESTMENT BY ISLAMIC BANKS, 1988

1. Faisal Islamic Bank of Egypt	
Industry	30.6
Trade	30.4
Agriculture	3.0
Other Sectors	36.0
Total	*100.0*
2. Dubai Islamic Bank	
Trade	90.6
Service and Family	7.6
Other Sectors	1.8
Total	*100.0*
3. Sudanese Islamic Bank	
Agriculture	34.0
Industry	23.5
Trade	10.8
Transportation	10.0
Other Sectors	21.7
Total	100.*0*
4. Faisal Finance Institution Inc. (Turkey)	
Metal Industry	26.3
Chemical and Petrol	17.8
Clothing	16.7
Food	7.9
Tools	5.7
Paper Printing	5.3
Agriculture	16.9
Contracting	3.4
Total	*100.0*

Source: *The Aggregate Balance Sheet of the International Association of Islamic Banks*, 1988 (Cairo, Egypt: International Association of Islamic Banks)

TABLE 2. ISLAMIC BANKS AND FINANCIAL INVESTMENT, SECTORAL ALLOCATION, 1996

Region	Trading	Agriculture	Industry	Services	Real Estate	Others
S. Asia	13.68	8.69	48.26	9.79	2.00	17.58
Africa	29.91	19.56	17.04	8.02	5.79	19.68
S.E. Asia	45.13	5.54	6.30	24.26	2.53	16.24
Mideast	27.50	9.85	28.80	5.00	21.95	6.90
G.C.C.	38.30	0.30	11.50	10.60	21.30	18.00
Euro./Amer.	32.60	0.60	1.31	21.54	16.74	27.21
Accumulated Avg. Rate	31.17	7.50	18.82	13.17	11.67	17.67

Sector Average	Trading	Agriculture	Industry	Services	Real Estate	Others
	31.17	7.50	18.82	13.17	11.67	17.67

Source: *Directory of Islamic Banks and Financial Institutions*, 1997 (Cairo, Egypt: International Association of Islamic Banks)

These overall trends point out that in view of the developmental needs of the predominantly agricultural economies of the Muslim world, the Islamic banks have either moved away from this focus, or in the hope of raising profitability have moved into secondary manufacturing. A neoclassical picture of sectoral tradeoff, instead of the much-needed intersectoral balance and linkages in development financing, appears in such shifts away from agriculture. With such substitutions, many of the variables in (M, X, p, F, P(r)), and hence in SW, would be adversely affected.

The financial figures for 1996 also point out a high degree of concentration in FTF. This would adversely affect the value of a compound financial index by substituting the elasticity of financing in this instrument for particular goods, most often petroleum and commodities in FTF. The development consequences of a resulting lack of product and risk diversification are lost by such a concentration of a few financing instruments.

The underlying high elasticity of FTF can also be seen by the concentration on *murabaha* (cost-plus pricing) for 1996 (Table 3), as opposed to the more important mode of financing by means of a combination of *murabaha* in FTF and equity participation (*musharaka*/*mudaraba*). In this combined form, a good deal of intersectoral linkages could be obtained. On the other hand, by a long-standing indication in other Islamic banking statistics (IDB, 1997), financing in profit-sharing ventures (*mudaraba*) is found to remain very low. This too points to weak performance on the side of essential Islamic financing instruments and the resulting weak intersectoral linkages among *Shari'ah*-approved outlets. It is then logical to conclude that product and risk diversification remained weak within the given pattern of financial instrumentation across Islamic banks globally.

The picture on the portfolio mix of financing instruments was similar in 1988 (Table 4). Islamic banks were found to focus overly on short-term investments as opposed to long-term investments. The latter are badly needed for socioeconomic development and sustained growth of incomes and entrepreneurial profits. It is clear that FTF, and thereby *murabaha*, would have played the major role in short-term investments. Besides, social spending and *zakat* funds remained unusually low (despite the low 2.5% rate of *zakat*).

It is conspicuous that a large proportion of the portfolio is in savings. This goes against the spending propensity that should exist in an Islamic economy. The implication is that Islamization, as a transformation of markets and development processes through mobilization of savings in *Shari'ah*-based directions, was not being realized, either in the Muslim world or through the role of Islamic banks as development financing institutions.

TABLE 3. ISLAMIC BANKS AND FINANCING INSTITUTIONS: MODES OF FINANCING, 1996

Region	*Murabaha*	*Musharaka*	*Mudaraba*	*Ijara*	Others
S. Asia	34.00	5.70	5.50	10.30	44.50
Africa	56.90	22.30	4.00	3.40	13.40
S.E. Asia	25.30	3.40	15.50	10.30	45.50
Mideast	42.00	28.30	5.40	7.80	16.50
G.C.C.	49.30	3.40	10.30	15.00	22.00
Euro./Amer.	34.30	13.30	1.80	22.40	28.20
Accumulated Avg. Rate	40.30	12.70	7.20	11.50	28.30

Region Average	*Murabaha*	*Musharaka*	*Mudaraba*	*Ijara*	Others
	40.30	12.70	7.20	11.50	28.30

Source: *Directory of Islamic Banks and Financial Institutions*, 1997 (Cairo, Egypt: International Association of Islamic Banks)

TABLE 4. INVESTMENT PORTFOLIO OF ISLAMIC BANKS, CONSOLIDATED BALANCE SHEETS, 1988

1988 (millions of U.S. dollars)	
Short-Term Investment	4909.8
Medium-Term Investment	453.1
Long-Term Investment	141.4
Real Estate Investment	1498.2
Social Spending	64.2
Zakat Fund	3.1
Current Accounts	1044.3
Credit Accounts	114.7
Investment Savings Accounts	6811.1
Total Shareholders' Equity	427.3
Participation in Other Banks and Companies (mainly for Kuwait Finance House, Faisal Islamic Bank of Egypt, Nasser Social Bank, Dubai Islamic Bank, and International Islamic Bank; zero for all others)	113.2

Source: *The Aggregate Balance Sheet of the International Association of Islamic Banks*, 1988 (Cairo, Egypt: International Association of Islamic Banks)

The Directory of Islamic Banks and Financial Institutions (1996) states that between 1985 and 1996, total capital subscriptions of the consolidated body of Islamic banks increased by 26 times, total assets by 18 times, total deposits by 17 times. But the 1996 figures also point out that the net profit rate (net profits divided by deposits) equaled only 1.66%. Clearly, the mobilization of funds toward productive and profitable ventures was not effective enough. Combined with the picture on the lack of sectoral interlinkages and the balanced extension of a diversity of financial instruments, there appears to have been the resulting lack of product and risk diversification, which otherwise could have increased resource mobilization and realized higher levels of profitability according to *Shari'ah* norms. Another contributing factor to the low profit rate could have been the high administrative cost experienced, particularly with the increased and expensive technological induction of Islamic banks.

In conclusion, it can be said that Islamic banks in general did not achieve real profitability, real income growth, and long-term investment benefits for development planning, which complement each other in the goal of realizing social well being. The picture in individual cases may have been different. For instance, there is the pioneering case of the Islamic Bank of Sudan. Indeed, all banks in Sudan have been Islamized.

With the impact of *Shari'ah*-based development financing remaining unproven by Islamic, banks taken as a whole across the world, the process of Islamization remained causally related to this low financial performance. On the one hand, the failure of the Muslim world to Islamize itself could have contributed to Islamic banks' difficulties. On the other hand, Islamic banks themselves may have sought avenues of resource mobilization (deposits) mainly in short-run investments. Here, risk remains high in terms of the limited scope of investments (and thus a heavy concentration on *murabaha*) and lack of diversification. Volatility in prices and currency values then adversely affects share values.

Relating these results to the expressions (1) through (7) given earlier, we note the following consequences with respect to profitability, socioeconomic development, and monetary matters. In the vector, (M, X, p, F, P(r)), the *Shari'ah*-based policy variable, P(r), remained weak, with r being low. This is reflected in the weak intersectoral linkages and in the inference of the weak degree of product and risk diversification. These caused high administrative costs. Consequently, the mobilization of resources in real economic transactions, generating X, remained low. This caused the development effect of Islamic capital markets and the Islamic economic transformation to remain ineffective. The prices, p, of real transactions in goods and services of Islamic banks remained high. Factor utilization, human resource development, and production costs remained expensive. The result was expected to be gross substitution among these possibilities. Thus, all the ramifications of neoclassical economic states were upheld. No new economic reasoning, institutional development, or social actions came forth to cause a paradigmatic shift toward an authentically Islamic way of thinking and doing business. Social well being also could not be attained in its essentially *Shari'ah* perspectives.

VIII. CONCLUSION: TOWARD STANDARDIZING THE ROLES AND GOALS OF ISLAMIC BANKS

The problems of Islamic banks and financial institutions, when viewed in light of the *Shari'ah*-based worldview of complementarity and creative evolution realized through interactive processes, necessitates a degree of standardization of goals, institutions, and policies in light of the *Shari'ah*. This paper has pointed out such directions to be premised on the epistemology of Divine Unity (*tawhid*). Such an Islamic worldview needs to be intellectualized and fed into the interrelationships among money, finance, and real economic transactions. At the level of development financing, the paradigmatic worldview is translated into a social well being criterion that describes market, institutional, and behavioral interactions among agents, variables, and their relations, in terms of the principle of complementarity and diversity of *Shari'ah*-based opportunities.

At the pragmatic level, the appropriate policies for transforming Islamic money into 100% reserve requirement would require the formation of Islamic capital markets and an Islamic economic union. Here Islamic banks must serve as catalysts toward realizing flows of goods and capital in segmented markets governed specifically by the *Shari'ah*.

When we study the present state of Islamic banks and their parent countries in the Muslim world, it is realistic to infer that the above paradigmatic shift remains a target that can at best be attained only over the long run. To initiate the process of positive change in that direction, it would be useful to adopt the following directions toward reorganization.

One, the need for establishing the specifically *Shari'ah* aspects of business in the national and global order requires that Islamic banks carry out business in selected areas that can be segmented and protected in their own right. This would take the form of transactions in specific kinds of goods, services, businesses, and instruments according to *Shari'ah* rules. The implication here is of effective regulation to open up market opportunities for Islamic banks in and with *Shari'ah*-specific markets and financial instruments.

Two, the markets for these items will accordingly be specific to themselves. Hence interlinkages among markets for goods, services, and capital within these segmented markets must intensify.

Three, in a globalizing environment, such markets, institutions, policies, and instruments must interconnect with other ones, but with selectivity in such foreign items in view of *Shari'ah* rulings and in light of the Muslim interest to diversify and develop interlinkages among their own specific kinds.

Four, cost-effective methods of technological change and mobilization of funds should be tapped more actively. The establishment and financing of microenterprises that promise productivity at the grassroots levels of society and have the potential to generate intersectoral linkages through production and marketing are to be encouraged (Akhtar, 1997). This has been the case with the Islamic Bank of Sudan. In the case of the Islamic Bank of Malaysia, the many unit trusts that were floated at the Kuala Lumpur Stock Exchange were openly traded with conventional shares. Sufficient protection was not accorded to them and the unit trusts were not used to develop and finance specific kinds of *Shari'ah*-based markets.

Five, *Shari'ah*-based rules, policies, and agent-specific preferences are to be specifically addressed at the national and Islamic global (*umma*) development perspectives. This would involve delineating the organizational, developmental, training, and resource mobilization roles of Islamic banks in an Islamic market transformation. Inter-institutional linkages, between both Islamic banks and financial institutions and with enterprises and governments, must increase. Microeconomic policy targets, such as trade and financing instruments to realize segmented market linkages, must apply. There must be a vigorous dialogue about microeconomic policy matters and a dynamic perspective on national development policies. In this way, intersectoral development balance can be realized. It is encouraging to note that the World Development Report (1997) gave full coverage to such an approach of the state, institutional, and market interface within an increasingly private-sector climate of change.

Six, Islamic banks and financial institutions should establish an autonomous center of advanced socioscientific research and policy analysis in the private sector. It would pursue research and action programs to implement findings in the area of paradigmatic shifts based on the roots of Divine Unity and its actualization in commerce, money, markets, and institutions. The methodology and methods of attaining elaborate goals of social well being of the *umma* should guide the center's vision. Human resource development in *Shari'ah*-based fields for financial and socioeconomic change would be pursued at this center. Institutions and enterprises from the public and private sectors throughout the Muslim world would collaborate at it. Other participation would be welcome.

Seven, such a center of advanced learning would become the pivot of collective discourse and policy formulation at the national, global, and micro-entrepreneurial levels.

Eight, with the assistance of sister Islamic organizations, such as the Islamic Development Bank, Islamic banks are to convincingly call for Islamic institutional and monetary changes in Muslim countries to enable them to realize the endogenous monetary system and its targets as explained in this paper. Even the incentive of earning sustained profits would motivate Islamic financial institutions on this front.

Nine, cost-effective and easily accessible databanks and networks on Islamic financial and socioeconomic data need to be established. This can be pursued with the existing ones at the Statistical, Economic, and Social Research and Training Center for Islamic Countries, the Harvard Islamic Finance Information Program, and the International Association of Islamic Banks. The data depository can be incorporated at the proposed center for advanced learning and policy analysis.

The standardization of goals, activities, and policies of Islamic banks and financial institutions are thus to be taken up in terms of harmonizing the targets of operations and development financing in the private sector at the micro-level of attaining social well being. Then, through vigorous dialogue with the intellectual and grassroots agencies of change, Islamic banks must learn about and implement feasible *Shari'ah*-based policies and programs to interlink among themselves through segmented markets, trade, and financing. It is assuring to learn that the World Bank is presently promoting such ideas of state-sponsored guidance and regulation with states, institutions, and private-sector interactions involving the extended public sector that comprises non-governmental organizations and the grassroots (World Bank, 1997).

From these initial stages onward, the dynamic synergy of progress by Islamic banks and financial institutions would be carried out incessantly into the global order. Islamic capital markets and an Islamic common market, with the specific role of Islamic banks and financial institutions and the move to endogenous money in Islam, should offer bold and visionary programs for the new millennium.

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Size, Profitability, and Agency in Profit- and Loss-sharing in Islamic Banking and Finance

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ABSTRACT

Negative relationships exist between profitability, size, and the use of profit- and loss-sharing (PLS) in financial contracts. This tradeoff is explained by analyzing the agency problem, dwelling on transaction and monitoring costs. The crucial assumption is the equality of agency costs and benefits of integration (or unitary output elasticity of reward incentives) in the environment in which contracts are drawn. A cooperative environment is a prerequisite for the existence of share contracts; an opportunistic environment in which property rights are ill defined or are not properly protected is not conducive to PLS. However, the tradeoff between size, profitability, and the existence of PLS is also expected to hold in a cooperative environment with well defined property rights.

I. INTRODUCTION

Profit- and loss-sharing (PLS) dominates the theoretical literature on Islamic finance. Broadly, PLS is a contractual arrangement between two or more transacting parties that allows them to pool their resources to invest in a project to share in profit and loss. Most Islamic economists contend that PLS based on two major modes of financing, namely *mudaraba* and *musharaka*, is desirable in an Islamic context wherein reward sharing is related to risk-sharing between transacting parties. Almost all theoretical models of Islamic banking are either based on *mudaraba* or *musharaka* or both, but the to-date actual practice of Islamic banking is far from these models. Nearly all Islamic banks, investment companies, and investment funds offer trade and project finance on markup (*murabaha* and *bai' mua'jjal*), *istisna'*, or leasing bases.[1] PLS features marginally in the practice of Islamic banking and finance.

Whatever the degree of success of individual Islamic banks, they have so far failed in adopting PLS-based modes of financing in their businesses. Even specialized Islamic firms, such as *mudaraba* Companies (MCos) in Pakistan, which are supposed to be functioning purely on a PLS basis, have a negligible proportion of their funds invested on a *mudaraba* or *musharaka* basis. In 1991, supposedly a boom period for MCos, income form PLS investments for the top 17 MCos accounted for less than a 0.5% of the total current income (CLA, 1992). The usage of PLS-based modes of financing used by Pakistani banks in 1984 was 11.1% (*musharaka* and equity participation), which marginally improved to 15.9% in 1995. According to the International Association of Islamic Banks, PLS covered less than 20% of investments made by Islamic banks worldwide (1996 figures). Likewise, the Islamic Development Bank (IDB) has so far not used PLS in its financial business except in a few small projects.[2]

Several explanations exist for this lack of PLS. First, PLS contracts are inherently vulnerable to agency problems, as entrepreneurs have disincentives to put in effort and have incentives to report less profit compared to the self-financing owner-manager. This argument is based on the idea that parties to a business transaction will shirk if they are compensated less than their marginal contribution in the production process, and as this happens in the case of PLS, capitalists hesitate to invest on a PLS basis. The argument further goes back to a different worldview of ownership under PLS as compared to the capitalist worldview, which allows only those who own certain crucial means of production to be legitimate residual claimants in the production process. Entrepreneurs claim residual income (profit). Capitalists, on the other hand, put an emphasis on the productivity of capital and, hence, are reluctant to bear any losses incurred in production. Capitalists' unwillingness to bear risk and entrepreneurs' tendency to exclude others from sharing profits has resulted in a less favorable response to PLS from the financial and business community.

Second, PLS contracts require well-defined property rights to function efficiently. As in most Muslim countries property rights are not properly defined or protected, PLS contracts are deemed to be less attractive or to fail if used.

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Third, Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to *mudaraba* or *musharaka* in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive.

Fourth, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense; the transacting parties share financial resources without participatory decision-making (Choudhury, 1998). Practice of MCos in Pakistan is a perfect example of such a non-participatory PLS. The *mudaraba* certificates issued by MCos do not give voting rights to certificate holders, and hence no AGM is called.[3]

Fifth, equity financing is not feasible for funding short-term projects due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially markup to ensure a certain degree of liquidity.

Sixth, unfair treatment in taxation is also considered to be a major obstacle in the use of PLS. While profit is taxed, interest is exempted on the grounds that it constitutes a cost item. This legal discrimination and its associated problem, tax evasion, make PLS less reliable as a tool for reward sharing. This argument is quite true in the case of growth of MCos in Pakistan. The MCos showed an impressive growth till 1992 when their tax-exempt status was withdrawn.

Seventh, secondary markets for trading in Islamic financial instruments, particularly *mudaraba* and *musharaka*, are non-existent. Consequently, they have so far failed to effectively mobilize financial resources.

Proponents of Islamic banking take the exclusion of PLS as a serious operational deficiency and face a challenging task ahead to innovate PLS-based products to make the asset side of banks more dependent on profit- and risk-sharing. The IDB has recently initiated a research project to identify operational problems of Islamic banks but it will take some time before its results are published.

While the above arguments explain practical problems that hinder the use of PLS by banks and other financial institutions, they exclude theoretical judgment on the issue. This paper attempts to develop a model of PLS capable of application to the practice of Islamic banking and finance. The primary focus here is on transaction and monitoring costs without an explicit reference to risk attitude of the transacting parties.

The next section briefly introduces some key concepts and states crucial assumptions to the analysis. Section 3 develops a model of PLS, which is used to draw policy implications, discussed in section 4.

II. Some Basic Concepts

This paper uses a simple model to explore relationships between size, profitability, and agency problems in the context of contract choice. While transaction and monitoring costs are not explicitly modeled here, their consideration is important in discussing policy implications. Agency problems are also central to the analysis here, as is the role of overall the socioeconomic environment. These basic concepts are briefly explained before modeling the contract choice.

Transaction costs comprise search costs, negotiation costs, and costs of drawing up the contract.[4] The term "search" refers here to the process of a capitalist (entrepreneur) finding and canvassing various entrepreneurs (capitalists) and of ascertaining the most favorable terms of contract (price, quality, and location etc.), and includes advertising. Search costs increase with activity of search, i.e., increased search yields diminishing returns (e.g., marginal benefits of negotiation or advertising on average go down). Dahlman (1979) offers three interpretations of transaction costs. The first, attributed to mathematical economists, defines transaction costs as a fixed proportion of the amount traded, which disappears in transaction itself. This shows that a specific medium of exchange is preferable because it consumes less real resources in exchange. Second, transaction costs concern "the idea that a trade may be costless to carry through, but may still require resources to organize: there may be set-up costs associated with each exchange. Such a cost is no longer proportional to the trade itself, but is a fixed cost which is independent of the amount to be exchanged" (Dahlman, 1979, p. 146). The third follows Coase (1960) and emphasizes poor information. So, transaction costs represent resource loss due to poor information. Formal contracts are drawn to account for poor information in different contingencies. Such contracts specify the rights of each transacting party in different contingencies, criteria by which they are evaluated, and reward functions. Specification should state limits on the behavior of contracting parties in terms of property rights, how such property rights may be exercised and transferred, and who will bear rights for ultimate control. Property rights determine resource allocation while the control has implications for residual claims and risk bearing. In principle, a perfectly articulated contract could solve the agency problem arising from moral hazard and strategic behavior. These specifications notwithstanding, contracts are essentially incomplete leaving an element of uncertainty in all contracts to which no probability can be assigned. William and Findlay (1986) argue that "as rights and duties can be expressed only in terms of the *ex ante* set of states, no ironclad (i.e., perfect) contract can, even in principle, be written. In a world where one cannot know all possible outcomes, one cannot contract away all (or even) most of the uncertainty of the future" (p. 37). This implies that transaction costs cause contractual incompleteness.

Monitoring costs are incurred to make sure that the terms of the contract are observed and that the problem of moral hazard is minimal. According to the definitions of transaction and monitoring costs used here, resources dedicated to controlling adverse selection are called transaction costs while costs incurred on controlling moral hazard behavior are defined as monitoring costs.

Consideration of transaction and monitoring costs, along with other costs, determines the share of rewards in a contractual arrangement and provides incentives for investment. In a world of positive transaction costs and incomplete contracts, *ex post* residual rights of control are important because of their influence on asset use.

Transaction costs are expected to be higher in the case of PLS contracts than fixed return contracts, given the need for careful definition of rights and roles of transacting parties in a participatory mechanism. However, monitoring costs are excessively high in the case of the PLS contracts, whereas fixed return contracts require practically negligible monitoring.

When parties to a transaction have conflicting interests, when, for example, one tries to maximize its own interests at the expense of others, an agency problem is said to exist between them. Agency stems from uncertainty, asymmetry in information, and self-interest-seeking individuals. With respect to financial contracting, efficiency is determined by control of agency and technical-administrative weakness arising from bounded rationality. Bounded rationality here denotes the whole range of informational constraints and management limitations that prevent writing complete contracts and implementation of incomplete contracts in the wake of business complexities. An agency problem arises from adverse selection, moral hazard, and strategic behavior. Adverse selection is related to uncertainty and the prohibitive transaction costs required to pick up the right transacting parties in the face of limitless contingencies in the business environment. Moral hazard describes opportunism or self-interest that includes subtle and devious behavior known as self-interest seeking with guile (Williamson, 1985).

The analysis here does not explicitly incorporate attitude toward risk, which is implicit in the behavior of transacting parties. Emphasis is rather on the profit-maximizing behavior of transacting parties. This approach is more realistic as gain maximization at the expense of other contracting parties is a major source of the agency problem. Loss minimization at the expense of others occurs only in cases of bankruptcy and unexpected liquidation.

The role of the overall environment in the contract choice is also important. It is assumed that individual behavior determines social behavior or what we call here environment. However, the environment becomes binding on individual behavior once the former gets established.

Duality of human behavior is assumed in terms of opportunism and cooperation. Depending on the dominance of one behavior over the other, the environment is described as opportunistic or cooperative. The new theory of the firm assumes that if benefits of integration exceed the cost of integration (agency costs), economic agents establishing a firm will cooperate.[5] The same applies to the financial contracts. Arrow (1968) says that cooperative behavior is characterized by relations of trust and confidence between transacting parties so that they do not cheat even though it may be rational economic behavior to do so.

Cooperation may be of three kinds, viz., voluntary, induced, and competitive. Arrow's definition refers to the first kind. Induced cooperation is enforced by a sovereign (i.e., a state), a social institution, customs, or through hierarchy as contended by Williamson (1985, 1993). Competitive cooperation is the result of a competitive process in which actions of individuals are integrated with each other in such a way that if an individual follows a particular course of action, it is in his own interest that others should do so, too. All individuals in such a community cooperate in a competitive environment. Following Bradrach and Eccles (1989), Korczynski (1998) attributes the voluntary, induced, and competitive cooperation to trust, power, and market, respectively.

III. Modeling the Contract Choice

The following assumptions are crucial to the analysis here.

Contrary to traditional theories of distribution wherein the capitalist is either viewed as a money lender who earns interest or profit, or as an entrepreneur who employs labor for profit, we assume here that the capitalist hires an entrepreneur who shares profit and loss in a venture financed and possibly supervised by the capitalist. In this context, the capitalist bears most of the risk not the entrepreneur (unless a share in capital is taken alongside salary). However, the entrepreneur is not an employee of the capitalist in the conventional sense. Being a residual claimant, the entrepreneur effectively becomes a joint owner of the enterprise. Their shares in the investment define the financial relationship between the capitalist and the entrepreneur.

Positive transaction and monitoring costs are assumed. This assumption along with duality of human behavior has implications for agency problems.

The assumption of bounded rationality is crucial to the analysis here. While the entrepreneur and capitalist are assumed to be rational in the neo-classical sense, the role of the overall economic environment and transaction and monitoring costs is emphasized in decision-making. For example, in an environment of high transaction and low monitoring costs, the capitalist will choose a reward structure for the entrepreneur, which maximizes the marginal productivity of monitoring and reduces transaction costs. This implies a fixed-remuneration management contract between the capitalist and the entrepreneur. Similarly, if low transaction and high monitoring costs prevail, a financial contract that takes benefit of low transaction costs and minimizes on high monitoring costs will be optimal—obviously an interest-based contract as it minimizes transaction and monitoring costs.

A. Model

Consider the following general form of the income function

$$Y = R + (1 - r)\Pi \qquad (1)$$

where Y is income of either party to a financial or a management contract, depending on the signs of R (a profit-independent component of income) and r (profit ratio), and Π is realized profit of the business.

R and r may take negative or positive values depending on the nature of the contract used. The above income function can be specified for different contractual arrangements by assigning different signs to the parameters R and r. For example:

1. If $R = 0$ and $0 < r < 1$, equation 1 will specify the income function of an entrepreneur using a pure PLS contract.
2. If $R < 0$ and $r = 0$, equation 1 will represent the income function of an entrepreneur using a fixed return (interest-based) contract. Equally, this will signify a situation wherein a capitalist invests in a project and relies on management that gets a fixed fee.
3. If $R > 0$ and $r = 1$, equation 1 will identify the income function of a capitalist using an interest-based contract.
4. If $R > 0$ and $r = 0$, equation 1 will be an income function of an entrepreneur who does not rely on external fund, and hence no financial contract.

r can be viewed as an incentive parameter that may generate an agency problem in a share contract (call it agency disincentives). However, it may also help reduce the agency problem stemming from the variability in the project output (call it reward incentives). An optimal contract should maximize the difference between the reward incentives and the agency disincentives.

Equation 1 is fundamental and may be used to explain different contractual relationships between capitalists and entrepreneurs in terms of transaction and monitoring costs. For example, if capitalist-entrepreneur relations are characterized by low transaction and monitoring costs, it leads to a contract that maximizes the marginal productivity of monitoring and optimizes on transaction costs. In practice, transaction costs do not vary much across different contracts, and, hence, leave monitoring costs to be a major determinant of the contract choice. Low agency costs, ignoring other things, will lead to choice of a PLS contract by capitalist and entrepreneur. However, if transaction costs are low but monitoring is costly, the capitalist will be reluctant to enter into a PLS arrangement. In addition to agency costs, the profitability and size of project need serious consideration. The entrepreneur will prefer a PLS contract if there is a perception that the project is less profitable, and would accept an interest-based contract if there is an expectation of large profitability, in which case the entrepreneur will be the sole residual claimant on profit stream. The capitalist is expected to provide funds on a PLS basis if project size is such as to make it easy to identify the agency problem by the capitalist. Large projects therefore may be financed on an interest basis as the capitalist may find it hard to detect the agency problem.

Transaction and monitoring costs are internalized in the model with the help of the incentive parameter, r. Suppose, initially a capitalist invests in a project and hires a manager to manage it. This signifies the case (ii) above wherein r = 0. It is not unrealistic to assume that the manager who has no financial stake in the project will have diluted incentives to work hard if more investment is poured into the project.[6] In other words, monitoring costs will be increasing on margin. Increasing the management fee (R) will not help strengthen incentives but an increase in r will help, establishing a positive relationship between investment and r. Similarly, an increase in uncertainty will give rise to more need for surveillance and monitoring, given that uncertainty makes it easy to shirk. In a more uncertain environment, more incentives are required to control the agency problem. Hence, an incentive function of the following form[7]

$$r = r(Q(k,\theta),\theta) \tag{2}$$

where Q is the level of output of the project, k is the level of investment, θ stands for the nature (uncertainty), and $r_k > 0$ and $r_\theta > 0$.

The element of uncertainty in the incentive function is important in the analysis that follows. While θ is affected by the degree of completeness of contracts, it can also be reduced by a well-defined and effectively implemented legal framework that regulates the situations that cannot be contracted.[8] In developed economies, the market for information tends to substitute for legal framework. Most lenders to consumers rely on information provided by credit rating agencies before making a decision to extend credit. In an environment with a developed market for information, there is less uncertainty and, hence, less need for incentives.

Assuming that output carries a unitary price, then using equation 2, equation 1 can be rewritten for a capitalist as follows:

$$Y^e = R + [1 - r(Q(k,\theta),\theta)](Q(k,\theta) - c) \tag{3}$$

Y^e is the expected income that depends on uncertain output and expected profit, $\Pi^e = Q(k,\theta) - c$.

Maximization of equation 3 with respect to k yields[9]

$$\eta = \left(\frac{1-r}{r}\right)\left(\frac{Q}{Q-c}\right) \tag{4}$$

η is the output elasticity of reward incentives and is defined as

$$\eta = \frac{\partial r}{\partial Q} \cdot \frac{Q}{r} = \frac{\partial r/r}{\partial Q/Q} = \left(\frac{\partial r}{\partial k} \cdot \frac{\partial k}{\partial Q}\right)\frac{Q}{r} = \left(\frac{\partial r/\partial k}{\partial Q/\partial k}\right)\frac{Q}{r} \tag{5}$$

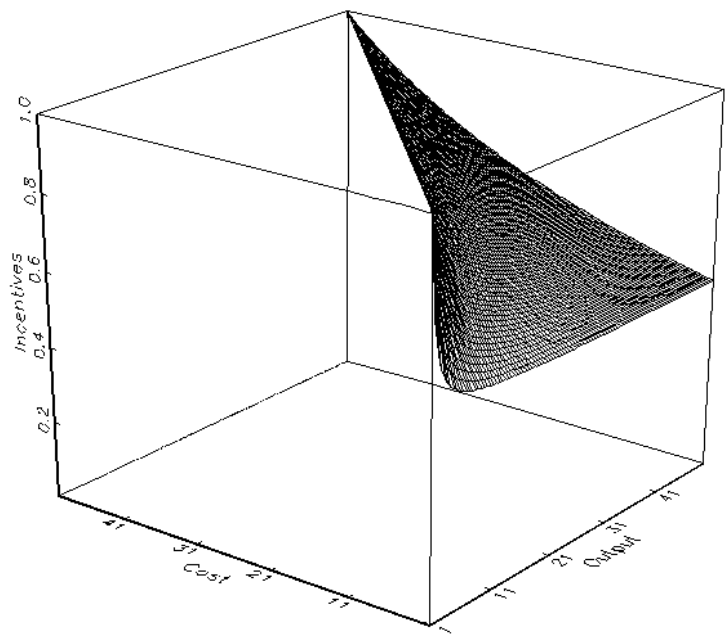
Output elasticity of reward incentives relates the size of the project to the agency problem between management and ownership. An increase in investment has two effects: output effect and incentive effect. While more investment is expected to increase output, it may lead to dampening incentives to put a desired level of effort by management, hence putting an upward pressure on r. A unitary value of η implies equality of proportionate change in incentives and proportionate change in output, i.e., $\frac{\partial r}{r} = \frac{\partial Q}{Q}$, a situation describing equality of benefits of integration and agency costs. In such a case

$$r = \frac{Q}{Q+\Pi} \tag{6}$$

with $\partial r/\partial Q$ and $\partial r/\partial \Pi$ both being negative.

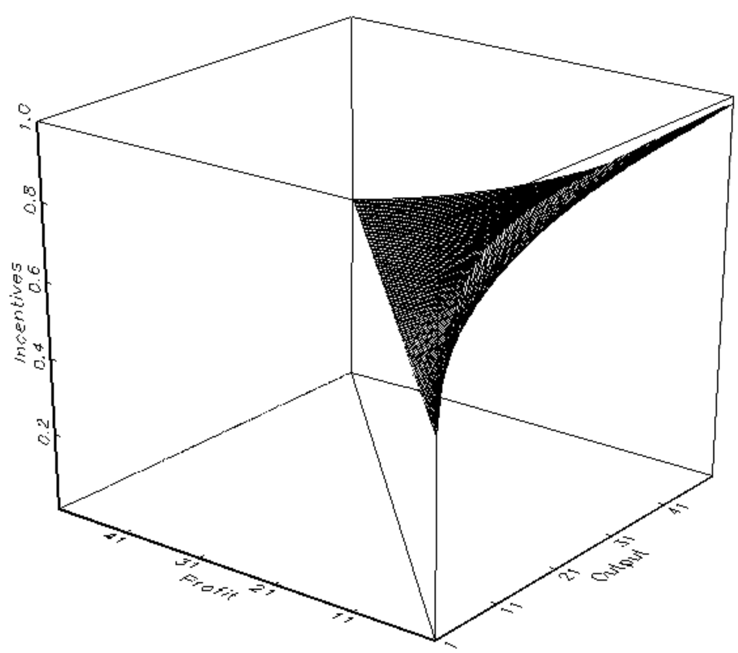
This equation has interesting implications indicating that the choice of contract parameters will depend primarily on the size of the project and profitability. It implies that, keeping other things constant, projects of very large size will tend to be financed on an interest basis while very small projects may be on PLS or may not attract external funds at all. Medium size projects are expected to be on a PLS basis. Similarly, owners of highly profitable projects will either not opt for external finances or will go for interest-based financing, ceteris paribus. Capitalists will be interested in investing in the least profitable projects on an interest basis, and projects with average profitability may be financed on a PLS basis.

DIAGRAM 1: OUTPUT, COST, AND INCENTIVES



The diagram plots reward incentives against output and cost as described in equation 6. It is interesting to note that a simultaneous rise in output and costs will give rise to convergence of incentives to one, a case of fixed return contracts. In contrast, gradual increase in size of the project (output) at low costs will make the incentives to converge to 0.5, a pure share contract.

DIAGRAM 2: OUTPUT, PROFIT, AND INCENTIVES



Equation 6 is used to plot incentives against output and profitability of the project. This shows that small projects with low profitability and large projects with high profitability will attract PLS, although for different reasons. Large projects with low profitability, however, will be financed on a fixed return basis.

Diagram 1 shows the possibility of existence of PLS arrangements in medium size projects. Even more interesting is the convergence of r to 0.5 at high levels of output with gradual decrease in costs. This means that change of profits in large projects leaves reward incentives intact and equal distribution of profits is optimal. On the other hand, small projects with low costs may not be able to attract external funds at all. Similarly, at high levels of output, costs (physical as well as agency costs) become enormous, a major hindrance in the use of PLS contracts. Diagram 2 relates reward incentives with the size of project and profitability. Large projects with low profitability are not financed on PLS basis for obvious reasons. Small projects with low expected profitability or large projects with high profitability may attract PLS.

However, in the case of large and very profitable projects, PLS arrangements may exist depending on the relative bargaining power of transacting parties and the complexity[10] of the project. In the absence of business risk, capitalists are likely to wish to retain control of very highly profitable projects, and would prefer to be the residual claimant on profits by hiring salaried managers; while entrepreneurs would seek outside funds, if required, on an interest basis (Table 1). Similarly, keeping other things constant, capitalists would like to control very large projects and, hence, to be sole residual claimants, while entrepreneurs would prefer debt contracts (Table 2). Hence, there would be no PLS contracts. But given volatility of profits and output, capitalists and entrepreneurs may agree to enter into PLS arrangements to share the total risk of net cash flows that tend to be large in large projects. However, such arrangements will involve the agency problem given the clashing interests of the transacting parties as regards profit distribution. Such an agency necessitates entering into further contracts or writing complete contracts.

The inherent agency problem of PLS can alternatively be explained with the help of Diagram 3 in the following. It is a graphical representation of the quadratic equation[11]

$$\Pi^2 - (Y^e - R)\Pi - (Y^e - R)Q = 0 \tag{7}$$

for different levels of $(Y^e - R)$.

$(Y^e - R)$ serves as an approximation of the contract choice. $Y^e - R = 0$ means that expected income from a venture is wholly independent of profits. Positive values of $(Y^e - R)$ imply a profit-related component in the total expected income, which increases at higher levels of $(Y^e - R)$. Diagram 3 suggests that variability of profits increases directly with output. More interestingly, profits tend to increase with a decreasing rate for a given contract, but can be increased by changing the contract mix in favor of more PLS. The following slope equation relates output, profits, and the contract mix (as given by $Y^e - R$).

$$\frac{dQ}{d\Pi} = \frac{2\Pi}{Y^e - R} - 1 = \frac{2\Pi - (Y^e - R)}{(Y^e - R)} \tag{8}$$

However, an increase in profits is accompanied by an increase in variability of profits (as shown by the spread of curves in Diagram 3). It is interesting to observe that spread in profits tilts in favor of positive profits, suggesting that expected profits will go up with an increase in PLS in the contracts mix. This should lead to an increase in the reward incentives.

DIAGRAM 3: RELATIONSHIP BETWEEN SIZE AND VARIABILITY OF PROFITS

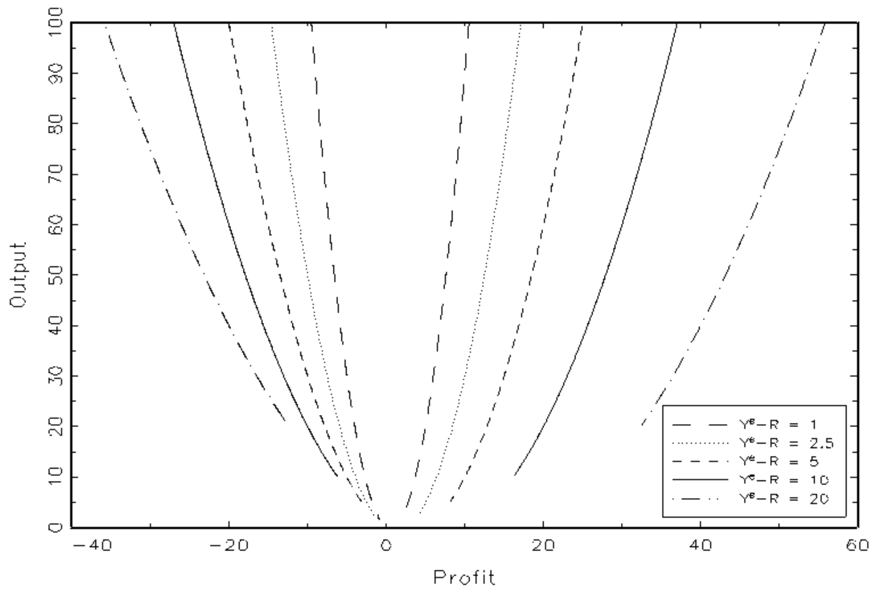


TABLE 1. PROFITABILITY AND CONTRACTUAL CHOICE

Profitability	Capitalist	Entrepreneur
Very low *($\Pi \to 0$)*	Fixed return contracts: mainly interest-based *($R > 0; r = 1$)*	-
Finitely high or medium	PLS contracts *($0 < r < 1$)*	PLS contracts *($0 < r < 1$)*
Infinitely high *($\Pi \to \propto$)*	Either no outside contract ($R > 0$; $r = 0$) or management contracts ($R < 0$; $r = 0$)	Fixed return contracts: mainly interest-based *($R < 0; r = 0$)*

TABLE 2. PROJECT SIZE AND CONTRACTUAL CHOICE

Project Size	Capitalist	Entrepreneur
Small (very low output)	PLS contracts *($0 < r < 1$)*	PLS contracts *($0 < r < 1$)*
Medium	PLS contracts *($0 < r < 1$)*	PLS contracts *($0 < r < 1$)*
Infinitely large *($Q \to \propto$)*	Either no outside contract ($R > 0$; $r = 0$) or management contracts ($R < 0$; $r = 0$)	Fixed return contracts: mainly interest-based *($R < 0; r = 0$)*

1. Diffusion of Ownership and Agency

It is useful to extend the analysis to a case where both parties share capital and/or management right. The following simple formula (similar to equation 1) can be used to describe such a relationship.

$$Y_i = R + r_i \Pi \tag{9}$$

$\forall\ i = 1, 2$, and $r_1 + r_2 = 1$. Subscripts 1 and 2 stand for capitalist and entrepreneur respectively. *R*, as defined earlier, is a profit-independent component of income, and r_i are profit ratios.

R, being opportunity cost of financing on a PLS basis, serves as a reference point. If PLS financing is to substitute interest-based financing then the capitalist will have an incentive to invest on a PLS basis only if r_1 is chosen such that return on investment exceeds its opportunity cost, i.e., $r_1 \Pi \geq R$ or $r_1 \geq \frac{R}{\Pi}$. Substituting the value of R from equation 7 and considering the binding case, the capitalist's share is

$$r_1 = \frac{Y_1}{2\Pi} \tag{10}$$

As $r_1 + r_2 = 1$, the entrepreneur's share should be

$$r_2 = 1 - \frac{Y_1}{2\Pi} \tag{11}$$

This negative relationship between profit and the capitalist's share is interesting. In the extreme case of infinite profit, r_1 approaches zero, which means no PLS. This implies, as discussed earlier, that capitalists prefer to use interest-based contracts for highly profitable projects. Entrepreneurs, however, prefer PLS as they expect to receive a larger share of profit.[12]

In case of n sharing partners, the total income of all transacting parties can be summed as follows

$$\sum Y_i = nR + \Pi \sum r_i \tag{12}$$

If an individual share (r_j) is chosen to be at least equal to the fixed interest payment, as mentioned above, then

$$r_j = \frac{\bar{Y}}{\Pi} - \bar{r} \tag{13}$$

In this case of diffused ownership, the negative relationship between profit and PLS sustains. An increase in the number of partners, however, makes individual shares smaller, which in the limit may cause breakdown of PLS arrangement due to an increase in monitoring and transaction costs.

2. Investment and Growth

The analysis here implies that further investment in a PLS project is curtailed if the incentive effect of investment either exceeds or equals the output effect of investment change. In other words, if reward incentives are unitary elastic to output or finitely elastic, capitalists will not make further investment on PLS basis as in such a case, benefits of expansion will go to the manager and/or entrepreneur only. Only when reward incentives are not sensitive to output, further investment in the project will increase the capitalist's share in total profits. Tight control over costs in large projects may make equal distribution of profits optimal (Diagram 1). Although PLS itself is a source of the agency problem, it creates more reward incentives than agency disincentives in such a case. When reward incentives are sensitive to output, a fixed return contract will be preferred over PLS.

Investment in and growth of PLS-based projects depend on a number of factors.

While the residual right over profit is inherently responsible for the agency problem in PLS, the residual right to control may mitigate the agency and, hence, provide incentives for further investment.[13] The decision to invest more by capitalists will be affected by the degree of *ex post* control they can exert on the project. Capitalists will make the more investment the higher the *ex post* control over the use of funds. Hart (1995) makes a similar argument in a discussion of a merger of two firms.

Considering the problem from an entrepreneur's point of view, PLS in the wake of unitary elastic reward incentives will induce the entrepreneur to acquire more funds on a PLS basis.

The investment decisions in this context depend on asymmetric information between and *ex ante* bargaining power of capitalist and entrepreneur. Asymmetric information and *ex ante* bargaining power are related with each other as much as the latter is with the ownership of crucial assets. The more an entrepreneur is able to conceal its incentives, the more *ex ante* bargaining power is possessed, and vice versa.[14] In many cases, it may be in the interest of the entrepreneur to create asymmetry of information to get access to some funds that are not otherwise available. A competitive environment, however, reduces bargaining power of contracting parties and induces a cooperative behavior, which makes it feasible to share information.

Signaling also plays an important role. Given the alternatives, choice of PLS by an entrepreneur will signal to the capitalist that the entrepreneur expects a large share of profit from the project as both output and incentive effects go in the entrepreneur's favor. This holds only if the project has sufficient history of profitability. Otherwise, the choice of PLS may give mixed signals to the capitalist.

IV. Conclusion

The analysis here suggests that PLS best works in small and medium size projects with relatively low expected profits. Governments in Muslim countries, almost all of them being developing countries, spend huge funds to encourage establishment of small and medium size industries as part of their industrial planning. Islamic banks and other non-bank Islamic financial institutions have a large scope in such environments. However, Islamic banks have failed to realize their potential in the economic development of the Muslim countries. Influenced by the already established banking practices, they have adopted a route not much dissimilar to that of conventional banks. As existing financial structure in the Muslim countries is not efficient in resource mobilization, the Islamic banks have consequently followed suit.

The implications of the preceding sections suggest the following to improve upon the current practice of Islamic banking and finance.

Islamic banks should be set up as specialized banks catering for specific sectors. This will help in monitoring the investments in the projects relatively cheaply. The current phase of privatization and the shrinking role of the public sector in resource mobilization should help Islamic banks as they can fill the post-privatization vacuum in development finance. Governments in almost all developing countries, including the Muslim ones, are pulling themselves back from development finance and are gradually introducing private finance initiatives. The Islamic banks have a role to play if they target traditional industries that have enjoyed comparative advantage in the past but now face financial constraints to expand or modernize their operations.[15] Specialized financial institutions can play a pivotal role in the development of these industries.[16]

Most Islamic banks and finance companies have so far been engaged in short term financing. *Mudaraba* and *musharaka*, being long term financing instruments, have as a result been ignored. Hence, there is a need to innovate in designing short term PLS contracts, for example, to stage the financing, as is common in venture capital financing.

Small but growing industries should be targeted by Islamic banks as the firms in such industries are in need of outside capital more than the established firms that in general have access to credit on an interest basis.

Given that capitalists are liable to losses in proportion to their capital shares in an investment project, it is recommended that PLS contracts should stipulate a profit-independent component in reward-sharing formulae in addition to a profit-related component. This will encourage the use of PLS by both entrepreneurs and capitalists. This amendment is not contradictory with the Islamic PLS and at the same time is symbiotic to the profit related payment schemes that have proved to be successful in the retail sector and labor market in Britain and elsewhere.

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[1] For legal definitions of the Arabic terms, see Ahmad (1993) or Kahf and Khan (1992).

[2] Even recent developments in Islamic banking have failed to spur the use of PLS. For example, Islami Bank Bangladesh, Sudanese Islamic Bank, Tadamon Islamic Bank, Qatar Islamic Bank, and Bank Islam Malaysia Berhad have so far failed to use *Mudaraba* as a mode of financing. Islamic banking in Europe (especially in Switzerland and Britain) is also heavily biased in favor of trade finance and project finance on *Murabaha* basis. PLS has yet to attract a successful practitioner in Europe.

[3] The *Mudaraba* managers face no restrictions from certificate holders. However, stock markets and different government authorities (Corporate Law Authority and the State Bank of Pakistan) monitor them externally to ensure transparency in business.

[4] This may seem contradictory to Coase and others who say transaction costs are costs of organizing resources across markets, or more precisely the costs of using the price mechanism (Coase, 1937). Coase (1960) explained the concept in these words, "In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on" (p. 15). So transaction costs could include not only search costs, contract costs, etc., but costs of enforcing agreements (monitoring costs). This is a broader definition. However, this study takes transaction costs to simply represent search costs, costs of drawing up the contract and of negotiating price of input.

[5] This argument is based on Coase (1937) who says that whether a transaction is organized within the firm or in the market by independent entrepreneurs depends on a comparison of costs and benefits of integration. Coase defines integration as joint organization of the transactions previously carried out between two or more entrepreneurs independently. He further explains that integration involves bringing different functions under one control (see Williamson and Winter, 1991). Coase links organization with cost while the argument here emphasizes the effect of cooperation and opportunism on agency costs and hence on contractual choice.

[6] Alternatively, it can be assumed that the probability that the manager deviates from the contract will increase as more is invested in a project, unless supervised more closely.

[7] An incentive function of the form $r = r(k, \theta)$ will leave the argument unaltered.

[8] Some argue that uncertainty implies incompleteness of contracts (Hart, 1995). In this paper, consideration is also given to the role of contracts in decreasing uncertainty in financial relationships.

[9] Given the income function

$$Y = R + [1 - r(Q(k,\theta),\theta)](Q(k,\theta) - c)$$

Maximization with respect to k yields

$$\frac{\partial Q}{\partial k}\left(1 - r\left(Q(k,\theta),\theta\right)\right) = \frac{\partial r}{\partial Q}.\frac{\partial Q}{\partial k}Q - \frac{\partial r}{\partial Q}.\frac{\partial Q}{\partial k}c$$

Transformation of the above equation into an elasticity expression gives

$$\frac{1-r}{r} = \frac{\partial r}{\partial Q}.\frac{Q}{r} - \frac{\partial r}{\partial Q}.\frac{Q}{r}.\frac{c}{Q}$$

Putting $\eta = \frac{\partial r}{\partial Q}.\frac{Q}{r}$ in the above equation and re-arranging

$$\eta = \left(\frac{1-r}{r}\right)\left(\frac{Q}{Q-c}\right)$$

[10] An organizational structure is said to be complex if it is easy to diffuse specific information relevant to decisions amongst different agents (Fama and Jensen, 1983).

[11] Equation 7 is simply a reduced form of equation 1 with the value of *r* as defined by equation 6.

[12] Evidence in farming supports this hypothesis. Dar (1996) shows that landlords prefer to cultivate profitable land by themselves or on fixed rent tenancy. Sharecropping (which is similar to PLS) is practiced on less profitable farms.

[13] The agency costs associated with PLS can be reduced by following what Fama and Jensen (1983) suggest. They suggest that *decision management* and *decision control* should lie with managers/entrepreneurs and capitalists, respectively, to control the agency problem. They divide the decision process into (i) *Initiation* – proposals for resource use and structuring of contracts; (ii) *ratification* – selection of projects; (iii) *implementation* – execution of projects; and (iv) *monitoring* – monitoring agents and distributing rewards. They assign initiation and implementation to the entrepreneur/manager, and call it decision management. Ratification and monitoring are the responsibilities of the capitalist and are termed as decision control. However, this specialization is useful only if it increases organizational efficiency by allowing valuable knowledge to be used at points in the decision process where it is most relevant; and if it reduces the agency problem such that additional costs are less than the benefits from increased organizational efficiency.

[14] *Ex ante* and *ex post* bargaining power will differ as informational asymmetry will decrease after the contract has been drawn. In a two-period model, if there is re-negotiation at the end of period 1, the bargaining power will depend on degree of informational asymmetry at that point (which is expected to have diminished since the start of the contract).

[15] Fishing and forestry in Malaysia and Indonesia, agricultural tools, leather products, handicrafts, and farming in Pakistan, carpets and rugs in Iran, and numerous other industries in all countries need attention to compete in the world market.

[16] The examples already exist in some countries. MCos in Pakistan can float either specific-purpose *Mudarabas* or multipurpose *Mudarabas*. However, their practice so far has been more general and there is a need to make it more specific.

The Survival of Islamic Banking

A Micro-evolutionary Perspective

Mahmoud A. El-Gamal*

ABSTRACT

Many economists have studied the macroeconomic properties of interest-free banking in the framework of an isolated and ideal Islamic economy. In this age of integrated global financial markets, it is important to consider an alternative model where interest-based and interest-free banking co-exist. An evolutionary game-theoretic model in which strictly Muslim agents (who use profit- and loss-sharing), regular interest-based banks, and hybrid-system Muslims/banks (e.g. banks with Islamic windows) interact is presented. In this model, a society where all agents and institutions are purely Islamic would be the most prosperous, even financially. However, in the face of competition with interest-based institutions, a critical initial mass of the hybrid type is necessary for the survival of the strictly Islamic agents in a heterogeneous environment. Moreover, their survival is predicated on the hybrid agents' acting among themselves in an Islamic way. When the hybrid agents act this way, their existence is both necessary and sufficient for Islamic banking to survive.

I. INTRODUCTION

The twentieth century has witnessed resurgence in the observance of fundamental Islamic practices around the world. The Islamization of the financial sectors of many Muslim countries was a natural consequence of this resurgence, and the degree of Islamization varied dramatically across countries with Muslim populations. The Islamic Republic of Iran and Pakistan are at one extreme, where the entire financial sector has been made officially "Islamic."[1] Malaysia, Saudi Arabia, and many Arab countries have developed a hybrid financial system where Islamic banks coexist with regular financial institutions, and the monetary authorities of those countries to varying degrees regulate both types of financial institutions.[2]

This increase in the practice of Islamic banking transformed "Islamic economics" from a sub-field of *fiqh* (Islamic jurisprudence) and comparative systems into one which interacts positively with mainstream economic theory.[3] The large ensuing literature since the mid-1970s (significantly assisted by the inception of a number of journals devoted to the subject) has helped dispelling a number of the myths that surrounded the field in earlier decades. In particular, it is no longer held that by abolishing interest, Islam denies the legitimacy of time preference and/or rates of return for capital (see, for instance the papers in M.F. Khan (1995) on this issue).

Moreover, M. S. Khan (1986) has noted that the abolition of interest-based transactions is not a subject alien to "western" economic thought. For instance, Fisher (1945), Simons (1948), Friedman (1969), and others have argued that the current (one-sided liability) interest-based financial system is fundamentally unstable. This view was made more popular in recent years due to the epidemic of Savings and Loans bankruptcies in the U.S., as well as the financial crises in Latin America, and - more recently - in Asia (instigated by the ambiguity of the financial positions held by banks seeking higher interest rates on foreign currency denominated bonds). Zarqa (1983), Khan (1986), and a number of papers that followed have illustrated the macroeconomic stability of a profit- and loss-sharing (henceforth PLS) system, which would replace interest-based transactions in an Islamic economy.

This paper attempts to add to the existing literature in two directions. First, I consider the stability of the institution of Islamic banking from a micro-economic point of view, where the survival of this institution depends on its ability to maintain sound financial positions for its customers (devout Muslims, and others). Second, I do not limit my attention to an idealistic Islamic economy which is isolated from the rest of the world; i.e. where all interest-based transactions are impossible, (e.g. Naqvi (1982) and others). Instead, I present an evolutionary game-theoretic model of the dynamics of Islamic banking in the existence of other interest-based financial institutions. This model is a closer representation of the current situation, where Islamic banks operate in most countries (Islamic and non-Islamic) side-by-side with traditional banking institutions.[4]

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At the micro-level, I replace the assumption of a population of homogeneous Homo Islamicus (Haneef (1995)) agents in the economy, with one comprised of three types of agents: (1) strictly Islamic agents, who never engage in interest-based transactions; (2) traditional banks and economic agents, who lend and borrow with interest; and (3) economic agents who deal symmetrically with both the strictly Islamic agents (in which case they engage in PLS transactions), as well as regular economic agents (in which case they have interest-based transactions). This last type will be labeled hybrid agents (e.g. banks with "Islamic windows," or "dual system"). Perhaps the strongest condemnation in the literature of those hybrid agents is that in Ahmad (1992):[5]

> "The sad reality is that though every one concedes that Islam prohibits interest, there is not a single Muslim country which running its financial institutions without resorting to interest. The fact is that no one knows how to do it, and when political pressure mounts, they can only resort to some kind of subterfuge" (p. 16)

Later, Ahmad (1992) criticizes Islamic banks engaging in such activities under subsections titled "And we claim, we have abolished interest!" and "Current posture of Islamic Economics."

> "It is not clear whom we are cheating..." (p. 47)

> "The worst part of the story is that Islamic economists, as a body in their International Monetary and Fiscal Conference held in Islamabad in 1981, gave their unreserved approval to this arrangement. So far this is the best that Islamic economics has to offer, viz., change the name of interest and you have abolished interest." (p. 48)

In the model I shall present, it will be shown, rather surprisingly, that it is exactly this type of economic agents that are needed in the interim to ensure the economic survival of pious Muslim agents. Religious and theoretical considerations, as well as some empirical evidence will motivate the assumptions of the model. Though highly stylized, this dynamic microeconomic approach may serve as a seed for further theoretical and empirical investigations of the necessary transition from interest-based to PLS systems. Section 2 reviews some of the general theoretical assumptions of the model presented in this paper. The religious, theoretical, and empirical findings motivate the assumptions of the model. Section 3 presents the model and the analysis of its dynamics, and Section 4 concludes the paper.

II. Assumptions of the Model

We take as fundamental the fact that interest rates payment and receipt are forbidden for all Muslims. Moreover, we recognize that the economy contains pious Muslims who never engage in any transactions involving interest payments, as well as regular economic agents and institutions, which routinely pay and receive interest. This hybrid economic system is likely to continue for some time, and it would be idle philosophy to contemplate how a purely Muslim economy would perform without knowing whether such a system can be sustainable in the presence of interest paying and receiving agents and institutions.[6]

A recently conducted survey of depositors of an Islamic bank (Abdel-Kader (1995)) showed that in addition to agents who never deal in interest and those who always do, there is a large contingency of agents who participate in both systems. In particular, the study found that for the depositors of BIMB in 1991, 64% of depositors had accounts with other (interest paying) banks. Moreover, the transactions of Islamic banks are themselves not purely Islamic. Whereas demand deposits do not pay any interest, savings deposits which remain with the bank for a significant period (e.g. 12 months) are rewarded with a "gift", which typically has a high correlation with market interest rates, although they tend to be lower than the market rates (BIMB (1994), Bank Negara Malaysia (1994)).

Most *mudaraba* arrangements carry in their contracts a clause that if the rate of return to the bank or investor is less than some percentage (usually written in the contract as an absolute monetary value of the "profit share"), the bank or investor has the right to audit the entrepreneur's operations. To avoid such an audit, entrepreneurs typically pay that threshold rate regardless of the actual profit or loss, which makes that rate functionally equivalent to an interest rate (Khan (1983)).

This empirical reality motivates our assumption that there are three types of economic agents in our evolutionary game model:

1. Strictly Islamic agents (denoted P^* for always using PLS financial instruments instead of interest-rate based instruments).

2. Regular banks and economic agents (denoted I*, for always choosing the interest-based instrument).
3. Hybrid agents (denoted W, who interact symmetrically with all agents; i.e. when making a transaction with a P* agent, they follow PLS rules; and when making a transaction with an I^* agent, they use the market interest rates). In addition to individuals who participate in both banking systems, those hypothetical *W* agents also represent the current practice of "banks with an Islamic window," and "Islamic" banks which offer interest-like.

Our model is an evolutionary game wherein the three types of agents are pairwise randomly matched in each period to play a two-person, two-move game (interpreted as an economic transaction). The two moves available to each agent are P (do not use interest rates), and I (use interest rates). Strictly Islamic agents—due to the religious prohibition—never choose I, and hence their lifetime strategy is P^*. Traditional economic agents are accustomed to interest rates, and believe that it is always better due to their risk aversion (it is argued below, based on the "equity premium puzzle", that this belief is empirically unjustified). Therefore, they always choose I, taking the borrower or lender side depending on which is more advantageous at the given interest rate.

We shall construct the normal form of the stage game as a prisoner's dilemma:

	P	*I*
P	*(a,a)*	*(0,b)*
I	*(b,0)*	*(c,c)*

where we shall assume that $b>a>c>0$. This makes the standard banking practice (*I,I*) the unique Nash equilibrium for the stage game, but it is Pareto inferior to the Islamic outcome (*P,P*).

The fact that (P,P) is not a Nash equilibrium (i.e. b>a) follows immediately from the impossibility of finding a profit-sharing rule which, for a generic profile of risk aversion in the population and distribution of potential profits, will make the certainty equivalent of the profit share greater than or equal to the interest rate times principal. Moreover, if an I^* agent is matched with a P^* agent, since the I^* type is always willing to take either the borrower or the lender side, and since the P^* agent has the option of holding their money and paying 2.5% *zakat* al-Mal or giving an interest free loan,[7] the outcome is an interest free loan from the P^* agent to the I^* agent. We normalize the service fees or other nominal fixed return to the lender in such a transaction at zero, and the I^* agent can then invest the funds, or collect unshared interest on them, hence justifying b>a.

The fact that the unique Nash equilibrium (I,I) is Pareto inferior to the Islamic outcome (P,P) (i.e. a>c) is justified on theoretical as well as empirical grounds. On the theoretical side, one may name: (i) the stability of an Islamic financial sector in the face of macroeconomic shocks (Simons (1948), Zarqa (1983), Khan (1986)); (ii) the more efficient allocation of resources, up to a lower marginal productivity of investment (Iqbal and Mirakhor (1987)); (iii) the reduction of "effort aversion" which would cause poorer choice of investment projects (Khan (1995)); (iv) the potential undertaking of riskier projects with a higher expected profit; and, above all (v) obedience to God; which is believed to lead to success in this life and the next. Those theoretical considerations support the assumption that a>c.

On the empirical side, an argument that a>c, even allowing for risk aversion, can easily be formulated based on the famous "Equity-Premium Puzzle" (Mehra and Prescott (1985)). Mehra and Prescott noted that the premium of the return on the S&P over the riskless rate (commercial paper) for the period 1889-1984 had a mean of 6% and a standard deviation of 18%. This large "premium" can only be explained by extreme rates of risk aversion in the economy. However, Weil (1989) has shown that if such a rate of risk aversion is assumed, we get a reverse puzzle, "the risk-free rate puzzle." Namely, if we assume a rate of risk-aversion, which justifies the equity-premium, then the rate of time preference that justifies the risk-free rate must be negative. Since a negative rate of time preference defeats some of the most fundamental justifications for interest rates, it would seem that risk aversion cannot explain why PLS (equity-based) systems yield returns so much higher than riskless rates. A number of other unsuccessful explanations have been proposed in recent years, but the "puzzle" remains an unexplained empirical regularity which justifies our assumption that a>c.

III. THE MODEL

We study the stage game discussed in the previous section, which shows that whenever any two agents are matched at any point in time, they play a prisoner's dilemma:

	P	*I*
P	*(a,a)*	*(0,b)*
I	*(b,0)*	*(c,c)*

with *b>a>c>0*. We further assume, following the discussion and motivation in the previous section, that there are three types of strategies agents use in the repeated game: P^* (always choose *P*), I^* (always choose *I*), and *W* (choose *P* if matched with a P^*-type, and choose *I* if matched with I^*). The only remaining degree of freedom is how *W* acts when matched with another *W*. The assumption we make for such encounters is crucial for the analysis to follow. We shall consider the two extreme cases:

1. [Case I: WW=PP] where the hybrid types mimic the pious types when they interact amongst themselves.
2. [Case II: WW=II] where the hybrid types mimic the interest-using types amongst themselves.

Time is assumed discrete. In each period, all the agents (in a very large, but finite, population) are matched pairwise, and they get to play the game for this period. The appropriately normalized payoffs in any period of the repeated game given the three strategies is:

	*P**	*I**	*W*
*P**	*(a,a)*	*(0,b)*	*(a,a)*
*I**	*(b,0)*	*(c,c)*	*(c,c)*
W	*(a,a)*	*(c,c)*	*(d,d)*

where (*d,d*)=(*a,a*) in CASE I, and (*d,d*)=(*b,b*) in CASE II.

It directly follows that the expected payoffs for each type at any given period are a simple function of the proportion of agents using P^* (we call that proportion x_t), and the proportion using I^* (we call that proportion y_t, and - trivially - the proportion using W is $(1-x_t-y_t)$). Those expected payoffs are:

$$\pi(P^*;x_t,y_t) = a - ay_{t,}$$

$$\pi(I^*;x_t,y_t) = c + (b-c)x_t,$$

$$\pi(W;x_t,y_t) = \begin{cases} a+(c-a)y_t & Case I \quad (WW=PP) \\ c+(a-c)x_t & Case II \quad (WW=II) \end{cases}$$

Which results in a population-wide payoff at time *t* of:

$$\pi(x_t,y_t) = x_t\pi(P^*;x_t,y_t) + y_t\pi(I^*;x_t,y_t) + (1-x_t-y_t)\pi(W;x_t,y_t)$$

Now, we assume that the agents making more money will have a stronger presence in the market in the following period, and vice versa. This can be interpreted as the rich having more progeny/followers, or simply as being larger economic entities which subdivide into more "agents," whereas those getting poorer get smaller and fewer. The particular dynamic model chosen here is the famous "replicator dynamics" model which is borrowed from Biology. This model has become the main paradigm for evolutionary game theory:[8]

$$x_{t+1} = \frac{x_t \times \pi(P^*;x_t,y_t)}{\pi(x_t,y_t)}$$

$$y_{t+1} = \frac{y_t \times \pi(I^*;x_t,y_t)}{\pi(x_t,y_t)}$$

The dynamics of this model are strikingly different for CASE I and CASE II. A schematic sketch of the phase diagrams for the model with b>a>c>0 in CASE I and CASE II are shown in Figure 1 and 2, respectively. In Figures 1 and 2, lines and points in boldface represent fixed points, and arrows in the interior represent the dynamic trajectories. Figures 3 and 4 show the phase diagram and 400 numerical trajectories each for the case b=3, a=2, c=1, however, the phase diagram is qualitatively the same for any b>a>c>0, although the exact turning points depend on the numerical values of those parameters. Notice that P^*'s average payoff is monotonically decreasing in y_t, and that I^*'s payoff is monotonically increasing in x_t; i.e. the I^* types are predators and the P^* are prey. The interaction of those two types with W in cases I and II produces interesting dynamics.

It is straightforward to verify the main analytical properties of our phase diagrams:

- [In CASE I] *WW=PP*:
  1. All the points on the x-axis (y_t=0) are fixed points, where the P^*'s survive forever, and the *W*'s survive forever acting like P^*'s.
  2. There is an isolated fixed point at y_t=1.
  3. All the points with (1-x_t-y_t)=0 (i.e., the diagonal, with no *W*'s), converge to the isolated fixed point, where all the P^*'s vanish.
  4. In a neighborhood of the diagonal defined by $1-x_t-y_t < \varepsilon(a,b,c)$, we get monotonic decline of x_t to zero, followed by a monotonic decline of y_t to zero. In the limit, only *W*'s survive, and they act in CASE I like P^*'s.
  5. With sufficient *W* types, $1-x_t-y_t > \varepsilon(a,b,c)$, the P^* types survive forever, with $\lim_{t\uparrow\infty} y_t = 0$, and the *W*'s in the limit act like P^*'s.
  6. There is no scenario in which both $\lim_{t\uparrow\infty} x_t$ and $\lim_{t\uparrow\infty} y_t$ are positive. In other words, the pious and the interest-using cannot co-exist forever.
  7. In order for Islamic banking to survive in a heterogeneous environment, it is necessary that *WW=PP* (see CASE II below), and that there is some mass of *W* types (the larger the mass, the higher the chance of P^*'s surviving, and the faster that interest-based dealings perish).

- [In CASE II] *WW=II*:
  1. The only manifold on which any Islamic banking can survive is defined by the x-axis y_t=0. All of the points on that axis converge to the isolated fixed point at x_t=1, i.e. where at time *t*=0 only P^*-types exist.
  2. All points with x_t=0 (on the y-axis) are fixed points, where the interest-using agents survive forever, and the *W* types mimic them and survive as interest-users.
  3. Starting from any other point with y_t>0 (i.e., with the slightest deviation from an idealistic, isolated, Islamic economy), $\lim_{t\uparrow\infty} x_t = 0$.
  4. There is no scenario in which both $\lim_{t\uparrow\infty} x_t$ and $\lim_{t\uparrow\infty} y_t$ are positive. In other words, the pious and the interest-using cannot co-exist forever. This is true in both cases I and II.

Of course, if we take intermediate cases where the W types sometimes use PP and sometimes use II when dealing amongst themselves, we may still get the survival of Islamic banking provided that the proportion of W's is above a critical level, and that they use PP amongst themselves sufficiently often. Figures 5 and 6 illustrate two of the more interesting scenarios under Cases II and I, respectively. Figure 5 shows that if WW=II, we may get a short period of increase in P^*, but such a resurgence of Islamic banking will be short-lived, and eventually self-defeating. Indeed, as we know from the above analysis of the phase diagram, the only scenario under CASE II in which Islamic banking (the P strategy) survives (is used in the limit), is for all agents to use P at time 0. This corresponds to the traditional view of Islamic economists that all interest must be abolished instantly, otherwise the Islamic practice cannot be sustained. Indeed, in both cases I and II, this point x_t=1 is trivially a fixed point, and this justifies the statement that if the economy were to convert to Islamic practice all at once, such practice can survive regardless of the environment.

However, this intuition is not useful in a complex world where interest-using agents coexist with—and strive to exploit—Islamic practice. In this environment ($y_t > 0$), it is not true that a sufficiently large x_0 (contingency of pious agents), can guarantee the survival of Islamic banking. This is obvious in CASE II, where all pious agents will perish if faced with a heterogeneous population. It is interesting to see in Figure 6 a scenario under CASE I where x_0 is large at the expense of $(1-x_0-y_0)$; i.e. there are not enough W type agents in the economy. In this case, the P^* types will still be easy prey for the I^*, and will be doomed to extinction. After all the P^* types have vanished (x_t=0), the W agents continue to outperform the interest-taking types, and eventually become the only survivors ($\lim_{t\uparrow\infty} (1-x_t-y_t)= 1$). This limiting result has Islamic banking surviving in the limit, but for economic rather than religious reasons, since the truly pious types are the first to perish. Indeed, the hybrid agents are the strongest economically. In both cases I and II, they can survive in the face of the interest-users. In CASE I, they can play an additional role (provided there are enough of them) of helping the pious agents survive in the long run.

Interpreting the W agents as the modern Islamic banks with some Islamic dealings and some transactions that either mimic interest, or are explicitly interest based, our results suggest that the severe criticism of those institutions in the literature may be misguided. It would be ideal to instantaneously obtain universal Islamic behavior x_t=1. However, since this is not a likely scenario, the "dual system banks" type seems necessary to ensure the survival of Islamic economic practice in a heterogeneous economy of Islamic and interest-using agents. If we further accept the limiting result $(1-x_t-y_t)=1$ as a form of Islamic banking survival (despite the fact that the truly pious agents would have perished), then the existence of W agents has been shown to be sufficient for Islamic banking to dominate the economy in the limit. Moreover, the larger the contingency of W agents, the faster an economy can rid itself of the interest-using types, provided that we are in CASE I, where the W types behave among themselves in the Islamic manner.

IV. Conclusion

Islamic economists and Muslims in general, diverge in their view of the modern phenomenon of hybrid Islamic/traditional banking. Some view the practices of those Islamic banks which mimic interest as practical short-run alternatives, and hope that they will gradually be replaced with practices that agree with the spirit as well as the letter of the Islamic law (Khan (1995)). Others are angered with what they view as an outrageous form of religious hypocrisy, and wish to transform the economy instantaneously to be in accordance with Islamic law (Ahmad (1992)).

In the highly stylized model presented in this paper, it has been shown that each of these divergent views is correct in a special case. The determining factor in this model is the manner in which Islamic banks deal among themselves. It is shown that the necessary and sufficient condition for Islamic banking to survive in the long run is the existence of agents who are willing to interact symmetrically with the Islamic and the interest-based parts of the economy, and that those agents deal amongst themselves in an Islamic manner. It is interesting to note that the Malaysian Islamic banking system (which is the most advanced hybrid financial system where Islamic and regular banks coexist) has recently adopted an Islamic check-clearing system which would facilitate the Islamic interaction amongst the Islamic banks (Bank Negara Malaysia (1994)). This suggests that our model can serve as a seed for future empirical, theoretical, and policy research on transition from regular interest-based banking to Islamic banking.

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[1] See Bank Markazi Jomhouri Islami Iran (1983) and State Bank of Pakistan (1984).

[2] The issue of Islamic bank regulation is a currently active area of research; see Mirakhor and Ul-Haque (1997), and El-Gamal (1997).

[3] The earliest well-known source on Islamic economics is Ahmad (1952). For a recent survey of the major figures in the field of Islamic economics, see Haneef (1995).

[4] Some referees and audience members where this paper was presented have mistakenly read it to say that the hybrid model is superior to the purely Islamic one. As will be seen later in the paper, this is incorrect. The model I present assumes that a purely Islamic financial sector will be more prosperous than the hybrid society. Unfortunately, such a system cannot be brought into existence without incurring monumental costs by severing all ties with the international monetary system. The question asked in this paper is whether the hybrid systems that currently exist in every Muslim society can evolve into a purely Islamic one, and under what conditions.

[5] Again, referees and audiences were quick to echo the sentiments in those comments, by immediately associating the hybrid agents with hypocrites (in the jurisprudential sense). We all know many good-willing, devout Muslims with banking businesses who are working hard to bring about the Islamization of our financial sectors. The dual agents in this paper are sufficiently abstract that their intentions cannot be inferred from their actions. They sometimes have to resort to Islamically acceptable transactions (e.g. *murabaha*) which are very similar to traditional banking practices, and other times may not be able to convert their institutions instantly to Islamic banks. However, no assumption about their intentions would be appropriate based on the fact that they have a hybrid portfolio of transactions at any point in time.

[6] Some readers seemed to jump to the conclusion that I am thus arguing that the hybrid system I am studying is assumed to be superior to a purely Islamic one. Again, this is completely contrary to what the model says. I am simply arguing that a hybrid system exists in reality, and therefore should be our focus of study.

[7] Any funds that remain unused for a year are subject to this form of wealth tax of 2.5% per annum. Interpreting the time period in our model as a year, the P agent would – from a purely financial point of view – rather lend the money with no interest than hoard it and pay 2.5% of its total sum.

[8] For a recent treatment and survey of the literature in Evolutionary Game Theory, see Vega-Redondo (1996).

The Institution of *Zakat* and Its Economic Impact on Society

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Abstract

The institution of *zakat* is the cornerstone of the Islamic economic system. The Qur'an emphasizes *zakat* as a critical component of socioeconomic justice. The institution works to ensure an equitable distribution of wealth and establishes a safety net for needy members of society. Both the sources and disbursement categories of *zakat* are specified in Islamic doctrine. The Qur'an identifies eight categories of disbursement, each of which carries clear social benefit. One positive economic effect of *zakat* is an increase in the money supply and a consequent increase in the demand for goods and services. *Zakat* also provides debt relief and enhances price stability. If accumulated in times of prosperity, *zakat* funds can aid society through times of depression. Though *zakat* has widely fallen out of use in modern times, it can have great economic impact if properly reestablished.

I. Introduction

Islamic finance is based on a belief system that regulates not only the bedroom but also the pocketbook. Only a few decades ago, it was unknown to the West and the world banking community as a better alternative to an interest-based economic system. It is ironic that forty years ago at Stanford Business School, it was impossible to find an advisor on the faculty for my proposed doctoral thesis on "Interest-free Banking." Today, universities like Harvard and Rice in the U.S. are engaged in rediscovering Islamic finance, a welcome sign of relief for a monetarily beleaguered world economy. As we know, the interest-based economic system, coupled with currency speculation, has to a large extent contributed to the recent near-collapse of the Russian, Brazilian, and Southeast Asian economies, not to speak of the hyper-recession of the 1930's which brought Hitler to power. Despite their tight grip over the world monetary system, international agencies like the IMF and the Paris Club have failed to achieve international monetary stability.

Like freedom from interest, *zakat* is also an integral part of Islamic economic system. Since *zakat* is derived from the *Shari'ah*, this paper is designed to cover some of the salient features of the economic impact of *zakat* on society within the framework of the Quranic perspective of economic justice.

II. The *Quranic* Perspective of Economic Justice

The Qur'an itself sheds light on the economic importance of *zakat*. The commandment to establish *zakat* is mentioned more than 100 times, usually in conjunction with *salah* (prayer), as two means of purification. God commands Muslims to pay *zakat* on their total wealth in excess of *nisab*, (minimum wealth) to the poor for benefit of the society's social and economic welfare. The following Quranic verses, among others, emphasize that all resources belong to God and that these resources are thus a trust (Qur'an 57:7) that must be used to satisfy the basic needs of all those who, for no fault of their own, cannot afford the basic necessities of life in a humane and dignified manner.

> For it is He who has brought into being gardens—(both) the cultivated ones and those growing wild—the date-palm, and fields bearing multiform produce, and the olive tree, and the pomegranate: (all) resembling one another and yet so different! Eat of their fruit when it comes to fruition, and give (unto the poor) their due (*zakat*) on harvest day. And do not waste (God's bounties): verily, He does not love the wasteful. (Qur'an, 6:141)

> "[so that] wealth does not circulate only among your rich" (Qur'an, 59:7).

> "And [would assign] in all their wealth and possessions a due share (*zakat*) unto such as might ask [for help] and such as might suffer privation." (Al Qur'an, 51:19)

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> The offerings [*zakat*] given for the sake of God are [meant] only for *fuqara* [poor] and the *masakeen* [needy], and *ameleen-a-alaiha* [those who are in charge thereof], and *muallafat-ul-quloob* [those whose hearts are to be won over], and for *fir-riqaab* [the freeing of human beings from bondage], and [for] *al-gharimun* those [who are over-burdened with debts], and *fee-sabeelillah* [for every struggle] in God's cause, and *ibn as-sabil* [for] the wayfarer: [this is] an ordinance from God—and God is all knowing, wise." (Qur'an, 9:60)

Likewise we find from the sayings of the Prophet Muhammad, who once said,

> "He is not a man of faith who eats his fill when his neighbor is hungry."
> "A locality where a person has to sleep hungry deprives itself of God's protection."[1]

Ali, the fourth Caliph, expanded on this idea in saying that:

> "God has made it obligatory upon the rich to pay out of their wealth whatever is sufficient for the poor. If the poor starve, or go unclad, or suffer difficulties, it is because the rich have deprived them. Hence it is proper for God, the Almighty and the Exalted, to bring them to account and to punish them."[2]

Because the known economic resources at a given point in time are relatively limited, establishing the Quranic perspective of economic justice and providing general well-being for all members of the society requires a focus on three critical economic factors:

1. earning *halal* (permissible) income;
2. ensuring an equitable distribution of wealth; and
3. creating an economic safety net to assure need fulfillment of those who, for no fault of their own, cannot afford the basic necessities of life.

Since *zakat* primarily relates to the second and third factors, let us first briefly define *zakat*. *Zakat* is one of the five pillars of faith. It is a unique, spiritually charged filtering device primarily designed to cleanse one's possession or wealth necessary to protect the owners of wealth against spiritual poverty. While protecting the rights of "haves" and "have nots," its main objective as an act of worship are: (1) the promotion of stable economic growth through investments, employment and balance consumption, and (2) the achievement of greater income equality through an equitable distribution of wealth, thereby eliminating poverty and extreme disparities of wealth between the rich and the poor.

Zakat is a cornerstone of the values that govern Islamic economics. Being directional and normative, *zakat* defines the norms of economic activity and, through its effects on economic variables, determines the direction along which the economy should move. On the revenue side, it specifies the manner in which revenue (*zakat*) is to be raised and who pays it, and on the expenditure side, it sets forth the uses (recipients) of the revenue. Like any modern budget, it describes the economic order that it attempts to establish and express the ideals and aspirations of society.

From a microeconomic perspective, *zakat* is a mechanism for self-help. Everyone contributes to need fulfillment and the general well being of society according to one's ability. And from a macroeconomic perspective, similar to the inheritance laws in Islam, the institution of *zakat* is designed to deal with the distribution of wealth in society. Being a re-distributive fiscal policy based on wealth and not on income, it provides insurance against unjust alliances between economic monopolies and political power, which leads to a social imbalance, exploitation, and eventually anarchy.[3] As such, it guards against the concentration of wealth in the hands of a few persons, families, or even the state.

Finally, as a fiscal mechanism, *zakat* performs some of the major functions of modern public finance, which deals with social security entitlements, social assistance grants for childcare, food subsidy, education, health care, housing, and public transportation in a welfare state. It separates public welfare expenditures from other budgetary items and puts the burden of meeting the economic welfare needs of the society where it belongs. Unlike tax levied by the government for the services provided to tax payers on a quid pro quo basis, *zakat* and its heads of expenditure are determined by the Qur'an and *Sunna*, irrespective of the economic conditions of the society. That *zakat* is distinct from taxes can be seen from a saying of the Prophet Muhammad that "in your wealth there are also obligations beyond *zakat*."[4] By paying *zakat*, a *zakat*-payer fulfills his/her *fard*, (religious obligation), whereas a taxpayer by paying his/her taxes only enables the state to perform its functions effectively.

To better understand the institution of *zakat* as an economic safety net for the society, the present paper will now look at the sources of *zakat* and its disbursement categories.

III. Sources of *Zakat*

As noted above, God commands Muslims to pay a certain percentage of their net worth above *nisab* (the poverty line) as well as a certain percentage of the net output of agricultural and mineral production. This payment is not as a favor, but rather an appropriate use of their wealth which God has given them as a trust (Qur'an, 57:7). This percentage varies from 2.5% to 20% depending upon the asset category.

Nisab, the dividing line that separates the basic necessities of life from luxuries, differs from society to society and changes over time. It sets an acceptable standard of living, which covers all necessities of life compatible to a particular community at a particular economic period. As a general rule, it includes food, clothing, household effects, a house for personal use, medical care, education, means of transportation, and tradesman's tools and equipment. (Large and medium size manufacturing plants are not considered tradesman's tools and equipment.)

By its very definition, *nisab* is a dynamic, not a static concept. While an automobile today may be a necessity in the United States, it may be a luxury in a country like Sudan or India. Similarly, a horse used as a means of transportation, and therefore a necessity in a country like Afghanistan, could be considered a luxury in the upscale suburbs of San Francisco. Simply stated, as ordained in the Qur'an, those who have more than *nisab*, no matter how modest it may be, must understand and accept that poor members of the society have a right to a portion of all of their wealth (Qur'an, 57:7). Nowhere do we see the term *manafi'a* (net profit) used in Qur'an in the context of *zakat*. Since Qur'an uses the term *amwa'al* (wealth), the basis for calculating *zakat* is clearly one's total net worth and not just on their annual income or net profits.

IV. Disbursement categories of *Zakat*

Just as it outlines the source of *zakat*, the Qur'an also defines its disbursement categories in the following verse:

> The offerings [*zakat*] given for the sake of God are [meant] only for *fuqara* [poor] and the *masakeen* [needy], and *ameleen-a-alaiha* [those who are in charge thereof], and *muallafat-ul-quloob* [those whose hearts are to be won over], and for *fir-riqaab* [the freeing of human beings from bondage], and [for] *al-gharimun* those [who are overburdened with debts], and *fee-sabeelillah* [for every struggle] in God's cause, and *ibn as-sabil* [for] the wayfarer: [this is] an ordinance from God—and God is all knowing, wise." (Qur'an, 9:60)

The eight categories mentioned in this verse clearly defines the disbursement of *zakat* as an economic safety net to assure need fulfillment of those who, for no fault of their own, cannot afford the basic necessities of life.

The first two categories, namely *fuqara* (the indigent/the poor) and *masakeen* (the needy) includes those people who, being underemployed or unemployed, have no means of support or insufficient income to meet their basic necessities of life and therefore are indigent or live below the poverty level. This may be because they are incapacitated, disabled, orphans, sick, homeless, or of similar status.

To maintain the integrity and the independence of collection and disbursement of *zakat*, the third category *ameleen-a-alaiha* refers to those expenses that are necessary to administer the *zakat* fund, including personnel salaries. *Muallafat-ul-quloob*, the fourth category, includes those people whose hearts are to be won over. According to some scholars this apparently means such non-Muslims who are to close to understanding and perhaps accepting Islam, and for whose conversion every effort should be made, either directly or indirectly (i.e., by means of the widest possible teaching of Islam).[5] The fifth category *fir-riqaab* relates to both ransoming prisoners of war and freeing slaves.[6] The sixth category, *al-gharimun*, includes those people who are overburdened with debts contracted in good faith, which - through no fault of their own—they subsequently are unable to redeem. The seventh category *fee-sabeelillah* embraces every kind of struggle for a righteous cause, both in war and in peace, including expenditures for the propagation and defense of Islam and for all charitable purposes.[7] This may include education, medical care, and social welfare work. Finally the eighth category *ibn as-sabil* (son of the road) denotes any person who is far from his/her home and who, because of circumstances beyond his/her control, does not have sufficient means of a livelihood at his/her disposal. In its wider sense it describes a person who, for any reason whatsoever, is unable to return home either temporarily or permanently: for example, a political exile or refugee.[8]

V. ECONOMIC IMPACT OF *ZAKAT*

When a certain percentage of one's wealth is spent annually over the foregoing eight categories as prescribed in the Qur'an, *zakat* has a significant economic impact on society. Income support provided to the poor and needy would result in a measured increase of the money supply in the economy causing upward shift in demand for goods and services. To support this upward shift in the demand for basic necessities of life such as food, clothing, shelter etc., the production facilities would gradually expand and begin to absorb the idle capital. To support the increased production, the economy would generate more jobs and new employment opportunities. This added employment in turn would generate more demand for goods and services, more room for additional investments, and finally, the growth cycle based on balance consumption would contribute to a balance economic growth.

As noted above, *fir-riqaab*, the fifth category of *zakat* expenditures, (in addition to ransoming prisoners of war), relates to freeing of slaves.[9] Today, obviously, human beings are no longer bought and sold as property. But by extrapolating the intent of this category, it can be safely stated that one of the basic purposes of *zakat* is to free human beings from economic slavery as well. The majority of people living in poor countries suffer from abject economic slavery at the hands of many local landlords, rich industrialists, and multinational corporations[10] that exploit natural resources. One of the best ways to free people from economic slavery is to first give these oppressed people temporary relief and then, for economic rehabilitation through essential financial resources to acquire training, equipment, and material. For example, small businesses or privately owned "cooperatives" could be created. A regular flow of income of these entities would accrue to the recipients. Depending upon the rate of profit and retained earnings, the value of these enterprises would progressively grow. The income multiplier effect not only would benefit the economy several times the original investment in these enterprises, it would enable the poor to eventually become self-sufficient and free themselves from economic slavery while contributing to the economic stability of the society.

Expenditure on the sixth category, al-gharimun, is designed to assist those people who, being overburdened with debts, are unable to fulfill their obligations. A closer understanding of this category would reveal that Islam does not allow bankruptcy where creditors, whether individuals or financial institutions, eventually pass on their bad debts to the consumers in the form of increased prices. Such increases, if not offset by other elements of consumer price index, eventually contribute to inflation.

To provide for such contingencies where debtors who contracted debts in good faith but due to conditions beyond their control, such as sudden sickness, natural or economic catastrophes, cannot redeem them, expenditure of *zakat* for redeeming the debts of al-gharimun not only helps maintain price stability, it eliminates one of the important factors which contributes to inflationary cycle.

To satisfy the seventh category, *fee-sabeelillah* (in the cause of God), *zakat* funds when spent for education, medical care, and social welfare of those who otherwise cannot afford them or are oppressed, provide moral stability and human dignity to the recipients, essential elements in maintaining economic harmony. Likewise, by providing financial assistance to *ibn as-sabil* who may be refugees or political exiles, the expenditure of *zakat*, while maintaining the human dignity and general well being of the recipients, contributes toward their economic self-sufficiency. Over a period of time they no longer will be a burden on the society.

That *zakat* is universal in its scope can be seen in the manner in which it is collected and distributed. After providing for the needs of eligible near kin, the *zakat* fund is designed to cover the needs of those who live in the community where *zakat* is collected and then to those eligible recipients living in the county, state, country, and finally the world at large.[11]

Through accumulation of surplus in *zakat* funds during prosperous years, the institution of *zakat* provides necessary contingency funds during depressed economic conditions when *zakat* revenues may not be sufficient to meet the required needs of the society.

The levy of *zakat*, particularly on the idle portion of an individual's wealth, induces the *zakat* payer to seek a return on his wealth at a rate at least as high as the rate of *zakat*, so as to be able to pay *zakat* without reducing his/her wealth.

VI. REESTABLISHING THE INSTITUTION OF *ZAKAT*

Due to a variety of eroding factors, the institution of *zakat*, which once provided an economic safety net to society, has lost its meaning. Today, it has an ad hoc and irregular function reduced to almost a ritual practiced individually by a small minority of Muslims.[12] Many who pay *zakat*, unfortunately, do not even know how to accurately calculate it, let alone its potential economic impact on society.

To re-establish the institution of *zakat*, it is essential that we first understand the importance of *zakat* in terms of its economic impact upon society. Also, in order to properly apply its rules and regulations to many forms of wealth, we must recognize that there are new categories of wealth (such as intellectual property and other intangible assets) which did not exist in early Muslim society, and for which we need to use appropriate evaluation methods (book value, replacement values, market value, present value of future earnings, etc.) in computing *zakat*.

Can the institution of *zakat* achieve its stated objectives of establishing economic justice and the general well being of all members of the society through equitable distribution of wealth in today's economic environment? Since there is no contemporary empirical data, this question can be answered only through simulation or extrapolation of the cumulative economic impact of a redistribution of wealth. To test if it is as valid as it was fourteen centuries ago, let's go through a simple accounting exercise. If we conservatively assume that collective net-worth of one of the forty industrial families of Pakistan has an estimated value of $500 million and earns $75 million annually in net profits (15% rate of return on equity)[13] a 2.5% *zakat* on this family's net-worth would be $12.5 million. On the national level, the forty families' combined net-worth of $20 billion (40 x $500 million) would produce an annual *zakat* of $500 million (or 4.4585% of Pakistan's 1993 budget). If we were to distribute this money among various categories of recipients of *zakat* as prescribed in the Qur'an over, say, every year for the next ten years, the cumulative result of this annual redistribution of wealth will substantially reduce unemployment, expand investment base, eliminate poverty and extreme disparity of wealth between rich and poor by the end of the tenth year. This projection is however based on the premise that this goal is achievable in a reasonable length of time provided the system of collection and distribution of *zakat* is credible, cost-effective, loophole-free and supported by strong accountability mechanisms to assure its integrity.

In this context, we may recall that in Madinah and Basra during the caliphates of Umar ibn Al-Khattab and Umar ibn Abdul Aziz (717-720 C.E.), respectively, there were years when there was a surplus in the *zakat* fund but no eligible recipients to receive it.[14] We may not attain this ideal condition within a projected ten-year period as suggested in this example, but we would certainly be on the road for reaching contentment. The institution of *zakat* when fully operational would become a fountain of economic harmony and contentment.

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[1] Al-Nisaburi, *Mustadrak al-Hakim*, vol.2, p. 12, from Ibn'Umar

[2] Abu Ubayd, *Kitab al-Amwal* (1353 A.H.), p. 784:1909

[3] George Knuffer, *The Struggle for World Power*, Revolution and Counter Revolution, p. 113, The Plain-Speaker Publishing Company, 1975, London. See also book title: *Quest for Oil*.

[4] Al-Darimi, *Sunan al-Darimi* (1349 A.H), vol 1, p 385; and Abu Ubayd, *Kitab al Amwal*, p. 495:926

[5] Muhammad Asad, *The Message of The Qur'an*, 9:60, note 85, p 270, Dar Al Andalus, Gibraltar, 1984.

[6] Ibid, note 85

[7] Muhammad Asad, *The Message of The Qur'an*, 9:60, note 86, p 270, Dar Al Andalus, Gibraltar, 1984.

[8] Ibid, The Qur'an, 2:17, note 145

[9] Ibid, note 85

[10] *Multinational Enterprises and Social Policy*, an ILO publication on multinational enterprises, p. 70-71, 75-78

[11] Muslim, vol. 2

[12] Sabzwari, M.A., 1979. *A Study of* Zakat *and* Ushr *with Special Reference to Pakistan*. Industries Printing Press. Results of this study made among middle-class educated Muslims in sub-division of Karachi show that while almost (95%) had heard of *zakat*, fewer than 25% had even heard of *ushr* (*zakat* on produce and mineral extraction).

[13] *Zakat* is calculated on an individual's net worth. To simplify calculations in this example we have used net-worth of a family instead of net-worth of each member of a given family.

[14] Dr. S.A.Q. Husaini, *Arab Administration*, Ashraf Publications, Lahore, Pakistan. See also Tanzil-ur Rehman, *Introduction of* Zakat *in Pakistan*, Islamabad: Council of Islamic Ideology 1981,

A Short Outline of the Foundations of Islamic Economics

Usamah Uthman[*]

ABSTRACT

Western economic theories are flawed in their lack of reference to absolute good and their focus on the life of this world only. Islamic economics, by contrast, has a strong moral dimension inspired by its religious basis. The belief in man's vicegerency on earth has important implications for economic behavior. In Islamic economics, a policy-oriented framework, normative values play a key role. *Riba* (interest) is forbidden in Islam. This guideline is both wise and economically sound. Money, instead, is understood in Islam as a store of value. The institution of *zakat* acts as a tax on hoarding, while encouraging productive savings. *Zakat* further carries important spiritual benefits that foster Islamic moral values.

I. INTRODUCTION

The early 1990's have witnessed the collapse of the USSR and the downfall of communism—one of the major events of this century and may be of the history of modern times. Capitalism has won the day against communism. But the defeat of communism was preceded and followed by alarming events in the capitalist camp. The financial crash of October 1987 in the United States, the prolonged high rate of unemployment in Europe, the massive economic crises in what used to be called the economic tigers of south east Asia and now, the deep financial crises of Japan, are only some symptoms of a deeper problem. This is not to mention other problems that beset the whole world, including the industrial economies, such as the high rates of pollution, crime, broken families, AIDS, and other social challenges. In spite of economic prosperity in the American economy over the past five years, some economists have warned that the American economy has actually gone through a long period of a "silent depression" (Peterson, 1994).

What has caused all of these gyrations? Does the problem lie in economics alone? There is a vast literature written about capitalism, its nature, characteristics, and its tendency toward stability or instability. It would be a daunting task to review the entire literature on this issue, but a few observations may help.

II. A NOTE ON THE CAPITALIST SYSTEM

The economy is an "instituted process" that results from the choices and behavior of society (Polanyi, 1944). Economics, as field of inquiry, is essentially a behavioral science. Scientists develop theories to describe World phenomena, to propose solutions for existing problems and to anticipate future events. The emergence of Europe from dark ages (dark for Europe) was manifested in four major events. The first was the revolt against the authority of church and religion. The second was the rise of nation-states. The third was the innovation of the machinery. The fourth was the spread of finance. The pervasive socioeconomic organization was the market. An intellectual revolution in almost every field of life took place. The growing importance of physical capital (the machine) has brought with it mass production and greater amenities of consumption. But it has also brought with it greater chances of unemployment. The spread of finance facilitated the rise of the corporation, the separation of the craftsman from the ownership of his instruments, and the greater dependence of many people on their physical and mental capacities as the only source of survival. It was natural to inquire about the causes and ideals of freedom, equality, and other values. But the individualist system has no supreme ideal that it tries to reach. Freedom and equality do not have clear definitions or objectives.

There has been dissatisfaction with the individualist insistence on man's absolute rationality as we have seen with Schumpeter. Some Western economists tried to come up with an alternative paradigm. According to the neo-institutionalist school of thought, (1) limited rationality and (2) opportunism characterize human behavior. The neo-institutionalist transaction cost economics approach looks at the firm as a governance structure of contracts; the purpose of which is to economize on man's bounded rationality and safeguard against his opportunism (Williamson,

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1985). This is a step forward indeed, for it recognizes some of the basic weaknesses of mankind. But it also implies that man is ill motivated: hardly an optimistic view. While neo-institutionalist economics tries to explain and remedy contractual shortcoming, it has no moral dimension to deal with inner weaknesses of the contractors. There are two basic problems with Western paradigms: (a) the absence of an "outside" reference of what is good and what is bad (to rectify for one's limited rationality), and (b) limited in horizons that do not go beyond this world. The ideas of resurrection, the hereafter, and the Day of Judgment are either absent or very weak in the Western "scientific" thinking. These concepts act as additional deterrents against opportunism in case the law is absent or powerless. Contracts, then, are necessary but not sufficient to economize on bounded rationality and guard against opportunism. A search for an alternative system is thus called for.

III. The System of Islam

A. The Moral Base

A major distinction between religion and philosophy is that religion has a spiritual dimension that philosophy does not have. This gives religion a source (but not the only source) of permanency and supremacy in organizing and directing the behavior of man. The separation of the moral code of Christianity from the common law that organizes the day-to-day affairs of people took place at an early stage of Christianity. This was followed over the years by sharp disputes among Christians about the essence of belief, and led to the abuse of religion by the church and confusion among the commons about its usefulness. This has led to the natural revolt against religion in Europe and the separation of science from religion. Judgments based on values were denounced as non-scientific as many of these values could not stand to reason. Nevertheless, it was too unscientific to judge every religion as every other religion.

Such a conflict did not exist in the history of Islam for three reasons. First, the Qur'an, the prime source of the Islamic faith, has been kept the same, unscathed over all times and places. Second, for the careful mind, there is nothing in Qur'an that contradicts reason. Third, the teachings of the Qur'an were the driving force for Muslims to investigate the universe and offer humanity major contributions in almost every field of knowledge. In other words, the religion of Islam has been a source of inspiration rather than an obstacle against development. This by itself is a historical proof that the Islamic approach to the matters of life is not only scientific, in the sense of amenability to world proof, but it is also much more firmly grounded than other speculative approaches. Ekelund and Hebert (1990) write:

> "The death of the last Roman emperor in 476 ushered in a long period of secular decline in the west and a concomitant rise in the fortunes of the east. For five centuries, from 700 to 1200, Islam led the world in power, organization, and extent of government; in social refinements and standards of living; in literature, scholarship, science, medicine, and philosophy. The Arab world acted as a sort of conduit to the west for Hindu wisdom and culture. It was Moslem science that preserved and developed Greek mathematics, physics, chemistry, astronomy, and medicine during this half millennium, while the west was sinking into what historians commonly call the Dark Ages. By 730 C.E. the Muslim empire reached from Spain and southern France to the borders of China and India, an empire of spectacular strength and grace. Perhaps the most significant, single innovation that the eager, inquisitive Arab scholars contributed to the west was their system of writing numbers. They displaced the clumsy Roman numerals of the previous empire with the much more utilitarian Arabic numerals of today. One of the more eccentric Arab mathematicians, Alhazen, founded the modern theory of optics around the year 1000. But for our purposes, the most important contribution of Arab culture was its reintroduction of Aristotle to the west."

After Toledo, Spain, was recaptured from the Moors in 1085, European scholars flocked to that city in order to translate the ancient classics. The ancient texts were turned from Greek (which Europe had forgotten) through Arabic and Hebrew into Latin. In this last mode their philosophical gems were mined for the next four hundred years by the Schoolmen of the medieval church" (Ekelund and Hebert, 26).

But what is the basic organizing principle of Islam? In a short verse of the Qur'an, it says, "I have only created Jinns and men, that they may worship Me" (51: 56). This verse implies that all acts, material and spiritual, has to be in accordance with what the Lord has ordered. Thus, every act is an act of worshipping. In such a system of life, material amenities and spiritual practices both complement each other, and serve toward the same goal - the worshipping of the Lord. To achieve that goal, the Islamic system has three tenets. These are (1) faith in God, The Creator and The Sustainer, and a belief in the Hereafter (Day of Judgment), (2) moral-preserving-enhancing codes of conduct, and (3) a comprehensive set of rituals and laws that organize every bit of the life of the individual and society. Whereas God is the ultimate Creator and Owner of everything in the Universe, Man is ordained as his vicegerent on earth for its cultivation and betterment. Chapra (1971) explains that the submission to the Lord implies that Man is subservient to none but to Him. Thus man is created free, and as a vicegerent he is not created as a sinner. *Falah* (felicity in both worlds) can only be achieved through these believes (Siddiqi, 1971). In the economic domain, vicegerency has three implications: (1) man's right of ownership and freedom of exchange must be respected, (2) contracts must be enforced and, and (3) work is the major source of ownership. For a Muslim, freedom is an essential ingredient of faith. By contrast, the European man acquired freedom only by revolt against religion. But Islam emphasizes collective responsibility and solidarity. Obviously then, Islam strikes a balance between personal freedom and collective interest. Some Marxist scholars accused Islam of being akin to capitalism since it protects personal freedom, while some capitalist scholars accused it of being akin to communism, since it establishes collective interests. Islam is neither; it represents a middle road between the two.

The general theme of Islamic jurisprudence can be described as one that seeks to attain benefits (collective and personal) and deter hardships. Protecting the five necessities: religion, life, [man]kind, reason, and wealth achieve this. Since the preservation of wealth is one of the five necessities, one wonders about the nature of the Islamic economy and economics.

B. The Nature of the Islamic Economy and Economics

We have already explained that the supreme organizing principle of the Islamic system of life is worshipping God and that the "worshipping man" replaces the "economic man." The recognition of the freedom of ownership and exchange implies that markets are an important socioeconomic Islamic Institution. Freedom is incomplete without markets. Markets are a necessary but not sufficient condition for the expression of freedom. Market competition is guided by moral geniality that promotes cooperation, and state deterrence that enforces the law. Government intervention, however, should be kept to the minimum. The limitations of this paper do not allow for a detailed discussion of the nature of government in Islam. The market has both legal and moral constraints. The distribution of wealth and the allocation of resources are the outcome of these two constraints, and prices are no longer considered in abstraction. The market process becomes a reflection of an objective-related exercise of the freedom of choice. The idea of the scarcity of resource is relevant but only in the relative sense of their possible abuse. Otherwise, the universe was created in a state of equilibrium. The Qur'an says, "And there is nothing but We have its treasures, and We send it down in due amounts."

Since faith is the source of law and behavior, Islamic economics becomes essentially policy-oriented, and the distinction between positive and normative economics becomes blurred, if even relevant. The teachings of Islam act as the agenda of research in economics and other fields, and as such, research becomes less speculative. A correct practice may precede a complete comprehension of the underlying theory. It requires belief before it requires theorizing. This does not imply that the two can remain indefinitely separate. Theory, on the basis of belief, is more required as belief is weakened and/or as new circumstances develop. Also, a correct theory should enhance, solidify, and promote the growth of a correct practice.

There are five areas of Islamic jurisprudence that effect the distribution of wealth and the allocation of resources. These are:

1. the laws of ownership of land and natural resources;
2. the law of inheritance;
3. the contract law;
4. the law on money and credit; and
5. the law of taxation.

These laws represent a vehicle to implement the moral code by giving detailed rules of conduct in every worldly affair. This paper discusses briefly only the implications of the last two laws.

C. The Economics of Money and Interest

Discussions about money and interest (usury) are at least as old as the time of Aristotle, if not earlier. For many centuries interest was understood in many, if not all, parts of the world as a contractual mark-up over loans. It was only with industrial revolution, the spread of finance, and the revolt against the church that people in Europe started to confuse interest and profit and consider both as acceptable forms of income. Eugen Von Bohm Bawerk has written three volumes surveying the history of the theory of interest in Europe (1884).

In Islam, *riba* (interest) is strictly prohibited, and there are many verses in the Qur'an and *Hadith* (traditions of the Prophet Muhammad) that severely warn against taking and giving *riba* (interest). Ibn Taymiyyah (1232-1299) defines *riba* by saying, "*Riba* is prohibited for it implies grievance, since it represents the taking of an excess (of wealth) that is a counter reward for nothing" (vol. 20, p. 341). The prohibition is applied to *riba* on all objects, money and otherwise. It is interesting to know that some major contemporary western economists share the same opinion about interest. In explaining the potential "Social Philosophy" of his General Theory, Keynes writes, "It would mean the euthanasia of the rentier…. Interest today rewards no genuine sacrifice, any more than does the rent of land…. I see therefore, the rentier aspect of capitalism as a transitional phase which will disappear when has done its work" (Keynes, 1936).

The *riba* that Islam came to forbid is two basic kinds: (1) *riba* of debts (on money loans) and (2) *riba* of sales. Without going into the details of each, the *riba* of debts is the form that used to be the most common before Islam and remains so today. Interestingly enough, there were several variations of the *riba* of debts before Islam that still exist today. One variation is for a person to lend money to another. On the due date either the principal is paid back or payment is deferred in return for a mark up. This resembles a penalty on delinquency in payment such as that when people use their credit cards today. In another variation, the payment of a mark up is conditioned at the beginning of the loan period. This is similar to simple interest today. A third variation is for interest to be paid every month, while the principle is left intact and paid at maturity. If the principle is not paid, more interest will have to be paid. The deal resembles a regular bond today. The common feature of debt-based interest is the fact that an increment is paid in return for delay in payment. It should be noticed that there is no difference in Islam between interest and usury. The magnitude of the interest rate makes no difference; both are considered *riba* (usury), and both are forbidden.

But why does Islam forbid *riba*? There are two issues here. The first is the *hikmah* (wisdom) of the prohibition of *riba*, the second is the *'illa* (motive, description) of prohibition. The *hikmah* (wisdom) has been already mentioned in the definition of *riba* given above: that *riba* is a source of injustice, because it is a return for nothing, or as Keynes puts it, "Interest today rewards no genuine sacrifice." What then motivates an interest-based contract? Interest results from a contract between two capitalists: one wishes to avoid risk (via a guaranteed return), the other wants to have control together with the speculative possibilities and the risks brought along with it (Hadley, 1884). The fulfillment of some expectations in some endeavors gives the illusion that fulfillment of another may be practically certain (Boulding, 1951). Interest then increases cost of production in two ways: it is a sure markup and it increases risk. The possible disappointment of expectations not only foils the borrower's speculation but also defeats the lender's attempt to avoid risk. Kenneth Arrow observes a "fundamental paradox in the determination of demand for information: that its value is not known by the purchaser until he has the information, but then he has in effect acquired it without cost" (1982). There is a similar paradox in the "sale" of money in the sense that the value of its use is not known until investment comes to an end or until the loan contract expires, whichever comes first" (Uthman, 1994). Thus, there is an analogy between information and money "in the sense that none of them fits the image of a 'normal' commodity" (Uthman, 1994b)

Islamic economists are not alone in their discomfort with interest as an economic institution. Schumpeter observes that "interest acts as a tax upon profit" (1961). He also observes that "as soon as it comes into existence many entrepreneurs are eliminated, and as it rises more and more of them disappear. For although possibilities of profit are practically unlimited, they differ in size and most of them are of course only small" (Schumpeter, 1961). The risk of entrepreneurship "makes the requisite profit rate (by the borrower) always higher than the market interest rate (which includes its own risk premium), by a risk sufficiently high premium…. The higher the accumulation of capital, the lower the MEC (marginal efficiency of capital) and, the higher the profit's risk premium would be. There is, thus, an element of stickiness in the requisite profit rate, in addition to the element of stickiness in the requisite interest rate. No doubt that the latter reinforces the former and, hence, the existence of interest is bound to kill numerous profit opportunities causing an involuntary unemployment of investment" (Uthman, 1994).

This is how the issue of risk enters into the prohibition of interest. The above discussion investigated some elements of *hikmah* (wisdom) of the prohibition of interest. What is the *'illa* (motive, description) for the prohibition of interest on money in particular? In other words, what particular characteristics of money make interest bad and thus prohibited?

Ibn Algayyem (1292-1350) explains that interest on the two monies (gold and silver) is prohibited because money is the standard of value. A measure of value has to be standardized and standardization requires stability over place and time (Vol. II, pp. 156-7). For this to happen it should not grow or depreciate on its own. In other words, the standard of value can be a medium of exchange but must not be the object of exchange. Interest, then disturbs the informational content of money. In other words, for Ibn Algayyem and many other Muslim jurists, the most important function of money is its service as a unit of account and thus a measure of value (a numeraire). The other two functions, the medium of exchange and the store of value, are derivative functions of the prime one. The major implication of Ibn Algayyem's reasoning is that interest must be prohibited on any object that serves as a measure of value.

The debate about the prime function of money continues today. It is interesting to note that the early Muslim scholars were ahead of some western scholars in arguing for the primacy of the numeraire function of money. Aschheim and Tavlas (1996) argue "that at least since Walras, a major strand of monetary economics imparts primacy to money's capacity to act as a numeraire." This "constitutes what may be viewed as embryonic money. A monetary exchange system appears once a numeraire exists. The unit of account is a sufficient condition for the existence of a money-exchange economy, whereas the medium of exchange does not constitute a sufficient condition." But the discussion of the functions of money by the economists of the 19th century, such as Walras, Walker, and Del Mar, was motivated by an inquiry about whether paper money or bimetallic money serve as a better mean to stabilize the price level. Both arguments imply a quantity theory of prices. Aschheim and Tavlas (1996) explain that the importance of a numeraire is explained in Walras' general equilibrium model where "The existence of a numeraire allows market clearing to occur, through a continuous groping for prices… Yet this process of atonement takes place without money changing hands (means of payment) and without money having served as a store of value. Consequently, it is the existence of money solely as a numeraire that allows for the distinction to be made between a money-exchange system and a barter-exchange system… The contraction in transaction costs (for example, calculation information, search) imparts a non-neutrality character to money." This explains the importance of the numeraire function of money but it does not explain the line of causality between money and prices. For if abrupt changes destabilize the value of money (its numeraire function) why would the quantity of money change.

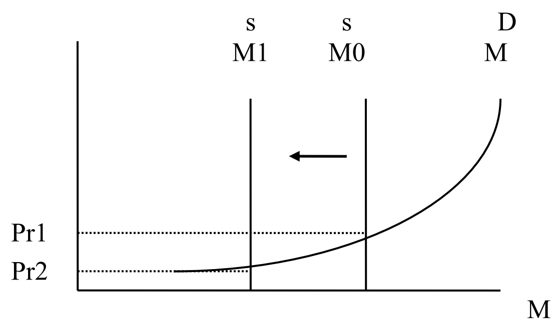
This forces us back to Ibn Algayyem and other Muslim scholars who considered the introduction of interest as a destabilizing element to the prime function of money. How does it work? In order to answer this question, let us assume that the stock of money is constant at quantity Y and interest on loans does not exist to start with. If interest is introduced into the economy, it will affect prices in more than one way. First, borrowers-producers will add an increment to the prices of their goods that is at least as high as the interest rate. At the end of the period, borrowers will have to pay back to lenders an amount of money equal to Y + interest. The introduction of the interest rate pushes the cost of production upward, raises the price level, increases the demand for money, and thus would increase the interest rate. If the stock of money is kept constant, the interest rate will rise further and a debt-deflationary process sets in. Bankruptcies may develop. Otherwise, the stock of money has to be increased, an action that tends to validate the inflationary process. The introduction of the interest rate makes the money supply endogenous. A further complication comes from the fact that production usually takes place in a world of uncertainty. There will be stories of success and other of failures. To impose a penalty of more interest payments on the ailing firms only worsens their position. A foreclosure will make things worse.

The Islamic financial solution, in addition to the prohibition of interest, is to give a moratorium on debt payment. Better yet, is to forgive the debtor if possible. If further debt is to be extended, it has to be interest -free. The Qur'an says, "If the debtor is in difficulty grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew" (2: 280). A major remedy to the current financial crises in Japan has been for banks to write off some of its debts i.e. to forgive debtors.

It might be noticed that Muslim scholars such as Ibn Algayyem and his mentor, Ibn Taymiyyah (1232-1299), did not come explicitly forward with a quantity theory of money and prices. Several reasons can be imagined to explain this. First and foremost, those scholars (as jurists) were concerned mainly about answering the question on the essential function of money. Reaching a satisfactory answer seems to have settled the issue for them. Second, the bimetallic money supply was highly inelastic. Discoveries of metals at that time (the 13th and 14th centuries) were not easy. The only way for money supply to be increased in the short run was either via debasement, or the introduction of new metallic money, such as phelos (copper money). Relaxing the law on interest would encourage both actions. One would speculate that sometime during periods of instability and weakening of belief, price and output instability occurred when the rules of *riba* were not strictly observed and gave Ibn Taymiyyah and Ibn Algayyem (T&G) an empirical support about their interest-based theory of the instability of the value of money.

To see this, in the absence of interest, and when the money supply is constant in the short run, the demand for money will be determined by the needs of trade and will be positively related to the profit rate (Pr).

FIGURE 1. MONEY DEMAND AND THE RATE OF PROFIT



If interest-based lending is permitted, the interest rate will rise from zero into some positive level. The emergence of a new business (the business of lending) will generate hoarding and speculation, reduce the money supply available for trade, and reduce the velocity of money. Output and the profit rate are going to fall, and prices are going to rise. The value of money, which is the inverse of the price level, will decrease. The introduction of interest must be encouraging to debasement and the introduction of other means of payment, such as copper-made phelos, or paper money later on, adding a further complication to the economy. We may say that the T&G theory is an interest-based theory of money.

Aschheim and Tavlas (1996) disagree with David Laidler (1991) that the prime function of money is to serve as a store of value and agree with John Hicks (*The Market Power of Money*) that money's prime function is the measurement of value. Aschheim and Tavlas (A&T), however take an exception to Hicks' argument that "money as a means of payment is just a debt." They argue that this fails to illuminate the difference between a barter-exchange economy and a money exchange economy. For debt can exist under both types of economy. To them, "The essence of money as a medium of exchange is the quality of money as generalized purchasing power." A&T are right in a microeconomic sense of the word debt. Money may not be debt in a microeconomic sense, because a person who accepts money in exchange for some good or service he offers has no recourse to the person who offered him money. But in a macroeconomic sense, money may be thought of as debt, because the person who accepted money, thinking of it as a generally accepted medium of exchange, will want to exchange it later on for other goods and services. In other words, the holder of money has a claim against society at large and thus money is debt in a macro sense of the word. This brings the issue of wealth into the discussion. For debt, whether it is monetary or in kind, represents a temporary transfer of wealth from debt acceptors to debt providers. If we can imagine this process to go on indefinitely, then there is a permanent transfer of wealth from the issuers of debt (monetary or in kind) to the buyers of debt. This is the essence of interest-based lending in general and the fractional reserve banking system in particular. Thus the issuance of money (a macro debt) entails no net addition of wealth to society at large, but money, as Laidler (1969) argues in his response to Pesek and Saving (1967) expands wealth just as trade expands it, without an increase in initial endowments. It may be argued that banks are entitled a return (a share of the national pie) because of the role they assume between savers and borrowers (the theories of the evolution of banks). But interest-based lending and the fractional reserve system are neither necessary, nor sufficient for banks to do a good job in intermediation.

Interest is, as Schumpeter describes it, a tax. Islam prohibits it. What about other taxes?

D. The Economics of Taxation in Islam

The taxation system of Islam includes but is not limited to, *zakat*. An understanding of the economic underpinnings of *zakat* should prove helpful on how to go about imposing other taxes, whenever necessary. At the end of a fiscal year, *zakat* is imposed on residual money holdings that could have been spent (but were not), on the pecuniary value of items that are intended for trade (but were not traded), and (in-kind) on durable agricultural products and livestock. Consumption items intended for personal use such as one's own house or car, assets that are means of production but are not capable of growing themselves, such as buildings, machines and equipment, are all exempt from *zakat*. It can be concluded then that *zakat* is an inventory tax on the items subject to it. It is a tax on some stocks of the balance sheet. This is in contrast to other flow taxes in the Western economic system such as the income tax and the sales tax. A tax on a flow may impair it while tax on a stock may mobilize it. It can be shown that the full incidence of *zakat* as a tax falls on producers, with no welfare loss associated with it. Unless it becomes necessary, the Islamic system of taxation avoids in rem taxes (taxes on objects or activities). *Zakat* is imposed on asset-holders, and such imposition relates payments of taxes to the taxpayers' ability to pay and provides for more equity in the tax system (Uthman, 1997).

Zakat is not a tax on savings. It is a tax on hoarding, be it monetary or physical. Savings that are invested, let us say in financial stocks and are intended for keep, are not subject to *zakat*, while if the stocks are for trade, they are taxed like any trade object. Garadawi (1969) warns that trade for the purpose of *zakat* requires two conditions. First, intent, and second actual, active work on trade. A person who bought a car for his own use, but thought he may sell it, if he is offered a mark up, is not considered a trader, and thus the object kept is not subject to *zakat*. If it is sold however, and the money kept until the end of the year, money balances that are equal to, or exceed *nisab* (the minimum tax exempt) will be subject to *zakat*. The anti-hoarding principle implies that neither income from salary nor invested savings are subject to *zakat*. Idle money balances are. It may be argued that *zakat* on livestock is a direct tax on some form of capital. Why not tax other forms of physical capital such as buildings and factories? The answer is that a livestock is a kind of capital that reproduces itself with very little or no effort from the owner. An excess supply, which reduces its prices and return, can be reduced much more easily than other forms of physical capital. The amount of work and degree of risk is usually (much) less with livestock capital than with physical capital. Also, in primitive economies, livestock represents a major form of wealth, and thus the need to tax it is greater. In advanced economies, livestock is much less important and nevertheless can be more easily and more abundantly produced, and thus can afford more taxes. The more advanced the economy is the more specialized and specific the physical assets are, and the more risky they become. They should never be taxed directly.

The importance of *zakat* goes beyond its fiscal and distributive aspects. The spiritual dimension is very important as it promotes the values of sharing, caring, and altruism. The Islamic economic system is one, and probably the only one system that combines moral values, economic policy, and economic theory as three non-separable elements of the system.

The Islamic concept of consumption and wealth can be illustrated by two *Hadiths*. The Prophet Muhammad said, "You have (actually own) of your wealth none but what you ate and (thus) destroyed, what you wore and depreciated, or what you donated and kept (as a good deed)." In another *Hadith*, he stated, "Whoever became secure in his neighborhood, healthy in his body, and acquired the needs of his day, verily has acquired everything in the world." The intuition or implications of the two *Hadiths* is that one's actual wealth (and income) is what he actually consumes of it. It is for this that *zakat* does not tax income, consumption, or invested wealth. What is being taxed is idle, or potentially idle, and hoarded wealth. The problems associated with the taxation of income, consumption, and savings are well known in the economics literature. One of the expected effects of such taxes is their impact on work incentives. *zakat* on inventory, or hoarding does not seem to affect work incentives. It encourages consumption, investment or both (see Uthman, 1997).

The timing of all *ibadat* (worship) in Islam follows a lunar calendar. For example, the time period between any two prayers in the day is not fixed by the hour, but rather by the length and shortness of the day and night. This is related to the movement of the moon around the earth. The fasting month, Ramadan, starts with observing the new moon of the ninth month of the lunar year. Hajj (Pilgrimage) falls on the twelfth month of the lunar year. While the timing of these worships is fixed relative to a lunar year, it is variable relative to the solar year. The production mode of basic economic products such as livestock and agriculture follows basically a solar calendar, even though technological advancement now made it possible to produce plants and animals out of the regular seasons. The timing of these *ibadat* being at times close and at times different from the times of production, influences the time of economic exchange.

Zakat is also to be paid on a lunar calendar basis. It is usually argued that taxes act as built-in stabilizes of economic activity. Tax proceeds rise with high income and fall with low income, thus helping to reduce the excessive moments of the aggregate demand curve. Tax payments, in magnitude and timing, are to the taxpayer procyclical, and help to stabilize the economy in that sense. In the same sense, *zakat* has the same economic impact; rising with high "income" and decreasing with low "income." It is well known that the beginning of the lunar and solar year coincide every 33 years and that every one hundred solar years are equivalent to 103 lunar years. This implies that the timing of paying *zakat* coincides at times and diverges at others from the production mode of basic goods that follow a solar calendar. It is possible during this astronomical cycle that negative supply shocks, due to drought for example, may take place. It is at this time when government revenues need to be increased to support people on welfare. Since incomes at a negative shock are low, taxpayers will not be hurt in terms of how much they will pay. Tax dues go in line with their wealth and incomes. But the timing of the tax payment becomes so crucial that it should help to stabilize tax revenue and incomes of the poor. This should help to sustain demand and prolong the business cycle. The length of the cycle is prolonged on the other side of the cycle when the economy is booming. If *zakat* payment falls due before the peak, it helps to restrain the excessive upward shift of aggregate demand. If it is due after the peak, it helps to sustain demand. In both cases it prolongs the business cycle. In short, the payment of *zakat* may coincide, predate, or post-date the turning points of a business cycle, helping to smooth out and prolong the cycle.

In other words there are two concepts of timing in the payment of taxes. The first is timing relative to the ability of the taxpayer. The second is timing relative to the need of the tax recipient. The payment of taxes in the western economies is fixed on specific dates on a solar calendar. The choice of the beginning of a fiscal year in Islam is the decision of the taxpayer on a lunar calendar. Furthermore, the government can borrow from people their tax dues for the next two or three year, if needed.

IV. Conclusion

Islam is a very comprehensive and integrated code of life. It guides man in every sphere. Islamic economics is part of that integrated system, the purpose of which is the betterment of life on the basis of the teachings of the Lord. While the contributions of the Islamic civilization in the areas of science, medicine, and philosophy have been recognized by many historians, it is curious why the contributions of Muslims to economics are rarely mentioned in books of the history of economic thought, if ever.

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Note: Reference to Laidler, 1991 and Hicks are taken from Aschheim and Tavlas, 1996, mentioned above.

PART II

THE *SHARI'AH*

Introduction

Yusuf Talal DeLorenzo[*]

Recently, while discussing some of the newer developments in the field of Islamic economics and finance, I remarked to a friend that there was no longer any reason to fear radical ideas. By way of explanation, I told him that scholarship in the field had now matured to the point where for every radical notion there would inevitably come a reasoned and researched response. In other words, while the field remains a new and open one, the body of scholarship it has generated is now so substantial, and vital, as to ensure that it will never lose its equilibrium to the unguarded speculations of a novice, or the profit motives of a multinational firm, or the verbal effusion of a self-styled visionary. At present, the institutional and intellectual foundations of the field are firm, having been grounded in the experience of over two decades. Today, universities, funds, banks, multinational institutions, governments, and even index-providers hold interests in the success of this new field. More importantly, however, Muslims in every walk of life may rest assured that their money is being handled for them in ways that comply with the teachings of their religion; and that by means of their *halal* earnings they earn blessings in this world and the next.

To have reached this stage of development, a stage of relative self-confidence in one's achievements to date, is comforting. More importantly, however, it is a stage in which ideas may thrive. Clearly, the success of nearly any endeavor requires ideas; but especially one so closely linked to the subtleties of law, finance, economics, and religion. Today scholars from each of these disciplines are contributing to the growing body of knowledge in this highly specialized field. It has been pointed out in a number of recent studies that the field is truly cross-disciplinary and as such, represents a challenge of major proportions to everyone involved in its development at both the theoretical and the practical levels.

Recent years have witnessed a spate of forums, such as the Harvard University Forum on Islamic Finance, seminars, and conferences. These are ideal for the circulation of ideas. Likewise, young scholars continue to write their graduate level dissertations and theses on subjects of relevance to the field. There are now dozens of journals devoted to the subject, chiefly in Arabic and English, but in Urdu and other languages as well. The recent special issue on Islamic Banking by the Thunderbird International Business Review is one that is deserving of special mention. Scholarly bodies, such as the OIC *Fiqh* Academy in Jeddah and the Council of *'Ulama'* in India, regularly consider issues related to the field and, of equal importance, disseminate their findings through the medium of print. Legal and legislative bodies throughout the Muslim world, like the Indonesian Parliament, the Supreme Court of Pakistan and the Islamic Ideology Council, deliberate on the subject. Very soon, God willing, Justice Muhammad Taqi Usmani of the Supreme Court of Pakistan will have completed a definitive ruling on *riba*. The Internet, too, has opened up new channels of communication for scholars and professionals, through Web pages, chat rooms, newsletters, and even courses (like those available through the School of Islamic Business Education and Research). My own contribution over the Internet will come, God willing, through a course to be offered in December, 1999, by the Dow Jones Interactive University on the Principles of Islamic Investing. I will be joined in teaching this course by Justice Usmani and Dr. M. Elgari of the Islamic Development Bank.

Still, the most important medium for the communication of new ideas is the print medium. I will return to discuss some of what I feel have been the more significant titles to be published recently. But before doing so, I would like to speak of another very important channel of communication. This is the channel made possible through the cooperation of management, whether of funds, or banks, or finance houses, with their *Shari'ah* advisors and supervisory boards. In a sense, this is the place, the point of contact, where the collective learning and experience of professionals with very diverse backgrounds come together for the purpose of solving very specific and practical problems. As these experiences increase, contact between scholars and business and finance professionals will grow more meaningful, in practical terms, and will thus add a dimension of depth to the understanding of both. In fact, it is the success of this sort of collaboration that will lead to the success of the entire sector. Clearly, no fund, no bank,

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no financial house or venture that calls itself Islamic can succeed without the advice and counsel of *Shari'ah* experts.

In fact, if I may be so bold as to make another prediction for the future of this sector, it seems to me that the *Shari'ah* advisory capacity of boards or individual advisors will become increasingly proactive. Thus, in addition to the all-important matter of ensuring *Shari'ah*-compliance through advice to management on how transactions may be structured, or how investments may be screened (through the application of religious criteria), the *Shari'ah* supervisory boards of the future will increasingly become involved in issues of advocacy and corporate governance and policy. This is a subject on which I hope to write at length, and in detail, in the future. My own feeling is that as Islamic financial products become available to a more diverse spectrum of Muslim investors, the need for proactive *Shari'ah* boards will become increasingly apparent. As with any other product or service, it is the ability to deliver that sets firms above the competition. With Islamic financial products, a part of delivering the product to consumers is the sort of careful attention that is given to the religious aspects of ownership. Thus, beyond structuring and vigilance are matters related to purification, to *zakat*, and to the representation of Muslim beliefs and sentiments with regard to corporate practice and policy. Increased involvement in capital markets by Muslim investors will increasingly entitle us to voice our concerns about the ways that business is conducted. It will be the responsibility of *Shari'ah* boards and advisors to represent Muslim investors in ways that promote the *ma'ruf* and mitigate the *munkar*. Here, too, there is no reason for trepidation. The modern corporation operates in a market that rewards both transparency and accountability; and corporate democracy has established itself as a sound fundament of that market. Given this atmosphere, there is no reason that Muslim investors should shy away from sharing their religious convictions about business and its proper conduct with management. In fact, there are bridges to be built between the religiously responsible investor and the socially responsible, and it will be the role of the *Shari'ah* supervisory boards to coordinate and provide leadership for these efforts.

The past two years have marked the publication of a number of significant new studies in the field of Islamic finance and banking. While this is certainly not the place to review or even to list all of these studies, I would like to turn the attention of my colleagues to a few of the works that I have found to be invaluable. Let me begin by mentioning the results of a collaborative effort undertaken by several teams of researchers under the direction of Dr. 'Ali Jumu'ah and sponsored by the Cairo office of the International Institute of Islamic Thought. These results were published in a six volume encyclopedia entitled *Mausu'at Taqwin Ada' al Bunuk al Islamiyah* (Encyclopedia of Performance Evaluation of Islamic Banks). Each volume, none less than four hundred pages, deals with a different aspect of performance. Volume One contains a general introduction and explains the subject of the research and the ways in which the research is carried out. Volume Two deals with the work of *Shari'ah* supervisory boards. Volume Three provides an analysis of the social role assumed by Islamic banks. Volume Four looks at the economic role of Islamic banks. Volume Five explores the management of Islamic banks, and Volume Six examines the performance of Islamic banks with respect to accounting and auditing. In fact, Dr. 'Ali and the IIIT Cairo are responsible for an entire series of publications in the field, numbering about forty, and including several gems. Among the more noteworthy of these is the study by Dr. Rifaat Al-Sayyid Al-Awadi entitled, *Al Manzumah al Ma'rifiyah li Ayat al Riba fi al Qur'an al Karim* (The Epistemological Congruity of the Verses of *Riba* in the Noble Qur'an). In his work, Dr. Al-Awadi undertakes a contextual study of the primary and secondary verses concerned with the subject of *riba* from the perspective of the Qur'an's *i'jaz* or inimitability. His insights, though centered on a subject other than *fiqh*, are invaluable for the modern student of Islamic law. One more book from this series that is especially deserving of mention is the work on terminology entitled, *Mustalahat al Fiqh al Mali al Mu'asir: Mu'amalat al Suq* (The Terminology of Contemporary Financial Law: Market Transactions). This book, like the six-volume Encyclopedia, is also the work of a team of researchers. While it breaks new ground on a number of fronts, the work is perhaps most important for the way it arranges and then deals, however briefly, with material.

Likewise, *Accounting and Auditing Standards for Islamic Financial Organizations*, by Professor Rifaat Abdel-Karim (in English) and published by the Accounting and Auditing Organization for Islamic Financial Organizations, promises to bring standardization to a sector that has long been troubled by differences. And Justice Muhammad Taqi Usmani's *Islamic Finance* is a significant contribution in its own right by a truly gifted and courageous scholar. A new and more readily available edition is planned for later this year. I will also mention my own work, in which Justice Usmani also had a hand, *A Compendium of Legal Opinions on the Operations of Islamic Banks*, published by the Institute of Islamic Banking and Insurance in London. That work—in conjunction with the recent work of my former colleague at the International Islamic University in Pakistan, Dr. Hussain Hamid Hasan, *Daleel Fatawa al Bunuk al Islamiyah*—brings the work of *Shari'ah* supervisory boards to the public domain and provides researchers access to a valuable body of legal thought. Finally, no one attending the Second Harvard Forum could not be familiar with the work of Professors Vogel and Hayes, *Islamic Law and Finance: Religion,* *Risk, and Return*. To my mind, the chief virtue of their work, aside from the obvious scholarship, is their call, their challenge, to Muslim thinkers to revisit the texts of the Qur'an and the *Sunna* and to work with them directly to find solutions to contemporary problems and issues.

Which brings me to the contents of this section of these Proceedings and the work of my friend, Waleed El-Ansary, "Linking Ethics and Economics: The Role of *Ijtihad* in the Regulation and Correction of Capital Markets." In producing this work, El-Ansary, a student of economic philosophy, compounds the philosophical element by including the speculations of T. J. al-Alwani on the nature of the *Shari'ah*. The real merit of this paper is its theme of recovering the Islamic economic intellectual heritage. Gohar Bilal provides quite a different perspective on the subject of capital markets in her paper, "Islamic Tradable Instruments: Basic Building Blocks." This is a logical and ordered paper that explains, often through the innovative use of graphs and tables, a number of *Shari'ah* concepts that are key to an understanding of Islamic tradable instruments and the principles underlying these, such as partnership, co-ownership, debt transfer, agency, and property.

The next two papers in the collection deal with the *murabaha* transaction. Shaykh Abdul-Rahman Abdullah bin Aqeel contributes a paper entitled "*Shari'ah* Precautionary Procedures in *Murabaha* and *Istisna'*: A Practical Perspective." As the title suggests, this paper is concerned chiefly with the *fiqhi* details of the transactions of *murabaha* and *istisna'* and is a useful guide to the ins and outs of those transactions. My own contribution, "*Murabaha*, Sales of Trust, and the Money-value of Time," looks at the *murabaha* transaction from the perspective of its utility, and how and perhaps even why the classical jurists accorded it the legitimacy that they did. Another practical guide to the subtleties of *Shari'ah* transactions comes from Dr. M. A. Elgari in "Some Recurring *Shari'ah* Violations in Islamic Investment Agreements Used by International Banking Institutions." Dr. Elgari shows the depth and breadth of his appreciation for the subtleties of contractual law. In the next paper, the noted legal expert Isam Salah makes a valuable contribution to the practical aspects of investing, in "Practical Legal and Tax Issues in Islamic Finance and Investment in the United States." Finally, my good friend and colleague, Shaykh Nizam Yaquby, gives a comprehensive ethical overview of Islamic religious teachings in his keynote speech, "Islamic Finance in View of the *Shari'ah*."

May the Almighty grant continued success to all those involved in these efforts. And it is God who prospers and assists.

Linking Ethics and Economics

The Role of Ijtihad in the Regulation and Correction of Capital Markets

Taha J. al-Alwani and Waleed El-Ansary*

ABSTRACT

In Islam, the intellectual effort to make ethical judgements on new issues such as contemporary capital markets is called *ijtihad*. It is not one "religious" judgement to be weighed against many, but an "all-things-considered" ethical judgement that takes economic and other factors into account. *Ijtihad* must therefore be based on properly utilizing transmitted (*naqli*) knowledge while integrating it with intellectual (*aqli*) knowledge derived from the fundamental Islamic doctrine of Unity (*tawhid*). Applied to economics, this doctrine asserts that spiritual ends are necessary for integrated preferences, and that spiritual values are not reducible to "arational" tastes such as the preference of apples to pears. However, *ijtihad* on capital markets is currently frustrated by the abuse of following the authority of previous scholars on one hand, and the eclipse of the Islamic economic intellectual heritage by secular economic thought that denies the implications of *tawhid*. This has inhibited current attempts to create an Islamic economic system in spite of the knowledge of transmitted sciences such as *fiqh*. Consequently, an Islamic theory of choice is necessary in addition to an Islamic theory of welfare to link ethics and economics through *ijtihad* on capital markets.

I. INTRODUCTION[1]

In Islam, the intellectual effort to make ethical judgements on new issues such as contemporary capital markets is called "*ijtihad*." It is a creative but disciplined effort to derive legal rulings for new situations from the accepted juridical sources of Islam. However, an ethical judgement such as *ijtihad* is not just one "religious" judgement "among many, to be weighed against economic, political, and other judgements in deciding how to act."[2] It is itself an "all-things-considered" judgement based on spiritual principles, taking economic and other factors into account.

Ijtihad is clearly distinct from *taqlid*, or following the authority of previous scholars. Such imitation applies to various types of "transmitted" (*naqli*) knowledge such as Quranic recitation, *Hadith*, and Arabic grammar. As Chittick points out, "Just as you learn to speak a language by imitating those who know the language, so also you learn the text of the Qur'an and how to say your prayers by imitating those who already know such things."[3] If we ask "why" concerning this transmitted knowledge, "the answer, for example, is that the Qur'an says what it says, or that you have to follow the rules of grammar for your speech to be understood."[4]

Simply accepting that others have transmitted knowledge and the right to teach is not sufficient for *ijtihad*, however, because the latter is a fresh attempt to apply the *Shari'ah* to newly created situations. In fact, *ijtihad* may need to incorporate additional information from "intellectual" (*naqli*) sciences to reach all-things-considered judgements. Such "intellectual" knowledge is clearly different from transmitted knowledge "because the only way to learn (the former)... is to understand it... (not) by simply accepting it on the basis of authority."[5] We cannot learn intellectual knowledge such as mathematics, logic, and much of theology simply by *taqlid*. To gain such knowledge, we must pose different questions than those in learning transmitted knowledge, such as asking "Why?" "It makes no sense to say 2 + 2 = 4 on the basis of someone else's opinion... The goal in intellectual knowledge is not *taqlid*, but *tahqiq*, which can be translated as 'verification' or 'realization.'"[6] Thus, *taqlid* cannot be the basis of *ijtihad* in the face of new circumstances, particularly in the analysis of capital markets that requires intellectual sciences to inform all-things-considered judgements.

Indeed, practically any *ijtihad* today requires both the transmitted and intellectual sciences. In fact, both are "essential to the survival of any religion—not only Islam."[7] However, we suggest that authentic *ijtihad* on economic policy is currently frustrated by the abuse of *taqlid* on the one hand, and the domination of secular neoclassical economic theory on the other. We argue that *ijtihad* must be based on properly utilizing transmitted knowledge while integrating it with intellectual knowledge derived from the fundamental Islamic doctrine of Unity (*tawhid*). This doctrine is expressed in its most universal manner in the first "testimony" of the Islamic faith*, La*

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ilaha illa'Llah (there is no god but God). "In all the different schools of thought that have appeared over Islamic history, one principle has been agreed by everyone... the fact that God is one and that He is the only source of truth and reality... To think Islamically is to recognize God's unity and draw the proper consequences from His unity. Differences of opinion arise concerning the consequences, not the fact that God is one."[8]

The first section of this paper is therefore devoted to defining the appropriate use of transmitted sciences and methodology for *ijtihad*, and the following sections are devoted to drawing the consequences of *tawhid* for intellectual sciences to inform *ijtihad* on capital markets. Turning to the first section, we attempt to justify the need for *ijtihad* by arguing that it is dangerous to assume that there is no possibility of giving fresh views on the basis of legal principles and no need to apply the *Shari'ah* to newly-created situations. Islam espouses *ittiba'*, or imitation based on sound evidence, not blindly following the authority of earlier legal opinions when *ijtihad* is necessary because of changed circumstances.

We suggest three essential Islamic principles for *ijtihad*: 1) *tawhid*, which implies integration and the inter-relatedness of creation; 2) *tazkiyah*, or purification of the individual and society from evil; and 3) '*umran*, or building civilization to accomplish the good. We maintain that these self-consistent and interdependent principles are governing values (*al-qiyam al-hakima*), and are "robust" for deriving Islamic law. While Revelation is the source of these principles, intelligence is necessary to apply them, making *ijtihad* a fundamental part of religion, and a narrow-minded approach to *fiqh* dangerous.

In addition, we suggest that *ijtihad* on economic matters was easier in the past than it is today. Relatively simple economic situations in the past made it possible for a single *mujtahid*, or individual qualified to perform *ijtihad*, to make all-things-considered judgements without the expertise of others. In today's complex environment of industrial production and institutional trade, this approach is no longer possible. Early *fatawa* dealt with relatively simple economic situations in which exchange was more individual than institutional, and production was more agricultural than industrial. Because questions about just and unjust transactions were simpler, the *faqih* did not need the expertise of others and could make all-things-considered deliberations alone. We believe that this is extremely difficult today since the knowledge required to deal with the complex environment is enormous, requiring specialized investigation in several areas. Thus, the need for teams of specialists to combine their expertise in different areas requires a "collective *ijtihad*" to match a more complex environment, integrating both transmitted and intellectual knowledge.

The following sections of the paper are therefore devoted to *aqli* knowledge in the analysis of capital markets. Applied to economic theory, we argue that *tawhid* implies that man can only be truly integrated around a Sacred Center. Indeed, *tawhid* has a verbal meaning in this context as the act of uniting or integrating all of life around the Sovereign Good. For the Muslim who organizes and integrates all his or her thoughts and actions into a harmonious whole and a unity, all thoughts and actions possess a religious character and spiritual significance. There is no longer any distinction between the spiritual and the temporal, for man is a unified whole in which all the parts (body, soul, and spirit) are ontologically interdependent, as we shall see. Consequently, only the *muqarrib* or "saint" is completely internally consistent, not the hedonist because what is ontologically "higher" is necessary to integrate what is ontologically "lower." Spiritual ends are therefore necessary for "instrumental" rationality, or having integrated, self-consistent preferences. As Mirakhor asserts, integrity is related to integratedness.[9] This does not imply that a hedonist will be completely inconsistent, but it does imply that a hedonist cannot have fully integrated preferences.

This is important for economic theory because without such self-consistent preferences, there is no equilibrium for individual choice, thus introducing an element of unintelligibility even from an instrumental point of view. Without this equilibrium, "maximizing efficiency" is meaningless because there is no integrated goal as the object of efficiency. In this sense, *tawhid* implies that equilibrium and efficiency are only possible when man successfully integrates the whole of life around God. Egoism cannot provide a base-line case for economic analysis, and economics cannot be a "separate science." The need to link ethics and economics is clear.

Tawhid also implies a "clear-cut relationship between the absolute and the relative, the eternal and the temporal, the necessary and the contingent."[10] This hierarchy provides the ontological basis of Islamic values, making possible the reasoned character of moral and ethical judgements. According to this view, values and ethical judgements can be substantively rational or irrational, or "right" and "wrong." They are not "arational" such as the preference of apples to pears, or vice-versa, which is not a matter of ethical dispute since "there is no arguing over tastes." Whereas tastes relate to a single level of desire that is not subject to criticism, and is unmodified by understanding, Islamic values relate to a hierarchy of spiritual, psychological, and physical needs.

Consequently, we believe that a single level "utility," whether defined as pleasure, happiness, or satisfaction of desire, negates spiritual values by negating hierarchy, and is appropriate only for tastes. By reducing values to tastes, we argue that "mono-utility" implies that "nothing is 'good' or 'evil' in itself, there is only 'more' or 'less'."[11] Economic models based on "mono-utility" cannot, therefore, be amended to incorporate Islamic values and inform *ijtihad*, but only serve to undermine its legitimacy. We maintain that an essentially different, anti-reductionist theory of choice is necessary to accommodate the multi-layered structure implied by hierarchy. (The argument that values cannot be grounded in reality, or the "naturalistic fallacy" argument, is itself a fallacy from the Islamic point of view—our critique of neoclassical economics is certainly not post-modern—and we shall return to related questions later in the paper.) Because mono-utility can accommodate any set of tastes, not values, and consistency does not apply to all values, *tawhid* implies that different models are necessary for different types of choices and values.

Unfortunately, neoclassical economics takes the opposite approach, reducing values to tastes based on mono-utility, and denying the need for spiritual principles in integrated preferences. Economists typically argue that a single model that assumes "egoistic consumerism" provides a "baseline" approximation of actual economic choices, and that the model can be amended to introduce ethical values as "disturbance terms."[12] We believe that this view represents a major obstacle to linking ethics and economics. Witness to this the fact that Milton Friedman declared in his Nobel acceptance address, "The great Saints of history have served their 'private interest' just as the most money grubbing miser has served his interest."[13]

Indeed, a growing number of scholars share the concern that mono-utility cannot accommodate ethical principles and social norms. Etzioni, for example, argues the need "for a multiple-utility conception" to integrate spiritual and ethical principles into neoclassical theory.[14] Similarly, Griffith and Goldfarb examine neoclassical attempts to amend the rational egoist model to include norms, and suggest that the results are unsatisfactory.[15]

Moreover, a hierarchy of multiple utilities can explain why ethical values lead to consistent preferences, whereas unethical values lead to inconsistent ones. For example, Kavka and others argue that weakness of will and competing passions create inconsistent preferences that can be explained in a multiple utility framework, and that individual choice is no less problematic than collective choice.[16] In fact, economists specializing in methodology including Caldwell and Boland point out the problems and limitations of arguments on the rationality of preferences.[17]

While these reservations apply to the neoclassical theory of choice, we argue that the neoclassical theory of welfare also denies a rational basis for ethics while excluding spiritual values. Indeed, the neoclassical definition of "well-being" includes the satisfaction of desires based on false beliefs or happiness based on illusion (depending on the definition of utility). This subordinates truth to utility and thereby reduces values to tastes. We argue that a "truth-based" theory of welfare that requires happiness or satisfaction of desire to be based on reality to count towards well being requires a hierarchy of utilities. The neoclassical theory of welfare is therefore consistent only with mono-utility, whereas the Islamic view of welfare is based on a hierarchy of spiritual and other needs.

We maintain that the combination of the neoclassical theories of choice and welfare has serious policy implications that undermine the possibility of *ijtihad*. For example, we suggest that neoclassical economics denies the need for ethical discussion in "technical" economic policy, and draws the wrong efficiency implications for ethical constraints. We therefore argue that the misapplication of neoclassical theory to choices involving values reduces "quality" to "quantity" and inverts spiritual principles. In this sense, we do not believe that neoclassical economics can properly inform *ijtihad*.

We do not suggest that all research by economists reduce values to tastes, but argue that economic models based on the axioms of neoclassical theory do. Specifically, the reduction of "rational preference functions" to "utility preference functions" is problematic since the former can accommodate hierarchy whereas the latter cannot. Moreover, we suggest that the misapplication of neoclassical theory is unavoidable because "qualitative" choices involving values precede "quantitative" choices involving tastes. Even a hedonist must first choose pleasure as an end before making choices involving tastes. In this sense, no decision can be based "only on tastes," whereas a decision based "only on values" is possible.

It is hardly coincidental that the neoclassical theories of choice and welfare emerged after a secular science of nature denied objective meaning to the hierarchic, qualitative aspects of nature. Indeed, higher levels of meaning in the beauty and harmony of nature as signs of God (*ayat Allah*) were reduced to the "subjective" and "unscientific." Spiritual values similarly lost their objective meaning, and were reduced to the subjective realm of tastes. Just as a hierarchy of multiple levels of meaning in nature gave way to the lowest level of understanding in the physical domain, a hierarchy of spiritual and other needs was reduced to a single level of desire based on tastes. Without reasons to justify values, there were only external causes of tastes, and loss of moral agency.

Similarly, the laws of nature were no longer known to be the laws of God operating on a particular level of reality. The concept that nature worships, loves, and obeys God, thereby producing order in the cosmos, was unscientific. Order without spiritual values therefore became a possibility for man, implying a different set of external laws to determine tastes, and the possibility of economics as a separate science. In this sense, both the neoclassical reduction of values to tastes, and denial of the need for spiritual values in the integration of man have their roots in a secular science of nature. This is the inverse of the Islamic sciences of nature that draw the consequences of *tawhid* to assert a hierarchic ontology and the necessity of spiritual forces to integrate lower levels of reality.

Thus, we argue that the relationship between ethics and economic theory and policy depends on: 1) whether values are reducible to tastes in a single level of utility, or involve an irreducible hierarchy of needs with an intellectual basis (the "hierarchy" question), and 2) whether spiritual values are necessary or unnecessary for integrated preferences as a baseline case for analysis (the "instrumental" question). This generates four combinations that we will analyze in more detail in the second section of the paper.

We claim that Islamic economics is "Islamic" because it draws the consequences of *tawhid* to answer these questions, not simply because it is developed by Muslims, examines economies in Muslim countries, or analyzes the economic implications of Islamic laws. Although Islamic economics may have these characteristics, they do not alone make it Islamic. The same applies to all the Islamic sciences, which are Islamic because they draw the consequences of *tawhid*.

Of the four possible responses to these two questions, we label the one that asserts a hierarchy of utilities for values and spiritual ends for integrated preferences as the "Islamic quadrant." Of course, other revelations also assert the need for spiritual principles to achieve equilibrium, and the existence of hierarchy based upon recognition of the Absolute. Therefore, other religious views of economics attach to this quadrant as well. However, this does not imply that an Islamic economy is the same as a Buddhist economy, or that all religions espouse identical methods to promote individual welfare. It simply implies that similar critiques against neoclassical economics can be made within the context of any revelation, and we enthusiastically support interfaith dialogue in this area.

Within the Islamic intellectual tradition, we suggest that *tawhid*-linked ethics and economics in this quadrant. We maintain that this is why Islamic economic thought never reduced values to tastes with a single model for all types of choices, and denied an egoistic baseline case, generating different economic policies for different types of choices. Because the Islamic theories of choice and welfare clarify that different "inputs" and "outputs" apply in these cases, Islamic economics highlights the need for discussion of ethics in policy, and the role of ethical constraints in the economy. We suggest that this can explain why economics cannot be a separate science, and its definition is "applied ethics" in the Islamic intellectual heritage. This clearly supports the role of *ijtihad* in the regulation and correction of capital markets.

We call the opposite quadrant that asserts the reduction of values to tastes in a mono-utility function, and the denial of the need for spiritual ends in integrated preferences the "neoclassical quadrant." In this case, economics is "constrained optimization" rather than applied ethics, for economics is a separate science with an egoistic foundation that can be amended to accommodate ethical disturbance terms. We argue that the other two quadrants on the "hierarchy" and "instrumental" questions are self-contradictory, and we analyze them in the context of the discussion on Islamic and neoclassical positions.

Given these four quadrants, we suggest that a theory of choice must be in the same quadrant as a theory of welfare to result in coherent economic thought and policy. A theory of choice that denies a rational basis for ethics, inverts spiritual values, and negates ethical discussion cannot be combined with a theory of welfare that recognizes an ontological basis for values in a hierarchic world with moral agency and meaning.

Because of the eclipse of the Islamic economic intellectual heritage, many Muslim policy-makers have attempted to combine an Islamic theory of welfare based on transmitted sciences in one quadrant with the neoclassical theory of choice in the opposite quadrant, resulting in confused thinking (at best) on economic policy. A similar problem has plagued departments of "Islamic economics" where students are taught *Shari*'*ah* sciences as the source of Islamic norms on one hand and the neoclassical theory of choice on the other. Such an approach implies that Islamic economics cannot offer a distinct theory of choice, the neoclassical view accommodates spiritual values, and the two could be integrated.

We believe that such confusion results from the loss of understanding of the Islamic economic intellectual heritage. Unfortunately, "both the transmitted and intellectual sciences are... gradually being lost throughout the Islamic world, and with much more reason among those Muslims who live outside Dar al-Islam."[18] However, the intellectual sciences have suffered even more than the transmitted sciences because "anyone can learn Qur'an and *Hadith*, but very few people can truly understand what God and the Prophet are talking about."[19] Intellectual sciences require both native ability and training, and there has been a particularly great loss of understanding of the Islamic intellectual heritage in sciences such as economics that take their axioms from "higher" sciences dealing with first principles.

We suggest that this loss has inhibited attempts to create an Islamic economic system in spite of the knowledge of *fiqh* and other transmitted sciences. Recovering the Islamic economic intellectual heritage is therefore vital to such efforts.

Although most Muslim economists currently recognize the need to go beyond economic assumptions of "consumerism," few seem to recognize that the neoclassical model cannot be amended to introduce Islamic values, and that abstracting from spiritual values leaves economics "fatally incomplete" with respect to consistency of preferences. Even worse are attempts by some Muslims to equate utility with *maslaha*, or total welfare including a spiritual dimension, and assert that the neoclassical theory of welfare is also "Islamic." We maintain that such attempts are intellectually flawed, and that the failure to refute the neoclassical assertion that Islamic economics is a "special case" of neoclassical theory has impoverished the discourse on Islamic economic policy.

An authentic Islamic policy requires that both *ijtihad* and economics distinguish between values and tastes and establish the correct "base case" through the application of *tawhid* to both *usul al-fiqh* (principles of jurisprudence) and economics. Rather than *taqlid* of the West in economic theory and policy, we must apply Quranic principles to both '*aqli* and *naqli* sciences, for the Qur'an contains the principles of knowledge and action for all time. We need to understand the *maqasid*, or higher values and causes of the *Shari*'*ah*, establishing a hierarchy of spiritual and other needs, and avoiding neoclassical reductionism. These principles guarantee that the character of our paradigm is *wassatiya* (avoids excess as evil and finds the good situated between two excesses), *tawazzan* (balanced), *'adl* (just), *istiqama* (direct, not winding), *rabbaniyya* (from God), *'alamiyya* (global), *al-'amum* (universal), and *ashshumul* (includes every part of life, leaving nothing unanswered). The solution must, therefore, come from an epistemological and methodological point of view that carefully defines and applies Quranic principles. By combining an economic theory of choice that accommodates an intellectual basis for values with a corresponding theory of welfare involving the transmitted sciences, we propose a framework to link ethics and economics in *ijtihad* on an Islamic capital market.

The paper is divided into three parts. In the first section, we argue against *taqlid* of past legal rulings, and discuss the requirements for an authentic *ijtihad*. In the second section, we argue against *taqlid* of the neoclassical theory of choice and in favor of an Islamic alternative that draws the consequences of *tawhid* for economic analysis. In the third section, we argue against *taqlid* of the neoclassical theory of welfare in favor of an Islamic conception, and suggest the role of Islamic principles in the capital market to help integrate preferences, and link them to welfare. Of course, a full treatment of this topic would require several volumes, and this paper will limit itself to some essential elements of the argument.

This introduction indicates how challenging it is to overcome the obstacles separating ethics and economics, and apply this to the capital market from an Islamic perspective. Research centers are needed that combine the talents of *fuqaha'*, economists, and other social scientists to provide an integrated Islamic approach. This concentration of resources can help eliminate erroneous *fatawa*, and apply Islamic principles to the contemporary world. True understanding of sacred text requires more than a dictionary—it requires an awareness of higher principles and the relationship between the Qur'an as the creative source of *ahkam* (legal rules) and the *Sunna* as the methodology to implement it. This approach gives *ijtihad* new significance for the *umma* to face the challenges of the future with the wisdom of the past.

Before leaving this introduction, we would like to point out that we do not attempt to give specific legal rulings or recommend particular policies in this paper. Because of the complexity of "all-things-considered" judgements and the many policy questions in capital markets, we focus our arguments on theories of choice and welfare linking ethics and economics through *ijtihad*, suggesting a framework that accommodates a wide range of ethical concerns and supports their discussion. By attempting to clarify the link between ethics and economics, we hope to deal with the principles that would help others apply them to specific cases.

II. *IJTIHAD*

When we think about *ijtihad* in our science of *usul al-fiqh*, we cannot unequivocally say that in its current format it provides us with an effective methodology for optimal solutions to all of our contemporary issues. We cannot make such a claim whether or not there is anyone in this time who can be a *mujtahid mutlaq* (an expert qualified to make *ijtihad* in all areas of *fiqh* without conditions), and whether or not we can identify such a person. Therefore, it is imperative that we reconstruct the concept of *ijtihad* itself so that it can become a methodological tool capable of responding to the challenges and questions of our time and future generations. *Ijtihad* need not be a closed tool to be used only within a specialized methodology.

To be able to reconstruct *ijtihad*, we need to take note of the following. First, in its *fiqh* dimension, *ijtihad* is limited to the genius of an '*alim* who is able to formulate the appropriate question given the event(s) and to go to the text of the Qur'an and *Sunna* for a ruling. If he cannot find a direct answer, then he looks for an answer where *ijma'* (consensus) was achieved. If that is not possible, then he proceeds to *qiyas* or articulates a legal principle to be his line of approach.[20]

Qiyas in this way was thought to be the farthest point beyond which the *mujtahid* was not warranted to go. It was Imam al-Shafi'i, in fact, who nearly reduced the whole process of *ijtihad* into *qiyas*, and argued vigorously against *istihsan* i.e. preference based on reason/interest. In this way, Shafi'i has certainly narrowed and restricted what was, otherwise, broad and flexible.[21] Many jurists, however, differed with Shafi'i on this restrictive approach, and at the top of the list were the Hanafis, the Malikis, and some later Hanbalites (like Ibn al Qayim, for instance). Those jurists argued that there are certain *masalih* that are neither explicitly supported by a text, nor are they explicitly opposed. This is an area for reflection, as Ghazzali, himself a Shafi'i follower asserts.

Maslaha refers here to various means that are conducive to protecting and maintaining the five ultimate objectives and aims of the *Shari'ah*. Actions and policies that happen in any way to endanger these objectives are designated as *mafasid*, the removal of which is itself a *maslaha* of a high rank that all religions and ideologies recommend. If we allow ourselves to intervene here and slightly widen the horizon of the jurists, we can safely say that all means of inculcating religious values, developing human resources, exploring physical material, or acquiring skills relevant to these activities are positive *masalih* that the *Shari'ah* recommends. Looking from the *Shari'ah* perspective, these *masalih* are not only accepted, but should be preserved. It is here, of course, that economics comes in, and it is also here that *fiqh* of *maqasid* is most needed rather than narrow *qiyas*. Traditional *fiqh* based on *taqlid* has to give way to new ways of inquiry in the text as well as the extended world.

But in our time, this is no longer possible with the explosion of knowledge and communication, which increases not only every day, but every hour and minute. There is additional information to incorporate into *ijtihad* with the advent of the social sciences, their appearance in world affairs, and spread into different spheres. Similarly, the collapse of the idea of the "limitedness of the text and the unlimitedness of the events" in the face of the holistic thought and purposes of the Qur'an and *Sunna* (which exemplifies Quranic principles) makes it clearly necessary to apply Islamic principles within *ijtihad*. In turn, this application requires information from other sciences, no longer allowing the limitation of *ijtihad* to the *fiqhi* sphere and no longer limiting it to one person. And thus we have to establish a strong connection between the social sciences (as a tool in understanding the event[s] to formulate the relevant ethical question) and *fiqh* (as the science according to which these formulated incidents have moral value and meaning).

Moreover, due to the difficulty of individual *ijtihad*, it becomes imperative that we adopt the principle of collective or institutional *ijtihad* established on multiple and diverse disciplines and specialists, outside of the framework of what is now known as *fatwa* committees or *fiqh* councils, despite their importance. *Ijtihad* should be undertaken within the framework of coming up with competent research institutions that include dedicated scholars (from all schools of *fiqh*) of *usul*, law, *Hadith* and *tafsir*, as well as social scientists, linguists, and community leaders. Guidelines may be established to determine the constitution of the *ijtihad* team depending on the issue. This does not negate the individual's role in *ijtihad*, rather it emphasizes it and gives it direction.

Whenever such an institution for collective *ijtihad* develops, the nature of *ijtihad* itself will change, taking a different shape with the following characteristics. First, *ijtihad* will no longer be a process based on a theoretical dialogue—undertaken by the individual *mujtahid*—between the text and dictionaries for the sake of deducing a ruling established on an inference based on the semantic that the *usul* scholars and logicians are accustomed to.

Second, the *ijtihad* institution will feel a great need for the utilization of all methodological means available in the social sciences (if they are spiritually neutral), and possibly some of the methodologies used in the natural sciences. These means and methodologies to aid in the study and analysis of the incidents under consideration will be used to understand, analyze, and better define the incident. Such an approach includes, in addition to the linguistic method, the statistical, quantitative, and qualitative methods as well as other tools. Even the linguistic method itself will have to be modified to better utilize the developments that have taken place in the study, analysis, and deconstruction of text for the purpose of gaining deeper insight as to its purpose.

Third, a need shall then arise to bring to the forefront the characteristics of the *Shari'ah* and the nature of its universal proofs (*al-adillah al-kulliyyah*). It becomes imperative, then, to understand the particular textual evidence within the framework of the universal textual proofs. It is not sufficient to only collect particular proofs relevant to the issue; rather, such proofs or evidence need to be understood within the context the *Shari'ah*'s universal proofs, its general goals and purposes, and the nature of its originating source, the Qur'an, and its particular, clarifying, and binding source, the *Sunna*.

Fourth, the need shall become apparent to understand the precise relationship between the Qur'an and the *Sunna*. This relationship shall consider the Qur'an as the only originating source of law and the *Sunna* as the only clarifying and binding source. Such a relationship between the originating and clarifying sources does not allow their separation. The relationship calls for understanding the nature of *bayyan*, its characteristics, and how it details the general, interprets the vague, specifies the generic, and generalizes the particular. All this is done for the sake of revealing the methodology used in applying the text to reality in the Prophet's time, and how such a methodology could be generalized for all ages so that humanity may be guided by the values and regulations of the Qur'an and the *Sunna* till the end of time.

Fifth, when these *ijtihad* centers and research academies get established, the need shall become apparent to reexamine what has come to be known as controversial legal indicators (*al-adillah al-mukhtalaf fiha*) and leave behind that which is no longer relevant. Other indicators may be renewed and developed and further regulated by the originating and clarifying sources.

Sixth, the higher values of the *Shari'ah*, *tawhid* (the unity of God, Truth that God is the Absolute), *tazkiyah* (purification from evil), and '*umran* (building of civilization to accomplish the good), shall be the guiding lights, regulating standards, and just scales against which the outcome of the institutional *ijtihad* shall be evaluated.

Seventh, it shall become apparent after such institutional *ijtihad* has become widespread that no matter how many safeguards and means human effort has been afforded, *ijtihad* cannot be presented as producing everlasting rules binding for future generations, or that these rules are even responsive to their needs. This *ijtihad* should not lead to the establishment of schools of thought and sects that may erode the unity of the *umma*, impede its future development, and become a barrier for future generations to practice *ijtihad*. The most we can expect from the *fiqh* of any generation is to offer solutions to crises and challenges that face a specific society in a certain time, place, and circumstance. The outcome of such *ijtihad* cannot be absolute and should not be binding for those other than the generation of that *ijtihad* and whoever chooses to adopt that *ijtihad*. In the case that a consensus exists among the people of a region or a certain time about a previous *ijtihad* ruling, it shall become binding upon them but not necessarily upon people of other regions or other times. Only the Qur'an and *Sunna* have binding authority. Thus, we recover the effectiveness, vitality, and continuity of *ijtihad*, making it an integral part of the psychological and mental state of the *umma*, and not an exception.

Eighth, the practice of *ijtihad* from academic and research centers will reveal the universal characteristics of Islam. These characteristics are not merely virtues of Islam, but should be applied as methodological guidelines in the formulation of collective *ijtihad*.

At the forefront of these characteristics is the universality of Islam. The universality is indicated by the fact that the *Shari'ah* is a law of ease and mercy (removes discomfort), is based on the authority of the sacred book, is connected with the finality of prophethood, and provides a necessary methodology. This universality indicates that the message of Islam is for all humanity in every place and time until the Judgement Day. The rapid spread of this message to all corners of the globe took place according to a perfect methodology that began by preparing the final Prophet, charging him with warning his relatives (the people of Makkah and the surrounding area), and then building an *umma* that provided a model for the rest of humanity to emulate.

The mission of Islam is global although it addresses humanity through a specific social entity in its own language (Arabic), dealing with the community's needs and problems. These are not necessarily the problems of all of humanity in all times and places, but can be used as a model for other societies which face different needs and problems by drawing from the methodology, values, and purposes of the Qur'an. The Qur'an is so resourceful that if you read it at any time or age, it will provide answers to specific questions. At one level, the Qur'an gives an answer for the Prophet's time. At another level, it applies the link to the Prophet's community to project the answer into the future. The multiple meanings and applications of the text are fascinating, and this is how the Qur'an addresses the problem of communicating absolute values in a relative environment, linking the transient to the eternal and the specific to the general. This correlation between the relative and the absolute has been achieved in the Quranic text. This was necessary because if the Qur'an had ignored the problems of the Prophet's community, it would have been impossible to project these absolute values forward. There would have been no example of how to apply the message.

In a short period of time, Islam was able to incorporate all other civilizations because of its universal vision, which proves its beneficial power in every time and place. This final message is characterized by the Absolute Book and Last Prophet. The message, therefore, contains categories to integrate the continuous and the temporary, the general and specific, and the global and local to satisfy its goals and objectives.

Unfortunately, our current religious teachings and studies do not prepare us to understand these essential principles. Because of these religious teachings, some people approach the Qur'an as if it were meant only for themselves, like a closed letter which our early doctors of law carried without opening. This leads some people to misinterpret the Qur'an from their current point of view, equating jinn with bacteria, or equating money with capitalism or socialism. Some people take the opposite position, thinking that the Quranic message is meant for our ancestors, simply providing the current generation with general directions without specific instructions. Both positions represent extremes that do not reflect a true understanding of the Qur'an, placing limits on the methodology used to understand the sacred text. A deep understanding requires a knowledge of the dichotomies in Islamic discourse, namely, the absolute and relative, the general and specific, the continuous and temporary, and the local and global in the Quranic teachings. We cannot understand the sacred text otherwise.

Our ancestors did understand these categories in Quranic discourse, and incorporated them into *usul al-fiqh* in what they called "chapters of terminology" and "chapters of what is common in Qur'an and *Sunna*." These chapters include discussion of the general and specific, absolute and limited, *ayat* with locked and flexible meanings, abrogation and the abrogated, etc. And they established some constraints and criteria to distinguish between different levels of Quranic discourse, and to differentiate between the legislative and non-legislative as well as the obligatory (*fard* or *wajib*) and the forbidden or reprehensible (*haram* or *makruh*). Indeed, our ancestors understood the Quranic distinctions between these things so clearly that they were able to differentiate five categories for action: forbidden, reprehensible, indifferent, recommended, and obligatory. They even distinguished between two types of reprehensible categories: *makruh tanzih*, which implies unsuitability for a person, and *makruh tahrim*, which leads to the border of *haram*. They also classified necessities into three categories, namely, essential needs, means to these needs, and embellishments or accessories to support these means.

To serve and carry the message of Islam, proving its applicability and usefulness for every time and place, we need to build upon what they have done. This requires using our knowledge to go back and rethink what should be the contents of the different categories discussed above. This is an essential, dangerous, and difficult journey, particularly for a mentality that has been in the habit of *taqlid* rather than *ijtihad* for several centuries. And we should establish centers for collective *ijtihad* to be the instruments to implement this task.

Let us consider a simple example of how a specific incident is developed into a general legal principle to understand how principles guide *ijtihad*. Let us take the case of adoption. The Qur'an deals with this through the example of Zayd (adopted son of the Prophet), declaring that the Prophet had no male children. Even though this message applied to a specific Arab community at that time, the principle applies today that adoption does not entail changing the child's name and literally creating new parents (although the Qur'an emphasizes the great rewards and spiritual virtues of caring for orphans). There are many other examples of establishing a principle through specific events in *fiqh*, such as emancipation of slaves, war booty, etc.

Since our ancestors understood how the Qur'an communicates principles through specific incidents, they were not waiting for the Qur'an to tell them that, "This is relative, this is absolute. This is general, this is specific. If the circumstances change, do this or that." But Allah revealed the Qur'an as He wills, and He revealed it to the *umma* in this way, placing a heavy task of interpreting this sacred text on the people of *dhikr* and the scholars. As the Qur'an states "(Here is) a Book which We have sent down unto thee, full of blessings, that they may meditate on its Signs, and that men of understanding may receive admonition." (38:29) "Nor should the Believers all go forth together; if a contingent from every expedition remained behind, they could devote themselves to studies in religion, and admonish the people when they return to them—that thus they (may learn) to guard themselves (against evil)." (9:122) Our ancestors produced many great achievements with this understanding, and if our generation continued on the same level without stopping *ijtihad*, we could properly understand the Quranic categories mentioned in our *usul al-fiqh*. If we pursue deep thought and illuminate our minds, we can build on the great achievements of our ancestors.

Their *mujtahids* set for themselves tens of principles for legal judgement, deriving solutions appropriate for their problems. Examples of these legal principles are: alleviate legal hardship, block licit means to illicit ends, choose the most prudent course, limit the matter to make options more plentiful, allow that difficulties attract facility, allow the illicit to be rendered licit by necessity or overwhelming circumstances, the needs of the public may be considered the same as those of the individual, and there may be acceptance in continuation for matters unacceptable in initiation. These rules represent deep jurisprudential, legal thought and past generations may have considered them more than enough to deal with their problems. Through these partial rules that are based on the total objectives of the *Shari'ah*, they were able to properly understand rules related to specific situations. They did not necessarily articulate the framework they used to derive these partial rules from the purposes of the *Shari'ah*, or how to apply the holistic point of view involving different levels of Quranic discourse and instruction.

Given this understanding of *ijtihad*, we now turn to economic theory, neoclassical objections to the application of Islamic law, and *taqlid* of secular economic policies supported by a *fatwa* relying on "micro *fiqh*" rather than principles in *ijtihad*.

III. Islamic Values and Economic Theory

When we turn to the Islamic economic intellectual heritage, we find a rich tradition of economics as applied ethics. By drawing the consequences of *tawhid* for economic analysis, Muslim intellectuals distinguished between values and tastes, asserted the role of spiritual values in equilibrium, and recognized the existence of a hierarchy of spiritual and other needs. We suggest that economics is defined as applied ethics in the Islamic intellectual heritage because *tawhid* implies that only ethical values can provide a "base case" for analysis, and values cannot be reduced to tastes in a single level of utility. Economics cannot, therefore, be a "separate" science, and a reductionist model cannot be amended to incorporate spiritual values. Different types of choices and values imply different models and different outcomes.

Neoclassical economics adopts the opposite approach, assuming egoism as a base case for analysis, and reducing values to tastes in a mono-utility function that implies a single model for any set of values and tastes. It therefore defines economics as a separate science based on "constrained optimization," separating itself from concern with ethics. We shall attempt to demonstrate that this theory of choice is appropriate only for tastes, and denies the possibility of intrinsic good and evil, thereby denying a rational basis for ethics and inverting spiritual principles. The problem is not just "consumerism" in economic theory, but the assumption of rationality based on a single level utility.

We therefore argue that different views on the link between ethics and economics depend on: 1) whether values are reducible to tastes in a single level of utility, or involve an irreducible hierarchy of needs with an intellectual basis (the "hierarchy" question); and 2) whether spiritual values are necessary or unnecessary for integrated preferences as a base case of analysis (the "instrumental" question). This generates four combinations that we illustrate in the figure below.

Table 1. Combinations of Value Hierarchies and Spiritual Ends

		Spiritual ends necessary for integration?	
		Yes	No
Hierarchy for values?	Yes	Islamic	Multiple Inputs Single Output
	No	Single Input Multiple Outputs	Neoclassical

The answer to the "hierarchy question" determines whether the neoclassical theory of choice can be amended to incorporate ethical values, or if multiple models are necessary for different types of choices and values as "inputs." The answer to the "instrumental question" determines whether economics is a separate science with egoism as its starting point, or if it is inseparable from ethics since different values imply different instrumental "outputs."

The "Islamic quadrant" asserts that different values require different models for inputs and outputs, whereas the "neoclassical quadrant" implies a single model for all inputs and outputs. The "single input" and "single output" quadrants take intermediate positions. We shall first focus on the hierarchy question before turning to the instrumental question, and then consider their joint implications for the relationship between ethics and the economic theory of choice.

A. Hierarchy

We begin by briefly examining Islamic values and spiritual principles to provide a better context for understanding the relationship between hierarchy, ethical values, and their implications for a theory of choice. Moving to spiritual principles, Islam is a religion based on the knowledge of God's Unity and surrender to His Will.

The faithful, therefore, find the ultimate purpose of any action in God because no end is beyond Him and no end has sufficient reason if it stops short of Him. The ultimate motivating cause for *homo Islamicus* is not simply happiness, pleasure, or satisfaction of a one-dimensional desire, but the Truth or God. For although happiness may accompany conformity to the Truth, it is an effect for the faithful rather than a motivating cause. "…our willing is not inspired by our desires alone, fundamentally it is inspired by the truth, and this is independent of our immediate interests."[22]

Accordingly, every aspect of life is sacred in Islam because nothing is outside of the Absolute, and no aspect of life is profane because everything is attached to God. Indeed, "Islam envisages religion as not just a part of life but as the whole of it."[23] It incorporates what one does, makes, thinks, and feels, sanctifying the whole of life in addition to answering questions of man's origin and return. What would appear to be the most mundane of activities has religious significance in Islam, fulfilling man's spiritual needs by integrating all of life around a Sacred Center.

Applied to Islamic economics, this unity of purpose is reflected in a saying from the Prophet of Islam that a man working to feed his family is performing "an act of worship as if he were praying."[24] Such a statement may be very difficult to understand in the modern West where a large domain of human life has been secularized and it is not possible to find religious meaning in most actions. However, the Divine Law in Islam makes the effort to earn one's daily bread a religious act as obligatory as specifically religious duties, and which a Muslim should perform with awareness that it is pleasing in the sight of God. In fact, the Divine Law gives religious meaning to all acts that are necessary for human life, but not those that are simply luxuries. The Qur'an, the Word of God in Islam, implies that to struggle for a living is tantamount to defending the faith.[25] The Prophet stressed this fact when a young man with a strong physique was running to his shop through the area where the Prophet was marshalling his men to repel an assault. Someone remarked that he wished the youth would use his body and health to run in the way of God by enlisting to defend the faith. The Prophet responded, "If this young man runs with the intention of not depending on others and refraining from begging, he is in the way of God. If he strives for the livelihood of his weak parents or weak children, he is in the way of God. If he tries to show his health out of pride, he is in the way of the devil."[26]

Thus, the combination of right intention with right action generates a hierarchy of utilities to simultaneously fulfill spiritual and other needs. Right intention is primary because of "the fact that one and the same action—we are not saying every action—may be good or bad according to the intention, whereas the inverse is not true: an intention is not good or bad according to the action."[27] Right intention clearly requires Truth as a motivating cause, and Islam asserts that goods and actions are only intelligible with God in view. Without a transcendent purpose, the intelligence is not operational and preferences are vacuous—one eats to live, lives to work, works to eat, and the cycle repeats itself indefinitely with no intelligible end-point. The loss of meaning is not simply a quantitative reduction within a level, it is the qualitative loss of a level.

We suggest that the neoclassical reduction of hierarchy to a single level of utility implies this qualitative loss, eliminating the possibility of meaning and intrinsic good and evil. We therefore believe the model cannot be amended to incorporate spiritual values. We maintain that the neoclassical theories of choice and welfare are appropriate only for tastes, not values, and that its misapplication to the latter inverts spiritual principles and denies a rational basis for ethics. However, neoclassical economics claims to offer a "formal" theory of choice capable of accommodating any range of values and tastes. It is therefore necessary to clarify this discrepancy, and we hope to clarify the need for a hierarchy of multiple utilities in the process.

We maintain that the confusion over neoclassical theory's ability to accommodate both values and tastes stems from the fact that some of its axioms accommodate both, whereas others do not. For example, the neoclassical axiom on "complete" preferences requires that a rational agent must be capable of comparing any bundles A, B, and C (for "completeness"), and the axiom on "consistent" preferences requires that if the agent prefers A to B, and B to C, then the agent must prefer A to C (for "consistency").[28] If the agent preferred C to A or could not compare the bundles, this would be "irrational." Consistency and completeness apply to ranking good and evil alternatives, are consistent with meaning in choices, and do not exclude a hierarchy of multiple utilities. Consistency and completeness clearly accommodate both values and tastes, and are necessary for "rational preference functions."

A major difficulty arises with the neoclassical axiom of "continuity" which is necessary to derive a "utility preference function" from a "rational preference function." This reduces all values to tastes in a single level of utility. We argue that while this is appropriate for choices involving tastes, it inverts ethical values. For example, continuity inverts the ethical values of one who "cannot be bought at any price." Imagine that we have the authority to prevent an evil act, and someone is trying to bribe us to permit it although we may be unwilling to accept any amount of money to permit the evil act. We may also have a limit on how much we would be willing to pay to stop the same event which others have the authority to prevent. The former is an "act" in which we participate to accomplish an evil, whereas the latter is an evil "event" others perform that we may not be able to afford to stop, and there is a qualitative difference between the two. The continuity axiom, however, requires that willingness to accept (WTA) be equal to willingness to pay (WTP). This excludes the ethical values of one who "cannot be bought at any price," although it can accommodate the unethical values of a miser. Moreover, it denies a rational basis for ethical values since WTA and WTP should not (necessarily) be equal if ethical values can be "right." In this sense, the choice of the amount to equate WTA and WTP is arbitrary (in the absence of special assumptions such as the cost of eliminating pollution being equal to WTP, making it ethical to accept the same amount and spend it on clean-up).

Continuity is appropriate, however, for choices involving tastes. For example, if we are willing to pay two apples for one pear in moving from bundle A to B, we should be willing to accept two apples for one pear in moving back from bundle B to A if we are indifferent between the two bundles. In this case, there is no qualitative difference between WTA and WTP because they are simply movements between two bundles on the same "indifference curve," a locus of points between which the consumer is indifferent. We suggest that this is because tastes are reducible to a single level of utility, whereas ethical values are not. The latter are based on a hierarchy of spiritual and other needs that do not "collapse" to a single level, and this creates discontinuities that allow WTA to diverge from WTP.

Thus, continuity is appropriate only when intrinsic good and evil does not apply, as in the case of tastes. The misapplication of neoclassical theory to ethical choices therefore implies the denial of intrinsic good and evil in values, as well as the loss of meaning in choice. With mono-utility, "nothing is 'good' or 'evil' in itself, there is only 'more' or 'less'."[29]

This critical distinction appears in dramatic form in contingent value (CV) surveys that measure WTP and WTA on pollution and other environmental concerns. From a spiritual point of view, the inner struggle, or jihad, to conform to the Truth should obviously create a large difference between the two numbers. In a recent dissertation, Carol Mansfield examined this problem in environmental surveys, and found that the spread between WTP and WTA was much greater than economic theory predicted.[30] Mitchell and Carson, for example, estimate that "WTP and WTA should be within 5% of each other..." for the types of goods usually valued in contingent value (CV) surveys.[31] Yet the survey data finds ratios of WTA to WTP ranging from 1.6 to 80, and that many surveys on ethical choices had missing WTA data, suggesting the "lexicographic" or "hierarchic" nature of these decisions. Some people "could not be bought" at any price, which neoclassical mono-utility would deny but a spiritually sensible economics based on the inner jihad between good and evil would predict. Mansfield concludes that "the disparity between WTP and WTA cannot be attributed to poor survey methodology nor can it be explained by neoclassical theory."[32]

We suggest that the disparity is explained by the different ontological levels between means and ends involved in ethical choices. In this case, multiple utilities are necessary because means do not constitute or make-up ends as they could if they were on the same level. For example, if means x constitutes or automatically leads to end y, multiple utilities would be redundant because x and y do not diverge, and a single utility would be sufficient to express outcomes. Even if we introduce intermediate means between x and y, a single utility is sufficient when the steps automatically "collapse" back to the "base mean." Similarly, one would say x leads to y, not x + y since the two do not diverge, and adding them would be redundant. However, adding x and y does apply when both are means to another end rather than being a mean or end of each other. We could then say that x + y are means to end z, which could also be expressed with a single utility if x, y, and z are on the same level. We suggest that this approach is generally adequate for dealing with choices involving tastes (with qualifications that we will not trouble the reader with here).

A hierarchy of spiritual and other needs is different in several respects. It involves ontologically different levels of reality and implies unity in the sense that "external goods" such as wealth are means to "goods of the body" such as health and beauty, which are in turn the physical support for "goods of the soul" through the spiritual work which manifests itself in intrinsic virtue. The "whole is not reducible to the sum of its parts" since lower level means are not sufficient conditions for higher level ends—physical goods such as health, and spiritual goods such as virtue require God's intervention and our cooperation. As the earlier example of the youth running to work indicated, the divergence between spiritual ends and lower level means is possible because of intentions. Spiritual results apply *ex ante* based on the intention, not *ex post* based on contingencies. This is the opposite of means and ends on a lower level, which can diverge *ex post* because of unexpected outcomes, but not *ex ante* because of intentions. In fact, lower level means are not even necessary conditions for higher level ends because sincere intentions play a spiritual role that is independent of outcomes. For example, spiritual goods do not disappear with the loss of goods of the body when one is sick, and can even increase since one's sins can be forgiven in sickness (as long as one has not purposely injured one's health).

In this sense, choosing between different intentions presupposes hierarchy, the possibility of *ex ante* divergence between means and ends on different levels of reality. It is the different intentions implicit in WTP and

WTA that allows for disparity between them. Whereas WTP is consistent with a spiritual end-point, WTA is not (in ordinary circumstances). Mono-utility equates WTP and WTA precisely because it denies the possibility of choice between intentions involving hierarchy, and cannot distinguish between an "act" and an "event." Neoclassical theory thereby denies the possibility of ethical choice as such, and this has implications for the possibility of internal struggle when we turn to the "instrumental question," and for policy when we turn to the theory of welfare. A mono-utility framework is therefore sufficient for tastes, but a multiple utility framework is necessary to accommodate ethical values.

Consequently, neoclassical theory either ignores spiritual ends outright, or handles the possibility of negative spiritual outcomes "additively," breaking the means-end relation between them. To see this more clearly, let us consider two simple examples using a "lexicographic" multiple utility function. In this function, more spiritual utility is preferable to less, regardless of tradeoffs with lower level goods. A spiritual end could not be "added in" as a means to another end, and would not be subject to trade with other types of utility. Mono-utility, on the other hand, requires adding spiritual ends with means into one utility, allowing exchange between them. However, for the faithful who conform to the Truth, it is unintelligible to sacrifice goods of the soul (spiritual disutility) for the sake of external goods (material utility), inverting the hierarchy. (For objections related to the case of the destitute, it is important to note that there is no spiritual disutility even from theft to survive. Islamic law asserts that the destitute cannot be punished for such actions, just as a drowning man has a right to use another's boat.)

Whereas mono-utility is continuous and requires the agent to be indifferent in an exchange of spiritual good for evil, a lexical utility function is discontinuous, and rules out the possibility of being indifferent in choices involving spiritual values. This ensures that the "right" choice does not change with desires, and that good and evil have intrinsic meaning. Thus, the "corner solution" in which *homo Islamicus* selects only what is spiritually acceptable is discontinuous and qualitative, and is not contingent upon physical utility. The corner solution of a mono-utility function, on the other hand, is continuous, quantitative, and contingent—"every man has his price." Such indifference is appropriate only for tastes.

Many economists suggest that adding an "infinite negative utility" for evil alternatives solves the problem of contingency without multiple utilities. However, this additive approach still denies the means-end linkage between spiritual and other needs, does not properly distinguish an act from an event, and introduces a new problem because all spiritually negative alternatives would have infinitely negative values, making it impossible to say some are worse than others. The same applies in the opposite direction—spiritually positive alternatives all have infinitely positive values. Thus, the attempt to avoid multiple levels of utility either paralyzes choice or makes it arbitrary. The "infinite negative utility" argument does, however, indicate the incomparability between ontologically different levels.

Turning to a second example, a lexicographic utility function allows "vertical" spiritual utility to complement "horizontal" physical utility since both are on different levels simultaneously, whereas mono-utility necessarily creates conflict between them even when it does not exist. For instance, neoclassical theory suggests that a spiritually inclined person should allocate his time between needs such as praying and working such that the marginal utility of time spent in each activity is equal. This would maximize utility since any discrepancy would mean the individual could increase utility by reallocating his time. The same principle applies to allocating time to different questions on an exam.

Yet, this approach to a hierarchy of spiritual and other needs is erroneous because vertical spiritual utility gives meaning to and accompanies horizontal "work utility." As the Prophet said, a man working to feed his family is performing an act of worship as if he were praying. Man's life can be integrated around a sacred center only if qualitatively different types of utility exist simultaneously, explaining how the sacred is always present without conflicting with man's other needs. Lumping spiritual utility and working utility into one utility requires substitutability between spiritual and other needs, creating tension between them that denies the possibility of meaning in work. For example, a hypocrite whose objective is to show-off with prayer and work may consider the trade-off between praying and working, calculating which combination maximizes his egoistic utility. This false perception of a trade-off is only possible on the basis of an inferior intention not based upon Truth. In this sense, mono-utility always requires a conflict between the spiritual and physical, even when it does not exist for *homo Islamicus*. Indeed, if everything is susceptible to trade in a single utility ranking, any goods such as loyalty and friendship that simultaneously accompany other needs are counterfeit, for they preclude such internal calculations by their nature.[33] We do not deny that choices must be made on how many prayers to offer, but argue that this choice does not occur in the way neoclassical theory suggests.

Taken to its logical extreme, the misapplication of the mono-utility solution appropriate to tradeoffs between means on a single level to ethical choices involving means and ends on multiple levels denies that God is the Absolute. If the Absolute is that which requires no further justification, then the idea that spiritual utility is subject to trade in a mono-utility function is to deny that God is the Sovereign Good "requiring no justification in terms of a higher good."[34] In short, it is to replace the unity of God with the uniformity of utility as man's ultimate end.

This implies that the opposition between pleasure and pain, happiness and unhappiness, or satisfaction and frustration of desire is absolute and irreducible, whereas the opposition between spiritual good and evil is reducible to a further quantitative end. This contradicts Islamic principles and denies a rational basis for ethics. Since what we like or dislike may change, Islam asserts that the opposition between pairs such as pleasure and pain is reducible, and is only real to the extent that it corresponds to the qualitative opposition between good and evil, not the reverse (as mono-utility requires). Similarly, a preference to have our desires fulfilled regardless of the intrinsic value of its objects is not coherent—it denies our preferences authority while "feeding" on them (which we shall return to when we examine the neoclassical theory of welfare). Thus, the oppositions implied by mono-utility cannot be absolute, for as the Qur'an asserts, we may like or desire what is bad for us, and dislike or not desire what is good for us.

In fact, every opposition is relative and reducible from a higher point of view according to Islamic principles except the opposition between the true and false, and spiritual good and evil. No other opposition could be irreducible because only God Is the Absolute. As Schuon explains:

> To be beyond oppositions means: beyond modes and accidents, such as activity and passivity, the dynamic and the static, hot and cold, white and black; or beyond opposite excesses, such as agitation and indolence, or violence and weakness; but it cannot mean: beyond the true and false, or good and evil, for in these cases the second term is a privation of being, if it may be so expressed, and not a mode of manifestation.[35]

An internal *jihad*, or "holy exertion," is necessary because only in the case of spiritual good and evil, truth and falsehood is it ontologically impossible to integrate this opposition with respect to a higher principle. Only the desire for the Absolute can be "absolute."

Thus, a theory of choice based on a hierarchy of utilities accomplishes two things that are necessary to accommodate Islamic values. First, it disallows the exchange of spiritual disutility for physical utility when such tradeoffs do exist. Second, it denies the existence of such tradeoffs when they do not exist. Neoclassical mono-utility does the exact opposite, first making spiritual utility subject to trade, and then creating tradeoffs even when they do not exist. The first step implies inferior intentions leading to the second, and ultimately negates the meaning and significance of choice. While the neoclassical theory of choice may be appropriate for the *nafs al-ammarah*, or soul that commands to evil, it is not a theory of choice for *homo Islamicus*. Nevertheless, most people (including many economists) believe that neoclassical theory is spiritually neutral because the conditions on complete and consistent preferences can accommodate values. Perhaps they (wrongly) assume that the third condition on continuity is a technical detail that does not have any ethical implications.

Consequently, Islamic economic thought never reduced values to tastes with a single model for all types of choices, denying a rational basis for ethics and contradicting *tawhid*. Whereas rational preference functions involving a hierarchy of multiple utilities are appropriate for choices based on ethical values, utility functions are appropriate only for choices based on tastes.

Unfortunately, the misapplication of neoclassical theory to values is unavoidable because "qualitative" choices involving values precede "quantitative" choices involving tastes. Since choices involving values relate to ends, they are unavoidable and logically prior to choices involving tastes. We therefore maintain that utility preference functions appropriate for tastes are embedded within rational preference functions based on ethical values. In this sense, there is no such thing as a decision based "only on tastes," whereas a decision based "only on values" is possible. Even a hedonist must first choose pleasure as an end before making choices involving tastes.

It is important to note that the preceding criticism of positive neoclassical theory is under conditions of certainty of economic payoffs. In many situations, what is in our economic interest is not clear, although what is morally right is. Indeed, a vast literature on the economics of uncertainty and limited human capability to process information shows that material payoffs are often unclear, and examines how people manage under such situations.[36] Out of four possible combinations of adequate and inadequate information and processing capability, only the single case of adequate information and adequate processing capability has certain economic payoffs. In all the other cases, we cannot combine what is spiritually certain with what is materially uncertain, making it even more important to recognize a spiritual level of utility. Indeed, several authors have shown that under a broad range of conditions, material gains are necessarily indeterminate, forcing non-instrumental rationality (such as spiritual values) into economic analysis to yield determinate solutions.[37] This indicates a clear role for spiritual principles to clarify determinate solutions, which the reduction of values to tastes would deny. Thus, the neoclassical reduction of values to tastes is even counter-productive in modeling situations of uncertainty and/or limited information processing capability. Since capital markets are "markets for risk," this has important implications for the role of *ijtihad* in capital markets.

Turning briefly to the last two quadrants of the matrix, it is clear that the "single input" quadrant is self-contradictory since it asserts that mono-utility can accommodate spiritual ends necessary for integration. The "single output" quadrant appears more reasonable since it asserts that mono-utility cannot accommodate spiritual ends. However, it differs from the Islamic quadrant in maintaining that they are unnecessary for integration, and we shall see that this denies an ontological basis for values by denying their integrating power. This quadrant therefore collapses back to the neoclassical quadrant. Multiple utilities play a key role in explaining integrated as well as dis-integrated preferences, to which we now turn.

B. Spiritual Ends for Integration

Neoclassical theory assumes that egoistic consumerism is the starting point of economic analysis, and that ethical values are "disturbance terms." The principle of *tawhid* in Islamic economics, on the other hand, asserts that inferior intentions cannot integrate man's being, and lead to inconsistent preferences. If spiritual principles are necessary to have an integrated "objective function," then unethical values are the real "disturbance terms," whereas ethical values provide the only fully intelligible base case. In this section, we will examine this argument, and draw out its implications for the relationship between ethics and economics. We suggest that although choices involving spiritually neutral tastes may typically be consistent, such integration is not automatic in ethical choices involving multiple utilities.

In fact, Sen, Boland, Caldwell, and other economists specializing in methodology argue that the neoclassical assumption of transitive preferences cannot be tested adequately.[38] Indeed, the notion that integrated preferences are possible without spiritual principles contradicts the teachings of all religions, and traditional philosophy. However, economists often argue for consistent preferences on the basis of "survival of the fittest"—those with rational preferences will exploit those with irrational preferences until only rational actors remain.[39] Yet, Hodgson shows that "survival of the fittest" only applies to firms, and that "it is more difficult to attach such a notion to the supposedly 'rational' consumer, as 'non-rational' consumers do not go extinct in the same way. If 'non-rationality' simply means inconsistent preferences, there is no obvious reason to assume a 'rational' consumer will have a superior survival value in socioeconomic evolution."[40]

Indeed, there is significant empirical evidence suggesting the pervasiveness of intransitive preferences that we believe cannot be "explained away." It is an everyday experience to feel the conflicting forces related to internal struggle, whether those conflicts be trivial or of great significance. Neoclassical economists are familiar with this possibility in the political macrocosm where multiple and, therefore, irreducible voters make intransitive choices. In a path breaking 1954 *Econometrica* article, Kenneth May first applied this public choice approach within the individual, presenting evidence from several sources demonstrating that "intransitivity is a natural result of the necessity of choosing among alternatives according to conflicting criteria."[41]

May first presents the results of an experiment with college students, who were given alternatives for hypothetical marriage partners with different rankings of intelligence, beauty, and wealth. The results showed that preferences were often circular, implying a conflict between irreducible criteria. In addition, May cites a Rand study which shows that circular preferences apply to individual commodities where the components are ranked in certain conflicting ways.

May points out that "the question is no longer 'Are preferences transitive?', but rather 'Under what conditions does transitivity fail?'"[42] He explains such circular preferences in terms of qualitatively conflicting criteria that cannot be integrated without hierarchy. May points out that if there is only one criterion by which to judge alternatives A, B, and C, then choosing A over B and B over C requires choosing A over C. On the other hand, if there are multiple criteria, then it is possible to have circular preferences, choosing A over B, B over C, and C over A instead of A over C. This is the individual analogue to the "Condorcet paradox," in which there is no majority preference for an option, leading to circular votes and no decision. Of three voters, two may favor A over B, two may favor B over C, and two may favor C over A, leading to circular voting. The final choice depends only on the stopping point, and is therefore "path-dependent." This is an arbitrary decision, and there is "no law of caprice."

Moreover, May notes that the existence of transitive preferences does not prove mono-utility any more than an election with transitive outcomes is proof that there is only one voter. Transitivity is a logical consequence of the assumption of a mono-utility function, not a sufficient condition for mono-utility. A rational preference function is not necessarily a utility preference function. May concludes, "It appears from the discussion that neither cardinal nor ordinal utility is adequate to deal with choices under all conditions, and that we need a more general theory..."[43]

Similarly, Kavka argues that individual choice is no less problematic than collective choice.[44] Multiple passions such as greed, pride, and lust, for example, may compete with one another for control and lead to intransitive preferences depending upon which passion(s) happen to prevail at the moment. Two passions may favor A over B, two may favor B over C, and two may favor C over A, leading to circular preferences. Such arbitrary decisions are typical of the *nafs*. Another analogy economists are familiar with is a "game without a core," a situation in which there is no stable solution among competing players (or passions in this case).

Thus, while indifference curves may exist within a passion, they do not exist across passions. Although the allocation between alternatives within the budget share of a given passion may be "optimal," budget shares between passions can be random or depend on the order of choice. Hence, competing passions violate the requirement for transitive preferences upon which neoclassical economic theory is built.

From the Islamic perspective, such concerns are well founded. *Tawhid* asserts that unethical values can be analyzed in terms of neither rational nor utility preference functions because unethical values lead to inconsistent preferences. Consequently, a complete theory of choice is not possible for unethical values, although we suggest that a partial model is possible. In this sense, the "inputs" of unethical values require ignorance, which is not (necessarily) permanent, and the "outputs" (in terms of consistency) are incoherent. This provides a key to why Islamic economic thought has emphasized models involving ethical values.

Islam asserts that the only way to establish internal order, therefore, is for the Truth to be the motivating cause. Only this creates transitive preferences and choices that are not path-dependent, creating a stable "core" in game theory. Indeed, "vertical" spiritual utility not only simultaneously accompanies other needs for *homo Islamicus*, it is the higher force necessary to integrate multiple needs on a lower level. Islam and other religions assert that two complementary needs such as resting and working can only be truly integrated by a force that is ontologically higher, not what is ontologically lower. Otherwise, such complements will be rivals that cannot be harmoniously integrated, and appear to be opposites. As Schumacher explains in a social context:

> "Justice without mercy," said Thomas Aquinas, "is cruelty; mercy without justice is the mother of dissolution." … Only a higher force can reconcile these opposites: wisdom. The problem cannot be solved, but wisdom can transcend it. Similarly, societies need stability and change, tradition and innovation, public interest and private interest, planning and laissez-faire, order and freedom, growth and decay.[45]

Because only the highest can integrate everything below it, and one of God's Names is the Most High (*al-'Aliy*), *tawhid* implies that God must be the Object of man's desires for him to integrate all needs on a lower level. In this sense, the Islamic theory of choice recognizes that the integration of multiple horizontal needs requires a vertical complement, involving at least three types of utility, i.e. a vertical spiritual utility based on right intention that qualitatively integrates two complementary horizontal utilities such as work and rest on a lower level. Indeed, a qualitative union of complements based on the unity of God is necessary to accommodate Islamic values, not a quantitative approach based on the uniformity of utility.[46] It is this vertical force that integrates the whole of man's being, and creates an identity based on permanence and stability that is the polar opposite of the neoclassical view of man as a container of (transient) mono-utility. As Guenon states, "Action, being merely a transitory and momentary modification of the being, could not possibly carry its principle and sufficient reason within itself; if it does not depend on a principle outside its contingent domain, it is mere illusion... (change is unintelligible) without a principle from which it proceeds and which, being its principle, is not subject to it, and is therefore necessarily unchanging."[47]

Consistency of preferences therefore requires hierarchy. Some economists may argue that changing mono-utility functions create inconsistent preferences, as if a "whole person" changed preferences. We think a better analogy is "competing body parts" because unethical values are necessarily fragmented, and incapable of integrating all aspects of one's being. Although mono-utility implies unethical values, the continuity applies "vertically," not "horizontally." In other words, unethical values exclude what is ontologically above, and are unable to integrate what is on the same level, leading to "horizontal" discontinuities. Tastes, on the other hand, do not affect consistency in and of themselves because they are embedded within choices involving values.

Vertical utility associated with spiritual values therefore explains integrated preferences, whereas horizontal utilities in the absence of spiritual ends explain dis-integrated preferences. Because the Absolute provides the ontological basis for integration as well as for values, the "single output" quadrant collapses to the neoclassical quadrant by denying the ontological basis of integration. In fact, qualitative vertical and horizontal equilibrium is the organizing principle of Islamic medicine, and we will return to this subject in the next section on the Islamic theory of welfare (*maslaha*).[48]

Given this equilibrium in which satiable needs are ordered with respect to a spiritual end, the problem of how to allocate scarce means across insatiable desires, or "constrained optimization," is no longer relevant. Instead, "restrained optimization" on how to use resources in conformity with man's spiritual and other needs is relevant. Frithjof Schuon explains the need for Truth in the integration of man's intelligence, will, and sentiment as follows:

> the good that man is capable of knowing he must also will in so far as this good can be the object of the will; in addition he must love this good and at the same time the knowledge of it as well as the will towards it; just as he must will and love the earthly and contingent reflections of this good according to what is required or permitted by their nature. One cannot devote oneself to knowledge without loving it and willing it, any more than one can will something without knowing it and loving its realization; and one cannot love without knowing an object and without wishing to love it.[49]

Thus, Islam asserts that consistent preferences are only possible when vertical equilibrium creates horizontal equilibrium. And vertical equilibrium is only possible when man conforms to the Truth with the whole of his being, leading to spiritual virtue, or "beauty of soul."[50] With spiritual virtue comes true happiness, for beauty and the love of beauty give the soul happiness, and this eliminates an internal tendency for change, for shifting or increasing desires. Indeed, "sensible beauties are situated outside the soul, and their meeting with it is more or less accidental; if the soul wishes to be happy in an unconditional and permanent fashion, it must carry the beautiful within itself."[51] Happiness is therefore an effect that constantly accompanies spiritual virtue, and this explains why a pious man with few means is far happier than an impious man of great wealth. As the Prophet said, "The Muslim in every situation is happy [*bi khayr*]." Consequently, the will and sentiment must be integrated in knowledge through the inner *jihad* against passion and inertia with Truth as its weapon. In this sense, neoclassical theory neither applies to those who are struggling with their passions and have intransitive preferences, nor to the saint who is satisfied and resolves choices both qualitatively and quantitatively (i.e., has a rational preference function based on a hierarchy of spiritual and other needs).

C. Implications for the Link between Ethics and Economics

Each of the four quadrants discussed in the previous sections implies a different number of models. The neoclassical approach is the simplest with one model for all types of choices and values. If neoclassical theory is correct, then egoism is the starting point of economic analysis, and ethical values are disturbance terms. Different ethical values and types of choices have no impact on theory, and there is no point in raising questions of "right" and "wrong" if WTA is equal to WTP. Economics is a separate science, and every other theory of choice is either invalid or a special case of the neoclassical mono-utility model.

The "single input" quadrant that assumes that one model is sufficient for all inputs while asserting that consistent outputs are based on spiritual values is self-contradictory. It implies that neoclassical theory applies to saints rather than hedonists, although mono-utility implies unethical rather than ethical values, and horizontal discontinuities are useful to explain intransitive preferences. Although ethical values are the starting point of analysis, they are ruled out in advance. Surprisingly, some economists adopt this position.

The "single output" quadrant assuming that hierarchy is necessary for spiritual values, but spiritual values are not necessary for integration implies different models for inputs, and suggests the same consistency of outputs. It implies that neoclassical theory is appropriate for hedonists, not for saints, and provides an additional model for ethical values. We suggest that this quadrant is also self-contradictory because it asserts the ontological basis of spiritual ends while simultaneously denying the ontological basis of their integrating power.

The Islamic quadrant asserts different types of choices and values, implying different models for inputs, and different outputs. Not only are unethical values unpredictable from an instrumental point of view, they are based on ignorance and change with knowledge. Because there is no science of ignorance and unethical values imply a lack of integration and intelligibility, Islamic economics focuses on models based on ethical values and substantive rationality without losing sight of deviations from them. Similarly, choices involving values are more important than and logically prior to choices involving tastes. Ethical deliberation is unavoidable if WTA should not equal WTP. Consequently, the Islamic theory of choice clearly links ethics with economic theory, and denies the possibility of economics as a separate science, and that the neoclassical model can be amended to incorporate spiritual values.

If the Islamic theory of choice is correct, then neoclassical economics is also internally inconsistent because it combines continuity and consistency for choices involving values. In a sense, neoclassical theory can (partially) model the inputs of unethical values, and the outputs for ethical values, but not the outputs of unethical values and inputs for ethical ones. Indeed, neoclassical economics is a special case of Islamic (or other religiously-based) economics since the former is appropriate only for tastes (or the *nafs*), whereas the latter accommodates values as well.[52]

Some neoclassical economists may respond to this critique by arguing that "real" economics does not examine choices that involve spiritual values. These economists recognize that mono-utility cannot accommodate spiritual values, and attempt to limit the application of indifference curves to situations in which the alternatives are qualitatively similar and morally neutral, such as optimally allocating one's time to questions on an exam to maximize one's score. Because a variety of further intentions are consistent with maximizing one's score on an exam, such situations accommodate multiple intentions.

While this approach to limiting the use of indifference curves is spiritually neutral in some cases, it suffers from the fact that these situations are too few to cover essential economic choices since spiritual considerations appear everywhere. For example, how much wealth one strives for is a spiritual choice, as is the nature of economic institutions in traditional Islamic civilization, for nothing is profane. Without explaining the "budget constraint" and other endogenous variables (including institutions because they also have a spiritual role), economic theory is fatally incomplete, abstracting from the essence of the problem it seeks to solve. Whereas constraints imposed by nature do not pose a challenge to neoclassical theory, endogenous constraints do.[53]

Even if we take such constraints as given, and apply indifference curves only to needs such as food and clothes, this does not eliminate the problem of spiritual neutrality. When one is directing needs to support the spiritual life, food and clothes are not substitutes and indifference curves do not exist—one cannot wear food or eat clothes. They can only be viewed as substitutes towards a single intention such as pleasure if the *nafs* is in control, in which case preferences can be unstable and indifference curves non-existent. Indeed, economists who recognize that indifference curves do not exist for spiritual needs must justify why they should exist between other qualitatively different needs.

Hence, mono-utility forces a choice between spiritual neutrality and logical completeness. We can either apply the neoclassical theory of choice in a spiritually neutral way, leaving essential economic questions unanswered and the theory incomplete; or we can attempt to provide answers to essential questions by reducing values to tastes, which is not spiritually neutral, and is incorrect because unstable preferences cannot provide a base case for analysis. The only alternative is to adopt a broader theory of choice that does not reduce values to tastes, and accommodates the ontological basis of spiritual values and their integrating function.[54]

Islamic economics therefore recognizes the need for ethics in economic theory, providing an approach that is spiritually neutral and logically complete—it recognizes God rather than utility as the Absolute, and that there is no horizontal equilibrium without vertical equilibrium. Only the *nafs* conflates values and tastes, ignoring the reasons for "preferences" because of insatiable passions. Neoclassical theory is therefore incapable of analyzing Islamic contracts and financial markets based on a hierarchy of spiritual and other needs, leading to normative errors to which we now turn.

IV. *MASLAHA* AND THE NEOCLASSICAL THEORY OF WELFARE

Maslaha is the Islamic word for welfare, and implies a hierarchy of utilities consistent with *tawhid*. It is derived from the root word *salaha*, which means that something has become pure, correct, and right. The Qur'an refers to Prophets as the *salihun*, those who are pure and righteous in the way of God. There is no divergence between the "right" and the "good" from the Islamic point of view. Thus, *maslaha* implies what is in the spiritual, psychological, and material interests of man, and combines right intention with right action. Indeed, numerous classical scholars in the philosophy of Islamic law such as Ghazzali and Shatibi have advanced elegant frameworks explaining this hierarchy.[55] Although a comparative analysis of their views is beyond the scope of this study, it is sufficient for the present purpose to note that a hierarchy of spiritual and other needs is common to them all.

The neoclassical theory of welfare claims to be formal (utility is defined as satisfaction of desire) rather than substantive, and able to accommodate the Islamic view of *maslaha*. However, just as the formal neoclassical theory of choice is unable to incorporate Islamic values, the neoclassical theory of welfare is unable to incorporate *maslaha* because the former negates a hierarchy of needs. We shall see that the neoclassical theory of welfare includes satisfaction of desire based on false beliefs or happiness based on illusion, and excludes Islamic criteria for welfare. This contradicts the Islamic view of welfare, which requires that the satisfaction of desires be based on true beliefs and happiness be based on reality to count towards well-being. The "truth requirement" is consistent with a hierarchy of spiritual and other needs, whereas the neoclassical approach to welfare subordinates truth to utility and thereby reduces values to tastes. The neoclassical view is therefore consistent only with mono-utility, and applies a single approach to both values and tastes.

Similarly, the neoclassical theory of welfare denies the need for spiritual principles in the integration of man. Indeed, neoclassical efficiency claims for "freedom of contract" and "complete markets" often lead to policies that deny spiritual constraints and contradict spiritual ends. We critique such arguments on "maximizing efficiency" that depend on consistent preferences based on true beliefs, which may be easy for tastes, but not for values. Indeed, inconsistent preferences imply that there is no goal that is the object of efficiency, and untrue beliefs undermine the worthiness of the goal. We maintain that "freedom of contract" and "complete markets" can even promote inconsistent preferences or untrue beliefs, particularly under conditions of uncertainty.

As we did for the neoclassical theory of choice, we first examine the reduction of values to tastes, or the "hierarchy question," in the neoclassical theory of welfare before turning to efficiency arguments related to the "instrumental question." We suggest that the neoclassical approach to welfare erroneously links unethical preferences to welfare by subordinating truth to utility on the hierarchy question, thereby denying a rational basis for ethics. We also suggest that the neoclassical theory of welfare erroneously links preferences based on unethical values to choice by assuming that unethical values are integrated on the instrumental question. By attempting to link choice, preference, and welfare in this highly questionable manner, the neoclassical theory of welfare draws the wrong efficiency implications for choices involving values. We conclude by arguing for the application of Islamic principles to the capital market to reestablish the link between choice, preference, and welfare.

A. Hierarchy and "Truth" in Definitions of Utility

Before proceeding to the question of hierarchy, it is necessary to define two alternative neoclassical approaches to welfare. The original neoclassical view of welfare in the early decades of this century was substantive, defining utility as happiness or pleasure. Hausman points out that even today, "Economists often slide from talking about utility to talking about happiness. Economists often talk about individuals 'seeking' utility, which makes no sense if utility is just a measure of the extent to which preferences are satisfied."[56] Hausman asserts that economists do not take the current formal definition of welfare as satisfaction of preferences literally, and "believe that the best way to implement a social policy that aims to make people happy is to satisfy preferences."[57] Thus, economists often have in mind a substantive account of welfare rather than a formal account. Indeed, talk of "moving to the highest indifference curve" makes "the temptation to equate utility and welfare… seemingly irresistible."[58]

It is therefore necessary to critique the neoclassical theory of welfare both for utility as a "mental state" (substantively as pleasure or happiness) and as a "state of the world" (formally as satisfaction of desire).[59] Each account has weaknesses that philosophers on opposing sides have accurately pointed out, and their criticisms are instructive. As Guenon notes, "the contentions of philosophers are often much more justifiable when they are arguing against other philosophers than when they pass on to expound their own views, and as each one sees fairly clearly the defects of the others, they more or less destroy one another mutually."[60]

Moving first to the pleasure or happiness account of utility, Griffin criticizes the theory because it does not distinguish between "the mental states involved in believing something that really is true and a successful deception."[61] According to this theory, actually realizing the meaning of existence and being fully deluded that one has done so can be the same. Griffin uses the example that "if a father wants his children to be happy, what he wants, what is valuable to him, is a state of the world, not a state of his mind; merely to delude him into thinking that his children flourish, therefore, does not give him what he values."[62] The mental state account clearly subordinates Truth to utility and is therefore inconsistent with *maslaha*, admitting happiness that is false because the object of happiness does not exist. As Griffin argues, "Bentham, Mill, and Sidgewick all saw utility as having to enter our experience. But we desire things other than states of mind; I might sometimes prefer, say, bitter truth to comforting delusion."[63]

The satisfaction of desire definition of utility partially corrects the mental state account by requiring that the object of desire actually exist to count towards utility. However, the satisfaction of desire account is still subjective because desirability defines goodness rather than goodness defining desirability. If people's preferences are based upon false beliefs, the satisfaction of desire account of welfare requires that they be fulfilled. As Hausman argues, "The only consistent ways out of this impasse are either to follow peoples preferences, even if they depend upon beliefs that are false and unreasonable, or to employ some substantive theory of welfare."[64] Thus, although the formal account "severs the link between 'fulfillment of desire' and the requirement that the person in some way experience its fulfillment," it does not rule out egoistic or illusory desires, just like the mental state account.[65] Truth is still subordinate to utility.

Moreover, the desire account cannot explain which preference to fulfill when preferences change without relying upon a mental state account. If we should not fulfill past preferences because they do not satisfy the person, then we are back to a substantive view of welfare. As Hausman points out, "If one says that satisfying past desires does not count, because giving people what they no longer want brings them no "satisfaction," then one has shifted from a preference-satisfaction model to a mental-state theory of welfare."[66]

Thus, both the mental state and satisfaction of desire accounts of utility subordinate Truth to utility, and justify the sacrifice of spiritual and other needs for false happiness based on inferior intentions. This reduction of values to tastes is consistent only with mono-utility, and excludes a "truth requirement" consistent with a hierarchy of spiritual and other needs. Only in the case of spiritually neutral tastes is either neoclassical approach compatible with *maslaha*, for tastes do not involve the same questions of truth and falsehood as values. Since mono-utility negates the distinction between the two, economists often misapply the neoclassical theory of welfare to choices involving values. The result is a theory of welfare of the *nafs*, not the spiritual welfare of *homo Islamicus*, and we shall see in the next section how subordinating Truth to utility denies the possibility of virtue. Although some philosophers have attempted to modify state of mind accounts with "qualitative hedonism" and state of world accounts with "informed desires," such modifications do not adequately distinguish between values and tastes from the Islamic point of view, and are still theories of morality that ultimately subordinate Truth to utility. Indeed, there is no possibility of avoiding philosophical problems in state of mind or state of the world accounts of utility that neglect man's spiritual needs.[67]

B. Consistency, Efficiency, and Welfare

Instrumental rationality links preferences and choice, and the neoclassical theory of welfare assumes an automatic link between preference and welfare because of the subordination of Truth to utility in its subjective approach. With preference as the link equating welfare maximization with choices, neoclassical economists argue that voluntary transactions must be in the welfare of both the buyer and seller because otherwise they would not be willing to exchange. Consequently, any restrictions on voluntary transactions will decrease utility. According to this view, laws should not reduce the choices available to consumers or producers in the absence of "market imperfections" (such as "asymmetric information" in which information imbalances lead to exploitation, or "negative externalities" which harm third parties). Economists therefore argue in favor of "freedom of contract" and "complete markets" regardless of whether values or tastes are involved. Economists claim that any restrictions violate Pareto optimality and reduce economic efficiency because two people can be made better off without anyone being made worse off. By reducing values to tastes and denying intrinsic "good" and "evil," there is no need for ethical discussion in "technical" economic policy.

But this argument for the efficiency of "freedom of contract" and "complete markets" applies only when preferences are linked to both welfare and choice. Without true beliefs linking preferences to welfare, efficiency is misdirected and no longer normatively relevant. And without self-consistent preferences linking preferences to choice, there is no goal as the object of efficiency. Since *tawhid* implies that unethical values violate both of these conditions, we argue that neoclassical economics draws the wrong efficiency implications for ethical constraints.

Efficiency claims for policies that create such inconsistent preferences are therefore meaningless. While such claims may be appropriate for tastes under specific conditions, the blanket application of these policies is unintelligible, leading the individual to internal disintegration and the community into social chaos in the name of utility maximization. Hausman concludes, "It seems that those who are benevolent need to consider not just preferences, but the origins of preferences or the justifiability of preferences."[68]

This problem is particularly important when policies and institutions affect preferences systematically, as occurs in development and environmental policies. "Assessments of policy must then depend in part on one's views concerning which preferences to promote or concerning which institutions provide a suitable framework within which desirable preferences will develop."[69] While changes in tastes may be neither good nor evil and unrelated to changes in welfare, changes in values are. If freedom of contract and complete markets change values, then such policies can establish, maintain, or break the link between preferences and welfare. Because neoclassical mono-utility cannot support the distinction between values and tastes and denies the existence of intrinsic "good" and "evil," the question cannot even be raised.

Consequently, arguments for freedom of contract and complete markets can be misapplied, replacing the Unity of Truth with the uniformity of utility. This leads to unhappiness and an ugliness of soul that makes man insatiable (which neoclassical theory then adopts as an axiom).

The divergence between welfare, preference, and choice is particularly clear in the case of "weakness of will," the problem of wanting to be moved by one desire and not by another, but "losing." One knows what one "should" do for one's welfare, but fails to act accordingly, or does so inconsistently. There is no weakness of will when it comes to tastes, for there is a "pre-existent motivation, not subject to criticism, unaffected by understanding."[70] A preference for apples to pears is not a subject of ethical dispute, and the connection between choice and welfare is clear—"there is no arguing over tastes." Such desires are "first-order preferences." Second-order preferences such as, "I should desire a pear instead of an apple" do not apply to tastes. In such cases, what we feel is "good" determines what is "right."

On the other hand, when economic choices depend on values rather than tastes, what is right does not depend simply on what we feel is good. Weakness of will applies, and the link between choice and welfare can be broken. Unlike tastes, values involve second-order preferences, judgements about what our preferences should be that imply a hierarchy of utilities. This involves a judgement that one first-order desire is "good" whereas another is "evil," such as abstaining from or using drugs, respectively. Because these ends are qualitatively different and irreducibly opposed, there is a real internal struggle. Weakness of will therefore depends on whether "the desire by which… [a man] is moved is either the will he wants or a will he wants to be without."[71] It is in this sense that a man may not always have the will he wants. This is not a question to do as one pleases. An unwilling addict, for example, is free to act but does not exercise freedom of will in the sense of having the will he wants.

Thus, weakness of will is the result of passions from the sentiment overcoming the intelligence—an inferior first-order preference based on falsehood overcomes a second-order preference based on Truth. Weakness of will highlights errors in the equation between choice and welfare based on mono-utility. Indeed, weakness of will does not exist in a mono-utility function because all qualitative conflict is negated by a continuous, quantitative measure. A lexicographic utility function, on the other hand, is discontinuous and can accommodate the qualitative conflict inherent in weakness of will, suggesting the need for Sacred Law.

Although some secular philosophers argue that Truth is not necessary to form second-order preferences, the conflict is irreducible only when one competing desire is based on Truth and another on falsehood. From the Islamic point of view, competition between two sentimental desires based on falsehood denies the possibility of a valid second-order preference, disqualifying this as an authentic case of weakness of will. Indeed, this is consistent with the neoclassical neglect of second-order preferences because of the reduction of values to tastes. A hierarchy of utilities is necessary for second-order preferences to exist.

It is also significant to note that Sen and others have shown that the neoclassical equation between choice, preferences, and welfare cannot logically apply to the formal definition of utility as satisfaction of desire.[72] Sen argues that, "Preference (as satisfaction of desire) can be defined in such a way as to preserve its correspondence with choice, or defined so as to keep it in line with welfare as seen by the person in question, but it is not possible in general to guarantee both simultaneously."[73] The problem is that preference can be used in two ways: a behavioral sense in which what we prefer is what we choose (for any reason), and an attitudinal sense in which what we prefer is what we like best or find most agreeable. Sumner points out that the behavioral sense can be linked to choice, and the attitudinal sense be linked with welfare, but preference "cannot, except by equivocation, be linked with both at once."[74] Preference cannot, therefore, serve as the middle term equating choice and welfare as satisfaction of desire, and normative economics trades on the ambiguity. Although this argument is limited to the formal account of utility, it points out that many economists actually rely on a mental state account to make efficiency claims.

C. Linking Preferences, Welfare, and Choice: Islamic Principles and the Capital Market

Tawhid implies that reestablishing the link between preferences, welfare, and choice requires the application of spiritual principles to public policy. Because the link between preference and welfare can be easily broken by inferior intentions, Islam rejects the secular neoclassical approach espousing unqualified voluntary exchange. As Islamic medicine asserts, vertical equilibrium in which the body is subordinate to the soul, and the soul is subordinate to the spirit is necessary for the *maslaha* of *homo Islamicus*. The origin and justification of preferences must therefore be considered because false happiness destroys vertical equilibrium and breaks the link between preference and welfare, taking man away from God rather than aiding the integration of life around a Sacred Center. Indeed, "Every bliss 'is' in some manner Bliss as such, however morbid the individual circumstances. The diabolical illusion could not reside in the positive nature of the facts; it is by detaching symbols from God, that is, by turning them aside, not from their nature or their content but from their positive function in relation to us, that the devil makes them illusory and satanic."[75] Islam therefore establishes policies to limit false happiness and establish the link between preference and welfare, fulfilling the spiritual needs of *homo Islamicus* that give meaning to all other needs.

Similarly, spiritual ends create the linkage between preferences and choice by integrating preferences. In Islam, the Divine Law gives *homo Islamicus* the ultimate freedom of will by making it possible for him to integrate all of life around a Sacred Center. In this way, man "avoids many unseen catastrophes and assures himself a life of wholeness and meaning."[76] While some may object that accepting the Divine Law completely destroys human initiative, this criticism "fails to understand the inner workings of the Divine Law."[77] Indeed, the Law places many paths before man which he chooses from according to his nature and needs. "Initiative does not come only in rebelling against the Truth which is an easy task since stones fall by nature; initiative and creativity come most of all in seeking to live in conformity with the Truth and in applying its principles to the conditions which destiny has placed before man.[78] By eliminating certain negative possibilities and influencing the order of choices man faces, the Divine Law helps man in his struggle with his *nafs* to have the will he wants and make the right choices in the face of path-dependent preferences discussed in the previous section.

We suggest that there are three Islamic principles for *ijtihad* related to the *maqasid* of the *Shari'ah* to establish a hierarchy of spiritual and other needs that link preference, welfare, and choice. The first principle is *tawhid*, the Truth that God is the Absolute and the necessary starting point of any Islamic analysis. The second principle is *tazkiya*, or purification of man and society from evil. The third principle is '*umran*, or the building of civilization for the accomplishment of good. We suggest that these principles are "robust" for deriving Islamic law.

The principles form a complete and consistent set, and all three are interdependent and necessary in a truly Islamic society, leading to the realization of man as both '*abd Allah* and *khalifat Allah fi'l ard*.[79] Indeed, the principles combine right action with right intention to integrate the whole of life around a Sacred Center. For example, knowing the Truth that God Is the Absolute requires the elimination of evil and the accomplishment of the good; it would be hypocritical to know the Truth without applying it to purify oneself and society from evil and neglecting real needs in building civilization for the accomplishment of the good. Similarly, purification from evil is not possible without knowledge of the Truth and the existence of an Islamic civilization is crucial in assisting the individual to recognize and conform to the Truth. Finally, building civilization to accomplish the good is not possible unless it is based upon Truth and is the reflection of pure intentions rather than greed.

The application of essential Islamic principles to derive an Islamic economy has been attempted by some contemporary economists like Syed Naqvi using an "axiomatic" approach.[80] However, his approach to Islamic economics leaves open the question of the reduction of Islamic economics to a "special case" of neoclassical economics, and the possibility of an "integrated objective function" without spiritual principles. Moreover, we suggest that *fuqaha'* can use other principles that match their technical vocabulary more easily to derive Islamic law. The importance of these concerns for avoiding *taqlid* and erroneous attempts to integrate an Islamic theory of welfare with a secular theory of choice should be clear by now.[81]

In any case, we suggest a methodology to integrate ethics and economics based on a hierarchy of spiritual and other needs established by the three essential principles of *tawhid*, *tazkiyah*, and '*umran*. All three principles have important implications for the Islamic view of wealth, and by extension, the role of capital markets in an Islamic society. Indeed, Naqvi, Chapra, Choudhury, and others have clearly drawn out the implications of various Islamic principles in their own research to provide specific policy recommendations.[82] Because we do not wish to make specific recommendations in this paper, and prefer to focus on the framework for linking ethics and economics, we limit ourselves to drawing general implications from the three principles. They are shared by the vast majority of scholars in the field, and will be useful in responding to objections raised by neoclassical economists that we will consider shortly.

Applied to wealth, the Truth that God is the Absolute requires that man recognize that wealth is a means which serves his spiritual interests, not an end in and of itself. This implies that material development (e.g. commercial transactions, industrialization, pursuance of profit, and maximizing benefits, etc…) can and should easily fit within an Islamic framework based on *tawhid*. No dichotomy between material and spiritual should ever arise in such a *tawhidi* paradigm. If the Absolute is that which requires no further justification, then the first principle excludes the possibility of money or anything else being viewed as a self-sufficient end. Only God is the Sovereign Good "requiring no justification in terms of a higher good."[83] This establishes hierarchy for consistency, and a scale by which to assess welfare.

The second principle, *tazkiyah*, requires that man's will and sentiment be pure, willing and loving all things for God. This requires that man must be grateful to God for his *rizq* (provisions) viewing nature as an *ayah* of Allah, and that he must be generous in his dealings with others. Indeed, *zakat* is based on the same root as *tazkiyah*, showing how generosity is intimately connected with purity. Purity requires that the sentiment should be objective in loving all things in their Divine context. It would be illogical and against Truth for *homo Islamicus* to will or love things outside their Divine Cause, for that would constitute the sin of idolatry and is "to hate indirectly the Cause from which all perfection and all love derive."[84] This helps integrate man's preferences, and ensure they promote his welfare.

Having said that we must always remember that *tazkiyah* cannot be achieved in a social vacuum, and an individual Muslim who seeks to purify himself has to do that within a society. He has to associate with others, get involved in activities and become engaged in the unceasing process of *amr bi'l ma'ruf* and *nahi an al munkar* (enjoining the good and forbidding what is wrong). It is only through such engagement that a Muslim can attain his personal *tazkiyah*, and it goes without saying that *tazkiyah* in this sense is the cornerstone in the process of social and economic development, which is often referred to as '*umran*.

The third principle requires that man accomplish the good in building civilization. This requires that man should not waste his God-given talents and resources, neither under-utilizing them, neglecting to fulfill his real needs, nor exploiting them in the service of greed rather than God. In accomplishing the good, the third principle requires man to be vigilant and not slothful, building wealth and civilization to fulfill real spiritual and other needs and not abuse them. This provides the external support to promote integrated preferences in the face of path-dependent outcomes.

These three principles, therefore, show that Islam recognizes the importance of wealth in a hierarchy of spiritual and other needs, or *masalih* of man. As mentioned earlier, the Islamic economic hierarchy recognizes that "external goods" such as wealth are means to "goods of the body" such as health and beauty, which are in turn the physical support for "goods of the soul" through the spiritual work which manifests itself in intrinsic virtue. The Islamic principles of *tawhid*, *tazkiyah*, and '*umran* regulate this hierarchy and integrate man's spiritual and other needs into a meaningful whole, realizing and implementing the *shahadahtayn* (the fundamental witnesses of faith). In this sense, Islamic economics recognizes the possibility that man can be motivated by the Truth or God rather than pleasure or happiness.

Islam, therefore, clearly recognizes the role of capital markets in raising funds for companies and projects that help the community fulfill its physical and other needs while providing necessary liquidity. But the operation of the capital market cannot betray the purpose of its existence that is determined by these three essential Islamic principles. Islamic values must be in the marketplace as well as the mosque, for God Is the Witness to all contracts. Therefore, companies and investors must use resources ethically in a way that is consistent with these principles, raising many questions on how the capital market can be used as a means to wealth or development that supports the spiritual ends of society. Such questions cannot even be properly raised within the neoclassical theories of choice and welfare, let alone answered. But these questions require answers because freedom is not an unconditional right, but is the result of fulfilling one's responsibilities. It is self-contradictory to argue that human dignity gives unlimited rights to the basest of men, allowing them to destroy what makes up man's real dignity, his attachment to God.

Sometimes Muslim leaders have to make decisions that serve the *maslaha* of the *umma*. This *maslaha* has to be a true and necessary one that does not contradict the internal *Shari'ah* system. Some jurists were skeptical about this process of *istislah* that is not directly stemming from the text and insisted on their demand for evidence. Other jurists replied that evidence here is uncountable (*kharijah 'an al hasr*). *Istislah* is not based on single Quranic verse or a Prophetic saying. Rather, it is based on the entire philosophy behind the Islamic legal system—which is maintaining the *maslaha* of human beings. Moreover, we argue that legal rulings based on a "micro *fiqh*" approach may select the wrong *'illa* , or occasional cause, and be inappropriate for changed economic circumstances. *Fatawa* based on superficial similarities between past and present exchanges may declare what is harmful to be right, or vice-versa. This violates the three principles (*al-qiyam al-hakima*) dictated by the *Shari'ah*.

As mentioned earlier, neoclassical economists and some Muslim modernists equate choice with welfare, and often object to the application of Islamic law in economic policy. Yet, scholars of the principles of Islamic jurisprudence (*usul al-fiqh*) have maintained that choice does not necessarily equate with welfare, and arguments based on what is relative (such as mono-utility) are not valid against arguments based on what is absolute, namely, God's Will in terms of Sacred Law. Indeed, Islam asserts that there is no divergence between the right and the good, and that the Sacred Law defines *maslaha*.

Some modernists respond that the Qur'an instructs man to think about what is in his best interests (*maslaha*) without referring to Revelation. This argument is absurd because the Qur'an commands man to think about his interests with an intelligence which is pure (*salim*), and this is only possible if one follows the *Shari'ah*. When passionate desires control man and he breaks the *Shari'ah*, his intelligence alone is not sufficient for him to determine what is in his best interests. While the intelligence must implement values, it cannot contradict the values contained in Revelation. In short, erroneous arguments that contradict the absolute based on the relative make the relative absolute. Without absolute and eternal standards, there is no basis upon which to evaluate either utility or changes in time.

Other modernists argue that the *Shari'ah* is relative, and that neoclassical economics is a helpful new source of law. However, the fact that some parts of Islamic law are relative cannot be used to argue that all parts are relative, and that neoclassical economics should be the new basis of *usul al-fiqh*. This erroneous argument implies that everything is relative, which itself is self-contradictory. One scholar answers this absurd proposition in the following manner:

> Relativism sets out to reduce every element of absoluteness to a relativity, while making a quite illogical exception in favor of this reduction itself. In effect, relativism consists in declaring it to be true that there is

> no such thing as truth, or in declaring it to be absolutely true that nothing but the relatively true exists; one might just as well say that language does not exist, or write that there is no such things as writing. In short, every idea is reduced to a relativity of some sort, whether psychological, historical, or social; but the assertion nullifies itself by the fact that it too presents itself as a psychological, historical, or social relativity. The assertion nullifies itself if it is true, and by nullifying itself logically proves thereby that it is false; its initial absurdity lies in the implicit claim to be unique in escaping, as if by enchantment, from a relativity that is declared alone to be possible.[85]

Thus, Muslim jurists do not accept secular utilitarianism as a basis for defining *maslaha*, and one cannot contradict the absolute on the basis of the relative. Contemporary scholars such as Muhammad Sa'id Ramadan al-Buti have correctly argued that secular utilitarian philosophy, of which economics is the central application, represents nothing short of an attempt to destroy Islam.[86] Indeed, those who favor *taqlid* with a *fatwa* based on confusing *maslaha* with utility invert the three Islamic principles.

We suggest that the interdependence between the *aqli* sciences in the Islamic intellectual heritage prevented the development of a theory of welfare based on mono-utility. By drawing the consequences of *tawhid*, Muslim intellectuals articulated an ontological and epistemological basis for reading the sacred message of creation, and offered intellectual support for ethical values and constraints. Hierarchy in both the "knowing" subject and "known" object prevented the reduction of values to tastes, and asserted the role of spiritual principles in creating order in man and nature.[87] The Islamic intellectual sciences thereby revealed a universe filled with meaning.

V. Conclusion

Hence, the link between ethics and economics depends on whether values cannot be conflated with tastes, and whether spiritual values are necessary for integrated preferences. Islamic economics affirms both according to the doctrine of *tawhid*, whereas neoclassical economics denies both. The result is that the Islamic economic theories of choice and welfare accommodate a hierarchy of spiritual and other needs as the baseline case for analysis, and do not negate questions of meaning, intrinsic "good" and "evil," and their relationship to instrumental rationality. Neoclassical economics, on the other hand, denies such concerns in favor of consumerism as a baseline case for analysis with ethical values as "disturbance terms," thereby reducing values to a single level of utility appropriate for tastes, and positioning economics as a "separate science." We suggest that the misapplication of neoclassical economics to choices involving values inverts spiritual principles, and denies moral agency and a rational basis for ethics.

Moreover, we suggest that the attempt to combine an Islamic theory of welfare based on *ijtihad* with the neoclassical theory of choice based on mono-utility is self-contradictory. The latter denies the need for ethical judgements and constraints. A theory of choice must be in the same "quadrant" as a theory of welfare to result in coherent economic policy. By combining an economic theory of choice that accommodates substantive rationality with a corresponding theory of welfare, we propose a framework to link ethics and economics in an Islamic capital market.

Consequently, we must avoid two types of danger to ensure "all-things-considered" judgements with both the theories of choice and welfare in the "Islamic quadrant." The first is *taqlid*, or blind imitation, of past Islamic legal opinions, and the second is *taqlid* of current secular economic fallacies. We suggest that the latter is even more dangerous than the former, and that contemporary Muslim scholars must have an accurate understanding of both *ijtihad* and Islamic economics on which to base policy on capital markets. We therefore urge the recovery of the Islamic economic intellectual heritage, the lack of understanding of which accounts for the frustrated attempts to create an Islamic economic system in spite of the knowledge of *fiqh*. A correct understanding of both disciplines must be achieved through applying three essential Islamic principles: *tawhid*, the Truth that God is the Absolute; *tazkiyah*, the purification of man and society from evil; and '*umran*, the building of civilization for the accomplishment of good.

If the current *ijtihad* fails to apply essential Islamic principles today, the *umma* will certainly face a more perilous situation in the future, for nothing useful can be accomplished without the Truth. Indeed, the most important cause of our current economic problems is lack of wisdom. Consequently, we do not know how to properly use the resources that God has blessed us with. The secular economist's argument that scarcity is necessary because everyone must have insatiable desires is a myth which the West has propagated. God's justice must be the source of our guidance, for wealth is God's wealth, humanity is God's creation, we are His vicegerents, and we must fulfill our duty to Him. God says the Truth, and may He guide us.

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[1] As co-authors, we feel delighted that this work has finally come out after a tedious process of writing and rewriting. We confess that it was not an easy task for either of us to re-read and reformulate his ideas in light of the criticism and comments of the other—a process that is unavoidable in all joint works. Nevertheless, we feel proud that we managed to work together despite our different academic backgrounds—one being an usuli faqih and the other an economist. However, it needs to be mentioned that in areas of economic argument, it was Mr. El-Ansary who took the trouble (and of course the responsibility) of argumentation and documentation. Our ideas are not necessarily identical but in itself this is quite in line with the principle of *ijtihad*—a principle that both of us believe in and advocate. Finally, we should note that for interested readers, an extended version of this paper is available through the Center for Muslim-Christian Understanding at Georgetown University.

[2] See the definition of ethical judgements by Thomas Hurka, "Ethical Principles," in Harold Coward and Thomas Hurka (eds.), Ethics and Climate Change: The Greenhouse Effect (Waterloo: Wilfrid Laurier University Press for the Calgary Institute for the Humanities, 1993), p. 23.

[3] William Chittick, "Recovering the Islamic Intellectual Heritage," forthcoming paper, p. 1.

[4] Ibid.

[5] Ibid.

[6] Ibid.

[7] Ibid, p. 2.

[8] Ibid.

[9] Baqir al-Hasani and Abbas Mirakhor (eds.), Essays on Iqtisad: The Islamic Approach to Economic Problems (Silver Spring: Nur Corporation, 1989), p. 89.

[10] Ibrahim Kalin, "The Sacred versus the Secular: Nasr on Science," forthcoming.

[11] Frithjof Schuon, The Play of Masks (Bloomington: World Wisdom Books, 1992) p. 61.

[12] For an excellent presentation of this concept, see Daniel Hausman, The Inexact and Separate Science of Economics (Cambridge: Cambridge University Press, 1992).

[13] Quoted from Tibor Machan, "Reason in Economics versus Ethics," International Journal of Social Economics (1996), p. 21.

[14] Amitai Etzioni, "The Case for a Multiple Utility Conception," Economics and Philosophy, Fall 1986, pp. 159-183.

[15] William Griffith and Robert Goldfarb, "Can the Rational Egoist Model Be Expanded to Include Norms?" in Kenneth Koford and Jeffrey Miller (eds.), Social Norms and Economic Institutions (Ann Arbor: University of Michigan Press, 1991), pp. 39-84.

[16] G. S. Kavka, "Is Individual Choice Less Problematic than Collective Choice?" Economics and Philosophy, 1991, 7, pp. 143-165.

[17] Bruce Caldwell (ed.), Appraisal and Criticism in Economics: A Book of Readings (Boston: Allen and Unwin, 1984). The readings include writings by both Caldwell and Boland.

[18] Chittick, p. 2.

[19] Ibid.

[20] For example, the avoiding of evil is prior to doing good.

[21] For a thorough discussion on *ijtihad* and a critical commentary on Shafi'i's views, see Taha Jabir al-Alwani, al-Ijtihad wa al-T*aqli*d fi al-Islam (Cairo: Dar al Ansar, 1979), pp. 35-38.

[22] Frithjof Schuon, Spiritual Perspectives and Human Facts (Middlesex: Perennial Books, 1987), p.93.

[23] Seyyed Hossein Nasr, A Young Muslim's Guide to the Modern World (Chicago: Kazi Publications, 1994), p.3.

[24] Seyyed Hossein Nasr, Ideals and Realities of Islam. San Francisco: The Aquarian Press, 1994, p. 98.

[25] Muhammad Abdul-Rauf, A Muslim's Reflections on Democratic Capitalism (Washington, D.C.: American Enterprise Institute, 1984), p. 5.

[26] Al-Ghazzali, Ihya Ulum id-Din (New Delhi: Kitab Bhavan, 1982), vol. 2, p. 54.

[27] Frithjof Schuon, The Play of Masks (Bloomington: World Wisdom Books, 1992) p. 61.

[28] Daniel Hausman, and Michael McPherson, Economic Analysis and Moral Philosophy, p.27.

[29] Frithjof Schuon, The Play of Masks (Bloomington: World Wisdom Books, 1992) p. 61.

[30] Carol Mansfield, Despairing over Disparities: An Empirical Analysis of the Difference Between Willingness to Pay and Willingness to Accept (College Park: University of Maryland Ph.D. Thesis, 1994).

[31] Ibid, p. 3.

[32] Ibid, p. 74.

[33] L. W. Sumner, *Welfare, Happiness, and Ethics* (New York: Oxford University Press, 1996), p. 118.

[34] E. F. Schumacher, *Guide for the Perplexed* (New York: Battam, 1997), p. 58.

[35] Frithjof Schuon, *The Play of Masks*, p. 8.

[36] See Shaun Hargreaves Heap, Rationality in Economics (Oxford: Basil Blackwell, 1989).

[37] For an excellent introduction to this topic, see Shaun Hargreaves Heap and Yanis Varoufakis, Game Theory: A Critical Introduction (New York: Routledge, 1995).

[38] Bruce Caldwell (ed.), Appraisal and Criticism in Economics: A Book of Readings (Boston: Allen and Unwin, 1984).

[39] Daniel Hausman and Michael McPherson, Economic Analysis and Moral Philosophy, p. 41.

[40] Geoffrey Hodgson, “Calculation, Habits and Action,” in The Economics of Rationality, op cit.

[41] Kenneth May, “Intransitivity, Utility, and the Aggregation of Preference Patterns,” Econometrica, January 1954, p. 5.

[42] Ibid, p. 1.

[43] Ibid.

[44] G. S. Kavka, “Is Individual Choice Less Problematic than Collective Choice?” Economics and Philosophy, 1991, 7, pp. 143-165.

[45] E. F. Schumacher, A Guide for the Perplexed (New York: Harper and Row, 1977), p. 127.

[46] In fact, Rene Guenon points out that uniformity is the polar opposite of principal unity. See The Reign of Quantity and the Signs of the Times (Baltimore: Penguin Books, 1972), chapter 7.

[47] Rene Guenon, Crisis of the Modern World (Paris: Luzan, 1945), p. 54.

[48] Seyyed Hossein Nasr, Science and Civilization in Islam (Lahore: Suhail Academy, 1968). See chapter 7 on Islamic medicine.

[49] Frithjof Schuon, Esoterism as Principle and Way, p. 95.

[50] Humility, for example, has its source in one’s total dependence on God, awareness of which prevents man from overestimating himself and underestimating others.

[51] Frithjof Schuon, Esoterism as Principle and Way, p. 94.

[52] If a single utility is adequate in a spiritual theory of choice and internal order is possible without spiritual principles, Islamic economics is simply a special case neoclassical theory (with input from Islamic preferences and institutions). If a single utility is inadequate for a spiritual hierarchy of multiple utilities, and spiritual principles are necessary for consistent preferences, then neoclassical economics is a special case of Islamic and other spiritually oriented economics.

[53] Griffith and Goldfarb, p.63.

[54] This approach is similar in a few respects to Lux and Lutz, but provides a metaphysical justification and asserts that spiritual needs are simultaneous with other needs. See Mark Lutz and Kenneth Lux, Humanistic Economics: The New Challenge (New York: The Bootstrap Press, 1988).

[55] For a discussion of several classical views, see Muhammad Khalid Masud, Shatibi's Philosophy of Islamic Law (Islamabad: Islamic Research Institute, 1995).

[56] Daniel Hausman, Economics and Moral Philosophy, p. 74.

[57] Ibid.

[58] Ibid, p. 117.

[59] James Griffin, Well-Being (Oxford: Oxford University Press, 1986), p. 7.

[60] Rene Guenon, The Reign of Quantity and the Signs of the Times (Baltimore: Penguin Books, 1972), p. 114.

[61] James Griffin, Well-Being, p. 13.

[62] Ibid.

[63] Ibid.

[64] Daniel Hausman, Economics and Moral Philosophy, p. 76.

[65] Ibid.

[66] Ibid.

[67] See El-Ansary, op cit.

[68] Ibid, p. 76.

[69] Daniel Hausman, Economic Analysis and Moral Philosophy, p. 79.

[70] James Griffin, Well-Being, p. 28.

[71] Harry Frankfurt, The Importance of What We Care About (Cambridge: Cambridge University Press, 1988), p. 19.

[72] See Amartya Sen, Choice, Welfare, and Measurement (Oxford: Basil Blackwell, 1982), chapter 2; and L.W. Sumner, Welfare, Happiness, and Ethics (New York: Oxford University Press, 1996), chapter 5.

[73] Amartya Sen, Ibid, p. 73.

[74] Ibid, p. 121.

[75] Frithjof Schuon, Spiritual Perspectives and Human Facts, p. 92.

[76] Seyyed Hossein Nasr, Ideals and Realities of Islam (London: Allen and Unwin, 1994), p. 98.

[77] Ibid.

[78] Ibid.

[79] The following approach is similar in important respects to Naqvi's axiomatic approach. However, we shall see that there are some very important differences, particularly regarding the neoclassical argument that Islamic economics is a "special case" of neoclassical theory, which leads to *taqlid* of secular economic policy with an erroneous *fatawa*. See Syed Haider Naqvi, Ethics and Economics: An Islamic Synthesis (Leicester, England: The Islamic Foundation, 1981).

[80] Naqvi applies four principles of *tawhid* (unity), *al adl wa l-ihsan* (equilibrium), *ikhtiy'ar* (free will), and *fardh* (responsibility). These axioms are consistent with the three principles discussed in this paper, but differ with respect to the independence of each axiom

[81] See El-Ansary, "Ethics, Economics, and Law in Classical Islamic Thought," SISS Occasional Paper, 1999.

[82] See M. Umer Chapra, Towards a Just Monetary Society (Leicester, England: The Islamic Foundation, 1985); and Masadul Choudhury, Money in Islam (New York: Routledge, 1997).

[83] E. F. Schumacher, Guide for the Perplexed, p. 58.

[84] Frithjof Schuon, Stations of Wisdom (Bloomington: World Wisdom Books, 1995), p. 94.

[85] Frithjof Schuon, Logic and Transcendence (Middlesex: Perennial Books, 1984), p. 1.

[86] Muhammad Khalid Masud, Shatibi's Philosophy of Islamic Law (Islamabad, Pakistan: Islamic Research Institute, 1995), p. 132.

[87] Seyyed Hossein Nasr, "Foreword," in Osman Bakar, Classification of Knowledge in Islam (Kuala Lumpur: Institute for Policy Research, 1992), p. xi.

Shari'ah Precautionary Procedures in *Murabaha* and *Istisna'*

A Practical Perspective

Abdul-Rahman Abdullah bin Aqeel*

ABSTRACT

At this stage in the development of Islamic banks, the first priority is to ensure that the financial contracts that Islamic banks use do not contradict the *Shari'ah*. The contracts should be real and devoid of superficiality in application. Two widely used contracts in Islamic banks are *murabaha* and *istisna'*. *Murabaha* traditionally refers to an immediate sale contract, but in modern times is usually thought of as a deferred-payment and markup contract. The unique Hanafi position on *istisna'* distinguishes it from the *salam* contract. Since, for instance, *murabaha* and *istisna'* contracts can be used to sidestep the prohibition of interest/usury, *Shari'ah* boards should pay attention to the many ways that both types of contracts could run afoul of Islamic law. Most importantly, those involved in administering the contracts should be believers in Islamic finance.

I. THE *MURABAHA* CONTRACT FOR THE ISSUER OF A PURCHASING ORDER

The *murabaha* contract has two different meanings, one old, the other contemporary. According to the original *Shari'ah* meaning, *murabaha* is a kind of sale contract in which the buyer orders the seller to buy the goods, and the seller then sells the goods to the buyer, with an additional sum as a profit paid at the same time. It is an immediate contract in which the seller exchanges the price for the merchandise.

To Islamic banks, *murabaha* means selling for a deferred payment after adding a markup to the cost of the goods. The seller should inform the buyer of the cost price. The *murabaha* contract differs in its original *Shari'ah* form from its contemporary banking form in that it does not follow the immediate selling transaction with a disclosure of the price for which the merchandise was bought. There is also the addition of a defined amount of profit (there is no dispute among Islamic scholars as to the legitimacy of this type of *murabaha*). In contemporary banking *murabaha*, the merchandise is not initially in the custody of the bank/seller. It receives an order for purchasing, and the issuer of the purchasing order promises to buy it later for a price that exceeds the banking cost by a defined sum or percentage. This is the reason for keeping the word *murabaha* in the wording of the transaction title "*murabaha* for the issuer of the purchasing order."

There is a significant dispute in scholastic and banking circles about the value of the *murabaha* contract in practice, compared with the contemporary concept, and the effect of such a contract on the workings of an Islamic bank. The scholastic dispute began when Islamic banks started their activities in the 1970s. Since the executive officers of Islamic banks gained their experience through long careers in traditional banks, they designed *murabaha* to appear similar to the lending contracts they were accustomed to. They sought to convince some of *Shari'ah* boards to make the *murabaha* contract binding at the start of the operation and to make the purchasing order issuer's promise a commitment from him. Some *Shari'ah* boards agreed with this argument in order to cope with the position of Islamic banks in that phase. Since Islamic banks back then were still in the idea-formation stage, everyone sought to advance their ideas into reality. However, the commitment of a promise in the contemporary *murabaha* contract is not a matter on which contemporary *Shari'ah* scholars agree.

One of the most important points of the contemporary *murabaha* contract is the commitment to a promise by the purchasing order issuer before signing the *murabaha* contract. The original opinion states a non-commitment to a prior promise in the *murabaha* contract, and contemporary scholars who oppose this commitment justify their position on this stipulation by arguing that:

1. it is a continuance of a historic practice;
2. the contract nowadays has been used as financial tool by the Islamic banks; and
3. the commitment promise makes it greatly resemble the lending contracts conventional banks use.

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If, to the commitment to a prior promise, is added the requirement that one who delays payment must pay financial compensation (on top of the original sum due the bank), the *murabaha* contract is transformed into an interest contract similar to the one used by conventional banks.

In addition, some Islamic banks are lenient about the correct application under the *Shari'ah* of the *murabaha* contract. The bank does not itself buy the goods specified in the contract, and does not have it under its custody, but pays their price to the client. The client purchases the merchandise himself, if he really wants it. Sometimes, the client will deposit the money directly in his bank account because his aim from the beginning was to acquire solvent money (*al-tawarruq*). This turns the *murabaha* contract into a trick to acquire an interest-bearing loan. Acquiring usury deceptively offends the *Shari'ah* more than acquiring it openly.

The contemporary *murabaha* contract, as applied by some Islamic banks, requires a commitment to a prior promise and requires the customer to perform all the transactions as an agent of the bank. The bank's role is limited to paying money in return for collateral. At the end, it receives the deposit plus the profit when it matures. The whole process is a superficial one; the entire operation is merely dealing in papers and money with no effort, responsibility, or risk on the bank's part.

The contemporary *murabaha* contract—in the form and application mentioned—has obstructed the work of Islamic banks. This is a circumstance that has induced one of the most famous Islamic bankers, Shaykh Saleh Kamel, to wish that Islamic banks escape the "*murabaha* bottleneck." Despite all that, most officers of Islamic banks rely on *murabaha* to invest the bank's resources. Much evidence shows that the focus of some Islamic banks on *murabaha* has obstructed the application of other *Shari'ah*-based financial products, and creates a distorted picture of the *Shari'ah* and Islamic banks for non-specialists.

Shari'ah boards should focus on the following important points respecting *murabaha* to ensure that the contract is consistent with the *Shari'ah*.

First, the contract at the promise phase should not be committing. This means that the client has the right, after the promise phase and after the bank acquires the requested goods, to change his mind for any reason he sees fit. He is not committed to buy the goods, except when he signs the selling contract with the bank and before the bank is in custody of the goods. The experiment of Al Rajhi Banking and Investment Company is a good example. Its *Shari'ah* board ruled that clients are not committed to a prior promise. In practice, the number of customers who breach the promise in *murabaha* contracts was negligible, had no effect on the bank's work in this field, and posed none of the risk that traditional bankers had expected when they rejected the form of the *murabaha* contract lacking a prior promise commitment.

Second, the bank must have bought the goods required by the client, and the goods must be in the bank's custody before the sale contract is signed with the client. This is to adhere to what the Prophet Muhammad (PBUH) said: "It is forbidden for one to sell what he does not own, and to profit from what he does not have in his custody."

Third, the bank should not have acquired from the client, before signing the contract, any collateral that may make the client committed in any way toward the bank. If the bank acquires any type of collateral, it should be recorded in a collateral contract. The bank does not have the right to use this collateral unless the client has signed the sale contract with the bank, and the client becomes committed by a contract to the bank.

Fourth, the *murabaha* contract may not include any delay fines or in any way compensate the bank for such a delay in case a client fails to pay on time.

Fifth, it must be ensured that the goods in the *murabaha* contract are not forbidden by the *Shari'ah*, or will not be used for forbidden purpose, such as selling grapes to a person known to be a winemaker or selling weapons to rioters or terrorists.

Sixth, no supplements or side-correspondence may have occurred between the bank and the client in a way that contradicts any of the contract provisions and turns it into a contract that violates the *Shari'ah*. The managers of some banks do not reveal such correspondence to their *Shari'ah* boards and seek to apply the *murabaha* contract superficially.

Seventh, if there is a conflict between the bank and its client, it ought to be solved according to the *Shari'ah*, either by resorting to a *Shari'ah* court or by arbitration according to *Shari'ah* rules.

II. THE *ISTISNA'* CONTRACT

The *istisna'* contract lets one buy a described manufactured item that the seller does not own at the time of contracting, whether the item is made by the seller or another manufacturer. The *istisna'* contract is a unique feature of the Hanafi school, for the other three schools (Maliki, Shafi'i, and Hanbali) consider it a *salam* sale and apply to it the *salam* rules. Because a *salam* sale is a sale of a described item the not in the seller's custody, the three schools besides the Hanafi attach to the *istisna'* contract a condition of paying the entire price at the contracting time. The

Hanafi school says that the *istisna'* contract has its own ruling, and is not considered as a *salam* sale would be. On the basis of the Hanafi opinion, contemporary scholars have ruled that the *istisna'* contract is valid; that the payment of the full price at the contracting time is not obligatory; and that the price can be paid in installments. Furthermore, *istisna'* is a committing contract based on fulfillment of the purchase specifications by the manufacturer.

The *istisna'* contract is misused by some Islamic banks. It has been turned into a form of contemporary *murabaha* on the basis that an item is sold for deferred payment and at a profit included. The *istisna'* contract has been used in a way similar to *murabaha*: as a financial tool by Islamic banks. Therefore, the following important points should be observed for the *istisna'* contract to ensure accordance with the *Shari'ah*.

The goods subject to the contract are manufactured and are not in their raw state (i.e., as God has created them). Therefore, *istisna'* is not applicable to grain, millet, crude oil, and such goods, since they are only to be sold through the *salam* contract because they have not been subjected to the process of manufacturing and have not changed from their God-made nature.

The manufactured item should itself be acceptable in Islamic law. Therefore, no contracts could be made for goods that the manufacture, sale, purchase, and use of which the *Shari'ah* forbids, such as liquor, pork, materials harmful to humans or damaging to environment, and other goods forbidden by Islam.

The *istisna'* contract may not state that the manufacturer will sell goods made by a certain company. The contract should mention only the technical specifications of the manufactured items and not connect them to a certain factory or certain party. Indeed, the Prophet Muhammad (PBUH) forbade such a clause in the *salam* contract, which is the basis of the *istisna'* contract. If this occurs, the contract will be a trading contract because it will involve selling manufactured goods that the seller does not own: an act the *Shari'ah* forbids.

The common procedure to protect the bank from price fluctuations is for the Islamic bank to sign an *istisna'* contract parallel to and with the same specifications as the contract it has signed with its client. The separation between the two contracts should be insured. The *istisna'* contract that the bank signs with its client should not refer to the other contract that the bank will sign with the factory or the party from which the bank will purchase the goods. The bank is committed to deliver to its client, at the time specified in the contract between them, the manufactured goods according to specifications. That is, the bank commits to meeting that contract's provisions, whether or not the factory delivers the goods at the time specified in the second contract between the bank and the factory.

It must be ensured that the Islamic bank does not absolve itself from its responsibility toward its client regarding manufacturing defects. The bank should commit to delivering quality goods that conform to specifications. It can limit the warranty period for the manufactured goods to a few months after delivery of the goods to the client in order to minimize the risk involved. If, during the warranty period, no defects are found, the bank is not responsible for defects that occur later. The contract can state that the original manufacturer of the goods must compensate the client in case any defects emerge. If the original manufacturer does not respond positively during the warranty period, the client has the right to charge the Islamic bank in its capacity as an original guarantor. (The name of the original manufacturer and its address should not be mentioned in the contract between the bank and the client, but should be supplied by the manufacturer in a separate letter, at a later date, and after delivery).

Further, the contract ought to commit all parties to resort to *Shari'ah* courts or Islamic arbitration in case of conflict between the contracting parties. This should be applied if the two parties of the contract are both Muslim. If one is non-Muslim, the two parties should agree to an arbitration procedure. The arbitration procedure and the decision of a court of law may not rule that an interest payment is required.

The *istisna'* contract may impose a fine, payable to the client, on the manufacturer in case it delays delivery. The client can obtain collateral from the manufacturer for the fulfillment of his responsibilities in the manufacturing contract. The client has no right to obtain and receive all the rights from this collateral unless the manufacturer fails to fulfill all the obligations stated in the manufacturing contract.

These are the most important points that should be noted to ensure the correctness of the contemporary *istisna'* contract from the *Shari'ah* point of view.

III. Conclusion

The best way to ensure that Islamic finance contracts follow the *Shari'ah* is to involve owners and senior management who believe in the cause and principles of Islamic finance, and to train staff accordingly.

Shaykh Saleh Kamel, on the occasion of the award offered him by the Islamic Development Bank, said:

> "I say to you in all sincerity that if I'm to turn back to what I have done, I would not choose the framework of a bank to achieve the teachings of Islam in fields of investment and economics. I would have chosen a

> different framework that is consistent with the *Shari'ah* rules that govern investment. This is because we have not only chosen the name of the bank but its basic concept as a financial intermediary. We have therefore failed to find for our financial institutions a concept that will bypass financial intermediation. What became widespread in Islamic banks is a hybrid between debt and investment. It is a hybrid that carries all the characteristics of debt and the weaknesses of capitalism. It does not reflect the elimination of interest, which is not possible without detaching ourselves from the realities and effects of the interest-based banking system."

This statement is based on the long experience of one of the leading authorities on Islamic banking. There is a need to define the philosophy of the Islamic banking system and enhance its activities and performance by developing the appropriate financial tools to achieve the goals of Islamic banks and to compete with conventional ones.

Islamic Tradable Instruments

Basic Building Blocks

Gohar Bilal[*]

ABSTRACT

Because Muslim investors have very few *halal* ways to actively trade in the securities market, there is a dire need to develop actively tradable Islamic instruments. True Islamic instruments can only be developed with three factors in mind: 1) an appreciation of today's securities market; 2) a sound awareness of the essential characteristics for their successful application; and 3) a thorough understanding of the *Shari'ah* principles for their structuring. Although professionals in the securities market are often aware of the first two factors, they lack the knowledge of the *Shari'ah* that is essential for structuring such instruments. This paper focuses on providing simple explanations of some *Shari'ah* concepts that must be understood before developing Islamic tradable instruments. The *Shari'ah* perspectives on partnership, co-ownership, debt transfer, agency, and property are discussed.

I. INTRODUCTION

Islamic finance presently has very few financial instruments through which Muslim investors can actively trade in the securities market. Under specific *Shari'ah* guidelines, trading in company stocks (shares) is allowed. *Shari'ah* scholars allow investment in the shares of companies whose interest-based debt is less than 33% of total debt and interest-based income does not exceed 10% of total income. Of course, investment is forbidden in companies engaged in *haram* activities such as the production of alcohol and pork or gambling. Various funds (established under *Shari'ah* guidelines) do not allow active trading and are mostly avenues of medium- to long-term investment. There is thus a need to develop instrument(s) that would allow Muslims to actively trade in securities while providing opportunities for short-, medium-, and long-term investment.

The term "Islamic tradable instruments" here means securities that can be structured in accordance with *Shari'ah* principles. Under the conventional system, the simplest tradable instruments or securities are shares that are traded in the stock market. This paper will use the trading of shares in a company as a basic example. It will highlight and briefly discuss relationships between different parties involved in share trading. Each element discussed here is a subject in itself. At this stage, it is necessary to start with the very first step—developing an understanding of some vocabulary and concepts of conventional and Islamic law. Grasping the two will assist one in studying, at a more advanced level, the structuring of other tradable instruments that comply with Islamic legal principles.

II. BASIC STEPS IN TRADING SHARES IN THE STOCK MARKET

Assume that a company has listed shares for trading in the stock market. Investors (individuals or corporations) purchase shares of the company from other existing common shareholders through stock-market operations. The stock market also determines the price of shares, which reflect a company's management, demand for its business/services, valuation (as assessed by the market) of company assets, and past, present, and future financial performance. Brokerage houses or individual brokers are authorized agents who assist investors in buying shares from existing shareholders who want to dispose of them in the stock market.

A. Parties Involved in Share Trading

To illustrate these relationships, it is useful to imagine a juristic (legal) person or entity named XYZ Incorporated. Parties involved besides the company include: 1) sponsors who form a company; 2) existing shareholders; 3) a potential investor interested in buying company shares; and 4) broker(s) who assist potential investors in buying and existing shareholders in selling shares. Before going further into the details of these

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relationships, we will briefly examine the conventional and *Shari'ah d*efinitions of the parties and elements involved in share trading.

1. Company (Legal/Juristic Person or Entity)

a. Conventional Definition

A company is an association of a number of persons for a common purpose, frequently for running a business with a view to profit. The term is, however, often used for associations that are legally partnerships or even sole proprietorships.

Members of a company are constituted by subscribing the Memorandum of Articles of Association or by subscribing of shares by purchasing shares.

A company is managed by a board of directors, which are the trustees of the company's interest and property, but not trustees of shareholders or creditors. They are also the company's agents for transacting business with other parties.

b. Shari'ah definition

In the words of Justice Taqi Usmani, the concept of a juristic person, as envisaged under the modern economic and legal system, has not been common in Islamic law, yet there are precedents from which the basic concept of a juristic person may be derived.

The first precedent is that of *waqf* (charitable trust), which is a legal and religious institution. In *waqf*, a person dedicates some of his property to a religious or charitable purpose. The property as such no longer belongs to its former owner. It seems that Muslim jurists have treated *waqf* as a separate legal entity and have ascribed to it some characteristics peculiar to that of a real person.

The example closest to the concept of a joint stock company as a juristic person is found in the *fiqh* of Imam Shafi'i. According to the Shafi'i school, if more than one person runs his in a common shop, where their assets are mixed with each other's, *zakat* will not be levied on each of them individually but will be paid on their joint stock.[1]

According to Imran Ahsan Khan Nyazee, the concept of a corporate (fictitious) personality (*shakhsiyah i'itbariyah*) has been a subject of prolonged debate in Islamic law. Most modern scholars believe that the concept was known to Islamic law, while a minority doubts whether Islamic law was aware it.[2] However, in his books *Islamic Law of Business Organizations* and *Corporations and Islamic Law*, Nyazee discusses and suggests the structure of a company as a legal person.

If *Shari'ah* scholars accept the trading of shares in a company, it implies that scholars do accept a company as a juristic person/entity. However, the subject of limited liability, which is beyond the scope of this paper, remains a debated issue among Muslim scholars.

2. Broker

a. Conventional Definition

A broker is an agent working for his client (investor) and has fiduciary responsibilities. He must act in accordance with his instructions and execute each transaction to the best advantage of his client according to his judgment at the time of dealing. The broker is entitled to indemnity from the client against any liability incurred by reason of his having contracted on the latter's behalf. Contracts of sale and purchase are also often made orally between the broker and the client.

b. Shari'ah definition

The concept of agency (*wakala*) in Islamic law is discussed below in section VI. This is explained in the section "Relationships," where the broker-client relationship is covered. One can notice several similarities between the concept of agency in Islamic and secular law.

3. Shareholders

a. Conventional Definition

Shareholders are the owners of fractional parts of the company, depending on the number of shares they hold. There may be several kinds of shares with different rights attached, particularly respecting the distribution of profits.

b. Shari'ah definition

The concept of co-ownership is discussed below in section IV.

4. Securities

a. Conventional Definition

Securities are viewed as evidence of money claims and financial assets. Securities are very similar to debt, as both are obligations of one party to pay money or its cash equivalent to another. Whereas loans (a form of debt) are contracts, securities become personal property.

5. Common Stock

a. Conventional Definition

Equities, or equity securities, issued as ownership shares in a publicly held corporation are called common stock. Shareholders have voting rights and may receive dividends based on their proportionate ownership.

B. Relationships between Parties Involved in Share Trading

TABLE 1. POSSIBLE RELATIONSHIPS IN SHARE TRADING

	Parties	Relationship
1.	sponsors of a company	partnership (*sharikat al-'aqd*)
2.	common shareholders and a company	co-ownership (*sharikat al-milk)*
3.	common shareholder selling shares and potential investor	transfer or assignment of debt (*hawala*)
4.	investor and broker	agency (*wakala*) and lease (*ijara*)

The sponsors of a company form XYZ Inc. by a partnership (*sharikat al-'aqd*) among themselves. The second relationship (*sharikat al-milk*) exists between common shareholders and XYZ Inc. (or its sponsors). Third, when an existing shareholder transfers a piece of his ownership to a new investor, a transfer or assignment of debt (*hawala*) occurs. Finally, the investor/broker relationship involves agency (*wakala*) on the part of the broker who buys shares for the investor and lease (*ijara*) between the two persons. It is to the *Shari'ah* perspectives on partnership, co-ownership, debt transfer, agency, and property that this paper now turns.

III. PARTNERSHIP

Under secular law, partnership is defined as the relationship that subsists between persons carrying on a business, including every trade, occupation, or profession, in common with a view to making profit. The individuals who constitute partnerships are collectively called the "company" or "firm" and they conduct their business under the firm's name. Partnership is not necessarily created by co-ownership or by sharing gross returns, though sharing profits and losses is indicative of partnership. Partnership is usually constituted by a written agreement or contract. It is presumed on mutual trust and confidence, and the utmost good faith is required in the relations of partners.

Under Islamic law, there is no single definition that covers the different type of partnerships. The definition of each is based on the conditions and rules that govern the relationship. Partnership refers to the relationship among a company's sponsors. This section discusses partnership through contract (*sharikat al-‘aqd*). As soon as there is an investment through capital for profits, *sharikat al-milk* changes into *sharikat al-‘aqd*.

TABLE 2. DEFINITIONS OF *SHARIKAT AL-‘AQD* IN THE DIFFERENT SCHOOLS

School	Definition	Comment
Hanafi	*Sharikat* is an agreement between two or more persons for common participation in capital and profits.[3]	The Hanafi school mostly discusses partnerships in wealth and/or capital. This definition only discusses partnership through wealth. All other partnerships, including *mudaraba*, are excluded from this definition.
Hanbali	*Sharikat* is a partnership of two or more persons in a transaction.[4]	
Maliki	*Sharikat* is permission, from each of the participants to the others, for transaction in his wealth and on his own behalf, while retaining the right to transact personally (in such wealth).[5]	In this definition, only partnership in wealth is discussed. All other partnerships, including *mudaraba*, are excluded.
Shafi'i	*Sharikat* is mixing and technically it is an established, undivided right in a single thing or a contract implying this.[6]	This definition is restricted to co-ownership or participation in wealth because other forms of partnerships are not valid according to the Shafi'i school. This school only accepts *sharikat al-milk* and a restricted form of *inan* based on *mal*.

A partnership has several basic elements. Its purpose of a partnership may be trading, a business venture, or something else. The underlying relationship may be by way of capital or skills. Each partner may contribute one or the other or both. While a partnership can not be formed without an agreement or contract, for co-ownership it is not necessary to have an agreement or contract.[7] The contract must indicate the main purpose of forming the partnership: sharing profits/income, trading, etc.

IV. CO-OWNERSHIP

Co-ownership in Arabic is called *sharikat al-milk* or *musha‘*. According to Islamic law, there are three basic kinds of alliances (*sharika*): *sharikat al-ibaha* (common sharing of things); *sharikat al-milk* (co-ownership); and *sharikat al-‘aqd* (partnership through contracts). Furthermore, under Islamic law there is no single definition that covers the different types of partnerships. The definition of each is based on the conditions and rules that govern the relationship. Trading in shares is governed by the concepts of both co-ownership and partnership. As soon as there is an investment through capital for profits, *sharikat al-milk* changes into *sharikat al-'aqd*.

Co-ownership in *'ayn* (ascertained property; discussed below in VI. Property) is defined as "the joint and exclusive ownership of two or more persons resulting from the cause of ownership, like purchase, inheritance, or by the mixing (*khalt*) of their property in a manner that does not accept distinction of separation."[8]

The concept of *sharikat al-milk* is very important to understand for business purposes for two reasons. First, it is not a partnership; it is co-ownership. The co-owner is a stranger (*ajnabi*) with respect to the share of the other co-owner, and therefore cannot use or dispose of the shares of the co-owner without his or her permission. Second, according to the Hanafi jurist Ahmad bin Mohammad Al Qaduri, "*Sharikat al-milk* can occur when two or more people inherit or purchase anything together."[9] No party may dispose of any other's portion without that other party's permission. Each of them is a stranger in regard to the portion of his colleague(s).

According to Sarakhsi, *sharikat al-milk* occurs when two or more people are partners in the possession of property. This can be of two types. One, the partnership becomes effective without any action on anyone's part, such as in the case of inheritance. Two, the partnership becomes effective through the parties' own actions, as in the acceptance of a gift.

Sharikat al-milk (co-ownership) is an extremely important concept. Under it, the division of revenues always follows the ratio of shares. When *sharikat al-'aqd* (partnership through contract) is either unenforceable (*fasid*) or void (*batil*), the rules for the sharing of earned profits and the division of property revert to the rules for *sharikat al-milk*.

TABLE 3. DIFFERENCES BETWEEN CO-OWNERSHIP AND PARTNERSHIP

Co-Ownership (*Sharikat al-Milk*)	**Partnership** (*Sharikat al-'Aqd*)
The division of revenues and usufruct always follows the ratio of shares.	The profit- or loss-sharing ratios can be altered.
The relationship between the co-owners is that of strangers (*ajanab*), but if authority is granted, the rules of agency take over.	The contract of partnership establishes an agency relationship.
Sharing of profits is not necessary.	The partnership contract causes profit sharing.
The co-owner may sell his or her interest to a stranger. When the shares of co-ownership are partitioned or apportioned, sale by a co-owner becomes possible without the permission of the other co-owner(s).[10]	A partner may not sell his or her share in the partnership without the permission of the other partners.[11]
Co-ownership is terminated as soon as the mixing of shares (*khalt*) is destroyed.	A partnership contract requires a formal termination.

On the one hand, the co-ownership relationship between common shareholders is that of strangers since shares are issued (partitioned) and owned (apportioned) in a specific number and a common shareholder can sell them without the permission of the other co-owner(s). Co-ownership is terminated as soon as the shares are sold. On the other hand, the relationship is also governed by the contract of partnership. Shares are proof of an individual's investment in a company, and this "contract of partnership" causes the sharing of profits (i.e., dividends). Depending on the type of shares, profit sharing can be altered. At a sponsorship level, the partnership contract most often does not allow a sponsor to sell his or her shares without the permission of other sponsors. Also, under the sponsor/partnership contract, existing sponsors usually have the first right of refusal to buy shares from another sponsor who is selling them.

V. Debt Transfer

Ownership in a corporation is represented by shares, which are claims on the corporation's earnings and assets. Securities or shares are like debt. Both are obligations of one party to pay money or its cash equivalent to another. Both can also be viewed as evidence of money claims and financial assets.[12] The main distinction between them is that debt is less amenable to trading then securities. Whereas loans are contracts[13], securities become personal property.

An existing shareholder (C) may dispose of (sell) its share to a potential investor (B). This introduces the concept of debt transfer, which in Arabic is called *hawala*.[14] The term literally means "to turn over or transfer a debt." A *hawala* can also be defined as "transfer of a claim of debt" by shifting the responsibility from one person to another. It is an assignment of debt and is a way of eliminating an obligation by transforming it into a new one. The *hawala* is an agreement by which a debtor is freed from his debt by another's becoming responsible for it.

A comparative analysis between buying shares issued by a company and buying shares in (portions of) a house is provided primarily to indicate that the company being treated as a legal person is a separate entity and is treated as such as a person in the *hawala* concept. By contrast, a house is just an asset in which an individual may buy shares. Since the house is a non-entity, relationships exist only between buyer(s) and seller(s).

Table 4. A Sample Comparison and Contrast

Buying Securities Issued by a Company	Buying Shares in a House
Relationships exist among the company (A), potential investor (B), and existing investor (C).	Relationships exist between the owner/shareholder(s) (A) and the potential investor (B).
A company is an entity, an artificial person. It is not an asset, but rather owns assets.	A house is not an entity but an asset.
Hawala applies only to a simple triangular situation: there can only be 3 parties.	There can be any number of parties.
A owes money to C.[15] As proof of this liability, A gives securities to C.	The house (a nonentity) does not owe any money to C or B.
If B, in addition to C, is allowed to buy shares of A, then the liability of A will increase.[16]	If B wants to buy shares of the house, it simply becomes a co-owner in the house.

How does B buy shares of A? Follow the *hawala* rule: If A owes C and B owes A, then B owes C. A "turns over" B to C in a *hawala* transaction. That is, A assigns B to pay off C, and thus securities from C are transferred to B, making A now an obligor to B.	How does B buy shares in the house? It simply acquires the shares from C.
The securities are traded in the market at face value.	The real estate market determines the house's worth at the time its shares are bought.

A. Fundamental Principles of *Hawala*

Hawala transactions must comply with several rules to ensure that they are valid under Islamic law. First, the debt must be both determined and due. Second, *hawala* is restricted to type of assignment: A is indebted to C for precisely the same amount that B is indebted to A. Third, *hawala* is valid when it is contracted as a result of mutual consent between the debtor (*al-muhil*), the delegated payer (*al-muhal 'alayh*), and the creditor (*al-muhal*). Fourth, no obligation may be left without being paid. Thus, in case of death or bankruptcy of the delegated payer, the obligations to pay the debt return to the transferor.[17]

B. Participants in *Hawala*

1. *Al-Muhil*

The debtor, or the one who owes, is designated A in this discussion. A company or a corporation is an artificial person, a legal entity, and a juristic person that is created by or under the authority of the law. Because it is distinct from the individuals who comprise it (i.e., its shareholders), a company survives the death of its investors. A company therefore has a personality and existence distinct from those of its members.

2. *Al-Muhal 'Alayh*

The delegated payer is here designated B. When B wants to buy shares in A, it becomes a delegated payer who is willing to pay the amount owed to C by A. In other words, B is "turned over" to C.

3. *Al-Muhal*

The creditor, or the one who is owed, is designated C. When an investor buys the securities issued by a company, the ownership of money is transferred to this entity. Thus, the investor is like a creditor and the corporation is like a debtor. Securities issued are represented on the liability side of the corporation's balance sheet. Moreover, the investor receives the securities, which constitute proof of investment. The money is a credit that the investor has given to the company. The securities are also the investor's proof to seek returns from the company.[18]

C. Can Shares Be Pledged? An Introduction to *Hawala*

Pledging is defined as "transferring property as a collateral for an obligation." A pledge does not involve a transfer of title. Suppose A pledges shares to B and borrows money against these shares. A has transferred to B the right to claim money from the issuing company. Since ownership of the underlying property is not transferred, it is the transferor's obligation to pay the debt.[19]

D. Fundamental Rules For Sale

Several basic rules apply to *hawala* (debt-transfer) transactions. Debt (what one owes) can not be sold, but it can be transferred. Credit (what one lends) can be neither sold nor transferred. The Prophet Muhammad is reported to have said, "Do not sell a thing that is not with you." Thus, a vendor must be able to deliver the sold commodity to the purchaser, and any commodity that is non-existent or not deliverable may not be transacted.[20]

VI. Agency

The relationship between a common shareholder (investor) and a broker (brokerage house) is a principal-agent relationship where the investor hires (or leases by *ijara*) the services of the brokerage house. An agency (*wakala*) is a contract by which one person represents another as the latter's agent. A *wakala* contract can be void at the will of either party. For Hanbalites, it does not even require a notice. However, according to Hanafi law, it can only be revoked after the agent learns of the termination.[21]

To distinguish between the rights and responsibilities of the principal (*muwakkil*) and the agent (*wakil*), the Hanafi school goes into more detail.[22] In this school, the rights of performance (*huquq*) belong to the agent, while the effects of the contract (*hukm*) belong to the principal. *Huquq* refers to the means adopted to achieve the main objective. Thus, carrying out the orders of the principal is the responsibility of the agent. For instance, if an agent buys shares for a principal, then the delivery of the shares is the responsibility of the agent. The principal cannot be sued for poor performance. *Hukm* means the effects that follow the actions of the agent. As such, in the case of share trading the title of the shares will always pass on to the investor. The liability (*dhimma*) of the agent is not affected. If the principal does not make payment for the shares, the agent is not liable.[23] The agent, under Islamic law, cannot be sued for the principal's non-payment.

A. Services Hired by the Investor from the Stockbroker

The investor hires (leases) the services of the broker. Lease/hire known as *ijara*, *kira*, or *iktara* is a bilateral contract of tenancy. It derives its names from the terms *ajr* (rent) and *ujra* (salary). Lease is defined as the transfer of usufruct (*manfa'a*) for a consideration. The consideration can be rent (*ajr*), such as in case the object hired is a car or house, or wages (*ujra*), if a skill (such as of a brokerage house) or a person (e.g., a driver) is hired.

The hirer or lessee is called the *ajir*, *mawjir*, *mukari*, or *muktari*. The person who receives the rent, the lessor, is the *mustajir*. A lease is a bilateral contract where one object is exchanged for another. Receiving the object sold (shares) engenders the obligation to pay an equivalent (brokerage fee). In *ijara*, the brokerage fee is considered equivalent to receiving the object.

An *ijara* contract is a valid one because the Prophet Muhammad said, "Pay the hireling his wages before the sweat on his brow has dried." At another place he stated, "If a person hires another, let him inform the other of the wages he is to receive." Furthermore, an *ijara* contract is a *darura* (necessity) and is thus *isthisan* (admitted for practical purposes because it is a general economic necessity).

There are two kinds of *ijara*: *manfa'a al 'ayn* (lease of property or capital assets, such as houses, cars, factories, and machinery); and *manfa'a al 'amal* (employment of labor or services, such as engineering, banking, or carpentry work).

Five fundamental rules apply to leasing services (*manfa'a al 'amal*). First, the leased assets must be fully identified by both the lessee and the lessor. In the case of brokerage services suggested in Table 4, the use of *manfa'a al 'amal* would entail defining the responsibilities of the broker (as agent) and the investor. Second, the property/asset—the enjoyment or use of which is the object of the contract—must exist. Shares are considered personal property. Third, the nature of the usufruct (*manfa'a*) must be defined, be it the use of property or the services of a person. Fourth, rent or wages must be specified. Finally, the time period for the hire/use must be clearly spelled out.

TABLE 5. EXAMPLES OF THE TWO KINDS OF *IJARA*

	Renting Property (*Manfa'a al 'Ayn)*	**Employment of Labor** (*Manfa'a al 'Amal)*
Object	a house	brokerage services
Purpose	Renting	to buy shares of a company
Tenure	1 year	usually the same day
Price	$50/month	agreed brokerage commissions

B. Can Shares Be Rented?

To answer this question, one would have to review the principles governing *ijara*. For purposes of argument, suppose that shares can be rented. Then the *ijara* rules can be applied as in the following hypothetical situation.

TABLE 6. APPLICATION OF *IJARA* RULES TO STOCK SHARES

	Renting Property (*Manfa'a al 'Ayn*)	**Comments**	**Permissible**
Parties	Shareholder and lessee (X).	Okay as per rules of *ijara*.	Yes
Object	Shares are not tangible property (*'ayn*). Rather, shares are *dayn*, which is like a claim or proof of co-ownership.	For the shareholder, shares are just an evidence of money claim on the company. A claim can not be rented.	No
Purpose	Say, to earn the dividends of the company.	The company may or may not have an income during the respective year. This introduces an element of uncertainty or chance (*gharar*).	No

Ownership	Assuming that the shareholder is the co-owner, all liabilities emerging from ownership are owner's responsibility	If the assets of the company are destroyed, the shareholder can not charge rent from X. Doing so would be an unjust gain (*riba*).	No
Tenure	1 year	The rental period agreed upon between the shareholder and X.	Yes
Rent	$100/year	See comments for Purpose. If the company pays no dividend, the rent is an unjust gain (*riba*) to the lessor.	No

As discussed, shares are similar to debt. Also, under Islamic law, debt can be neither sold nor rented. Thus, shares can not be rented. From a different perspective, the only reason one may possibly rent shares is to earn the dividends of a company. If the company does not declare any dividend for the period the shares are rented, the rental income earned by the lessor would constitute *riba*. Also, since the company can not beforehand specify its future dividends, the resulting element of uncertainty (*gharar*) is a possible disadvantage to the lessee (i.e., the person who rents shares in this example). Thus, shares can not be rented.

VII. Property

Property in Arabic is called *mal*. The word *mal* is related to *mulk* and implies the exercise of ownership rights over things owned. Three of the different schools of Islamic law define ownership as follows.

1. The Hanafi school considers it "the right of absolute and exclusive control and disposal of a thing."[24]
2. In the Hanbali school, ownership is "a legal authority justifying the right of disposal."[25]
3. The Maliki school considers "ownership as a legal authority that allows a person or his delegate to process the use of ownership rights, and also to accept compensation in case of transfer of owned properties or use rights to others."[26]

A. The Spectrum of Legality

The concept of property in Islam embraces everything that God permits. Hence, it is necessary to understand what is permissible or allowed in Islam. Which acts, rights, obligations, and objects are permissible? What can be owned and possessed? What must be avoided, what is not preferred, and what is completely prohibited? Islam defines five degrees of permissibility and applies it to everything from personal affairs to commercial dealings.

Table 7. Degrees of Permissibility

Category	Arabic Term	Comments
mandatory	*wajib*	A Muslim must do *wajib* acts and will be punished for neglecting them. This includes obligations such as prayers and *zakat*.

recommended	*mustahab*	*Mustahab* activities are preferable to do. There is reward in doing them, but no punishment otherwise. This category includes charity and *nafl* prayers after the obligatory prayer.
permissible	*mubah*	The *mubah* category comprises acceptable/legal private and public dealings and objects. There is no reward or punishment.
not recommended	*makruh*	It is better to avoid what is *makruh*: those who engage in what is *makruh* will not be punished, but people who avoid it will be rewarded.
prohibited	*haram*	*Haram* actions and things must be avoided. If they are not, one is punished.

TABLE 8. REWARD AND PUNISHMENT POSSIBILITIES

Category	Reward Possible	Punishment Possible
required/*wajib*	X	X
recommended/*mustahab*	X	
permissible/*mubah*	No reward	No punishment
not recommended/*makruh*	X	
prohibited/*haram*	X	X

An object or subject of property must be at least permissible *(mubah*). That is, it must be Islamically allowed/accepted, justifiable/proper, legal/authorized, and legitimate/rightful. For example, both wine and pork are allowed, justifiable, legal, and legitimate under secular law.[27] However, under Islamic law, both objects fall into the last category of prohibited items and actions.[28]

FIGURE 1. RELATIONSHIP BETWEEN DEGREE OF PERMISSIBILITY AND CONSEQUENCES

permissible to an extent that it is an obligation *(wajib)*	rewarded
	halal and recommended
Property must be a subject or object that can be owned *(halal)*.	
	although *halal*, not recommended
disallowed to the extent that is prohibited (*haram*)	Punished

Under conventional law, property can be real or personal, tangible or intangible, and visible or invisible. Physical property at a basic level is divided into two categories: real and personal. Real property is a fixed, immovable, and permanent thing, whereas personal property is readily mobile, often easily consumed and destroyed, and is regarded as something impermanent or transient. Other characteristics that property in secular law might have include interest or rights, a value in exchange, and usufruct (the legal right to use something).

B. Property Classifications

Islamic law, strictly speaking, does not define property as real/personal or tangible/intangible. It categorizes property that is visible, existing, specific, and unique as *'ayn*, while something invisible, such as an obligation, a responsibility, or a claim, is called *dayn*. *'Ayn* is a specific, existing thing and is considered a unique object. *Dayn* is a property that is not an *'ayn* that, for instance, a debtor owes now or in the future.

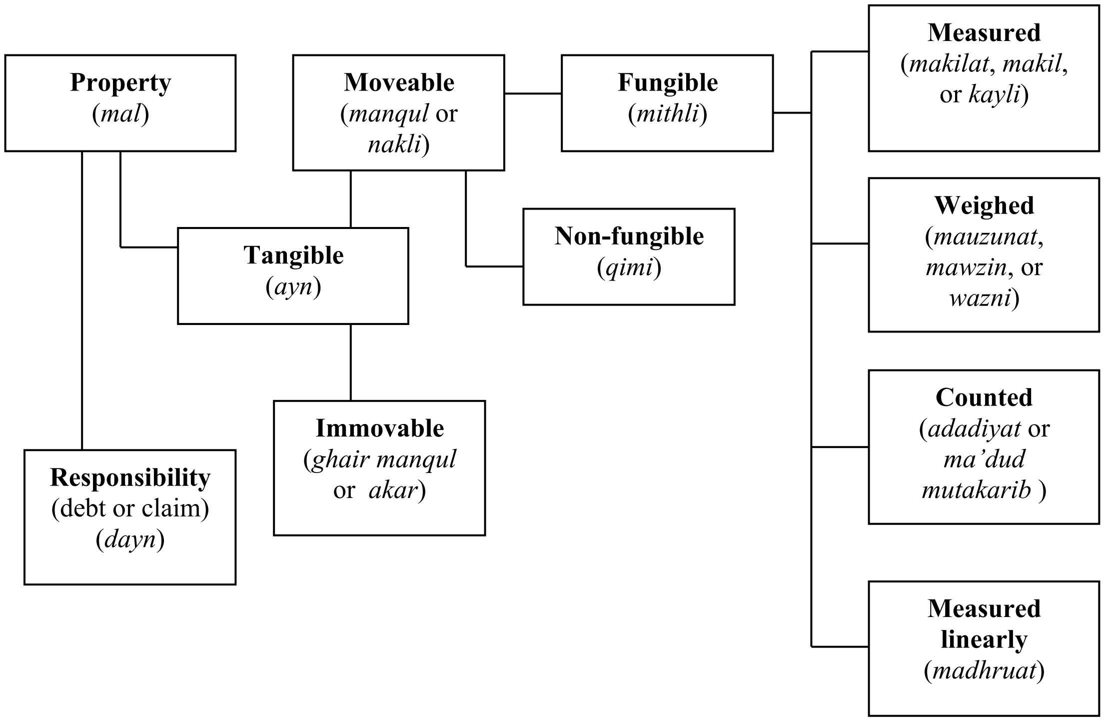
Dayn literally means debt. In *fiqh* it refers not only to an obligation per se but also to property that is the subject of the obligation and is already owned by the creditor.[29] Examples of *'ayn* are "my house" and "my brown bag." An example of *dayn* is "the claim on the book for which I have lent \$100 to Ayesha." The Arabic for obligation is *dhimma* (liability), which literally means compact, bond, obligation, responsibility, protection, or security. Vogel and Hayes also define *dayn* as "property subsisting in the *dhimma*" of the obligor.

An *'ayn* (property) can be movable (*manqul* or *nakli*) or immovable (*ghair manqul* or *akar*). For example, "my car" is movable property, whereas "my house" is immovable. Movable property can be fungible (*mithli*) or non-fungible (*qimi*). For example, a fungible could be "one hard cover Webster's Dictionary (1st edition) printed by publisher X."[30] A non-fungible could be "a brown horse."[31]

Fungibles are divided into four categories—those that are:

1. measured, such as dates and wheat;
2. weighed, such as oil, gold, silver, and metals;
3. counted, such as eggs by the dozen; and
4. measured by linear standards, such as cloth by the yard.

FIGURE 2. TAXONOMY OF PROPERTY



In legal terms, ownership of a corporation is represented by shares, which are claims on the corporation's residual earnings and assets. As such, securities would most likely be classified as *dayn* in Islamic law. Common shareholders equity is a contingent liability on the company. Shares, like debt, are evidence of money claims. Debts in the forms of loans are mostly in contracts, whereas securities are personal property.

VIII. CONCLUSION

The concepts presented here are some of the necessary elements that one should understand while one studies tradable instruments. For more research on Islamic tradable securities, a further understanding of concepts such as *sharikat al-milk* (co-ownership) and the different forms of *sharikat al-'aqd* (partnership through contract) is essential. Additionally, one would have to review other important elements in the study of asset-backed securities, such as *amana* (trust), *kafala* (guarantee), and *dhimma* (liability). Finally, the notion of juristic personality and limited liability would have to be closely examined.

[1] Chairman of Islamic *Shari'ah* council in Pakistan. Extract from the article "The principle of Limited Liability from the *Shari'ah* viewpoint" printed in Journal of Islamic Banking and Finance.

[2] Islamic Law of Business Organizations (partnerships) by Imran Ahsan Nyazee, Pg. 316. Published by the International Institute of Islamic Thought and Islamic Research Institute, Islamabad, Pakistan.

[3] *Majallah* 1329, see Nyazee p. 18.

[4] Ibn Qudamah, *al Mughni*; see Nyazee p. 19.

[5] See Imran Ahsan Khan Nyazee. *Islamic Law of Business Organization Partnership* p. 18.

[6] Definition of *sharikat* by Shams al Din Muhammad ibn Abu al-Abbas Shihab. See Nyazee p. 19.

[7] As discussed below, co-ownership could be a result of inheritance.

[8] According to the Journals (Majallah).

[9] Udovitch, Abraham L. *Partnership and Profit in Medieval Islam*. 1970, p. 18.

[10] The Prophet Muhammad is reported to have decreed the partners (*al-shuraka*) the right of preemption in property that had not been divided up. When boundaries are fixed between them, then there is no right of preemption. According to another Tradition, the Prophet is reported to have granted preemption to the partner in every case of undivided (joint) property. If, however, the boundaries of the property have be demarcated or fixed, there is no preemption.

[11] The Pakistan Partnership Act.

[12] Assets in the form of bank balances (cash), rights (receivables), certificates, bonds, and so on are called financial assets, as distinguished from physical, tangible, real assets such as property.

[13] One could however won rights of the contract (which becomes personal property).

[14] The word is derived from *al-thawwul* or *al-tahwil*, which means change of locality from one person to another or change from one situation to another.

[15] The investment of C is a liability on A. Investment in shares is classified as contingent liability.

[16] If a company does not issue only a fixed number of shares, its liability will continue to increase.

[17] Ali b. Abi Talib.

[18] The company might use the funds raised through the investor to acquire assets. The income generated from these assets could be shared with the investors.

[19] Usually, the shares pledged have a higher market value then the sum borrowed against those shares (over-collateralization). In case the value decreases, the financial institution usually asks the borrower to make up for the shortfall.

[20] *Salam* sales by farmers are an exception to this general rule of Islamic law.

[21] This issue could be resolved using the contract of *ijara* with the contract of *wakala*.

[22] The other schools do not make this distinction.

[23] According to SEC requirements, the brokerage firm is always responsible for making the payment. A brokerage firm has internal contracts so as to have recourse to the investor.

[24] The words of Ibn Al Humam.

[25] In the words of Ibn Taymiyyah.

[26] In the words of Ibn Al Shati.

[27] However, even under secular law, the purchase and consumption of alcohol is only allowed only for those above a certain age.

[28] Islam allows the consumption of *haram* objects only in a matter of life and death, such as starvation or medical necessity.

[29] Vogel, Frank E. and Samuel L. Hayes III. *Islamic Law and Finance*, Chapter on “Islamic Law of Usury, Risk and Property.” The Hague: Kluwer Law International, 1998, p. 94. This book is hereafter referred to as Vogel and Hayes.

[30] Notice that it is necessary to replace like for like.

[31] Although the horse may be of the same breed and age, two horses can not be exactly the same.

Murabaha, Sales of Trust, and the Money-value of Time

Yusuf Talal DeLorenzo*

ABSTRACT

It is estimated that *murabaha* contracts constitute nearly 70% of all financing in Islamic banks.[1] Yet, despite its popularity and utility, *murabaha* remains controversial in Islamic financial circles because it appears to accord a money-value to time, which would be a form of the prohibited *riba* or, more precisely, *riba al-nasi'ah*. If the rationale for Islamic banking stems from the desire to make the services provided by banks available to practicing Muslims through banking practices that avoid *riba*, it follows that *murabaha* must be eliminated. This line of reasoning that has led many *Shari'ah* scholars, investors, and shareholders in Islamic banks to question the *murabaha* transaction. While some defend *murabaha* as a concession to modern banking exigencies, couching their defense in legal terms like *darura* or necessity, it may be possible to approach this matter through a study of its *'illa* or ratio legis.

I. INTRODUCTION

If the numbers indicate anything about Islamic banking, it is that an exciting chapter in the religious, cultural, and intellectual life of Muslims is opening.[2] The relatively new field of Islamic economics and banking is particularly challenging for the reason that it brings together scholarship from jurists, economists and finance professionals. Realistically speaking, however, there is much about this novel interdisciplinary field that is not well understood, even at the conceptual level; and a great deal of groundwork still needs to be done. The problem at the present time, if we seek to reduce the matter to its lowest common denominator, is that scholars from both fields bring their own intellectual and disciplinary predilections to their understanding of the new phenomenon, and these are often at theoretical loggerheads.

For example, many Muslim jurists are reluctant to exercise any sort of independent thinking on economic issues, preferring instead to rely on the scholarship of past ages. Thus, their response to new questions is to locate in the classical legal literature questions of a similar nature, through the liberal use of what may at best be termed "rough" analogy, and then to graft the old solutions prescribed there to the questions at hand.[3] In contrast to the literalist and traditionalist orientations of many Muslim jurists, our economists have suffered from a lack of Islamic contributions to their field. A former official of the State Bank of Pakistan asserts that Muslims writing on economics often apply western standards in proposing their "Islamic" models. "Let us admit that we Muslims are oriented in western theories of economics and are apt to believe them to be a fair standard of judging policies and decisions."[4] Moreover, in their inability to appreciate *Shari'ah* principles and purposes, many Muslim economists appear in their thinking to assume that the only purpose of *fiqh* is to regulate and facilitate economic activity. At a very fundamental level, they would endow *homo Islamicus* with the same traits as the neoclassical *homo economicus* whose primary motivation is utility and precious little else.[5]

In modern times the appearance of serious thought, from an Islamic perspective, on the subject of economics coincided closely with the emergence of Muslim nation states following the colonial experience. This occurred at a time when Muslims sought not only to repair their ailing economies, but to reestablish their cultural and religious identities as well.[6] Gradually, the ideas generated by this preliminary thinking led some Muslims to speak in terms of "Islamic economics," and a respectable body of literature on the subject (however tentative) appeared in several different languages, especially in Arabic, English, Persian, and Urdu, with significant contributions by both Muslim economists and jurists.[7] Clearly, these works contributed to the establishment of Islamic banks as the most immediately achievable manifestation of the desire on the part of Muslims for working models of an "Islamic" economic system. The success of the first handful of Islamic banks, particularly in the decade of the seventies, led to the growth in the next decade of Islamic banks and banking all over the Muslim world. Today western economists are busy studying the potential impact of Islamic banking on economic

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relationships, as well as some of those aspects of Islamic banking which have met with success and show promise as profitable alternatives to established norms.[8]

If I may venture a prediction of my own, the work of economic historians will become increasingly important as their studies begin to inform the thinking of Muslim economists, financiers, and jurists, further increasing the complexity of the interdisciplinary mix, and further emphasizing the inadequacy of present classifications to encompass this fascinating new field. No doubt, the economic history of Muslims is fraught with lacunae;[9] and there is much in our past that may be of relevance to the economic activity of our future. In particular, the ways in which Muslim scholars, especially the jurists among them, wrestled with problems of credit, trade, and production in the centuries prior to the depredations of the colonial powers may have much to tell us about how these issues may be dealt with today. Until recently, this has been a subject that failed to gain the attention of Muslim jurists, owing perhaps to their preoccupation with the classical period and its texts, so that many legal scholars remain in the dark with regard to the practices and strategies developed in the recent legal past.[10] Indeed, the point has been made, and it seems a valid one, that we are dealing with an interrupted process. Between the "medieval" and "modern" forms of Islamic banking transactions, as described by Nicholas Ray in his work on Islamic banking, there lies a historical hiatus of as yet undetermined proportions and significance.[11]

II. *MURABAHA*

One of the areas of chief concern in the operations of Islamic banks at present has been identified as trade financing or, in its particularly Islamic form, *murabaha*. In recent years *murabaha* has been challenged as suspect from an Islamic legal perspective by shareholders and *Shari'ah* boards alike. I should like, therefore, to make a few brief observations on the aspect of the *murabaha* transaction that has led to misgivings concerning this important transaction.

Murabaha, essentially a form of deferred payment sale, has been described as "interest-like" owing to its implied acceptance of the time value of money.[12] Certainly, this is an engaging aspect of *murabaha* as an Islamic transaction, particularly in light of the well known prohibition in Islamic law of *riba*, or interest, for, as Abdullah Saeed points out, "accepting the time value of money logically leads to the acceptance of interest," or *riba al-nasi'ah*.[13] Thus, despite its utility and its popularity, many Muslim investors and shareholders view *murabaha* as a suspect operation. In order to clarify this matter, it will be necessary to review the jurists' classification of *murabaha* as a sale of trust, and their arguments for its legitimacy as an authentic and sound Islamic transaction.

III. SALES OF TRUST

Let us begin by looking at a specialized dictionary entry on the subject of *amana* sales, or sales of trust:

> "The classical jurists categorized sales, with regard to the way prices are determined, as either sales in which trust, *amana*, is the key element, or sales in which bargaining, *musawamah,* is the key element. Sales of bargaining are sales in which the seller does not disclose the amount of his investment in whatever he is offering for sale. In such a sale, both parties will agree to transact for a certain price, without the seller's disclosing to the buyer the price he originally paid for the goods or whatever it is he is offering for sale. Ibn Jazzi, the Maliki jurist, defined *musawamah* as "the buyer's negotiating with the seller over a price until they come to an agreement on it, without there ever being mention of how much the seller originally paid for the goods." In sales of trust, however, the price is specified as being the same as the seller's investment, or more, or less. Such sales are called sales of trust because the seller is to be taken at his word when he informs the buyer what he paid for the goods for sale."[14]

Let us continue by considering the meaning of trust, or *amana* in sales of this nature. According to Professor Shacht, "The main consideration in all such sales is the exclusion of dishonest, unjustified enrichment."[15]

We may now turn to another encyclopedia entry for the purpose of furthering our understanding of *amana*.

> The lexical meaning of *amana* or trust is the opposite of betrayal, and it denotes any legal responsibility charged to a person, including acts of worship or entrusted property. The classical jurists, however, used the word in two ways; as a noun, and as an adjective. The meaning of trust, as a noun, is that which is kept with a trustee. As an adjective, the term is used to denote trust sales, like *murabaha*, in which the purchaser depends on the conscience of the seller and trusts his/her truthfulness. The Almighty stated in the Qur'an: *O you who believe! Do not be false to Allah and His Prophet, and do not knowingly be false to the trust that*

> *has been reposed in you* (8:27). Moreover, the Prophet, upon him be peace, said, "He is not one of us who attempts to cheat us." This *Hadith* was related by Muslim, Abu Dawud, and Ibn Majah, from Abu Hurayrah.
>
> It is for this reason that if any sort of misrepresentation should be discovered in a *murabaha* sale, the buyer would have the option to retain the goods he/she purchased, or to return them. Some scholars have added that the buyer will have the further option to subtract from the price whatever extra amount was falsely reported as the original purchase price, and then to subtract a corresponding percentage from the agreed upon margin of profit. Details of the same may be seen in Kashani, 5/223, Ibn Qudamah 4/203, Dasuqi 3/164, and Nawawi, *al Muhadhdhab*, 1/295.[16]

To elaborate further, sales of trust are of three kinds, *murabaha*, *tawliyah*, and *wadi'ah*. *Tawliyah*, in the terminology of the jurists, refers to a sale in which the value of the goods as represented by the seller is itself set as their price, with no profit or loss. As such, *tawliyah* may also be understood as resale at the stated original cost. The classical jurists therefore define *Tawliyah* as the transfer of goods in their entirety from the seller to the entrusted by means of the words, "I entrust you," or the like, without increase or decrease. This is resale at the stated original cost. *Wadi'ah* refers to a sale in which the price is set at less than what the seller says is the value of the goods, or resale with a rebate on the stated original cost. *Murabaha* is resale with a stated surcharge that represents the profit.[17]

IV. The Rationale for *Murabaha*

But beyond this simple definition, *murabaha* sales perform a further function. Indeed, "*murabaha* is a form of commission sale, where a buyer who is usually unable to obtain the commodity he requires except through a middleman, or is not interested in the difficulties of obtaining it by himself, seeks the services of that middleman."[18] What must further be added, however, is the element of trust. The middleman performs a dual service, he facilitates the financing of a deal, and he does so in such a manner that even the most naive of consumers may rest easy with regard to the value he is receiving for his money.[19]

This last point is an intriguing one, and one that deserves further consideration. The classical jurists were careful to trace every transaction they described and regulated to a clearly Islamic origin, thereby to establish the transaction as one that had the approval of the Almighty. Thus the manuals of *fiqh* and their glosses are sure to begin their discussions of every new form of transaction by establishing Islamic authenticity, or justifying licitness or otherwise, through reference to the Qur'an, the *Sunna*, consensus of the community, and/or the practice of the Caliphs or early Companions.[20] In a very few cases, however, the only sort of recourse available was to the practical grounds of its economic function in society. Apparently, and despite the best efforts of the jurists to find a more sacred source for it, *murabaha* falls under this last category.

V. The Islamic Authenticity of *Murabaha*

In the main, the legal evidences or indicators variously adduced by the classical jurists for the legitimacy of the *murabaha* transaction are clearly general in nature and not at all specific to *murabaha*. Consider, for example, the following evidence cited for the legitimacy of the *murabaha* transaction, found in nearly all the *fiqh* manuals:

> And when the prayer is ended, disperse freely on earth and seek to obtain [something] of Allah's bounty (62:10).

In a very general manner, this verse establishes that it is lawful for people to go out in the world and earn their living. Such generalized permission may suffice as proof that trade and commerce are sanctioned by the Almighty; but there is clearly nothing there about the specifics of how one might, or should, go about seeking the bounty of Allah. There is certainly nothing in the verse about *murabaha*. The same is true of the other verses cited by the jurists in support of this transaction.

> He it is who has made the earth easy to live upon: go about, then, in all its regions, and partake of the sustenance that He provides (67:15)
>
> Allah has made buying and selling lawful (2:275)

The *Hadith* literature presented by the jurists for the same purpose is equally imprecise and inclusive. For example, the *Hadith* related by Tabarani: *Seeking the lawful is the duty of every Muslim.* Or the *Hadith* related by Muslim, Abu Dawud, Tirmidhi, Nasa'i, and Ibn Majah: *If the two [countervalues] are of different kinds, then sell as you like, provided that the deal is hand to hand.* Or, finally, the *Hadith* related by Ibn Hibban and Ibn Majah: *Verily, a sale is what takes place when there is mutual agreement.*

Several of the jurists appealed to *ijma'* as the justifying factor.[21] An interesting twist to the same was claimed by Badr al Din al 'Ayni, in his commentary on *al Hidayah*, in which he explained that *murabaha* is lawful:

> … because the item for sale is known, and so is the price. People deal in it without anyone's objecting to it. And when people deal in something without objecting to it, that is proof in itself of its validity because the Prophet, upon him be peace, said, 'What is considered becoming by the Muslims is considered becoming by Allah.'"[22]

In the classical Islamic hierarchy of evidence, the indicators, *adillah*, from the Qur'an, the *Sunna*, and the *ijma'* are the ones that carry the most weight. It should be clear from the foregoing, however, that the proofs adduced from those sources are hardly specific to *murabaha*, and thus quite open to challenge. Clearly, the jurists had to rely on other evidence from other sources in order to establish the lawfulness of this particular transaction. In other words, while the jurists did cite evidence from the Qur'an and the *Sunna* in support of *murabaha*, the evidence itself is in no way specific to *murabaha*. Moreover, while the root of the word *murabaha*, r-b-h, is used in the Qur'an,[23] the transaction known as *murabaha* is nowhere mentioned in the Book of Allah. Likewise, no specific mention of the transaction is to be found in even the weaker *Hadith* literature. In other words, the most pertinent and substantial indicators for the legitimacy of the *murabaha* transaction are the ones accorded the least weight of all by the jurists.

VI. OTHER CONSIDERATIONS IN THE LEGITIMACY OF *MURABAHA*

Burhan al Din al Marghinani (d. 593AH), in his work *al Hidayah fi Sharh al Bidayah*, the mainstay of latter Hanafi *fiqh* scholarship, first has recourse to legal principle when explaining the legitimacy of *murabaha*: "It is lawful owing to its meeting all the conditions for validity," (*ja'iz li istijma`i shara'it al jawaz).* Thereafter, his commentator, Ibn al Humam noted,

> Since more than just the meeting of conditions is required to establish legitimacy, the author further mentioned the occasioning factor by saying, 'There is a great need for this sort of dealing because one inexperienced in the ways of business will have to depend on those more experienced, and be satisfied with paying as much as the more experienced one has paid, plus an additional amount of profit. This is why it is essential to term these sales lawful.' It should be clear that there is no need for proof of their legitimacy beyond the proof establishing the legitimacy of sales in general when there is mutual agreement and there is nothing to interfere with the conditions for a valid sale. Rather, the proof of the legitimacy of sales in general is the proof of the legitimacy of *murabaha* and *tawliyah*.[24]

Here, what the commentator means when he refers to "meeting conditions" is that it is not enough for a transaction to fulfil the prescribed legal formula of there being a buyer, a seller, an object for sale, an offer by the seller, and an acceptance by the buyer. These are the elements of a transaction deemed essential by the classical jurists. However, just because these elements are present, it does not automatically follow that the transaction will be lawful. All of these elements, for example, are present in usury; and Allah has declared usury unlawful.

In addition, then, al Marghinani had to offer more convincing evidence for the legitimacy of this particular transaction, *murabaha*. That is why he mentioned the occasioning factor, or *'illa*. The classical jurists explained that while there are no occasioning factors in matters related to worship, *ibadat*, because these are related to the inscrutable will of the Almighty, there are always occasioning factors in transactions, *mu'amalat*, because these are related to the worldly interests of humans.[25] They further explained that the benefit of occasioning factors is that they facilitate an understanding of *Shari'ah* rulings and categorizations by clarifying cause and effect relationships in the law. If a feature can be shown to constitute the occasioning factor behind a ruling in a principal case, then it becomes relatively easy to establish the same ruling in a novel case with the same feature.

What al Marghinani and his commentators, both Ibn Human and Badr al Din al 'Ayni, appear to be attempting, however, is to provide a rationale for the transaction; thereby establishing its ethical and Islamic legitimacy. Not all jurists, however, held that a rationale, or *hikmah*, could function as an *'illa* or occasioning factor.[26] That they resorted to this sort of justification is indicative of the difficulties they had with the transaction and its apparent according of a money value to time.

VII. Conclusion: Revisiting the Sources

These efforts on the part of the jurists were expended in the attempt to legitimize a transaction they recognized as essential to the success of the marketplace in their times. To my mind, the recourse by the classical jurists to a rationale for *murabaha* was essentially the same as recourse to *maslaha* or the public interest. Of course, not all the classical jurists held *maslaha* to be a valid indicator; and that may well explain the approaches taken by the Hanafi jurists mentioned here.

What may be deduced here, however, is that *murabaha*, in its protecting the innocent consumer, actually assigns a money value to trust rather than to time. The same is true of the other two sales of trust, *Tawliyah* and *wadi'ah*, where there is no increase, because there is a value to knowing, and to being able to trust that knowledge. Seen from this perspective, *murabaha* contains nothing that could be considered grounds for prohibition or legal disapproval, *karahah*. On the contrary, such an appreciation of the value of trust[27] is key to the understanding of Islamic contractual justice in general.[28] When dealing with the challenges of modern financial practice, it may be noted that consideration of such factors may well lead to a new appreciation for the *Shari'ah*.

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[1] Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (Graham & Trotman: London, 1995) p. 37.

[2] Today there are over 187 Islamic banks worldwide, with 271,000 employees in upwards of 21,000 branches. For an excellent overview of the current situation, see Samir Abid Shaikh, "Islamic Banks and Financial Institutions: A Survey" *Journal of Minority Affairs*, Vol. 17, no. 1, 1997 pp. 117-127

[3] A few examples of such "grafting" may even be found in the pages of this work.

[4] Hassanuzzaman, "Defining Islamic Economics" *Journal of Islamic Banking and Finance*, vol. 14, Jan-Mar 1997, no. 1, p. 13.

[5] Waleed El-Ansary, "The Spiritual Significance of Jihad in Economics," *The American Journal of Islamic Social Sciences*, Vol. 14, No. 2, Summer 1997, pp. 230-263. El-Ansary writes: "... Islamic economics should be seen as applied ethics, an examination of policies and institutions in terms of *homo Islamicus*' inner and outer jihad - his efforts to integrate the economic aspects of life around a Sacred Center."

[6] See the entry on Banking by Rodney Wilson in *The Oxford Encyclopedia of the Modern Islamic World* edited by John Esposito (New York: Oxford University Press, 1995), vol. 1, pp. 191-195. See also Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Leiden: E. J. Brill, 1995) pp. 8-16.

[7] For one of the best surveys of literature on the subject, see M.N. Siddiqi, *Muslim Economic Thinking* (Leicester, UK: The Islamic Foundation, 1981).

[8] See, by way of example, the study of financier remuneration embodied in *mudaraba* by John Presley and John Sessions, "Islamic Economics: The Emergence of a New Paradigm" *Economic Journal*, vol. 104, no. 424, May 1994, pp. 584-596.

[9] Nicholas Dylan Ray, "The Medieval Islamic System of Credit and Banking: Legal and Historical Considerations," *Arab Law Quarterly*, Vol. 12, Part 1, 1997, p. 44.

[10] S. E. Rayner, *The Theory of Contracts in Islamic Law,* (UK: Graham & Trotman, 1994), pp. 274-276.

[11] Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (UK: Graham & Trotman, 1995). I should further explain that there are two aspects to the hiatus I mention here. The first is in the record of Muslim legal thinking on economics and finance, and the second is in the suspension of Islamic financial practices when western commercial banks gained ascension in the Muslim world and replaced whatever institutions and practices had been prevalent there.

[12] Abdullah Saeed, Op. Cit., p. 95.

[13] Ibid.

[14] Dr. Nazih Hammad, *Mu`jam al Mustalahat al Iqtisadiyah fi Lughat al Fuqaha* (Herndon: International Institute of Islamic Thought, 1995), p. 351.

[15] Joseph Shacht, *Islamic Jurisprudence* (Oxford:), p. 154. Shacht completes the sentence by saying, "... but the exact part which these transactions played in the economic life of early Islamic society is not always clear." One wonders if Professor Shacht assumed that "early" Islamic society was the only Islamic society to use these transactions.

[16] *Kuwaiti* Fiqh *Encyclopedia*, (Kuwait: Ministry of Endowments and Islamic Affairs, 1988) vol. 6, pp. 236-239

[17] ibid.

[18] Udovitch*, Partnership and Profit in Medieval Islam* (Princeton: Princeton University Press, 1970)

[19] Professor Udovitch goes on to say, "Al-Marghinani suggests that their [sales of trust] purpose, particularly of the *tawliyah* and *murabaha* sales, was the protection of the innocent general consumer lacking expertise in the various items of trade from the wiles and stratagems of sharp traders." Op. Cit. p. 220.

[20] In this context it is interesting to note the comment of Franz Rosenthal, in his introduction to Charles Cutler Torrey's, *The Jewish Foundation of Islam* (New York, Ktav Publishing House, 1967) p. v. concerning Dr. Torrey's dissertation, *The Commercial Theological Terms in the Koran* (Leiden: E. J. Brill, 1892) "Its principal conclusion was that the commercial terminology of the Qur'an was characteristically Arabic and that it consisted almost entirely of native words, not acquired from other languages, in contrast to other terms of Arabic theology."

[21] See, for example, al Kashani, *Bada'i al Sana'i* (Beirut: Dar al Kutub, 1982) vol. 5, p. 220; and Ibn Rushd, *Bidayat al Mujtahid* (Cairo: Maktabat al Kulliyat al Azhariyah, 1389). Vol. 2, p. 321.

[22] Badr al Din al 'Ayni, *al Binayah fi Sharh al Hidayah* (Beirut: Dar al Fikr, 1982) vol. 6, p. 487.

[23] At 2:16, and then only in a metaphorical sense.

[24] Ibn al Humam, *Fath al Qadir* (Bulaq: al Matba`ah al Kubra al Amiriyah, 1316AH) vol. 5, p. 254.

[25] Kuwaiti *Fiqh* Encyclopedia, vol. 12, p. 319

[26] Bernard Weiss, *The Search for God's Law* (Salt Lake City: University of Utah Press, 1992) pp. 555, 556, 564.

[27] See the Qur'an at 8:27, 23:8 and 70:32.

[28] Hideyuki Shimizu, *Philosophy of the Islamic Law of Contract* (Japan: Institute of Middle East Studies, 1989)

Some Recurring *Shari'ah* Violations in Islamic Investment Agreements Used by International Banking Institutions

M. A. Elgari[*]

Abstract

Most recurring violations in Islamic investment agreements international banking institutions use occur in conditions attached to contracts, which are subject to four important *Shari'ah* provisions. Although indemnity clauses are in most international trade and commercial agreements and do not usually mention interest, the wording of most of them actually runs afoul of the *Shari'ah*. Most of the misconception arises from confusion between indemnities and guarantees: the guarantor provides a guarantee against something, while an indemnity is a form of insurance against outside variables. In its worst form, indemnity makes one party liable for things neither under its influence or control nor related to the transaction itself. Although such conditions clearly violate the *Shari'ah*, not every indemnity clause is forbidden (*daman al-derak*, for instance, is permissible). Indexation of lease payments to the LIBOR and inclusion of a "hell or high water" clause, both common in conventional lease contracts, violate the *Shari'ah*.

I. Introduction

The volume of Islamic finance carried out by conventional banks is growing every day. Unfortunately, *Shari'ah* supervision on the Islamic banking practice of these banks is inadequate because *Shari'ah* experts who are well versed in English and equally knowledgeable in banking and law are quite rare. When a violation occurs in a transaction and passes unnoticed by the *Shari'ah* supervisory board, it keeps recurring. Many banks just copy the format of agreements used by others, assuming that the previous user has adequately attended to the *Shari'ah* aspects. Many Western law offices try to fill this *Shari'ah* expertise gap. However, few lawyers are able to actually appreciate the intricate differences beyond the general principles between the *Shari'ah* and the Western legal system.

The area where most recurring violations occur in Islamic investment agreements used by international banking institutions is that of conditions in contracts. The subject of conditions in exchange contracts is a profound area of Islamic jurisprudence. Conditions in contracts, though left to the mutual agreement and consent of the parties, are nevertheless subject to the provisions of the *Shari'ah*, which has its own rules and requirements in such conditions.

First, no condition is allowed if it causes the contract to change in nature. In such cases the parties must follow the rules and requirements of the de facto contract, not the declared one. For example, if it is a condition in a *mudaraba* contract that the *mudarib* guarantees capital to the *rab-al-mal*, then the de facto contract is a loan rather than a *mudaraba*. Hence, the parties must follow the *Shari'ah* rules for lending; namely that no benefit should accrue to the provider of capital.

Second, the *Shari'ah* is keen on maintaining just exchange. Therefore, contracts must not be used to permit one party to take advantage of another. Hence *Shari'ah*-acceptable contracts are not manipulative. It is not permitted to include in a contract conditions that are not germane to the transaction involved.

Third, exchange contracts should always be separated. Merging two contracts may void both. Therefore, one has to be careful of conditions that may in effect create a contract within a contract. For example, if one sells an item to another with a condition that the buyer lends him money, then both contracts are void, though if separated, both are valid and permissible.

Fourth, conditions that, although part of the contract, are uncertain or ambiguous are not be permitted. For example, the price in an exchange contract should be specified and known to both parties at the time of contract. If this is not satisfied the contract might be void.

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II. The Indemnity Clause

Indemnity is a standard clause that appears in most trade and commercial agreements, particularly ones done internationally. Since an indemnity clause will usually not mention interest, it is assumed (or so it appears) that including such a clause in an Islamic banking agreement is permissible. However, the wording of most indemnity clauses the writer sees actually renders these agreements void from a *Shari'ah* point of view. Most of the misconception emanates from confusion between indemnities and guarantees. This part will define the indemnity clause and the difference between an indemnity and a guarantee. Examples of the indemnity clause will be presented, and finally the *Shari'ah* aspects will be discussed.

A. Meaning of Indemnity

An indemnity is different from a guarantee because the obligation of the guarantor in a contract of guarantee is the same as that of the principal debtor. In an indemnity, such undertaking is independent, in its content and enforceability, from the terms and volatility of that given by the debtor. For example if A says to B, "Supply goods to C. If he does not pay you, I will." This would be a contract of guarantee. But if A says to B, "Supply goods to C, and I will see to it that you receive the price," this is an indemnity.

In an indemnity contract, one party might indemnify the second respecting the second party's liability to the first. It could also involve an insurance, such as arrangement, where one party is indemnifying a second party to a contract in respect of the second party's liability to a third party arising from that contract.

Both indemnity and guarantee are a form of security. The reason for both is to give the other party protection against certain perils and liabilities. Nevertheless, an indemnity is different from a guarantee. A guarantee is provided by a party (the guarantor) against something. Because the ownership of the other party (the beneficiary) is already established by the contract, it becomes a defined obligation on the other party. For example, A sells his car to B on deferred payment. The price becomes an obligation against which B will provide a guarantee from a third party or collateral of some sort. However, an indemnity is a form of insurance, the purpose of which is to make sure that a certain position is protected from the effect of outside variables that might affect on the final outcome. In the previous example, if B protected A against the fall in the purchasing power of the sale price, this then is a form of indemnity.

B. Examples of Indemnity Clauses Found in Some Islamic Banking Agreements

The first example is from a *murabaha* agreement in which a bank is selling equipment on a deferred payment basis to a foreign client. The bank (i.e. the creditor) wants the client (i.e. the debtor) not only to guarantee prompt payment of the amount due, but also to indemnify against several possible obligations that may fall on the bank. The agreement reads:

> If, by reason of (i) any change after the date hereof in any law or in its interpretation or administration and/or (ii) compliance with any request from or requirement of any central bank or other fiscal, monetary, or other authority made after the date hereof (including, without limitation, a request or requirement which affects the manner in which the seller allocates capital resources to its obligations hereunder):
>
> the seller incurs a cost as a result of its having entered into and/or performing its obligations under this agreement, any purchase agreement or any supply contract and/or assuming or maintaining a commitment under this agreement;
>
> the seller is unable to obtain the rate of return on its overall capital which it would have been able to obtain but for its having entered into and/or performing its obligations and/or assuming or maintaining a commitment under this agreement, any purchase agreement, or any supply contract;
>
> the seller becomes liable to make any payment on account of tax or otherwise (not being a tax imposed on its overall net income) on or calculated by reference to the amount of its commitment or payments under this Agreement, any purchase agreement, or any supply contract and/or by reference to any sum received or receivable by it hereunder or thereunder,
>
> then the purchaser shall, from time to time and no later then twenty-one (21) days following demand therefore by the seller, pay to the seller amounts sufficient to indemnify the seller against (1) such cost, (2) such reduction in such rate of return (or such proportion of such reduction as is, in the opinion of the seller, attributable to its obligations hereunder), or (3) such liability."

The second example is also from a *murabaha* agreement. It reads:

> "The purchaser shall indemnify and hold [the Bank], the Collection Agent, their directors, officers, employees, and agents harmless on an after tax basis from and against all expenses, claims, actions, liabilities, costs, and proceedings which [the Bank], the Collection Agent or their directors, officers, employees, or agents may incur, or which may arise, directly or indirectly, out of or in connection with this agreement, each Contract of Purchase, holding or disposing of any Supplies, or otherwise howsoever in connection with this Agreement."

It is apparent that the bank, in these two agreements, not only desires to assure the full payment of the amount due by the buyer of this equipment, but also wants to make sure that recouping its investment and seuring its return is assured regardless of what happens.

C. Indemnity from a *Shari'ah* Perspective

Indemnity, in its worst case, boils down to making one party liable for things that are neither under his influence or control nor are related to the transaction itself. Such conditions are in clear violation of *Shari'ah* rules and they render the contract, void from a *Shari'ah* point of view. However, the *Shari'ah* does not forbid every indemnity clause. In fact, it allows certain indemnities: in classical *Shari'ah* books one finds what is called *daman al-derak*.

D. Why the indemnity clause?

From the standpoint of the law, the parties involved in a contract do not only create rights and obligations through the contractual relationship. They also allocate between themselves the risk of possible contingencies. They agree beforehand to allocate all or some of the loss. It is apparent that such allocation can only be done within a legal framework that allows the assignment of risk for monetary compensation. Within a legal system that allows such transfer, an indemnity clause of this nature creates no problem because the parties could have formed a separate contract designed solely for the transfer of risk for a price. However, such a contractual relationship is dubious from a *Shari'ah* point of view. The condition is not any more permissible if it is stated in a *murabaha* contract rather than in an autonomous contract.

III. Floating Rate Leases

In conventional leases, rental rates may be fixed, but they can also be variable by way of indexing the rental payments. In this case, lease rates will be adjusted as an independent variable changes.

In most cases, these payments are related to the LIBOR (London Interbank Offered Rate) or a similar variable. This becomes especially necessary in contracts that are 5 years or longer, as the need of matching assets and liabilities for the lessor becomes a critical one. Indexing rental rates to the LIBOR is quite prevalent, even in agreements that are called Islamic.

Two examples from actual "Islamic" lease agreements reads as follows:

> "Profit: Three (3) months US$LIBOR for the relevant lease period plus a margin of 5% per annum."

> "Monthly rental payments will be made on an annual adjustable basis through the life of the lease payment [and] will be calculated according to floating LIBOR + 3%."

A lease from a *Shari'ah* point of view is a sale contract. The sold object is the usufruct of the leased assets, the price is the periodical payment. Like any other exchange contract within the *Shari'ah*, the price must be known at the time of contracting without any uncertainty or vagueness. If this requirement is not satisfied, the contract is null and void. Indexing the lease contract to the LIBOR means that rental rates can only be known in the future, as the future value of the LIBOR itself is unknown. The *Shari'ah* forbids this.

A. "Hell or High Water" Clause

Conventional lease contracts often include what a "hell or high water" clause. Under such a clause, the lessee is obliged to pay the full rental payments regardless of any event affecting the leased equipment. This provision assures the lessor that the lease payments will be made unconditionally.

An example from an actual "Islamic" lease agreement is:

> "This lease agreement will provide for a 'net' lease whereby all risks and costs of ownership, maintenance, insurance, repair, and operation will be borne by the lessee."

As mentioned earlier, a lease under the *Shari'ah* is a sale contract. The sold items are the usufructs of an asset that will survive the term of the contract. The lessor deserves his compensation, (i.e. the rent) only if such usufructs can be extracted in the same level contemplated in the contract. Hence, if the leased equipment is damaged to the degree that such usufructs are no longer generated, the lessor is not entitled to rents. Clearly, the lessee is liable for damages caused by his own negligence or misuse.

Furthermore, lease contracts are based on trust. The lessee is entrusted with the leased assets that remain in his custody. Hence, the lessee can not be held liable except when it is proven that he failed to live up to expectations of honesty or that he breached the trust.

Therefore, the *Shari'ah* does not permit a hell or high water clause. The problem becomes particularly acute in the case of a full-payment lease contract, in which the entire relationship ceases to be lessor-lessee and becomes lender-borrower.

Practical Legal and Tax Issues in Islamic Finance and Investment in the United States

Isam Salah and W. Donald Knight, Jr.*

ABSTRACT

Several practical legal issues arise in the implementation of financing transactions structured to comply with the *Shari'ah*. Transactions involving an interest-based lender usually involve a special-purpose entity (SPE). *Shari'ah* committees have different views on some of the structural elements of SPE transactions. The cases in which the financing between the SPE and the investor is structured as a *murabaha* and *ijara* transaction are discussed, as are two cost issues in transactions involving SPEs. Although certain features of Islamic leases are unpalatable to conventional lenders, some *Shari'ah* committees allow a solution putting an Islamic lessor in the same economic position as a conventional lessor. When Islamic structured financing is viewed as being no different from its conventional counterpart, except that the finance recipient is trying to satisfy additional considerations, Islamic financing should seem no stranger than any other structured financing. Several regulatory developments should enable more widespread use of Islamic finance by conventional U.S. financial institutions.

I. INTRODUCTION

This paper addresses the practical legal issues that arise in the implementation of financing transactions that are structured to comply with *Shari'ah* principles, and on some of the regulatory developments in the utilization of Islamic financing structures. Financing transactions in which the parties—that is, the finance provider and the finance recipient—must comply with the *Shari'ah* present fewer complications because the expectations of the parties on *Shari'ah*-sensitive issues should be consistent.

More issues arise in transactions that bring together interest-based lenders and Islamic finance recipients, and it is with these transactions that the author has had a greater degree of experience. The goal in financing transactions of this type is to reconcile the *Shari'ah* concerns of the finance recipient with the objectives and industry expectations of the interest-based lenders. In handling these transactions, King & Spalding has had the opportunity to represent both sides of the transaction and, therefore, to have gained an intimate appreciation of each side's objectives and concerns.

II. THE ROLE AND *SHARI'AH* VIEW OF SPECIAL-PURPOSE ENTITIES

Transactions involving an interest-based lender generally involve the use of a special-purpose entity (SPE) that receives the interest-based financing, reformulates it, and passes it on to the ultimate finance recipient. Let us assume that an Islamic investor seeks to acquire an asset and requires financing to make that acquisition. In a typical transaction, a neutral SPE would be established to make the acquisition. By "neutral," it is meant that neither the interest-based lender nor the finance recipient owns or controls the SPE. Often the SPE is established in a tax-neutral jurisdiction, is owned by a charitable trust, and is set up to be remote from bankruptcy.

The SPE would acquire the asset from the seller and would pay for it with funds from two sources: an interest-based loan from the conventional lender and a down payment from the Islamic investor. The SPE would enter into a loan agreement with the lender that would evidence its obligation to repay the loan at maturity and to pay interest on the scheduled interest payment dates. The SPE would also enter a lease and purchase agreement with the Islamic investor, pursuant to which the SPE would lease the asset to the investor and would agree to sell the asset to the investor at the end of the lease term. Payments under the lease will equal that the payments be made by the SPE under the loan.

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Shari'ah committees have different views on some of the structural elements of such transactions. Some of them require the initial amount paid by the investor to be characterized as an advance payment of rent rather than as a down payment against the subsequent purchase of the asset. Other *Shari'ah* committees prefer that the lease transaction be structured as a *murabaha*. Yet other committees stipulate that the asset purchase obligation be structured as an option that may be exercised by the investor rather than as a mandatory purchase obligation. Aside from these structural differences, these transactions present many of the same issues. Although many of these issues seem technical or relatively minor, they can stop a deal if not properly addressed.

III. COST ISSUES

If a lender makes a loan with interest based on its prime rate, and the lender subsequently incurs an increased cost or expense as a result of a change in law or regulation, the lender would typically not have the right to receive compensation for such increased or additional cost or expense. The rationale is that the prime rate, a fluctuating rate, would eventually adjust to provide the lender with the additional compensation necessary to offset the cost or expense.

A conventional loan with interest based on the LIBOR operates differently. It entitles the lender to collect additional compensation from the borrower to offset such increased cost or expense. This difference arises because the LIBOR is set for the interest period and cannot be changed. The right to collect for the additional cost or expense allows the lender to protect its margin, which is the basis of LIBOR-based loans. Most lending is based on the LIBOR, so it becomes necessary to determine if any increased cost assessed by a lender on the SPE, which is its borrower, can be passed on to the investor.

We have thus far not seen a perfect solution to this problem. If the financing between the SPE and the investor is structured as a *murabaha* transaction, the nature of that transaction does not permit an adjustment in the purchase price to provide the SPE with the funds necessary to pay the increased cost assessed against it by the lender. Although increased cost provisions are rarely invoked, interest-based lenders and their credit committees expect to have those protections and will raise questions if they are not provided. One approach that offers some possibility with a flexible lender is to agree to increase the pricing by an agreed amount to compensate the lender against the remote risk that it will suffer an increased cost for which it will not be entitled to be compensated. If (as is likely) the increased costs never arise, the lender will have received some additional interest compensation for taking that risk. On the other hand, if significant increased costs are incurred, the lender may find that it has an unexpected shortfall. Lenders with an interest in participating in Islamic finance may be willing to consider such an approach.

If the financing between the SPE and the investor is structured as an *ijara*, some *Shari'ah* committees allow the use of an adjustable rent component. This flexibility allows the rent to be increased for subsequent interest periods if an increased cost is imposed on the SPE. Compensation would not be available for increased costs during the current interest period, but this adjustment mechanism may come close enough to satisfy a lender.

Another cost issue arises if the SPE is required to make a prepayment under the loan agreement and that prepayment is required to be made during, rather than at the end of, an interest period. The loan agreement will require that the SPE compensate the lender for any "breakage costs": costs or losses incurred by a lender as a result of its early receipt of funds. Breakage costs are most often incurred if interest rates have dropped since the beginning of the interest period, as any re-lending of funds will not produce the same return to the lender for the remaining duration of the interest period. As with increased costs, we are not aware of a perfect solution to this problem. The one solution that we have seen requires the Islamic finance recipient to pay the "LIBOR spread" for the duration of the rent period (which would correspond to the interest period under the loan agreement) if an early payment of rent were required at any time during that rent period. In effect, the Islamic finance recipient makes a payment (if any) that may or may not correspond to the actual breakage costs that the lender may incur. A solution of this type would, of course, require the lender to agree to a corresponding provision in the loan agreement.

An Islamic finance recipient would be reluctant to make a prepayment in a transaction structured as a *murabaha* because it would end up paying the full profit element over a shorter period of time. To avoid this uneconomic result, a prepayment obligation could be replaced with an obligation to post cash collateral that is pledged in favor of the SPE, which would in turn be pledged to the lender. Funds held in the cash collateral account could be invested in acceptable Islamic transactions so that the Islamic finance recipient would have some profit during the period of the cash collateral arrangement.

IV. Leases in Islamic Finance

Lease arrangements used in Islamic financing often have several features that distinguish them from conventional finance leases. A conventional finance lease will be structured as a "net" arrangement, meaning that the lessee takes all risks and responsibilities arising from the leased equipment. In other words, the lessee must make all lease payments regardless of what happens to the equipment. An arrangement of this sort is generally unacceptable in a lease intended to comply with Islamic requirements. Most *Shari'ah* advisors will require that the lessor, as the owner of the property during the lease term, retain some of the major responsibilities of an owner. Often, a lessor under an Islamic lease will be required to retain the obligation to perform major maintenance and required alterations. In addition, *Shari'ah* advisors will generally require that the lease of the equipment terminate if the equipment is destroyed, and will not require the lessee to pay a stipulated termination value for the destroyed equipment unless the destruction arose from the negligence or misconduct of the lessee.

Limitations of this sort will not be acceptable to a conventional lender, but there is at least one solution to this problem. Although the lessor takes responsibility for certain maintenance/alterations and for the risk of loss to the leased equipment, some *Shari'ah* committees will allow the lessor, in a separate agreement, to appoint the lessee as its paid agent for the purpose of fulfilling those lessor responsibilities. The amount to be paid to the lessee, as an agent of the lessor, would be factored into the lease payments the lessee must make under the lease agreement, so the Islamic lessor ends up in the same economic position as a conventional lessor. These arrangements will then correspond with the loan terms between the SPE (lessor) and the lender.

The ownership and control of the SPE must be taken into consideration in financing using structures of this sort. The SPE will usually be established as a bankruptcy remote entity so that its introduction into the financing does not complicate the credit risks being taken by the parties (lender and Islamic finance recipient) that have an economic interest in the transaction. In addition, the parties will be interested in having the SPE controlled by a party neutral to the transaction.

We are often asked to include in the documentation a provision to the effect that disputes between the parties will be resolved in accordance with the *Shari'ah* or by arbitration proceedings conducted before agreed *Shari'ah* advisors. Thus far, we have resisted the inclusion of such provisions. In our view, the *Shari'ah* advisor should pass on a review of the transaction terms and documentation prior to closing of the transaction. Once the *Shari'ah* advisor is satisfied that the terms of the documentation comply with Islamic law, our objective is to have the documentation enforced according to its terms under the laws of a recognized commercial jurisdiction (New York or England). If the courts of those jurisdictions properly interpret the law, the documentation should be enforced according to its terms and the parties will obtain the results they bargained for. In addition, it is reasonable to expect that the commercial lender providing the loan financing to the SPE would not be prepared to rely on a lease agreement (which is its underlying credit document) that is governed by the *Shari'ah* because of the lender's unfamiliarity with that body of law and the difficulty that could arise if it were required to prove that governing law if legal proceedings became necessary.

V. Conclusion

Financial institutions that seek to become involved in Islamic financial transactions must deal with the legal and practical issues, some of which are described above, that will be confronted in such transactions. They must also take a "long view" of the Islamic financial market and its long-term potential. When approaching lenders with a proposal that they engage in a transaction that is structured to satisfy Islamic requirements, we generally present the transaction as a structured financing utilizing an SPE. All lenders are familiar with structured financing and the use of special-purpose entities in such financing, as such transactions are often undertaken to achieve tax or accounting objectives. An Islamic structured financing is no different, except that the finance recipient has additional considerations that it is trying to satisfy. Presented in this light, Islamic financing should seem no stranger or more foreign than any other structured financing. The presentation to a potential lender and the documentation should also not use foreign words, as new terminology can raise unnecessary concerns.

Some financial institutions in the United States are seeking to finance Islamic transactions directly rather than through loans made to SPEs. For example, the New York branch of the United Bank of Kuwait recently obtained regulatory approval for a home lease/purchase program. Obtaining this approval was significant because it represented an exception to the regulatory prohibition on a bank's ownership of real estate. Permission for the program was received in recognition that the transaction essentially represented a financing and that the risks of the program were comparable to the risks of conventionally structured financing. Another approval was given to

Citibank, N.A. to engage in *murabaha* transactions. This approval was sought on the basis that such transactions constitute the economic equivalent of a financing and that such transactions are consistent with foreign banking practices. The approval was granted on the basis of the second rationale. These developments on the regulatory front should enable a more widespread utilization of Islamic financing structures by conventional U.S. financial institutions.

Islamic Finance in View of the *Shari'ah*

Nizam Yaquby*

ABSTRACT

Islam governs all aspects of a believer's life, and the concept of worship in Islam is broad and comprehensive in meaning. The struggle for one's livelihood is thus also an act of piety. Wealth in Islam must be earned through permissible means. This rule is in keeping with the faith's balance between worldly and spiritual concerns. Islamic banks were conceived of by Muslim scholars decades ago, and gained momentum following western interest in Islamic finance. *Shari'ah* committees play a central role within Islamic banks. These committees review articles of association, review financial contracts, and place in-house *Shari'ah* auditors to oversee *Shari'ah* compliance.

I. INTRODUCTION

Islam means "total submission to God." As the Qur'an says, "To Him submitted all creatures in the heaven and the earth willingly or unwillingly." This total submission to God requires obeying His rules and commands, and this obedience to God is an act of worship. The term "worship" (*ibadat*) has a very broad meaning as Shaykh ul Islam Ibn Taymiyyah defined it. He says, "Worship in general terms encompasses all acts and utterances that please God." The commands of God, which are to be followed and obeyed, are not restricted to rituals and prayers or confined to mosques. They are very comprehensive and cover almost all areas of life. Even the specific teachings in Islam find their basis in general principles derived from the Qur'an and the *Sunna*. Therefore, a Muslim must subject all of his life, activities, and actions to God. The Qur'an clearly states, "Say that my Salah, my sacrifice, my living and my dying are for the sake of God, Lord of the Aalameen (all that exists and all creatures)."

Indeed, one who reads the Qur'an and the *Sunna* finds guidance in all aspects of life—social, political, economic, etc. Earning our livelihood is one of our most time-consuming tasks. Usually, we spend much more time and effort during work hours (i.e. in the office), than during Salah, which is only a few minutes a day, or fasting, which is one month in a year. It follows that our jobs must be done in accordance with what God has ordained. Furthremore, according to Islam, working hard to earn one's own living and sustain one's dependents is in itself an act of worship if done with the right intention. Food so earned is the most blessed source of income: the Prophet said, "Hands that are always busy in earning that which is *halal* are very far from the hell fire."

II. MONEY AND WEALTH IN ISLAM

Struggling for money is believed to be as pious work as struggling for the faith. The hand that gives is better in the sight of God then the hand that takes. However, the *Shari'ah* lays down conditions on business and financial transactions that must be fulfilled in all aspects. The Prophet informed us that on the Day of Judgment nobody will be able to move from the place he/she is standing without answering four questions. First, what did you do with the life provided by God? Second, what did you do with your youth years that were provided by God? The Prophet emphasized the youth years because they are the most productive ones. Third, what did you do with the knowledge that God gave you? You are born from your mother's womb without any knowledge. Therefore you gain knowledge in the world, and God facilitates this learning. Did you do good with it? Did you learn? Did you teach? Did you do whatever God commanded you to do with it or not? Finally, how did you gain your income and means of subsistence, and how did you spend it? Did you spend it wisely in accordance with the teachings of God?

It is clear from this *Hadith* and many others that the means of income must be *halal*. This concept of purifying the source of subsistence and source the income (*al-kasb al halal*) is very important and is very deeply rooted in any Muslim's education and psychology from the beginning of childhood. God says in the Qur'an, "O mankind, eat of that which is lawful and good on the earth and follow not the footsteps of the Satan. Verily he is to you an open enemy."

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Those who disobey God's commands go astray, do not care about *halal* and *haram*, and do not care about what is allowed and what is prohibited in their sources of income will risk the punishment of burning in hell on the Day of Judgment. As another *Hadith* records, "The body that is nourished by unlawful means, is better to be in the hell fire." Even the prayer and supplication of those who do not purify their sources of income are not answered by God. When one of the companions approached the Prophet and told him, "I want my supplications, my prayers to be answered. I want God to answer my supplications," the Prophet replied, "Purify your sources of income and God will answer your prayers."

Obviously, money or wealth in itself is not degraded or demeaned in Islam. In fact, money in the Qur'an is called with the beautiful term *khair*, which has the beautiful meaning in Arabic of blessing and goodness. God states clearly in Surah Kahf, "Wealth and children are the adornment of the life of this world," but it should not be the only aspiration because the life here is but limited to a few days and there is no eternity here. And so the verse in Surah Kahf continues, "But the good righteous deeds are better in respect of hope in the hereafter."

Islam teaches us how to maintain this balance between the material, temporary world and the next spiritual and eternal life without moving the scale (*mizan*). God says, "But seek with that wealth which God has bestowed on you the place in the hereafter and for that *waqt* (time) have a portion of the wealth in this world. And do good as God has been good to you and seek not the change in this land. Verily God likes not the *mufsideen*—those who commit great crimes and sins are tyrants, mischief makers, and are corrupt." It appears that this emphasis on *kasb al halal*—on purifying the source of income—is not very prominent in all religious teachings. It is surely present, however, in Judaism and Christianity. A recently published book by Rodney Wilson, *Economic Ethics and Religion in Jewish, Christian, and Muslim Economic Thought*, demonstrates the fact. It does seem, nonetheless, that the principle of pure income is not emphasized and adhered to strongly enough in other faiths. Muslims, by contrast, need only look to the hundreds of questions that the *muftis*, the scholars of Islam, receive every day regarding these matters. Is a given transaction *halal* or not *halal*? Can we invest in this bank or not? It is a very pressing issue for the Muslims, and I personally receive ten to twenty calls each day about this subject. Many scholars throughout the Islamic world likewise receive such questions. If this concern is understood, it is easy to realize the demand to have Islamic banks and financial institutions that facilitate investment and financial transactions in accordance with Islam.

III. The Rise of Islamic Finance

For more than 12 centuries, Muslims had their own system of banking. It is mentioned in many books (for example, Udovitch's *Book of* Fiqh) and is abundant in the details of *fiqh al muamalat*. The *fiqh* relating to Islamic business and financial transactions is much more comprehensive than that relating to *ibadat*. Also, for the forms of contracts there are books of *shurut*.

During the modern era, the western system of banking, along with many other systems, was introduced in Muslim countries. But Muslim jurists, traders, and most of the public never accepted these systems, even if they had to deal with them. A substantial number of Muslims today, including some in the United States, hold their earnings outside financial institutions. Some Muslims who are obliged to deal with banks have their own conditions attached to the application forms. In fact, some time ago Muslim merchants opened an account with HSBC and specifically mentioned that they do not take or give interest and follow the *Shari'ah*. During the 1960s and 1970s, Islamic economists and *Shari'ah* scholars floated the idea of banks or financial institutions based on *Shari'ah* principles.

When such banks later came into existence, few people thought they would succeed. Critics argued that Islamic banks were idealistic, that banking without interest is like conservation without water. A great scholar in Bahrain, when the Bahrain Islamic Bank was established in the late 1970s, responded to the conventional banking community's objections by saying that when western bankers form Islamic banks, they would try to follow the originators' footsteps. This has indeed happened. When large western banks showed interest in Islamic banking, conventional banking started to follow in their footsteps.

IV. The Role of *Shari'ah* Committees

Islamic banks and financial institutions have many elements unfamiliar in conventional ones. The essential element of Islamic banks is *Shari'ah* supervision and a *Shari'ah* supervisory board: this is unheard of in the conventional banking system. It is useful to highlight what *Shari'ah* boards do because students and even professionals are sometimes confused about the actual work that *Shari'ah* committees do.

The *Shari'ah* committees usually consist of top Islamic scholars who are well-versed in Islamic law as well as in financial transactions laws. The first things a committee does are look into its bank's Articles of Association and Memorandum of Association to ensure they comply with the *Shari'ah* (if the bank is in the beginning stages).

If, however, the *Shari'ah* committee comes into being after the bank's establishment, the committee will amend these articles in accordance with the *Shari'ah* and a general assembly meeting will be held on the amendments. Second, the committees develop and write all the Islamic contracts of transactions that the banks and institutions are going to work under. They also review every form and bank application. The contracts are reviewed by *Shari'ah* standards—a long process. For example, the Abu Dhabi Islamic Bank was established more than a year ago, but because of all the preliminary *Shari'ah* processes, it will only soon begin operations. After drafting the contracts and examining all these forms, committees monitor the *Shari'ah* compliance of the transactions to see whether their requirements are really applied rather than being merely ink on paper.

Many *Shari'ah* boards have instituted the procedure of having internal *Shari'ah* auditors. Boards themselves take random samples, but having internal *Shari'ah* auditors permits constantly following up transactions on a day-to-day basis. Another role that *Shari'ah boards* play is to educate not the staff of the banks and the institutions, as well as the wider public, through books and *fatawa*, conferences and meetings, and *khutbas* (sermons). These scholars are very social within the Muslim community. They are *imams*, they are *khateebs*, they are judges—enabling them to teach the general community about the benefits of investing and the benefits of Islamic finance. They have even been published on the Internet (in so-called "cyber *fatawa*").

In the future of *Shari'ah* boards, there is an emphasis on the ramifications of their *fatawas*. Ramification is not important to board members, but "authentication" is. That is, that the legal rulings and contracts be authentically and genuinely based on the Qur'an and the *Sunna* and the *fiqh* of our great scholars. They ought not to contradict these teachings.

Although authentication is important, not everything has to be uniform. There are things that are static and things that are dynamic. For instance, things such as *ibadat* (prayers) are not subject to change, while in other areas with a wide range of reasoning and *ijtihad*, it is possible to have differences of opinion. Disagreements can be found throughout Islamic history, and its appearance, at least is found in every system of thought. Even conventional banks and financial institutions have hundreds of contracts that are different and not standardized. Finally, it is important to have widely accepted *Shari'ah* boards. The OIC *Fiqh* Academy, although accepted by all the *Shari'ah* scholars, does conduct research on several matters pertaining to Islamic finance.

PART III

ISLAMIC FINANCE

Introduction

Muhammed-Shahid Ebrahim*

The sessions on Islamic finance at the Second Harvard University Forum on Islamic Finance was as a vital marketplace for the exchange of ideas among top-tier academics and practitioners. The discussion focused on the current state of affairs of the Islamic financial system and served as a strategic road map for the future. This is essential for the economic development of the Muslim *umma*, as the present state of Islamic financial intermediation is a retail banking system that is described as an economic system in its infancy.[1] Thus, it is exigent to move to the next stage of development, i.e., the addition of capital markets. This is the essence of the papers in the Islamic finance part of this volume.

Adnan Al Bahar gave a keynote speech on the new era of Islamic finance and investment. He defines Islamic financial markets, institutions, and innovations and tracks the development of the market from its home base in the Gulf region to a market encompassing the globe. In a similar vein, Iqbal Ahmad Khan traces the development of Islamic finance and classifies different Muslim countries according to their current stage of evolution. He believes that Islamic financial institutions (IFIs) need to meet future challenges by performing quality asset management; cooperating and with their peer institutions; maintaining an Islamic cultural and professional identity; exercising creativity through *ijtihad*, *ijma'*, and *qiyas*; and standardizing products and services. The contribution of this paper lies in the identification of the state of economic development of the different sections of the *umma*. Some of the strategies articulated are similar to the ones proposed by Fuad Abdullah Al-Omar and Munawar Iqbal. However, Khan fills the void between Al Bahar and the following two authors.

Al-Omar and Iqbal present a futuristic outlook in their essay. They discuss current hurdles such as: (1) the restricted use of profit- and loss-sharing contracts and the concentration of short-term assets by Islamic banks; (2) lack of formal training of *Shari'ah* scholars in modern finance; and (3) the extremely limited teaching, training, research, and development by Islamic universities and banks. They argue that actions need to be taken along three dimensions to effectively compete with the giants in conventional banking:

I. Islamic Financial Markets and Instruments
   A. Develop better products and services using modern technology and financial engineering techniques.
   B. Establish long-term equity-oriented instruments, secondary markets, and interbank markets.

II. Islamic Financial Institutions
   A. Build bridges and strategic alliances with existing Islamic banks and conventional ones that are genuinely interested in the Islamic financial arena.
   B. Develop economies of scale via mergers.

III. Legal and Regulatory Framework
   A. Develop viable financial reporting and auditing standards.
   B. Enact appropriate tax legislation on the Islamic banking industry.
   C. Establish pertinent regulations on the industry to foster the growth of the economy at large.

This is a very well thought out road map for Islamic banks to follow. However, the long-term instruments discussed in (1b) need not be equity vehicles only: they can be hybrid ones incorporating a modified version of *mudaraba*, as I describe in my paper below. Second, the authors rationalize the extensive use of the *murabaha* facility and call it "indispensable." The reason Islamic bankers use this instrument is that the majority of them have a conventional banking background. Furthermore, this facility is the easiest for them to implement, as it is asset-backed and reduces moral hazard. The Muslim *umma* has yet to look beyond this and develop modern instruments compatible with the *Shari'ah*.[2]

The broad vision of Al-Omar and Iqbal is currently being realized in Malaysian bank mergers as far as item (IIb) is concerned. The remaining papers on this topic delve further into issues (1) to (3).

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I. Islamic Financial Markets and Instruments

Tariq Al-Rifai stresses that it is foolhardy of sponsors of Islamic mutual funds to target high-net-worth individuals, as they are sophisticated individuals who are already clients of conventional institutions. Furthermore, they are indifferent to Islamic versus conventional products and services. The market that is still untapped is the one comprising middle-income professionals. To target this market, Islamic banks need to educate this client base and comply with disclosure policies as enforced by the Securities Exchange Commission in the United States. This will eliminate any institutional mistrust and nourish their growth to develop the economy. To a certain extent, I agree with Al-Rifai. However, this *umma* needs to develop instruments consistent with the *Shari'ah* and package them for the Muslim mass market to further their economies and not those of the developed nations. Two papers expand on this issue.

Ebrahim elucidates the classical modes of Islamic finance in the context of those in conventional finance. However, *mudaraba* possesses unique features and is difficult to translate in terms of modern corporate finance. Most scholars have translated both *mudaraba* as well as *musharaka* as equity instruments akin to common stocks (Ismail, 1999). Nonetheless, *mudaraba* is devoid of any control features. In this case modern finance requires equity instruments such as *mudaraba* to have either of two features.

One, they must be provided with additional compensation for the loss of voting (control) privileges (Pratt, Reilly, and Schweihs, 1995). This is empirically observed in certain stock exchanges where specially designated stocks without control features command additional dividend payment.[3] This is contrary to the *fiqhi* view that the *musharik* gets paid a premium for his efforts in a venture funded equally by both *mudaraba* and *musharaka*.[4] This disparity between modern finance and Islamic law is due to that fact that in a modern corporation, entrepreneur-managers are paid a salary in addition to a dividend, which is based on the profitability of the venture.

Or two, they must be considered senior to already-existing equity (common stock or *musharaka*). In this instance, *mudaraba* can be considered as a hybrid. This view has empirical evidence: *mudaraba* account holders of the restructured Dubai Islamic Bank were given priority over the *musharik* (stockholders).

If *mudaraba* is seen as a hybrid facility, then it can be decomposed into a combination of a *murabaha* facility and a call option (*al ikhtiyarat*). This relationship gives the pricing relationship or the profit-sharing parameter of it. It is also shown to be malleable in the two dimensions of return and risk. This has profound implications in the securitization of assets, as one can design a *mudaraba* vehicle to cater to uses ranging from bonds to growth facilities financing venture capital projects.

Zamir Iqbal also ventures into the scope of financial engineering, securitization, and risk management via commodity swaps. Iqbal rationalizes the urgency to develop long-term Islamic facilities to foster the growth of the Muslim economy because emphasis on debt instruments such as *murabaha* can hamper long-term growth and render it vulnerable to exogenous shocks. Another vital issue in the development of Islamic financial markets is the process of securitization. Iqbal illustrates this via a simple example. However, there are many issues that have yet to be resolved in this arena. These include the design of Islamic money market and bond funds, the impact of the closed-end puzzle on the securitization of assets, and so on. Finally, Iqbal discusses risk management using commodity swaps, a very modern instrument, and delineates its relationship with *bai' salam*, a classical Islamic instrument. Iqbal's paper should guide Islamic financial engineers and policymakers to develop and implement products and strategies to minimize risk.

I. and II. Islamic Financial Markets, Institutions and Instruments

Shaukat Aziz presents a very basic perspective, stating that Islamic banks have the potential to evolve out of a narrow niche market to one encompassing a wide array of products and services on a global scale as long as they:

(a) Standardize products and services while narrowing down the different interpretation of the *Shari'ah*. This can cut costs and create liquidity.

(b) Behave professionally and provide full disclosure

(c) Increase public awareness

III. Legal and Regulatory Framework

A. Financial Reporting and Auditing Standards

Rifaat Ahmed Abdel-Karim discusses how his organization is working to set standards to promote transparency and accountability. In the current environment, Islamic banks do not use a consistent method for financial reporting, as there seems to be no regulation. AAOIFI's mission is to assist Islamic banks in developing a consistent methodology for preparing financial statements and auditing them. Although AAOIFI has made numerous accomplishments, it lacks the power to enforce its standards and therefore works with governmental and professional organizations to implement them. The development of AAOIFI is an important step in reducing *gharar*, as the organization effectively tries to provide information on the operating efficiencies of IFIs to depositors, shareholders, and potential clients.

B. Government Fiscal Policy

Walid Hegazy focuses his study on the amendments to the Malaysian tax laws to address the tax treatment of IFIs. These amendments pertain to the Income Tax, Stamp Duty, and Real Property Gains Tax Acts. The intention behind the legislation is to put both types of institutions (conventional and Islamic) on equal footing.[5]

C. Regulation and Supervision

Luca Errico and Mitra Farahbaksh discuss the Islamic concept of *hisba* (regulation and supervision) as applied to IFIs. They contrast IFIs with conventional financial institutions (CFIs) and extend the regulatory framework of the Basle Committee on [Conventional] Banking Supervision to IFIs. However, the actual practice of IFIs is not very different from that of CFIs, and it differs drastically from the theoretical paradigm.

This disparity between the theory and practice of Islamic banks should serve as an eye-opener to those of us who are striving to Islamize the financial activities of the Muslim *umma*. Some Muslim economists, such as Kahf (1999), have expressed their displeasure over this result. However, Errico and Farahbaksh have a valid point, reinforced by Ahmad (1989), that "no significant device has been evolved by Muslims as a substitute for interest." This is certainly a very good paper. I only disagree with them on the assertion that *mudaraba* has more risk than *musharaka*. If *mudaraba* is given seniority over *musharaka*, its risk can be lower.

The Second Harvard University Forum on Islamic Finance contained a good blend of technical and non-technical papers in the area of Islamic finance. This should serve as a beacon to strategically assist in the development of Islamic capital markets, and as a source of inspiration to Islamic academics, practitioners, and policymakers in the coming years.

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[1] Boot and Thakor (1997) elaborate that a "financial system in its infancy will be bank dominated, and increased (capital) market sophistication diminishes bank lending."

[2] The concentration of assets of IFI in *murabaha* was of concern to the pioneer of Islamic Banking, the late Ahmed El-Naggar (1994), who stated that the actions of Islamic banks could easily be imitated by conventional banks if they use this vehicle extensively. Iqbal and Mirakhor (1991) reiterated the feeling of other notable Islamic economist such as the late Shaikh Mahmud Ahmad, "who expressed his frustration at the failure of Islamic banks to implement a true interest-free model."

[3] The New York Stock Exchange does not allow companies to register for trading unless they adhere to a one-share one-vote policy. This is designated as optimal corporate stakeholder policy (see Grossman and Hart, 1988, and Harris and Raviv, 1989).

[4] I am grateful to Monzer Kahf, formerly of the Islamic Development Bank, for enlightening me on the *fiqhi* aspects of *Mudaraba*.

[5] There are instances where governments can provide incentives to promote or dissuade Islamic banking. The Pakistani government's preferential tax treatment of *Mudaraba* companies has promoted their incorporation (Uppal, 1999), whereas the Egyptian government's policy of controlling the growth of private Islamic financial institutions curbed their development (Galloux, 1999).

Islamic Finance

Opportunities and Challenges in a New Global Environment

Shaukat Aziz[*]

ABSTRACT

The opportunity for the growth of Islamic finance is immense in light of the fact that the ten largest Muslim countries have a combined GDP of $1.2 trillion. This potential, however, can only be realized by overcoming challenges such as fragmentation of the industry, differences in the interpretation of the law, the need for regulation, globalization of the industry, and promoting an appreciation for Islamic financial products. The requirements for growth are consistent treatment of issues under law, the development and enforcement of standards, transparency in dealings, liquidity in the market, and professionalism in the interactions of Islamic institutions.

I. INTRODUCTION

In the current climate of globalization and economic interdependence, the study of Islamic finance can be broken into the opportunity, the current challenges, and the requirements for future growth. Islamic finance's appeal to all people lies in their need to conduct financial transactions in accordance with ethical and religious requirements. In the past, the target market for Islamic banks was limited to those with strong Islamic beliefs. Today, Islamic banks are catering to a larger variety of clients by offering more creative and competitive products. Islamic banks now have total capital of more than US$7 billion, assets of more than US$137 billion and deposits of more than US$100 billion.

Citibank, for example, sees increased demand for Islamic finance across all of its market segments: retail, high net worth, corporate, industrial, institutional and government. Furthermore, the opportunity is not limited to countries traditionally considered part of the Islamic world. The Islamic market itself is immense. According to the World Bank, the 10 largest Islamic countries have a population of nearly 800 million and a GDP of US$1.2 trillion. Another additional 100 million Muslims live in non-Islamic countries.

In the traditional markets, the initial source of wealth was largely from oil. Subsequent investments in infrastructure and technology over the past 30 years have multiplied the original wealth and thereby increased the demand for sophisticated financial services. The potential can only be realized by overcoming five key challenges.

II. CHALLENGES FACING ISLAMIC BANKING

A. Fragmentation

While promising, the market is not fully developed. Islamic banking does not represent the core banking or financial system of any major Islamic country. It is still viewed as a niche product or an option but not as a holistic and all encompassing financial system that can cover all aspects of today's requirements. This prevalence of this view in the Islamic world is partly responsible for the fragmentation in the Islamic banking industry. Fragmentation results in institutions with limited earnings capacity, inadequate ability to hold assets and a relatively limited equity cushion to absorb shocks and losses.

B. Interpretation

At the core of Islamic banking lies a strict adherence to ethical banking practices. However, the differences in interpreting the lawful and the prohibited create redundancies that significantly raise the cost and substantially extend the time to execute broad market transactions.

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C. Regulation

Every major developed market has a strong regulatory structure and strong standardized accounting and reporting. The traditional Islamic banking markets are not as developed. Regulatory oversight and standardized procedures promote investor confidence expand the market opportunity and lower costs.

D. Globalization

It is a mistake to treat Islamic finance as a regional market opportunity. The world economy is changing and forces of globalization no longer constrain the demand for these services to a handful of countries. Besides, Islamic financial products are based on principles that can and do have a much broader appeal. For all of these reasons, we must act accordingly and prepare to meet this growing need on a global, not merely regional, stage.

E. Appreciation

Several years ago, very few people understood Islamic finance. While awareness is increasing, we still suffer from gaps in knowledge. However, in some countries Islamic finance is neither understood nor appreciated.

III. The Path to Growth

Given these challenges, how can the industry grow? Evolving into a sophisticated global business is predicated on five basic requirements:

A. Consistency

Consistent treatment of economic issues under law is the sine qua non of investor confidence and market growth. Consistency in evaluating, interpreting, and acting on all issues related to Islamic banking is absolutely essential.

B. Standards

A globally consistent set of accepted products in accordance with *Shari'ah* principles—and in accordance with conventional banking and investment products and systems is needed. This requires creativity and flexibility. For example, many of the risk management products that emerged in the past decade have been forbidden in Islamic finance because these same products could be used for speculative purposes. An acceptable Islamic rationale is needed for modern products that have an application for either reducing or increasing risk. A case-sensitive analysis that considers products like swaps and futures and accepts them when they reduce risk but rejects them when used for speculation would dramatically broaden the range of products.

In addition to a standard product set, a globally accepted policies and procedures must also be developed. A global *Shari'ah* board, independent of any one institution, but funded by the banks collectively could promote market standards for the approval of products and services. The Islamic Development Bank, along with key players must play a major part in mobilizing the effort and creating a global platform for success.

C. Transparency

Years ago, secrecy was the hallmark of the private banking business. Today, secrecy is dead and transparency is the minimum standard. Transparency is the invisible hand that will drive this business. Open markets and rules forcing complete and accurate disclosure will increase investor confidence and give them the tools to evaluate risk. Only then will higher level of participation be achieved.

D. Liquidity

Investor confidence and liquidity are the accelerators of a "virtuous cycle" of market depth and growth. Only when standardization and transparency are entrenched can liquidity evolve. Standardization and transparency increase investor and issuer confidence to a level that permits the easy issuance and exchange of securities with low transaction costs. When this happens, benefits can accrue quickly and markets can grow rapidly. The need exists for cross-border lender of last resort to provide a liquidity cushion for previously approved products. Perhaps a reshaped IDB can play a role.

E. Professionalism

The injection of professionalism into the system is an enormous opportunity, but the challenges it poses require the participation of more institutions that can attract top talent, provide training, and commit the necessary resources to encourage and support it. Professionalism and understanding go hand in hand. A system that supports the sharing of information to promote a better understanding and respect for the religious and ethical underpinnings of Islamic finance will attract top talent.

We must continue to work together to foster a better understanding between the Islamic and non-Islamic worlds. The Harvard Islamic Finance Information Program (HIFIP) is already playing a significant role in facilitating this dialogue through seminars, lectures, and forums on topics relevant to Islamic finance.

IV. CONCLUSION

The structure of modern Islamic finance has to be built on the foundation of stable markets with standards. Transparency backed up by enforcement of standards draws sufficient capital to ensure that critical mass is achieved and that top talent and professionalism thrive. The opportunity is enormous and the challenges, while stringent, are not onerous.

Islamic Project Finance

Problems and Promises

Don Babai *

ABSTRACT

In spite of the huge needs and the substantial opportunities, project finance has been a relative laggard in the development of the Islamic financial industry. With the possible exception of Malaysia, a robust Islamic market for the financing of infrastructure projects has yet to emerge anywhere. This article examines the combination of internal and external factors that have limited the scope of Islamic project finance to date. Above all, institutional shortcomings, ranging from the lack of standardization of legal rulings and provisions for liquidity mechanisms to the capabilities and choices of Islamic financial institutions themselves, are emphasized. The article concludes with an exploration of some of the ways in which Islamic finance could make distinctive contributions in the area of project finance.

I. INTRODUCTION

Islamic project finance represents a peculiar amalgam of limitations and potentials for the Islamic financial industry. The potentials are substantial yet as largely unfulfilled. The limitations are formidable and are ascribable to factors both intrinsic to the Islamic financial market itself as well as to ones beyond it.

The objective of this paper is to provide an overview of these limitations and potentials. The paper addresses three sets of questions.

First, what are the opportunities for Islamic financial institutions in the area of project finance? In many respects, the paper argues, Islamic finance and project finance appear to be tailor-made for each other. Moreover, judging by the needs, one would think that of all the areas of activity that should be the focus of energies of Islamic bankers and investors, project finance should rank, if not at the top, at least very close to it.

Second, what are the constraints against the spread of Islamic project finance? This is not exactly a segment of the market that has taken off. Why not? What are the reasons that work against its doing so?

Third, what is the promise of Islamic finance in the area of project finance? What, if anything, can the Islamic financial industry bring to project finance? Where can it make a critical difference?

II. THE OPPORTUNITY

This would seem to a particularly opportune juncture for the industry when it comes to project finance. There would appear to be several factors that make it so.

We might begin by noting that a revolution that has taken place in the world of infrastructure project financing at large.[1] Before the 1970s, the financing of infrastructure projects in developing countries was largely, almost exclusively, the domain of official sources of finance: governments, multilateral institutions, and export credit agencies. At least 90 per cent of these countries' annual spending on infrastructure continues to be derived from public revenues and borrowings, while an equal proportion of investment for infrastructure is still funneled through government sponsors, which assume virtually all project risks.[2] In recent years, however, the private sector has emerged as a source of infrastructure financing in a growing number of countries and sectors. Meanwhile, the privatization of assets and the liberalization of services in infrastructure has continued to spread around the world in the 1990s.[3]

Underlying the latter trends is a sea change that would appear to hold a special promise for Islamic finance and investment. Almost everywhere, the state has begun to climb down from the commanding heights of the economy.[4] Contributing to this change is widespread disenchantment with the performance of state-owned enterprises in the provision of infrastructure services in areas ranging from power and water to transportation and telecommunications. A combination of budgetary constraints, a reduction in the supply of external financial

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assistance for funding large-scale projects, a concomitant increase in the number of claimants among countries for such assistance, and a growing recognition of the scope of infrastructure investments required to sustain development, have all reinforced the need to involve the private sector more directly.[5] Facilitating the process are a host of other factors, including technological changes that are paving the way for increased competition and for private entry, and innovations in financial markets, which are allowing private projects to tap a wider array of financing sources and financial products.[6]

To be sure, the shift to private financing of infrastructure remains both limited and uneven. A recent survey found that the majority of private projects is concentrated in only a few sectors.[7] In the Middle East, and particularly in the Gulf region, which remains the heartland of Islamic banking and finance, private finance has yet to make major inroads. Therefore, whether in terms of volumes of financings or the number of projects, private sector participation in infrastructure is miniscule relative to what has been witnessed in Latin America, East Asia, or Eastern Europe. Moreover, when it comes to privatization and liberalization, there is still a great deal of ambivalence not only among governments but also within the private sector itself.[8] One account puts it bluntly: "Despite all the pronouncements and the debate on privatization in the Gulf countries, very little has been achieved in this direction."[9]

Nevertheless, an incipient process appears to be underway, with consequences that at present cannot be fully discerned but that may prove to be far-reaching. The revenue shortfalls that most states in the Middle East, including the petroleum producing countries, have had to contend with for much of the 1980s and 1990s have forced governments throughout the region to actively seek new sources and new methods of financing. In doing so, some have begun to entertain possibilities they would have dismissed in the past. All of them have admitted that they cannot go it alone, that when it comes to the task of financing infrastructure the sheer scale of what is required is beyond their capabilities.[10]

The requirements certainly are massive. The World Bank has estimated that between 1995 and 2004 East Asian countries alone will need more than \$1.5 trillion in spending for infrastructure.[11] By the year 2010, according to another World Bank estimate, the Middle East and North Africa region will need \$350 billion to 400 billion in additional investments in infrastructure.[12] Many governments in the region have made it clear they have no choice but to turn to the private sector—private savings and private investments—to meet these needs. East Asian countries, among them Malaysia and Indonesia, seem to have arrived at this conclusion even before they were enveloped by the financial crisis that erupted in 1997. The fallout from that crisis, including the defection of foreign bankers and investors, along with the collapse or retrenchment of many projects, is bound to accelerate the search for alternatives in financing infrastructure.[13] Together, these trends should augur well for Islamic financial institutions.

To these institutions, investments in infrastructure should hold a great deal of inherent appeal. The investments are in real assets—hardhat projects such as highways, airports, power plants, telecommunications networks, oil and gas pipelines. As such, they represent a realm far removed from the operations associated with hedge funds such as Long-Term Capital Management. Insofar as part of the mission of Islamic banking and finance is the creation of value, infrastructure investments need little justification. Indeed, infrastructure is considered to be a principal determinant of economic success or failure. It has been estimated that a growth of 1 percent in a country's stock of infrastructure is commonly associated with an increase of 1 percent in its gross domestic product.[14] In that they contribute to growth and productivity *within* Muslim countries, infrastructure investments, be they conventional or Islamic, also represent an antidote to the spate of Islamic equity funds, which, by virtue of their overwhelming concentration on markets in the West, contribute to taking capital *out of* those countries.

The evolution of project financing itself has significant ramifications for Islamic financing and investment. While frequently a source of confusion, and even definitional anarchy,[15] project finance is generally understood to consist of a financing structure in which, for security, the financier looks, either exclusively (in the case of nonrecourse financing) or primarily (in limited recourse financing), at the performance of the project itself—at its cash flows, future revenues, and physical assets—rather than at the general assets of the project sponsor.[16] Such financing would seem to be particularly attractive to Islamic bankers and investors. The contractual arrangements involved in project finance necessitate a sharing of risk between providers and users of capital. The sharing of risks among all participants in an enterprise is eminently in conformity with the ethos of Islamic finance. Indeed, it constitutes one of its bedrock principles.[17] On a more tangible level, the off-balance sheet financing that in general is characteristic of project finance corresponds to the preferred modality of the preponderance of participants in the Islamic marketplace. Project financing structures are sufficiently versatile to accommodate a multiplicity of financial instruments and market participants. Thus all the major vehicles of Islamic finance in the market today—*ijara, istisna'*, *mudaraba*, *murabaha*, *musharaka*—can be deployed in project finance. In addition, Islamic project finance is combinable with conventional financing, i.e. lending by private banks, as well as with official sources, especially export credit agencies and multilateral institutions such as the World Bank or the International Finance Corporation.[18]

III. THE LIMITATIONS

Having noted both the needs as well as the opportunities, we cannot overlook the fact that they have yet to be fulfilled by Islamic project finance. A cursory look at the record leads to no conclusion other than that, one important qualification aside, the magnitude of Islamic project financing to date has been paltry.

The qualification pertains to Malaysia, the one country where we do find a sizeable amount of Islamic financing for large-scale infrastructure projects. To date, the largest of these financings has been for Kuala Lumpur International Airport. The funding for this multi-source project amounted to RM8.8 billion or, at the exchange rate prevailing before the East Asian financial crisis, slightly under $2 billion. Of the latter total, one-fourth, RM 2.2b (roughly $500 million. at the time) came from a *bai' bi-thaman ajil* syndication. (This instrument, a variation on *murabaha*, is a deferred payment contract allowing for payments in installments instead of cash.) The syndication was securitized through the issuance of notes guaranteed by the government and tradable on the secondary market. The facility was arranged by a consortium of local banks led by Bank Islam Malaysia Berhad. At 20 years, the tenor in this structure was unusually impressive.

Variations on this structure have been used in more than 12 other major private infrastructure projects in Malaysia, prominent among which are the Kuala Lumpur Light Rail system (commonly designated by the acronym "PUTRA"). In more ways than one, not the least of which is the trading of debt instruments, or *bai' al-dayn*, this record reinforces what we already know about the exceptionalism of Malaysia in the Islamic financial market.[19] Malaysia is also the exception in the realm of Islamic project finance.

Elsewhere, Islamic money has not gone in a big way into financing infrastructure investments. Discussions of Islamic project finance beyond Malaysia typically produce less than a handful of examples, among them the Hub project in Pakistan and the Equate project in Kuwait is another. Yet at least one of these projects, Hub, illustrates not so much the strengths but the *limitations* of what has been subsumed to date under the rubric of Islamic project finance.

Islamic money for the Hub River Power Project consisted of an *istisna'* facility of $92 million and a $110 million *murabaha* facility. At about one-tenth of the total cost, these facilities were fairly small relative to the size of the conventional financing for the project. The Islamic tranches, all short-term credits, allowed for the purchase of equipment from Western suppliers. As such, the importance of Islamic finance in facilitating the consummation of what by all accounts was an exceedingly complex transaction cannot be dismissed. Nevertheless, the Islamic funds did not amount to anything more than bridge finance and were not intended to be anything other than that. Islamic finance in this instance barely merits the designation of project finance per se. Nor was Islamic funding vital for the project at large. More vital was the lending from the World Bank and, perhaps even more so, the guarantee of political risk provided by that institution.[20]

The Equate Project, which drew two *ijara* facilities for a joint venture between the Kuwait Petrochemical Industries Company and Union Carbide, involved both a larger proportion of Islamic funding as well as substantially longer tenors (eight and ten years). It probably provides a more definitive indication of the potential contributions Islamic finance can make toward project finance. Yet, questions about the decisiveness of Islamic money for this project aside, the Islamic financial industry has contributed to an extremely limited number of such projects.

While the risks in project finance are higher, so are the rewards. In a decade when profit margins on more traditional activities like trade financing have been squeezed, thanks to increased competition, we have not witnessed a rush to structure project finance Islamically. Most Islamic financial institutions have not devoted to project finance anywhere near the energy that they have in recent years to equity funds. The question that remains to be answered is why has Islamic project finance been a laggard? Why, relative to the needs and the opportunities, is the weight of project finance for the Islamic financial industry as a whole is miniscule? By way of explanation, four sets of factors may be suggested.

First, there are a variety of obstacles that are by no means inherent in or unique to Islamic financial institutions. Any financier, Islamic or non-Islamic, in most parts of the Gulf, or in Egypt or Pakistan, is not operating in a benign economic environment because investment codes are murky, legal remedies are problematic, regulations regimes are capricious, and capital markets are thin.[21]

In such settings, not many private agents, whether Islamic or non-Islamic, are inclined to undertake long-term financing of projects. Poject finance is daunting enough in the best of circumstances. It presumes a predictable regulatory and political environment. It also is predicated on a threshold of institutional development, especially in the legal and financial areas, that is absent in many Muslim countries.[22]

The second and third factors that need to mentioned are characteristic of the Islamic financial industry as a whole. There are intrinsic needs that must be met by any financial system for that system to sustain itself. One of these is liquidity. The problem of liquidity takes us smack into one of the constraints against seriously pursuing Islamic project finance. The disjunction between the short-term nature of deposits of most Islamic financial institutions and the long-term nature of investments in projects continues to plague the industry at large. In the absence of liquidity, it difficult to attract meaningful investments in illiquid assets, given the absence of a positive cash flow in the development phase—not coincidentally the riskiest phase—of the typical infrastructure project. The Malaysian answer to the liquidity problem, the creation of a market in Islamic private debt securities, is one that is fraught with controversy elsewhere. A partial remedy may come from the infrastructure funds that are coming on stream. The IDB (Islamic Development Bank) Infrastructure Fund, which was launched in 1998, is explicitly designed to allow for asset securitization. However, this vehicle remains in the realm of potential.[23] And without organized interbank and secondary markets, the liquidity problem will not be overcome. Liquidity is all the more imperative when one considers the size of most Islamic financial institutions. Project finance, after all, is not the province of small players.

The third factor that militates against the spread of Islamic project finance concerns transaction costs. This touches on yet another need in the industry, standardization, a need encountered by anyone who has experienced the problems of structuring Islamic funding for projects. What is at stake here is more than the absence of uniformity of *Shari'ah* rulings. Although partially attenuated in recent years, the latter remains a serious problem: time and time again, we are told of transactions that have had to dispense with Islamic tranches because of conflicting rulings.[24] However, the issues in standardization go deeper. For other players in the business of project finance, especially conventional financiers, there is often confusion and uncertainty about what will be demanded by different Islamic banks. If one does an *ijara*, and one has resolved inter-creditor issues on ownership and entitlements with one Islamic bank, does one have to go through the same process with other Islamic banks? And does one have to start all over again in a similar *ijara* down the road? It is dilemmas such as these that have led more than one commercial banker to demand: What is the rulebook? *Is* there a rulebook in Islamic finance?[25] The absence of an answer is likely to hamper efforts to deploy Islamic finance for projects more widely. Standardization would seem to be all the more imperative when cross-border transactions bring together multiple creditors as is commonly the case with project finance.

The fourth and final barrier against Islamic project finance concerns the capabilities of Islamic financial institutions. Project finance demands a skill set not possessed by many Islamic banks. It requires a variety of sectoral analysts. It requires financial modelers who can who can prepare complex cash flows projections. It requires expertise in project appraisal and monitoring. Perhaps, above all, it requires specialists in risk management—professionals, along with the attendant organizational systems, with the wherewithal to allocate and price different kinds of project risk. The available evidence suggests that at present few Islamic financial institutions are equipped to perform these tasks or have even begun to think seriously about equipping themselves with the capabilities.

IV. CONCLUSION: THE POTENTIAL

The final question that remains to be addressed is perhaps the most difficult of all: what difference would Islamic finance make? Let us imagine that in the coming decade the constraints mentioned above were to be lifted. Let us imagine that Islamic project finance were to take off. We still need to inquire whether Islamic project finance is destined to become merely an appendage to conventional project finance. To put it differently, and more bluntly, will it simply go along for the ride? Or does Islamic project finance have anything *distinctive* to offer (besides bringing to the table funds that are labeled Islamic)?

This is a more challenging question to answer, but there are several areas where Islamic project finance might be able to add value of a kind that would set it apart from conventional project finance.[26]

First, it might allow for a lowering of the overall costs of financing in a project. Obviously, this is not an in inconsequential consideration even in ordinary circumstances. It could become even more consequential if it could be demonstrated to investors that their current financing costs could be lowered if they refinanced a project Islamically.[27]

Secondly, Islamic project finance might allow for the undertaking of sound projects that otherwise would not be get off the ground. For example, it might pave the way for projects that do not satisfy the creditworthiness criteria of ratings agencies. Commercial banks face exposure ceilings to borrowers and, even where these ceilings are not an overriding issue, few of them are prepared to offer 10-20 year tenors. In such cases, by plugging the funding gaps, Islamic project finance could make the critical difference. In addition, Islamic funding could permit economically and technically viable projects that are unable to attract conventional financing on account of non-commercial, especially political, considerations. It could be a boon to sponsors of promising ventures who cannot avail themselves of conventional avenues of funding either because they do not have the necessary track record or because they continue to be dogged by past financial problems.

Thirdly, Islamic finance could play a critical role in many projects that are likely to remain beyond the "radar screens" of traditional investors. Among these are small independent power projects, waste water treatment plants, waste recycling and disposal facilities, and small operations in process industries. Such projects may not attract much interest from traditional lenders and investors. Many are decidedly less than fashionable. Few are likely to exceed the $50-75 million range. Yet all could have a large economic impact.

There is yet a fourth area where Islamic project finance could make a decisive, and perhaps even the greatest, difference. And that is in terms of adjusting the risk profile of projects. Islamic banks may be able to bear certain types of risks that commercial lenders are either unwilling or unable to assume, such as cross-border risks. A specific, and not entirely hypothetical, example of transit risk might involve natural gas or crude oil pipelines or grids crossing one or more Muslim countries. Another might involve terrestrial telecommunication systems, e.g. optical fiber trunk lines, including submarine cables. The key contribution in these, as well as in many other projects, becomes the allocation and mitigation of risk, one of the vital areas in project finance at large.[28] Obviously, this role too remains largely in the realm of potential. But this is where the greatest value could be added by Islamic project finance.

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[1] A good overview of the changes that have paved the way for the surge in project finance can be found in World Bank, *World Development Report, 1994: Infrastructure for Developing Countries* (New York: Oxford University Press for the World Bank, 1994). See esp. ch. 5.

[2] Ibid., p. 89.

[3] For surveys of recent trends, see International Finance Corporation, *Financing Private Infrastructure* (Washington, D.C.: World Bank, 1996).

[4] A stimulating account of this phenomenon in the realms of both ideas and policy is offered by Daniel Yergin and Joseph Stanislaw in *The Commanding Heights: The Battle Between Government and the Marketplace that is Remaking the Modern World* (New York: Simon and Schuster, 1998).

[5] Philippe Benoit, *Project Finance at the World Bank: An Overview of Policies and Instruments*, World Bank Technical Paper no. 312 (Washington, D.C.: World Bank, 1996), pp. 3-5.

[6] Some of these changes are noted in Gary Bond and Laurence Carter, *Financing Private Infrastructure Projects: Emerging Trends from IFC's Experience*, IFC Discussion Paper no. 23 (Washington, D.C.: World Bank, 1994), pp. 1-4.

[7] This is one of the major findings of recent surveys summarized in World Bank, *World Development Report, 1994*, pp. 89-96, and IFC, *Financing Private Infrastructure*, pp. 12-14.

[8] A review of the limited progress in these areas may be gleaned from Mohamed A. El-Erian and Susan Fennell, *The Economy of the Middle East and North Africa in 1997* (International Monetary Fund: Washington, D.C., 1997), and from World Bank, *Claiming the Future: Choosing Prosperity in the Middle East and North Africa* (Washington, D.C.: World Bank, 1995). See also Nemat Shafik, ed., *Economic Challenges Facing the Middle Eastern and North African Countries* (New York: St. Martin's Press, 1998) and Iliya Harik and Denis J. Sullivan, eds., *Privatization and Liberalization in the Middle East* (Bloomington, Ind.: Indiana University Press, 1992).

[9] "Private Finance of Infrastructure Projects in the Gulf," *The NCB Economist*, v. 6, no. 6 (Nov. /Dec. 1996), p. 9. The gap between professed commitments and tangible achievement is similarly noted by Roula Khalaf in "The Pressures for Change Mount," Survey on Middle East and North Africa Privatization, *Financial Times*, March 26, 1998. More generous assessments are offered by Martin Amison in "BOTs Will Power Middle East Project Growth," *International Financial Law Review*, v. 16, no. 2 (Feb. 1997), pp. 15-18, and by Jane Pittaway in "Privatization and the Growth of Financial Markets in the Gulf," *International Financial Law Review*, v. 14, no. 2 (Feb. 1995), pp. 23-5.

[10] For a discussion of the effects of declining petroleum revenues on the search for alternatives in financing infrastructure, see Gregory Millman, "The Decline of Petro Finance," in *Infrastructure Finance*, v. 4, no. 4 (Aug./Sept. 1995), pp. 71-5.

[11] World Bank, *Infrastructure Development in East Asia and Pacific: Towards a New Public-Private Partnership* (Washington, D.C.: World Bank, 1996).

[12] According to a senior World Bank official, the financing of infrastructure projects is the biggest economic challenge facing the Middle East and North Africa. Remarks by Inder Sud, Middle East and North Africa Regional Office, World Bank, at Conference on Infrastructure and Finance in the Middle East, Manama, Bahrain, Feb. 27, 1996. The lag in progress in infrastructure development in the region is underscored in Mark Hubard, "Investment Held Back by Neglect," *Financial Times*, March 26, 1998.

[13] "Asia Crisis Hits Dream Sector," *Financial Times*, Aug. 10, 1998; "In Search of an Alternative Source of Funds," *Financial Times*, Sept. 23, 1997; Ashoka Mody and Michael Walton, "Building on East Asia's Infrastructure Foundations," *Finance and Development*, v. 35, no. 2 (June 1998), pp. 22-5.

[14] World Bank, *World Development Report, 1994*, p. 2.

[15] For an elaboration of this point, see "Tracking a Moving Target," *Infrastructure Finance*, v. 6, no. 2 (March 1997), pp. 47-8, and Scott L. Hoffman, *The Law and Business of International Project Finance* (The Hague: Kluwer Law International, 1998), p. 6. In addition to Hoffman, pp. 6-8, authoritative explications of the concept are offered in Clifford Chance, *Project Finance* (London: Clifford Chance Publishers, 1991), pp. 1-2; Peter K. Nevitt and Frank Fabozzi, *Project Financing*, 6th ed. (London: Euromoney Publications, 1995), pp. 3-4; John D. Finnerty, *Project Financing: Asset-Based Financial Engineering* (New York: John Wiley, 1996), pp. 2-4; and Benoit, *Project Finance at the World Bank*, pp. 7-8.

[16] Most projects in fact rely on limited recourse financing, especially in the construction and startup phases. Moreover, while many governments have withdrawn guarantees for private infrastructure projects, other agencies, e.g. multilateral institutions, export credit agencies, and private insurers, have stepped in to provide additional comfort to lenders and investors. For examples, see Deepak Gopinath, "Ready or Not," *Infrastructure Finance*, v. 6, no. 4 (May 1997), pp. 62-4, and "Exposure Only to Partial Risk, *Financial Times*, Sept. 16, 1996.

[17] The affinities between project finance and Islamic finance are noted by Mansoor H. Khan in "Designing an Islamic Model for Project Finance," *International Financial Law Review*, v. 16, no. 6 (June 1997), pp. 13-16.

[18] It is striking to note that at least one of these organizations, the IFC, has even crafted instruments for the Islamic market. See Iyad Malas (Manager, Regional Capital Markets, Central Asia, Middle East and North Africa, IFC), "The Role of the International Finance Corporation in Developing Islamic Leasing," Nov. 27, 1996. What exists in the marketplace today hardly exhausts the possibilities of blending conventional and Islamic techniques in project finance. An exploration of other permutations is offered by Muhammed-Shahid Ebrahim in "Integrating Islamic and Conventional Project Finance" in this volume.

[19] An elaboration of this theme is presented in D. Babai, "Islamic Finance in Malaysia: Model or Exception?", manuscript.

[20] An extended discussion is offered in Michael Gerrard, *Financing Pakistan's Hub Power Project: A Review of Experience for Future Projects*, RMC Discussion Paper Series 118 (Washington, D.C.: World Bank, 1997).

[21] While a detailed substantiation of this point is beyond the confines of this paper, evidence may be gleaned from the sources cited in fn. 8. See also Joe Saba, "Foreign Direct Investment in the Middle East: A Comparative Assessment of Investment Regimes," Private Sector Development Dept. Paper, World Bank, 1995, and Henry T. Azzam, "Capital Markets in the Arab World" (National U.S.-Arab Chamber of Commerce, April 1995).

[22] Cogent discussions of these prerequisites can be found in Hoffman, *The Law and Business of International Project Finance* and in World Bank, *World Development Report, 1994*.

[23] While the Islamic Development Bank has stated a commitment to longer term and private sector financing, as one observer notes, "the impact of this policy has yet to filter through, especially in infrastructure finance." "Restructuring Islamic Funds" (editorial), *Islamic Banker*, no. 12 (Dec. 1996/Jan 1997), p. 2.

[24] Interviews conducted by author 1994-98 as part of research for Harvard Islamic Investment Project.

[25] Ibid.

[26] The author is greatly indebted to Wael Al-Mazeedi for insights about many of the points that follow.

[27] As Al-Mazeedi (ibid.) notes in private communication, the latter is a "big if, considering the propensity of Islamic finance as currently practiced to *add* to the overall costs of financing." Leasing structures constitute perhaps the sole area where the industry can plausibly claim to have lowered overall financing costs.

[28] For recent discussions, see Arturo Olvera Vega, "Risk Allocation in Infrastructure Financing," *Journal of Project Finance,* v. 3, no. 2 (Summer 1997), pp. 38-42; and Timothy Irwin et. al., eds., *Dealing with Public Risk in Private Infrastructure* (Washington, D.C.: World Bank, 1997).

Islamic Finance and Investment

A New Era

Adnan A. Al Bahar*

ABSTRACT

Islamic banking is important because it provides a financial intermediation system that allows the global community to access the savings of Muslims worldwide and vice versa. The market for Islamic finance is currently estimated at US$100 to $150 billion, which represents approximately 20% to 30% of Muslims' savings and capital. The Islamic finance market is defined as the global pool of money that needs to be invested in a manner consistent with the *Shari'ah*. This "niche" global industry has the potential to grow to handle 50% to 60% of Muslims' savings worldwide within a period of ten years. Furthermore, Islamic finance is important to the global economy because it can complement the traditional system and overcome the conventional system's inability to integrate the Islamic markets and its participants into the global economy.

I. INTRODUCTION

The Islamic finance and investment industry can be a valuable ingredient in the development of more efficient and capable capital markets in the Muslim world and can hence contribute toward creating a more efficient world economy. Islamic banking can provide a financial intermediation system that allows the global community access the savings of Muslims worldwide and vice versa.

The lessons from the Islamic financial industry are two-fold. First, it offers us a model of how different segments of the global community can integrate efficiently even when cultures and value systems differ. Second, it also gives us a clear example of how to customize services for cultural and religious value systems.

If Islamic finance is useful to the global community, it is critically important to the Muslim world because it is a very important mobilizer of local and regional savings and an important provider of capital. While Islamic finance is small from a global prospective, it is very big in the Islamic world, especially in regions such as the Gulf, with market share ranging form 15% to 40% in different markets. It is also an important bridge to the global capital markets for many of those economies. Finally, it is a very important quickly growing regional industry that is sufficiently differentiated to be able to survive and prosper without "protection," and an industry that makes the Gulf region its home base.

Defining and clarifying some important terms and concepts will help in understanding this industry better.

II. DEFINTIONS

A. The Islamic Market

This is a global pool of money that needs to be invested in a manner that is consistent with the *Shari'ah*. It has no single location, but it is geographically concentrated. The largest contributions to this market come from the Gulf region, though other regions such as Southeast Asia, the Near East, and Turkey are growing in importance. Looking ahead, one can reasonably anticipate that contributions to this market would also come from the 16 million or more Muslims in Europe and America.

B. The Islamic Bank

An Islamic bank, by its own choice, complies with two sets of laws: the law of the land (jurisdiction) and Islamic law. This is why Islamic bankers have two types of legal counsel: traditional lawyers and *Shari'ah* councils.

It is important to understand that a *Shari'ah* advisor is legal counsel and that the *Shari'ah* is a form of law. Furthermore, as is the case with any legal system, nobody has succeeded in writing down the book of law so that lawyers are no longer needed.

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Shari'ah advisors like lawyers come in different areas of specialization. As such, it is not good enough to get the legal opinion of a respectable lawyer; he must also be a specialist in the relevant area of financial or commercial law.

C. Innovation in Islamic Banking

Innovation, like in other industries, is not the result of legal noncompliance but the result of creativity and strong legal compliance.

III. Development of the Market

This market has grown from nothing to a US$100 to $150 billion market over the last in 18 years. It is currently growing at around 10% a year. Within 8 to 10 years, this market will handle at least 50% to 60% of the total savings of Muslims worldwide.

This market is growing not only due to the growing awareness of Islam but also due to the fact that Muslims in the last 15 to 20 years have built significant wealth. Wealth in the hands of Muslims creates the need for Islamic banking services primarily because usury is a very serious sin in Islam.

The fact that Islamic banking is not the biggest (in terms of market share) in the most Islamically conservative markets supports this assessment. Rather it is prominent in those markets that have developed a significant middle income group and where economic development has made the need for banking services a must for convenient daily living. Compare Kuwait to Saudi Arabia—Kuwait has a market share penetration of Islamic banking of 30% compared to only around 10% to 15% in Saudi Arabia.

It follows that as national economies in the Muslim world develop, so too will demand for Islamic financial services grow. Another important factor supporting this growth in market share is that the industry is getting much more efficient and sophisticated, and transaction volumes have been steadily increasing.

The cost and quality of Islamic financial services is improving fast and closing the gap with the conventional market. This means that more and more Muslims are finding their needs satisfied and more and more are recognizing the value added and are hence willing to "buy" into Islamic banking. One can envision what the Islamic banking industry will look like when it can deliver quality and price at levels comparable to the conventional markets. That is to say, deliver the special design at no extra cost. At that time, which is not too far away, the Islamic market will be responsible for managing no less than 60% of the savings of Muslims worldwide.

IV. The Home Base of the Islamic Banking Industry

The home base of this industry today is the Arabian Gulf region. That is where the major customers reside and where most international operators have based their own in-house Islamic banking units. The Islamic banking cluster in the Arabian Gulf is partly due to the sophisticated demand for these services and the wealth and status of those demanding these services. Bahrain seems to be the industry's most favored offshore center, with the key players coming mainly from Saudi Arabia and Kuwait. Saudi Arabia has the largest overall market, followed by Kuwait, which seems to be the most advanced in terms of market share penetration and sophistication.

V. Conclusion

Islamic banking was first allowed to exist because of political necessity and subsequently developed to the point where it was an "interesting experiment." Now it has reached a stage where regulators and policy makers see it as an important local and regional industry and a niche global industry that deserves to be nurtured and promoted. Islamic banking has already made valuable contributions to the development of many Muslim countries and remains important for their future growth.

Islamic banking is important to the Muslim world because it is the intermediary of choice for anywhere between 20% to 30% of savings and capital, a figure that might possibly approach 50% to 60% in 8 to 10 years. It has also developed into an important regional and niche global industry. Already, Islamic banks are some of the largest private sector financial institutions in the Islamic world, with growing regional networks.

Furthermore, Islamic finance is important to the global economy because it can complement the traditional system and overcome the conventional system's inability to integrate the Islamic markets and its participants into the global economy. Islamic banking is a better and more efficient way to link the Islamic world to the global market. For, if conventional banking is disagreeable to Muslims, Islamic banking, although different and abstruse to some, is not disagreeable to the rest of humanity. This fact alone indicates that it can become a key link between the Muslim world and the rest of world.

Value systems are an important source of energy and if used positively they are valuable assets that make for a better world. Realizing this allows us to approach social and economic development with an appreciation for the importance of culture and values. This will help us produce better results with fewer resources, and let concerned societies develop unique competencies and comparative advantages. This is an approach of a world that flourishes on variety and seeks to drive us to achieve our best, a world that makes use of differences to fashion a better and more interesting global community.

Integrating Islamic and Conventional Project Finance

Muhammed-Shahid Ebrahim*

ABSTRACT

The first objective of this paper is to translate the basic modes of Islamic financing in the context of conventional security design principles and to illustrate how these can be structured as a package to finance a complex project. The modes should be consistent with Islamic law as well as be economically efficient. The modes examined include debt (*murabaha* and *ijara*), hybrid (*mudaraba*), and equity (*musharaka*) instruments. The second part of the paper emphasizes the traditional *mudaraba* security. It can be adapted to cater to the financial objective and the risk profile of the clientele. This fact is important in the design of Islamic debt facilities and Islamic long-term growth instruments.

I. INTRODUCTION[1]

First, this article elucidates the traditional modes of Islamic project financing in the context of modern financial engineering. The modes of financing selected should not only avoid *riba*, *gharar*, and *maysir* but also be economically efficient.[2] The vehicles elaborated include debt, hybrid and equity instruments. The first category entails the careful structure of *murabaha* (markup) and *ijara* (leasing) facilities; the second incorporates the classical *mudaraba* (profit sharing) contract, while the third category comprises the *musharaka* (equity) vehicle.

II. ELUCIDATION OF THE BASIC MODES OF ISLAMIC FINANCING

A. Islamic Debt Facilities

Since exchanging money for more money (or monetary equivalents) over an extended period of time is interpreted as *ribawi* and hence forbidden in Islam, debt instruments have to be carefully structured so that the exchange involves goods for money or partnership shares for money over time. The intention is to facilitate trade or business and not to get around the religious injunction. It might be noted that conventional finance literature attributes *ribawi* loan transactions to the presence of (i) asymmetric information between insiders (managers) of firms and outside investors (see Ross (1977) and Myers and Majluf (1984)); (ii) conflict of interest (agency effect) between managers and shareholders of firms (see Jensen and Meckling (1976)).[3] If corporate insiders were required to reveal vital information such as profitability and their stake in the firm on an ongoing basis and if managers were given performance incentives such as stock options, conventional debt instruments would lose much of their financial rationale in capital markets.

Debt instruments in Islam comprise the following: (i) the deferred contracts of *bai' murabaha* (cost plus)/*bai' mua'jjal* (deferred installment sale) and (ii) *ijara* (leasing)/*ijara wa l-iqtina'* (lease-purchase).

In *bai' murabaha* (cost plus), an Islamic bank facilitates purchase of equipment/ goods for an economic agent and charges a fee for its services. The title of the goods is passed to the client subject to a lien on it. This is removed on final payment to the Islamic bank. This contract is a very contentious issue with some denominations in Islam, which have classified it as borderline *ribawi* (see Cizakca (1996)). However, other notable scholars in Islam such as Ibn Al-Arabi, Al-Qurtabi, and Al-Jassas have allowed it based on their commentaries of the Qur'an (see Ismail (1992)). Khoja (1995) also provides the *daleel* (religious endorsement) for the legality of this vehicle. The two conflicting views on the legality of *murabaha* are reconciled by Rahman (1969), who cites instances in the life of Prophet Muhammad (PBUH) and his exemplary companions where credit sales were practiced. However, later scholars, afraid that it would serve as a loophole to get around the restriction of *riba*, did not sanction the custom.

Al-Omar and Abdel-Haq (1996) provide the rationale for the additional compensation to the Islamic banks based on (i) providing a needed service in locating/ buying goods from a vendor for a cash strapped agent in the economy, (ii) cost incurred by the banks in servicing their clientele and (iii) exposing the bank to risk of the transaction explained as follows: The buyer (client) may refuse to take delivery of the goods thereby leaving the financing entity (bank) stuck with unnecessary goods. The financial intermediary may also encounter other

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expenses such as storage costs and hence be exposed to damage in storage and /or transit. Furthermore, the client could default and the financial intermediary would have to expend resources to recoup its capital. The markup in the *murabaha* facility is thus designed to compensate the financial intermediary for the above three reasons.

Bai' bi-thaman ajil (BBA)/*bai' mua'jjal* (deferred installment sale) is similar to *bai' murabaha*. The main distinction here is that it is the seller or an Islamic bank that allows the deferment in payment by installment to facilitate the asset purchase. He again charges a higher fee in lieu of the service provided, expenses incurred, and exposure to risk.

From the perspective of modern finance, a *murabaha* facility is equivalent to an asset-backed risky loan. If the capital markets are perfect and all agents in the economy have equal access to information, then competition between Islamic banks and conventional (*ribawi*) banks would result in *murabaha* having the same expected return as that of *ribawi* loans. Thus, due to integration of global capital markets, Islamic banks are constrained to price their loans on an ex-ante basis as a function of the prevailing interest rates, as lamented by Thomas R. (1995) and Siddiqi (1995). However, their realized return would not be like that of conventional *ribawi* banks which can go after the other assets of the borrower and impose *ribawi* penalty for delayed payment. Islamic banks are exposed to cash-flow risks that can easily erode the capital base of the depositors of Islamic banks.[4] A way around the above dilemma as suggested by Siddiqi (1995) is to price loans based on a profit margin that does not covary with the *ribawi* market rate. This author agrees with Siddiqi (1995) and adds that if Islamic banks aim for a higher productivity (through optimal use of resources such as technology), they can easily underprice *ribawi* banks and become market leaders, determining the benchmark for the allocation of funds.

When an *ijara* (operating lease) is employed, the Islamic financial intermediary again facilitates the use of equipment or a productive asset by a client. The Islamic bank buys the asset and rents it to the client. The client is thus able to pay for the services of the asset from its operating income and is able to avoid an excessive initial capital outlay. The client is the lessee and the Islamic bank is the lessor. The lessor retains title of the asset till the end of the term. The lessee continues to benefit from the asset (by making regular lease payments) till the asset fails to perform the services it was originally intended to do. The lease contract remains in force even if the asset is damaged. The asset can be sold to the lessee at the end of the lease term. However, the price of it cannot be pre-determined at the beginning of the lease term.

In lease-purchase (financial lease) agreements (*ijara wa l-iqtina'*) the lessor designs the lease payment to contain a portion of the price of the asset.[5] The title of the asset can be transferred at the end of the lease as a gift (see Khoja (1995), Al-Omar and Abdel-Haq (1996)).

Leasing provides benefits such as "tax savings, flexibility of lease contracts, savings in financial transaction, information costs, valuable options in lease contracts and risk-sharing opportunities with leasing (see Schallheim (1994))." Financial economists conceptualize leasing as a financial contract akin to that of an asset-backed risky loan. This is because leases require the lessee to make a set of fixed payments similar to a loan contract. In the worst case of default, the lessor can file a lawsuit against the lessee to repossess the asset and impose penalties for any possible deficiencies. In fact there is a plethora of articles in the leasing literature that discusses the extent to which leases supplement or substitute for the debt capacity of a firm (see Schallheim 1994). This article modifies the basic model for pricing a lease from the well-known Myers, Dill, and Bautista (MDB, 1976) study. It describes the mathematical relationship between expected after-tax return on a lease and equivalent loan amount in terms of sum of after-tax lease payments, depreciation tax shelter, and expected salvage value, offset by after-tax operating cost savings such as maintenance, insurance etc. provided by the lessor.

Although leasing firms price the asset rental payments on an ex-ante basis based on a *ribawi* benchmark such as London Interbank Offered Rate (LIBOR) (see Thomas R. (1995) and Siddiqi (1995)), they may not realize their expected return as the lessee may not pay on time and the lessor may not realize the anticipated salvage value - a wild card in the estimation process. Lease, McConnell and Schallheim (1990) offer an excellent study of the divergence between realized rates of return and contractual (ex-ante) yields based on prevailing interest rates. Islamic banks are in fact exposed to cash flow risks analogous to those faced in their deferred installment sales.

In the context of conventional project finance both *murabaha* and *ijara* can be illustrated by Figure 1. The cost of goods financed or asset leased is Q. The bank breaks even at s_1. However, the incremental payoffs in terms of a profit is only realized after a critical level s^*_c, below which the Islamic bank receives a negative discounted return. The transaction is not *ribawi* as the incremental payoffs to the Islamic bank is not fixed but is random and dependent on several factors including the success of the project.

B. Islamic Hybrid Facility of *Mudaraba*

Muslims are extremely nostalgic about *mudaraba* financing, as the Prophet Muhammad (PBUH) himself resorted to this facility as a trader. His eminent companions and his family members also selected this for investing surplus funds of orphans (see Kahf and Khan (1992) and Siddiqi (1985)). The Prophet (PBUH) endorsed this security with the following statement narrated by his companion Sahib and recorded in Ibn Majah:

> "There are three things that have the blessings of *Allah* (the Glorious): deferred payment sale, *al-Muqaradah* (*al-mudaraba*), and mixing of barley with wheat for home consumption (not for sale)." (Ibn Majah: *Tijarah* Chapter: 63)

The *mudaraba* security combines the features of both equity and Islamically allowed debt contracts. Here the investor (*rabb al-mal*) has a junior position with respect to debt investors discussed above. However, it has a preferred position over that of an equity investor (*musharik*). Figure 2 below illustrates this feature showing that under the state s_1, the *rabb al-mal* (financier) is not able to re-coup his capital and suffers a loss. Between the states s_1 and s^*_c, he breaks even. However, beyond the critical state s^*_c the *rabb al-mal* shares in 'θ' fraction of the profit. In most of the Islamic banking and economics literature this is termed a profit-sharing principle (PSP). The modern finance equivalent to this instrument is a participating preferred stock with no contractually promised interest. Inclusion of participation clauses in a financial contract mitigates the stockholder-bondholder conflict, enhances the value of a project and serves to control the under-investment problem (see Haugen and Senbet (1981, 1987), Green (1984) and Schnabel (1993)).

Proposition: A *mudaraba* facility can be synthesized as a combination of a *murabaha* (cost-plus) facility and fractional (θ) shares of *al-ikhtiyarat* (European call option) such that the profit from the *murabaha* in the good states of the economy offsets the call price.[6]

The above proposition determines the pricing relationship of a *mudaraba* and is a major contribution in this article. It has some crucial ramifications. It defines the profit sharing ratio (θ) as a simple ratio, which dynamically varies with the expected return from an equivalent *murabaha* facility as well as with the option premium. This result is contrary to some researchers of Islamic economics who have assumed this ratio to be invariant to specificity of the project and across time.

C. Equity Security: *Musharaka*

Musharaka, derived from the Arabic term *shirkah*, implies partnership in a venture. The classical Islamic business literature lists many forms of business enterprises (see Chapra (1986) and Siddiqi (1985)). The one implied by this study is *shirkah al-'inan*, i.e., partnership with unequal contribution of capital and with different profit- and loss-sharing ratios. The conventional financial instrument that is closest to the above Islamic concept is equity as it connotes ownership (control) of an enterprise. This offers the highest potential reward at the expense of highest possible risk. This is because an equity owner is a residual claimant in any venture. He hopes to gain the most under favorable economic conditions but loses the most under unfavorable conditions. This is the reason why this contract is referred to as the profit- and loss-sharing (PLS) contract. Figure 4 illustrates this fact by showing that equity owner suffers a loss below the future critical state s^*_c, breaks even at s^*_c and profits from the venture if the future state is better than s^*_c. In a situation where both *mudaraba* as well as *musharaka* fund the project, the *musharik* retains only (1-θ)% of the profits.

The mathematical pricing of the *musharaka* facility is described in this article by resorting to the Zero-Beta version of the capital-asset pricing model (see Black (1972) and Lintner (1969)).

III. The Two-Dimensional Malleability of the *Mudaraba* Facility

Mudaraba is a very versatile instrument in two separate dimensions described below in combination with the *musharaka* vehicle.

A. Adapting the *Mudaraba* Instrument to Cater to the Financial Objective of the Clientele

The classical *mudaraba* facility can be explained as a growth instrument where a trader would reinvest the proceeds of all trade until the termination of the contract where the principal amount would be returned to the *rabb al-mal* and the excess (profits) would be shared according to the agreed ex-ante profit sharing ratio. In case of a loss, the balance or residual would accrue to the *rabb al-mal*. In the context of modern finance, this device can imply sharing or allocating a fraction of income and/or the appreciation of a project (business venture). Instead of terminating a *mudaraba* contract at an inopportune moment, it is preferable to sell it in the secondary market. The profit sharing parameters of income and appreciation can be reset by a custodian bank (in consultation with the management of the company which represents the *musharik*, i.e., equity investor) according to the changes in (i) economic conditions, (ii) risk of the project (business ventures) and (iii) clienteles of this vehicle. Thus in modern times, one can financially engineer a *mudaraba* instrument to suit the financial goals of the investor in several forms as described below:

1. Income *Mudaraba*

Here the investor shares in the income or revenue of the project only and is paid back the principal (preferably in real terms) at the termination of the contract. This is similar to the income/ revenue bond described in the previous subsection.

2. Growth and Income *Mudaraba*

Here the investor shares in a fraction of NOI as well as the appreciation of the project (venture). Both the fractional parameters of income and appreciation need not be equal. In terms of conventional finance, this can be interpreted as a participating bond.

3. Growth *Mudaraba*

This is similar to the classical *mudaraba* where it is assumed that the project (business venture) has an optimal policy of paying no dividends. All the earnings are retained in the business and distributed at the termination of the business. This is rather cumbersome and restrictive in contemporary times as incorporated businesses or ventures are assumed to have an infinite life.

B. Adapting the *Mudaraba* facility to Cater to the Risk Profile of the Clientele

This is perhaps one of the most contentious issues confronting the Islamic financial engineer. It can be addressed as follows: Is it Islamically feasible for the *rabb al-mal* (of the *mudaraba*) to transfer part of the risk of the venture to the *musharik* in exchange for a lower profit sharing ratio and vice versa? This can be accomplished by partially combining the *mudaraba* discussed above with a protective put option such that the premium of the put is offset by the call premium in the *mudaraba* resulting in a lower profit sharing ratio. When the buyer of the protective put is the *rabb al-mal* (and the seller obviously is the *musharik*), the situation resembles Figure 5. Here the *musharik* guarantees to bear the risk of part (λ) of the funds of the *rabb al-mal* in return for a higher participating ratio ($1 - \theta + \phi$). Thus, for future states of the economy below s_1, the *rabb al-mal's* payoff schedule shrinks inwards parallel to the original schedule and for states above s^*_c, it rotates clockwise. For the *musharik*, the risk now increases by the amount guaranteed (λ) for states below s_1 and for states above s^*_c, the payoffs (in terms of the profit sharing ratio) increase by ϕ. In the limit as λ approaches Q (nominal risk becomes zero for the *rabb al-mal*), ϕ approaches the limit ϕ^* s.t. θ^* tends to $(\theta - \phi^*)$ and the *mudaraba* instrument tends to become a fully hedged vehicle. It should be noted that even though risk is reduced in nominal terms, there is still residual risk due to inflation. Finally, the opposite scenario can also be configured when the *musharik* transfers part of the risk of equity to the *rabb al-mal* in return for a lower profit sharing ratio. The payoff schedule of the *rabb al-mal* below s_1 would expand outwards and above s^*_c rotate anti clockwise. The crucial debatable *fiqhi* (Islamic jurisprudential) issue is as follows. To what extent is this risk-return tradeoff allowed in Islam? Note that the reduction in risk is arrived at by creating a portfolio of a *mudaraba* facility and a *takaful* (insurance) policy in the form of a put option, both of which are permissible in Islam (see Kahf and Khan (1992) and Kamali (1997)). This is an *ijtihadi* issue left for the *'ulama'* of the *fiqh* academies to resolve.

IV. CONCLUSION

This study interpreted and modeled Islamic project finance instruments in the language of a conventional banker. A *mudaraba* is envisioned as a combination of a *murabaha* facility and a call option. This leads to an endogenous estimation of the profit-sharing parameter. The *mudaraba* is pliable along two separate dimensions: the financial objective and risk tolerance of the investor. This is of prime importance in the design of Islamic debt facilities, ranging from commercial paper to bonds, because due to the current lack of theoretical development, some Muslim practitioners construe Islamic debt instruments as a portfolio of *murabaha* instruments packaged and sold to investors in the secondary market. The majority of the *'ulama'* spurn this practice inasmuch as it violates the Islamic injunction of *bai' al-dayn*[7]: it involves sale of a debt (*murabaha*) facility at a discount, which is interpreted as entailing *riba al- nasi'ah*. The design of a *mudaraba* facility as an income bond, discussed in this study, avoids the issue of *bai' al-dayn*. It is also important to Islamic long-term growth instruments for venture capital financing.

Finally, this study illustrates that if dual-purpose vehicles of *mudaraba* and *musharaka* finance a project, one can provide some cushion to highly risk-averse *mudaraba* investors in lieu of a guarantee, which is not permissible in Islam.

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[2] *Riba* is interpreted by Ibn Qayyim (n.d.) to imply (i) any form of unfair trade, market manipulation or engaging a market participant to trade under duress (*riba al-fadl*) and (ii) interest based debt contracts (*riba al-nasi'ah*). In the context of modern financial economics, *riba al-nasi'ah* can be defined as a real risk-free return from an investment vehicle or strategy. The element of *gharar* in a contract entails deception (see Ibn Taymiyyah (n.d.) and Thomas A. S. (1995)). Promoting it preempts *maysir*, which is gambling (*qimar*).

[3] In the first instance debt serves as a signal to convey the future prospects of a firm and in the second case debt pre-commits the cash flow of a firm and reduces the chances managers will squander it in frivolous activities.

[4] This is a major difference between Islamic banks and conventional banks. There can be no guarantee of profit or even of depositors' capital. Conventional (*ribawi*) banks on the other hand, guarantee depositors capital and promise a fixed return. Any negative deviation from promised liability is absorbed by the conventional bank's capital (equity).

[5] In the basic *Ijara* (operating lease) agreement, the lease payment typically incorporates the depreciation of asset over the term of the lease.

[6] Kamali (1997) extensively discusses the controversy surrounding *Al-Ikhtiyarat* (Options) based on the Islamic perspective. He is of the view that options do not involve *gharar* and can be traded for a premium (price).

[7] I am in debt to Mr. Taha bin Hasan Abdul-Basser for enlightening me on this issue.

Islamic Banking

Issues in Prudential Regulations and Supervision

Luca Errico and Mitra Farahbaksh*

Abstract

This paper analyzes the implications of Islamic precepts on banks' structure and activities, focusing on banking supervision issues, which have received little attention. These issues are pointed out and discussed in the contexts of a paradigm version of Islamic banking and frameworks that fall between the paradigm version and conventional banking. Effective supervision of banks is just as necessary and desirable in Islamic banking as it is in conventional banking. Although several standards and best practices of the Basle Committee on Banking Supervision provide useful guidance, they are not always applicable to Islamic banking. Regulations governing Islamic banks must place greater emphasis on the management of operational risks and information disclosure issues than is normally the case in conventional banking. To help develop such a regulatory framework, a CAMEL rating system adapted to an Islamic environment is discussed, along with issues such as legal foundations, information disclosure requirements, and licensing procedures. The case of Islamic banks operating in a conventional system is also examined.

I. Summary[1]

Islamic precepts influence the structure and activities of banks in several ways, the most important being the prohibition against the payment and receipt of a fixed or predetermined rate of interest. This is replaced by profit- and loss-sharing arrangements whereby the rate of return to financial assets held with banks is not known and not fixed prior to the undertaking of each transaction. Islamic banks thus differ from conventional banks, but the issue of what prudential standards should apply to Islamic banks has received little attention.

This paper argues that effective prudential supervision on banks is just as necessary and desirable in Islamic banking as it is in conventional banking. To help reach this goal, a number of standards and best practices established by the Basle Committee on Banking Supervision are useful and provide a valuable reference. These standards, however, are not always applicable to Islamic banking. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure issues than is normally the case in conventional banking. To help develop such a regulatory framework, a CAMEL rating system adapted to an Islamic environment is discussed, along with issues such as legal foundations, information disclosure requirements, and licensing procedures.

Islamic banking in actual practice diverges markedly from its paradigm version and is carried out in a variety of ways that lie somewhere in between the benchmark case and conventional banking. The degree of divergence from the benchmark differs from country to country. The focus of banking supervision should shift accordingly, and each argument discussed in the benchmark case needs to be reevaluated and given the appropriate emphasis in light of the circumstances and specific Islamic banking practices prevailing in a country.

Islamic banking is expanding outside the traditional borders of Muslim economies into western countries where conventional banking is followed, notably the United Kingdom. This situation is unprecedented. Specific areas in the operation of Islamic banks are likely to be viewed by supervisory authorities in conventional systems as well as potential counterparties as difficult to understand. To mitigate these concerns, effective prudential supervision of Islamic banks in their home countries should be viewed as a key factor in the process of establishing a fuller international integration of Islamic banking.

II. Introduction

At the heart of every robust economy is a sound banking system. In its endeavors to help strengthen the economies of its member countries, the Fund is increasing its emphasis on stronger financial system surveillance

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through improved supervisory efforts. Experience has shown that given the close interrelation between banking system soundness and macroeconomic policy implementation and performance, a key element of financial system surveillance is effective prudential supervision of the banking system.[2]

Forty-eight developing and emerging market countries, representing almost one-third of all Fund-member countries, are increasingly involved, with varying intensity, in Islamic banking.[3] In the Islamic Republic of Iran, Pakistan, and Sudan all banks and financial institutions have adopted Islamic banking principles since the early 1980s; other countries, such as Malaysia, Indonesia, Bangladesh, Jordan, and Egypt operate Islamic banking alongside conventional banking.[4] By some estimates, Islamic banking has been growing at an annual rate of 15% over the past five years; the market's current size is estimated at US$70 billion, and is projected at about US$100 billion by the year 2000.[5] Moreover, Islamic banking is increasingly expanding outside the traditional borders of Muslim countries into western economies, notably the United Kingdom.

Islamic banking differs from conventional banking in several important ways. These include the prohibition of transactions based on a fixed or predetermined rate of interest, and the requirement that banks' operations be carried out according to certain procedures through the use of certain financial instruments. However, broadly speaking, in the majority of countries where Islamic banks operate the same regulatory framework applies to both conventional and Islamic banks. This regulatory framework tends to follow standards and guidelines established by the Basle Committee on Banking Supervision.[6] However, these standards are not always applicable in an Islamic banking framework in the same way as they are in other banking systems. Therefore, a fuller understanding of how Islamic banks operate is key to developing an appropriate and effective regulatory system. Until now the issue of what standards used for conventional banks should apply to Islamic banks has received little attention, even in countries where all banks follow Islamic principles. This paper focuses on those aspects of Islamic banking that need to be recognized and addressed to help make the conduct of banking supervision more effective in an Islamic framework. Greater stress on these issues is likely to strengthen financial system surveillance in countries where Islamic banking principles are followed.

The lack of uniformity in specific forms of Islamic principles applied in Muslim countries makes it difficult to generalize as to what might be considered Islamic banking in practice. In other words, similar banking procedures and financial instruments may be accepted in one Muslim country and be rejected in another one. Another constraint in the search for a common set of banking practices in Muslim countries is the different degree of public sector involvement in the economy in general and in the financial and banking sectors in particular. The spectrum is rather wide, ranging from full public-sector control of banks in Iran, to more liberal environments, such as Malaysia.

Given that there are many variants of Islamic banking practices, it may be useful to reach an understanding of a paradigm version of Islamic banking and use it as a benchmark against which to measure current practices. By so doing, effective supervisory norms can be developed to address special issues that characterize banks operating according to a paradigm version of Islamic banking. This may prove to be the best course of action because it is always difficult to envisage general prescriptions that are valid for all countries at all points in time.

The paper is organized as follows. Section III provides a basic understanding of the fundamental features of Islamic banking with a view to defining a paradigm version of Islamic banking and characteristics of banks operating according to it. Based on this understanding, Section IV discusses how the regulatory framework should be designed to address in an effective manner special issues that characterize banks operating according to a paradigm version of Islamic banking. Section V discusses how the focus of banking supervision should shift when Islamic banking practices diverge from the paradigm version; it also examines the case of Islamic banks operating in a conventional system. Section VI provides concluding remarks.

III. Review of the Fundamental Features of Islamic Banking

To understand Islamic banking is to realize that its banks and their operations are considered to be an integral part of a complete Islamic economic system, which is based upon the codification of injunctions outlined in the Qur'an and the traditions of the Prophet Muhammad, that is the Islamic *Shari'ah*. Key elements of the Islamic economic system include individual rights, property rights, contracts, work and wealth, and the role of the State.[7] While preserving their key tenets, the rules established in the *Shari'ah* have been elaborated upon and refined over time by Islamic scholars and economists in order to adapt them to the evolving economic environment. Hence, this section reviews the fundamental features of Islamic banking as they are presented in the literature with a view to defining a paradigm version of Islamic banking and characteristics of banks operating according to it.[8] The following features characterize these Islamic banks:

A. Prohibition against the Payment and Receipt of a Fixed or Predetermined Rate of Interest

This is replaced by profit- and loss-sharing (PLS) arrangements where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of return can be determined only ex-post, on the basis of actual profits accrued from real sector activities that are made possible through the productive use of financial assets.

B. Requirement to Operate through Islamic Modes of Financing

These modes affect both the assets and liabilities sides of a bank's balance sheet and can be divided into two groups: the ones that are based on the PLS principle (core modes) and the ones that are not (marginal modes). Table 1 provides a summary description of the main features of both groups.

C. Investment Deposits

Such deposits are not guaranteed in capital value and do not yield any fixed or guaranteed rate of return. In the event banks record losses as a result of bad investment decisions, depositors may lose part or all of their investment deposits. The only contractual agreement between depositors and banks is the proportion (ratio) according to which profits or losses are to be distributed.

D. Demand Deposits

Such deposits are guaranteed in capital value, although no returns are paid on them. The reason to justify the capital value guarantee is the assumption that demand deposits have been placed as *amanat* (i.e., for safekeeping). Hence, they belong at any time to depositors.

TABLE 1. ISLAMIC MODES OF FINANCING

TYPE	DESCRIPTION	COMMENTS
PLS Modes	**Profit- and loss-sharing modes**	**At the core of Islamic banking**
Mudaraba	**Trustee finance contract** The bank provides the entire capital needed for financing a project, while the entrepreneur offers his labor and expertise. The profits (or losses) from the project are shared between the bank and the entrepreneur at a certain fixed ratio. Financial losses are borne exclusively by the bank. The liability of the entrepreneur is limited only to his time and efforts. However, if the negligence or mismanagement of the entrepreneur can be proven he may be held responsible for the financial losses incurred. It is usually employed in investment projects with short gestation periods and in trade and commerce. It affects both assets and liabilities sides of banks' balance sheet. On the liabilities side, the contract between the bank and depositors is known as unrestricted *mudaraba* because depositors agree that their funds be used by the bank, at its discretion, to finance an open-ended list of profitable investment and expect to share with the bank the overall profits accruing to the bank's business. On the assets side, the contract between the bank and the agent-entrepreneur is known as	Three conditions need to be met: 1. The bank should not reduce credit risk by requesting a collateral to this purpose: it bears entirely and exclusively the financial risk. Collateral may be requested to help reduce moral hazard, e.g., to prevent the entrepreneur from running away. 2. The rate of profit has to be determined strictly as a percentage and not as a lump sum. 3. The entrepreneur has the absolute freedom to manage the business. The bank is entitled to receive from the entrepreneur the principal of the loan at the end of the period stipulated in the contract, if an only if a surplus exists. If the enterprise's books show a loss, this will not constitute default on the part of the entrepreneur, except for negligence or mismanagement.

	restricted *mudaraba* because the bank agrees to finance a specific project carried out by a specific agent-entrepreneur and to share the relative profits according to a certain percentage.	
Musharaka	**Equity participation contract** The bank is not the sole provider of funds to finance a project. Two or more partners contribute to the joint capital of an investment. Profits (and losses) are shared strictly in relation to the respective capital contributions. It is usually employed to finance long-term investment projects.	Banks can exercise the voting rights corresponding to their share of the firm's equity capital. Their representatives can sit on the firm's board of directors. All parties invest in varying proportions, and have the right to participate in the management of the enterprise.
Muzar'ah	Traditional counterpart of the *mudaraba* contract in farming. The harvest is shared between the bank and the entrepreneur. The bank may provide funds or land.	
Musaqat	Traditional counterpart of the *musharaka* contract in orchard keeping. The harvest is shared among the partners based on their respective contributions.	
Direct investment	The same concept as in conventional banking. The bank cannot invest in the production of goods and services that contradict the value pattern of Islam, such as gambling.	Banks can exercise the voting rights corresponding to their share of the firm's equity capital. Their representatives can sit on the firm's board of directors.

Non-PLS Modes	Non-profit- and loss-sharing modes	They are used in cases where PLS modes cannot be implemented, for example, in cases of small-scale borrowers or for consumption loans.
Qard Hasana	**Beneficence loans** These are zero-return loans that the Qur'an exhorts Muslims to make to "those who need them." Banks are allowed to charge the borrowers a service fee to cover the administrative expenses of handling the loan, provided that the fee is not related to the amount or maturity of the loan.	
Bai' Mua'jjal	**Deferred payment sales** The seller can sell a product on the basis of a deferred payment in installments or in a lump sum payment. The price of the product is agreed upon between the buyer and the seller at the time of the	Contrary to contracts based on the PLS principle, modes such as markup, leasing, and lease purchase have a predetermined and fixed rate of return and are associated with collateral.

	sale and cannot include any charge for deferring payments.	In fact, banks add a certain percentage to the purchase price and/or additional costs associated with these transactions as a profit margin, and the purchased assets serve as a guarantee. Additionally, banks may require the client to offer collateral. These instruments can be considered to be more closely associated with risk aversion and they do not substantially differ from those used in a conventional banking system, other than in their terminology and in some legal technicalities. They are considered to conform to Islamic principles because the rate of return is meant to be tied to each transaction, rather than to the time dimension. However, some Muslim scholars advocate a stricter utilization of such modes.
Bai' Salam* or *Bai' Salaf	**Purchase with deferred delivery** The buyer pays the seller the full, negotiated price of a product that the seller promises to deliver at a future date. This mode only applies to products whose quality and quantity can be fully specified at the time the contract is made. Usually, it applies to agricultural or manufactured products.	
Ijara* *Ijara wa l-Iqtina'	**Leasing** **Lease purchase** A party leases a particular product for a specific sum and a specific period of time. In the case of a lease-purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.	
Murabaha	**Markup** The seller informs the buyer of his cost of acquiring or producing a specified product; then profit margin (or markup) is negotiated between the buyer and the seller. The total cost is usually paid in installments.	
Jo'alah	**Service Charge** A party undertakes to pay another party a specified amount of money as a fee for rendering a specified service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements, and trust services.	

Source: Kazarian (1993); Iqbal and Mirakhor, 1987.

E. Consistency with One of the Following Two Systems of Operation[9]

1. Two-tier *Mudaraba* (also designated in this paper as Scheme A)

In this situation, the assets and liabilities sides of a bank's balance sheet are fully integrated. On the liabilities side, depositors enter into a *mudaraba* contract (a trustee finance contract, see Table 1) with the bank to share the overall profits accruing to the bank's business. Thus, depositors act as financiers by providing funds, and the bank acts as an entrepreneur by accepting them. On the assets side, the bank, in turn, enters into *mudaraba* contracts with agent-entrepreneurs who search for funds to invest and who agree to share profits with the bank according to a certain percentage stipulated in the contract. In addition to investment deposits, banks are allowed to accept demand deposits that yield no returns and may be subject to a service charge. These deposits are repayable on demand at par value. However, depositors are also aware that banks will be using demand deposits for financing risk-bearing projects. Under this arrangement, banks may grant short-term interest-free loans (*qard hasana,* see Table 1) to the extent of a part of total current deposits. Finally, it should be noted that, although the concept of reserve requirements is a recognized one in Islamic banking, the two-tier *mudaraba* scheme does not mandate specific reserve requirements on both types of deposits.[10]

2. Two Windows (also designed in this paper as Scheme B)

Under this arrangement, bank liabilities are divided into two windows: one for demand deposits and the other for investment deposits. The choice of the window is left to depositors. Demand deposits are assumed to be placed as *amanat* (safekeeping), thus they are considered to belong to depositors at all times. Hence, the bank cannot use them as the basis to create money through fractional reserves. Consequently, banks operating according to this arrangement must apply a 100% reserve requirement ratio on demand deposits. By contrast, investment deposits are used to finance risk-bearing investment projects with depositors' full awareness. Therefore, the bank does not guarantee these deposits and reserve requirement are not applied to them. The bank may charge a service fee for its safekeeping services. Interest-free loans may only be granted from funds specifically deposited for that purpose.

Table 2 summarizes the above characteristics and provides a synoptic comparison of Islamic and conventional banking frameworks.

TABLE 2. COMPARISON OF BANKING FRAMEWORKS

Characteristics	**Paradigm Version of Islamic Banking**	**Conventional Banking**
Nominal value guarantee of: Demand deposits Investment deposits	Yes No	Yes Yes
Equity-based system where capital is at risk	Yes	No
Rate of return on deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final returns on deposits	Depending on banks' performance/ profits from investment	Irrespective of banks' performance/ profits from investment
PLS principle is applied	Yes	No
Use of Islamic modes of financing: PLS and non-PLS modes	Yes	N/A

Use of discretion by banks with regard to collateral	Possible for reducing moral hazard in PLS modes[11] Yes in non-PLS modes	Yes always
Banks' pooling of depositors' funds to provide depositors professional investment management.	Yes	No

Several points are worth noting. First, neither the capital value of nor the return on investment deposits is guaranteed by Islamic banks, and these banks basically pool depositors' funds to provide depositors with professional investment management. This situation underscores an interesting similarity between the operation of Islamic banks and investment companies.[12] There is, however, a fundamental difference between the two that needs to be recognized. It lies in the fact that investment companies sell their capital to the public, while Islamic banks accept deposits from the public. This implies that shareholders of an investment company own a proportionate part of the company's equity capital and are entitled to a number of rights, including receiving a regular flow of information on developments of the company's business and exerting voting rights corresponding to their shares on important matters, such as changes in investment policy.[13] Hence, they are in a position to take informed investment decisions, monitor the company's performance, and influence strategic decisions. By contrast, depositors in an Islamic bank are entitled to share the bank's net profit (or loss) according to the PLS ratio stipulated in their contracts. Investment deposits cannot be withdrawn at any time, but only on maturity and, in the best case, at par value. Moreover, depositors have no voting rights because they do not own any portion of the bank's equity capital. Hence, they cannot influence the bank's investment policy (as noted, their relationship with the bank is regulated according to an *unrestricted mudaraba* contract, see Table 1).

Second, because of the structure of their balance sheets and the use of profit- and loss-sharing arrangements, banks operating according to a paradigm version of Islamic banking appear to be better poised than conventional banks to absorb external shocks.[14] Indeed, as noted previously, these Islamic banks have the ability to reduce the capital value of investment deposits in the case of a loss.

Third, Islamic banks are not expected to reduce credit risk by systematically requiring collateral or other guarantees as a prerequisite for granting PLS facilities.

Fourth, a critical difference between the two permissible systems of operation needs to be recognized. Islamic banks can use all of their deposits (demand and investment) for their financing and investment activities in Scheme A, while only investment deposits can be utilized for such purposes in Scheme B. This makes Scheme A, where banks' assets and liabilities are fully integrated far riskier than Scheme B, where banks' liabilities are divided into two windows. Indeed, in Scheme A—given the fact that (1) demand deposits are guaranteed in capital value and are redeemable by the depositors on demand; (2) demand deposits can be used to finance risk-bearing investment projects; and (3) there is not a mandated specific reserve requirement on demand and investment deposits—an asset-liability mismatch can occur, leading possibly to negative net worth, or bank insolvency.

IV. Banking Supervision in an Islamic Framework

Prudential supervision is just as necessary in an Islamic banking framework as in conventional banking to reduce risks to the soundness of the banking system and enhance banks' role as active players in the development of the economy.[15] This is so for a number of reasons. First, it is worth keeping in mind that, as argued in Section II, even in a paradigm version of Islamic banking, insolvency risks cannot be ruled out, notably in cases where banking operations are carried out according to a two-tier *mudaraba* arrangement (Scheme A), that is, when the assets and liabilities sides of a bank's balance sheet are fully integrated.

Second, risks of economic losses, or losses incurred as a result of poor investment decisions, are equally possible when banks carry out operations according to either Scheme A or B. Poor investment decisions may derive from a mix of factors, including a volatile operating environment, weak internal governance—notably mismanagement, and limited market discipline. Economic losses not only would be reflected in the depreciation of the value of depositors' wealth, but also in a decline in banks' profitability. If not corrected in due course, such an economic downturn could jeopardize banks' soundness. This, in turn, would progressively reduce banks' intermediation role and hamper the mobilization of private savings toward investment.

Third, weak banks may detract from the achievement of fundamental macroeconomic objectives, such as the efficiency of the payments system and the effectiveness of monetary policy, particularly if implemented through the use of indirect instruments. Unsound banks may also reduce public confidence in the financial system, thus impeding or delaying necessary structural reforms in this area.

Fourth, a weak banking system is likely to prevent the economy from benefiting from the ongoing globalization process and the liberalization of capital markets, particularly in developing and emerging market countries—such as the ones where Islamic banking principles are followed—where banks are the major (or the sole) players in domestic financial markets.

Therefore, as in conventional banking, an appropriate regulatory framework for an Islamic system should aim at reinforcing banks' operating environment, internal governance, and market discipline. To help develop such a regulatory framework, standards and best practices established by the Basle Committee on Banking Supervision are useful and provide a valuable reference.[16] However, these standards are not always applicable in an Islamic banking framework in the same way as in conventional banking systems.

Islamic banking implies special issues that need to be recognized and addressed to help make the conduct of banking supervision more effective. First, it is most important to recognize the impact of PLS modes of financing on Islamic banks. Specifically the fact that when Islamic banks provide funds through their PLS facilities, there is no recognizable default on the part of the agent-entrepreneur until PLS contracts expire, barring proved negligence or mismanagement on the part of the agent-entrepreneur. In fact, a "default" of PLS contracts means that the investment project failed to deliver what was expected, that is a lower or no profit, or a loss. In this case, the lower profit/loss is shared between or among parties according to the stipulated PLS ratios. For example, in the case of a *mudaraba* contract, the bank is entitled to receive from the entrepreneur the principal of a loan at the end of the period stipulated in the contract, if and only if, profits have accrued. If, on the contrary, the enterprise's books showed a loss, the bank would not be able to recover its loan.[17] Moreover, such a situation would not normally constitute default on the part of the entrepreneur, whose liability is limited to his time and efforts. Additionally, banks have no legal means to control the agent-entrepreneur who manages the business. This individual has complete freedom to run the enterprise according to his best judgment. Banks are contractually entitled only to share with the entrepreneur the profits (or losses) stemming from the enterprise according to the contractually agreed PLS ratio.[18] In *musharaka* and direct investment contracts, banks have better opportunities to monitor the business they invest in. Indeed, in these arrangements, all partners may concur to the management of the enterprise, and banks hold direct voting rights (see Table 1).

The above situation underscores investment risk as the most critical operational risk affecting banks operating according to a paradigm version of Islamic banking because it is inherent in their core activities: those carried out through the PLS modes of financing. Moreover, the assessment and management of investment risk becomes more difficult in an Islamic environment than in conventional banking because of the following factors: (1) in *mudaraba* contracts, the bank cannot exert control on the management of the investment project; (2) PLS modes cannot systematically be made dependent on collateral or other guarantees; (3) administration of the PLS modes is more complex compared with conventional financing. Indeed, these modes imply several complex activities that are not normally performed by conventional banks. These activities include the determination of profit- and loss-sharing ratios on investment projects in various sectors of the economy, and the ongoing auditing of financed projects to ensure that Islamic banks' share of profits are fairly calculated; and (4) the relatively weak legal framework supporting bank lending operation.

Therefore, in order to safeguard invested funds and realize profits, Islamic banks would need to rely more than conventional banks on a set of appropriate policies and adequate infrastructure for portfolio diversification, monitoring, and control. They would also need to rely on the existence of an adequate supply of trained banking staff skilled in investment and Islamic banking practices to implement these policies. However, as the experiences of other developing and transition economies indicate, appropriate policies and infrastructure for risk-management and human technical expertise are difficult to establish and require a considerable amount of time to develop.[19] Therefore, the regulatory framework for banking supervision should be designed to help address these issues.

Second, information disclosure is more important in an Islamic environment than it is in a conventional banking system. This is the case because the absence of protection for investment depositors is at the core of Islamic banking, as argued in Section II.[20] Indeed, the more depositors are left unprotected, the more public disclosure of information about banks' policy objectives and operational strategies is necessary to enable creditors and depositors to monitor banks' performance. Further, in an Islamic banking framework, depositors have more incentives to monitor banks' performance than conventional depositors do. This is due to the fact that capital value of and returns on investment deposits are not fixed and guaranteed, but, as noted previously, depend on banks' performance in investing depositors' funds. Hence, depositors have incentives to monitor Islamic banks not only to seek to protect the capital value of their funds, but also to seek to ensure that the rates of return paid to them reflect a fair application of the PLS principle on banks' net profit. Therefore, by reducing information asymmetries, a clear and concise disclosure of key data and information is likely to allow depositors more flexibility in choosing a specific bank in which they can allocate their funds according to their risk preferences. This is the case in a paradigm version of Islamic banking (where the relationship between banks and depositors is regulated according to an *unrestricted mudaraba* contract) because depositors would be able to choose among different banks disclosing different investment objectives and policies. It is even more the case if banking practices diverged from the paradigm version as, for instance, in the Islamic Republic of Iran where banks are allowed to accept depositors' funds for investment in specific types of projects (in this case, a *restricted mudaraba* is possible also on the liabilities side). Additionally, appropriate information disclosure can provide the supervisory authorities with a better understanding of banks' strategies and their relevant risks. This places the supervisors in a better position to exercise effective prudential supervision, hence reducing systemic risks.

Based on the above considerations, an appropriate regulatory framework for banking supervision in an Islamic environment should be designed to ensure that: (A) legal foundations for the supervision of Islamic banks are in place; (B) investment and other risks are adequately dealt with, taking into account that financing through the PLS modes adds an element of complexity to the already difficult task of investment banking; and (C) adequate information is disclosed to allow the supervisory authorities to exercise a more effective prudential supervision and to enable the public to make reasonably informed investment decisions. Greater stress on these issues, particularly during the licensing process, is likely to strengthen financial system surveillance in countries where Islamic banking is followed.

A. Legal Foundations

In order to provide the legal foundations for the supervision of Islamic banks, it is necessary that either the general banking laws or specific laws pertaining to Islamic banks define in detail the nature of these banks and their specific operating relationship with the central bank and other conventional banks, if applicable. Such a legal framework should contain provisions relating to licensing and permissible modes of financing, and should state clearly powers to address compliance with laws and regulations. In particular, such provisions should determine which enterprises may call themselves Islamic banks, collect deposits, and carry out banking practices on the basis of Islamic principles. Moreover, laws should state clearly that the central bank (or a separate supervisory authority) has the authority and all necessary powers to supervise Islamic banks and conventional banks, if applicable.[21]

B. Management of Operational Risks

Management of operational risks in Islamic banks could usefully be addressed through an appropriate CAMEL rating framework. CAMEL rating is a measure of the relative soundness of a bank and is calculated on a 1-5 scale, with one being a strong performance. The acronym stands for capital, assets, management, earnings, and liquidity. These are the five critical dimensions of a bank's operations. They reflect in a systematic fashion a bank's financial condition, compliance with supervisory regulations, and overall operating soundness.[22] The standard CAMEL rating system would need to be appropriately adapted to an Islamic banking environment as discussed below.

1. Capital

In a standard CAMEL rating, capital adequacy is evaluated (1 through 5) according to: (1) the volume of risk assets; (2) the volume of marginal and inferior assets; (3) bank growth experience, plans, and prospects; and (4) the strength of management in relation to all the above factors. In addition, consideration may be given to a bank's capital ratios relative to its peer group.

The bulk of the assets of banks operating according to a paradigm version of Islamic banking is represented by PLS transactions—that is, mostly uncollateralized equity financing. These assets are far riskier than the ones represented by non-PLS transactions, which are commercial or retail financing operations with collateral. As noted in Section II, PLS transactions are at the core of Islamic banking, while non-PLS modes are at the margin. Hence, the ratio of riskier assets to total assets can be higher in an Islamic bank than it is in a conventional bank. Therefore, a CAMEL rating for capital adequacy in an Islamic environment should place more emphasis on factor (1) than is the case in a standard CAMEL. All the other rating factors can usefully be applied in an Islamic framework without major changes from standard practices. Additionally, an appropriate assessment of the capital adequacy ratio in an Islamic environment should address two issues: the level of this ratio and the risk-weighting methodology for its calculation.

a. Level of the Capital Adequacy Ratio

According to widely accepted international standards defined by the Basle Committee on Banking Supervision, banks' risk-weighted capital adequacy ratio should be at least at 8%. However, while the Basle Committee's minimum level of 8% may be an acceptable floor given the operational environment of banks in OECD countries,[23] it should be somewhat higher in an Islamic environment. This is the case because of specific reasons inherent to the operation of Islamic banking, as well as more general reasons that are de facto part of the high-risk environment in which most Islamic banks operate. The specific reasons are the following: (1) *mudaraba* contracts put depositors' funds at risk, but allow a portion of profits to accrue to banks' owners. This creates a potentially strong incentive for risk taking and for operating financial institutions without suitable capital. Hence, to help reduce moral hazard, it would be important for the banker to have substantial amounts of his own capital at risk; (2) as argued above, the ratio of riskier assets to total assets is typically higher in Islamic banks than it is in conventional banks; and (3) as noted previously, the lack of control on investment projects in *mudaraba* transactions and, more generally, the absence of collateral and other guarantees in PLS transactions clearly raise the overall riskiness in Islamic banks' operations.[24] Some of the factors contributing to the high-risk environment of most developing and emerging market countries in which Islamic banks (as well as conventional banks) operate are: (1) a relatively weak legal infrastructure supporting bank lending operations; (2) underdeveloped financial markets; (3) a volatile economic environment, contributing to an uncertain financial condition in the enterprises sector; and (4) the less diversified nature of the economy.[25]

The assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be primarily based on a thorough analysis of the composition of the underlying asset portfolio between PLS and non-PLS transactions. To complete this exercise in a meaningful way, one should have detailed information on current assets valuation and loan-loss provisioning practices in each country where Islamic banking is followed. However, the general lack of uniformity in accounting standards, particularly in relation to income recognition and profit calculation, makes it difficult to compare financial statements of different Islamic banks. This situation remains a serious one despite considerable progress made by the Accounting and Auditing Organization for Islamic Financial Institutions to produce common standards designed to be consistent with and complement International Accounting Standards.[26] Moreover, current information on the adequacy of Islamic banks' provisions, procedures for making such provisions, and data reported to central banks regarding classified loans and corresponding provisions is not easily accessible to researchers. Additionally, differences in the tax treatment of loan loss provisions and banks' profits further complicate this exercise. Therefore, while it can be reasonably argued that the minimum capital adequacy ratio for Islamic banks should be somewhat higher than the Basle Committee's minimum level of 8%, it is more difficult to envisage a precise figure which may make sense for and reflect the particular situations of so many countries. Hence, it seems appropriate to conclude that the assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be carried out on a bank-by-bank and country-by-country basis, taking into account all the elements discussed in this section.

b. Risk-Weighting Methodology

Conventional banks' assets side includes three broad categories of assets: current facilities to customers, net investments, and mortgage loans that present, *inter alia*, a credit risk.[27] The Basle Committee's reference risk weights are 100% for current facilities to customers, 100% for net investments, and 50% for mortgage loans on residential properties. The lower risk weight assigned to mortgage loans is explained by the fact that loans fully secured by mortgage on occupied residential properties have a very low record of loss in most OECD countries.

As noted in Section II, Islamic banks' assets side includes all transactions carried out under the permissible Islamic modes of financing. On the basis of the economic functions that these models are expected to fulfil (see Table 1), it is possible to reconcile them with the three conventional broad categories of assets mentioned above, while recognizing that this exercise inevitably involves some approximation. For example, Islamic banks may have on their balance sheet transactions that are the result of a mix of different permissible Islamic modes of financing. Hence, it may become somewhat difficult to reconcile such transactions in a single conventional category. Moreover, very different Islamic modes, such as *mudaraba* and non-PLS modes that are not secured by a mortgage (e.g., installment finance) fulfil the same economic functions of *current facilities to customers*.[28] Nevertheless, and keeping in mind the above caveats, *mudaraba* contracts may be considered as *current facilities to customers; musharaka* and direct investment as *net investments.* Depending on the specifics of each transaction (notably, the existence or not of a mortgage), non-PLS modes may be considered as *mortgage loans*, i.e., the least risky transaction, or *current facilities to customers.*

As noted previously, Islamic modes of financing also involve different degrees of riskiness. In particular, PLS modes are far riskier than non-PLS modes. Among the PLS modes, *mudaraba* transactions appear to be riskier than *musharaka* or direct investment transactions because banks do not hold any tangible assets (i.e., shares representing a portion of equity capital of enterprises banks have invested in) to secure the funds loaned out. Additionally, as noted, Islamic banks have a lower degree of control (often no control at all) on the management of the enterprise they finance through a *mudaraba* contract. By contrast, credit risk related to financing through non-PLS modes is lessened by the possibility of collateralization, including mortgage.

Therefore, an appropriate risk-weighting structure for an Islamic system should have the *mudaraba* contract carrying the highest risk weight, followed by the two other main PLS modes, namely *musharaka* and direct investment. The lowest risk weight should be assigned to non-PLS modes fully secured by a mortgage. All other non-PLS modes should be assigned a risk weight somewhere in-between the lowest one in the system and the one assigned to *musharaka* and direct investment.

There appear to be no strong reason why *musharaka* and direct investment should not carry the same risk weight assigned by the Basle Committee to the comparable assets category of *net investments,* i.e., 100%. This is the case because arguments for advocating a risk weight lower or higher than 100% seem to balance each other.[29] If *musharaka* and direct investment transactions are assigned a risk-weight of 100%, then the appropriate risk weight on *mudaraba* transactions should be *at least* 100% to reflect their somewhat higher riskiness. Non-PLS transactions fully secured by mortgage may well carry the same risk weight assigned by the Basle Committee to the comparable assets category of *mortgage loans*, i.e., 50%. By implication, all other non-PLS modes should carry a risk weight somewhere in-between 50% and 100%, to be determined on a case-by-case basis. However, it is more practical to minimize the number of risk weights that are used in the evaluation of Islamic banks' portfolios. Hence, assuming a conservative approach, all non-PLS transactions that are not fully secured by mortgage can be assigned a risk weight of 100%, in line with the Basle Committee's reference risk weight for the comparable assets category of *current facilities to customers*.

c. Off-Balance Sheet Commitments

On the basis of available information, it appears that off-balance sheet activities, such as issuance of letters of credits, endorsements, and guarantees, do not substantially differ from similar activities carried out in conventional banks.[30] Accordingly, the Basle Committee methodology is applicable in this case. This means that all categories of off-balance sheet commitments must be converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor; the resulting amounts are then weighted according to the nature of the counterpart. Hence, depending on the specific cases, off-balance sheet commitments should carry a credit risk conversion factor ranging from 100% (general guarantees, bank acceptance guarantees and stand-by letters of credit) to zero (short-term commitments that can be unconditionally canceled at any time).

2. Assets

In a standard CAMEL rating, asset quality is rated (1 through 5) according to: (1) the level, distribution, and severity of classified assets; (2) the level and composition of nonaccrual and reduced rate assets; (3) the adequacy of valuation reserves; and (4) the demonstrated ability to administer and collect problem credits.

With regard to factors (1) and (2), it should be recognized that, in an Islamic environment, assets represented by *mudaraba* transactions cannot be classified until the relative contracts expire. Until that moment, there is no recognizable default with the exception of the proven negligence or mismanagement on the part of the agent-entrepreneur. As noted previously, "default" of PLS contracts mean that the investment project failed to deliver what was expected, that is a lower or no profit, or a loss. Nevertheless, PLS assets that deliver lower or no profit should be considered as reduced rate assets until the expiration of the relative contracts.

The ability of Islamic banks to reduce the capital value of investment deposits in case of a loss should *not* be viewed as tantamount to an automatic setting aside of provisions against loan losses. Indeed, this situation can hardly be compared with sound loan loss provisioning practices aimed at preserving the solvency and the viability of an Islamic bank as an ongoing operation. Additionally, it introduces strong incentives for moral hazard that could result in systemic risks. Hence, to help prevent the corrosive effect of problem assets on the level of capital, adequacy of valuation reserves should also remain a key factor in an Islamic environment.

With regard to factor (4), the ability of an Islamic bank to administer and collect problem credits should be evaluated in those cases where PLS contracts default before expiration because of negligence or mismanagement on the part of the entrepreneur as well as in all cases of defaulted non-PLS transactions.

3. Management

In a standard CAMEL rating, management is evaluated (1 through 5) according to: (1) technical competence, leadership, and administrative ability; (2) compliance with banking regulations and statutes; (3) ability to plan and respond to changing circumstances; (4) adequacy of and compliance with internal policies; (5) depth and succession; (6) tendencies toward self-dealing; and (7) demonstrated willingness to serve the legitimate needs of the community. All these factors are applicable in an Islamic banking environment too. Of course, in this case, the management's specific competence in Islamic banking practices and procedures should be key in such an evaluation (see also Section III.C).

4. Earnings

In a standard CAMEL rating, earnings are rated (1 through 5) according to: (1) the ability to cover losses and provide for adequate capital; (2) earnings trends; (3) peer group comparisons; and (4) quality and composition of net income. Earnings rated 1 are sufficient to make full provision for the absorption of losses and the accretion of capital when due consideration is given to asset quality and bank growth. Banks so rated typically have earnings well above peer group averages. Banks whose earnings are rated 5 are typically experiencing losses.

The above criteria are generally applicable to Islamic banks. Nevertheless, it should be kept in mind that, in Islamic banking, economic losses would first result in a depreciation of the value of the depositors' wealth, and then in a decline in the Islamic bank's profitability, particularly when that bank has also used its own resources (for example, through a *musharaka* arrangement) to finance the loss-making investment projects.

5. Liquidity

In a standard CAMEL rating, liquidity is rated (1 through 5) according to: volatility of deposits; reliance on interest-sensitive funds; technical competence relative to structure of liabilities; availability of assets readily convertible into cash; and access to interbank markets or other sources of cash, including lender-of-last resort (LOLR) facilities at the central bank.

Contrary to conventional banks, Islamic banks cannot obtain funds through LOLR facilities, including Lombard and discount windows, as well as overdraft or other credit facilities operated by the central bank. This is due to the fact that all of the above facilities require the payment of an interest rate. Additionally, while, in principle, appropriately designed short-term financial instruments, interbank and money markets are possible in an Islamic banking framework, in practice they are rather underdeveloped or even non-existent. As a result, Islamic banks may face more difficulties than conventional banks in securing short-term funds if need be. However, some countries have found ways to provide Islamic banks with access to short-term funds. For example, in Malaysia the authorities established an interbank investment facility whereby Islamic banks can obtain short-term funds from one another based on profit- and loss-sharing arrangements. Also, in Iran, since all banks are state-owned, the authorities view these banks as "part of the family" and extend short-term loans under a LOLR facility. Loans extended under this facility are exempt from payment of interest.[31] It should also be kept in mind that Islamic banks have obligations only toward demand deposit holders, while conventional banks have obligations toward all depositors. Therefore, the above criteria for liquidity rating need to be evaluated in light of these circumstances. As in the case of conventional banks, adequacy of liquidity should be assessed on a bank-by-bank basis.

In an Islamic environment, reserve requirements (RR) can be viewed as a particular case of liquidity ratios.[32] Indeed, to help reduce the possibility of asset-liability mismatch when Islamic banks operate according to a two-tier *mudaraba* arrangement (Scheme A), the RR ratio applied on demand deposits could be set at a level that would help banks meet unexpected demand deposit withdrawals. In principle, a RR ratio on demand deposits of 100% would rule out the problem, as is the case in the two-window arrangement (Scheme B). This, however, would excessively limit Islamic banks' ability to engage in maturity transformation, which is at the core of every bank's activity, and add an element of complexity to the transaction and payments functions that demand deposits are meant to perform. Therefore, a preferred alternative solution—especially if the ratio of demand deposits to total deposits is relatively low—is to mandate specific RR on all deposits held in banks operating according to a two-tier *mudaraba* arrangement.[33] However, if applied to total deposits, RR may represent an excessive burden for the banking system given the fact that, in an Islamic framework, RR may not be remunerated.[34] These issues should be considered when calculating an appropriate level of the RR ratio.

C. Information Disclosure

As argued before, information disclosure is more important in an Islamic banking environment than in conventional banking. Particularly in an Islamic environment, information disclosure should be designed to reduce information asymmetries—due to the *unrestricted mudaraba* contract between an Islamic bank and its depositors—and incentives for moral hazard due to the fact that capital value of and returns on investment deposits are not guaranteed. Moreover, information disclosure would introduce an element of flexibility in the system, and provide both the supervisory authorities and the public with a better understanding of banks' strategies and relevant risks. Additionally, information requirements should be designed to assist supervisory authorities in addressing Islamic banks' special risk characteristics. In this regard, two areas need particular attention on the part of bank supervisors: (1) the appropriateness of policies and adequacy of infrastructure for portfolio management; and (2) the adequacy of human technical expertise to implement these policies. Hence, supervisory authorities should envisage a list of appropriate data and information that Islamic banks are to be required to provide. Such information should be provided to the supervisory authorities first, and, subsequently, to the public. The authorities should decide on whether information provided to the public could be less comprehensive and detailed than the information provided to the supervisory authorities. Supervisory authorities should also ensure that information provided by Islamic banks is adequate, relevant, and not presented in a misleading way so that the public faith is protected. Finally, they should authorize the public disclosure of such information.[35]

Given the operational similarities between Islamic banks and investment companies underscored in Section II, it may prove useful to consider information disclosure requirements established for investment companies in conventional systems (for example by the United States Securities and Exchange Commission), and adapt them to the specific needs of an Islamic banking environment as delineated above. In this vein, information disclosure requirements for Islamic banks could usefully include *at least* the following interrelated areas: investment objectives and policies, including concentration; types of securities; risk factors; internal controls; and performance data. Additionally, the authorities should require the disclosure of professional qualifications and experience of management and senior staff. While these disclosure requirements are also appropriate in a conventional system, they are not regularly requested from conventional banks. By contrast, because such information disclosure addresses the specific risk characteristics of Islamic banks, it should be considered as a necessary component of an appropriate regulatory framework governing Islamic banks (see also Section III.D). The content of the proposed disclosure requirements is briefly reviewed below.

1. Investment Objectives and Policies, Including Concentration

This section should provide the supervisory authorities with sufficient information to assess the appropriateness of policies with regard to portfolio diversification (see also next point). It should provide an accurate description of the investment objectives and policies, including with respect to concentration: investment of more than 25% of total assets may define concentration in any one industry. In addition, any economic, business, or political developments or changes that can affect that industry or group of industries should be briefly discussed. Such disclosure may include proposed national or regional legislation involving the financing of the projects; pending civil and/or religious courts decisions relating to the validity of the projects or the means of financing them; predictable or foreseeable shortages or price increases of materials needed for the projects, and the like.

2. Types of Securities[36]

As noted in Section II, Islamic banks operating according to a two-tier *mudaraba* arrangement run the risk of an asset-liability mismatch in case of unexpected withdrawal of demand deposits for which no adequate reserves have been posted (a possible solution to this problem has been discussed above). This section should provide the supervisory authorities with an indication of an Islamic bank's degree of exposure to any type of securities or other assets, particularly those for which there is no established market, that is illiquid assets. An excessive exposure to illiquid assets should prompt the supervisory authorities to action, which may include establishing a limit on aggregate holdings of illiquid assets. This section should also illustrate the "filtration" process that has been followed by the Islamic bank to select securities to invest in.[37]

3. Disclosure and Monitoring of Risk Factors

This section should provide information on the main risk factors associated with the investment portfolio. It should also describe the internal procedures, organization, and infrastructure for the monitoring and handling of risk factors. Because of the virtually open-ended list of activities that an Islamic bank can engage in, and the virtually open-ended list of ways to provide funds through the use of combinations of the permissible Islamic modes of financing, each Islamic bank should be allowed some degree of freedom in engineering how best to monitor and handle the risks inherent to its specific activities. However, in any case, supervisory authorities should satisfy themselves about the adequacy of such procedures and infrastructure.

4. Internal Controls

An Islamic bank performs internally several complex activities that are not normally performed by conventional banks, including the determination of profit- and loss-sharing ratios on the projects it finances and the ongoing auditing of these projects to ensure that its shares of profit are being fairly calculated. These specific activities highlight internal controls as key to ensuring that all phases of the investment process are monitored, comply with the Islamic bank's investment policies, and are properly accounted for. Adequate internal controls are also crucial to the depositors' interests because, as noted, an Islamic bank's net profits are, in turn, shared with its (investment) depositors. Hence, particularly in an Islamic environment, adequate internal controls serve two goals: (a) reduce mismanagement risk (typically the most important factor of weak internal governance); and (b) reduce moral hazard. Therefore, supervisory authorities should satisfy themselves about the adequacy of arrangements for internal controls.

5. Performance Data

Particularly in an Islamic environment, expected return on investment deposits is key to the depositors' choice of a particular credit institution. As noted in Section II, an Islamic bank can only indicate the expected rate of return on investment deposits. The actual rate depends on the Islamic bank's ability to finance successful investment projects, thus accruing profits to be shared with its investment depositors. Ill-conceived, unsound institutions might seek to attract depositors by promising unrealistic rates of return, thus crowding-out serious and well-managed institutions. Hence, it becomes a key supervisory issue to reduce the moral hazard inherent in this situation. To help reach this goal, this section should provide a brief explanation on how an Islamic institution calculates its historical performance in order to advertise this data. This should be done in a concise description of the essential features of the data and how it has been computed. A statement should also be included that advertised yields are based on historical earnings and are not intended to indicate future performance.

6. Management and Senior Staff

This section should provide information on the education and professional background of an Islamic bank's management, including the Board of Directors, and senior staff (at least at the level of director of department). Particular attention should be paid to the assessment of staff's competence and skills in Islamic banking. This section should also clarify the role of *Shari'ah* Boards, particularly whether their role should be limited to approving financial products and services or should extend to the approval of individual credit decisions.[38] Supervisory authorities should satisfy themselves about the "fit" and "proper" requirements for management and senior staff to ensure that credit and investment decisions are taken by experienced bankers.

It is worth noting that the growing emergence of institutional investors, such as Islamic funds, will more than likely make the market enforced discipline mechanism inherent in the process of information disclosure more effective and binding on banks' strategies and risk-taking decisions.[39] As it has already happened in conventional systems, it can be reasonably expected that institutional investors in an Islamic environment are to play a crucial role in collecting, interpreting, and evaluating the flow of information disclosed by Islamic banks. These investors will act as Islamic banks' major private monitors while smaller private depositors and other investors are developing such skills. Such a development will more than likely help facilitate banking supervision in an Islamic framework.

D. Licensing Procedures

As with conventional banking, an appropriate licensing process is just as necessary in an Islamic banking framework to enable supervisory authorities to ensure that new banks are sound and stable. To establish an effective entry policy in the banking industry is key to protect the public faith and the banking system from unfair and dangerous competition from undercapitalized, ill-conceived banks or those that are operated by unqualified or less reputable owners and managers. Accordingly, new banks must meet certain requirements to enable them to operate successfully. As Lindgren et. al. have noted, with the exception of the European Union, there are no international agreements on licensing standards.[40] However, there are some basic elements of an appropriate licensing process that are usefully applicable also in an Islamic banking framework. These elements should be seen as an integral part of an appropriate regulatory framework for banking supervision in an Islamic environment.

1. Transparency

Laws, regulations, criteria, and requirements for a banking license should be published and applied in an even-handed way. Applicants should be notified about the decisions made on license applications.

2. Set the Ground Rules

Requirements for a license should set rules for corporate governance; establish "suitability" standards for owners; establish "fit-and-proper" specifications for boards of directors and managers; determine whether commercial and industrial firms can own banks; define the organizational structure of the bank, including internal controls, internal and external audit functions, and any provisions necessary to prevent conflict of interests. Additionally, such requirements should ensure the transparency of the corporate structure of the bank.

3. Capital Requirements

Minimum levels and composition of initial capital should be set forth.

4. Specify Activities

The scope of a bank's activities should be indicated, that is whether and to what extent the bank is allowed to take equity positions in nonfinancial enterprises, engage in securities, underwriting, licensing, factoring, and other activities.

5. Business Plan

The license application should include a feasibility study and a business plan detailing the bank's strategy to attain profitability and maintaining it over the initial period of operation.

Additionally, an appropriate licensing process in an Islamic framework should ensure that due consideration be given to the specific aspects of Islamic banking discussed in the previous parts of this section concerning legal foundations, capital, assets, management, earnings, liquidity, and information disclosure.

V. Current Practices and Future Developments in Islamic Banking

Islamic banking in current practices diverges in several important ways from the paradigm version delineated in Section II. These differences can be summarized in four main points:

A. All deposits, including investment ones, are always explicitly or implicitly guaranteed.

In some cases, the capital value guarantee is formally written in laws and regulations; in other cases, it is based on implicit understandings among the authorities, banks, and the public.

B. The PLS principle is never strictly applied.

There are various degrees of noncompliance with respect to the PLS principle in current banking practices. In some cases, the bank guarantees the expected rate of return on investment deposits.[41] Moreover, this rate of return is de-linked from banks' profits. As a result, the expected rate of return for each type of deposits is the same for all banks, irrespective of banks' different levels of profitability. In other cases, the PLS principle is partially implemented through complex formulas aimed at maintaining the link between returns to financial assets and profits originating from banks' investment of deposited funds. However, central banks discourage large variations in the rates of return that banks are allowed to offer to customers in order to avoid destabilizing shifts in deposits. This is done through the imposition of ranges (differentiated by sectors of the economy and nature of borrowers) within which banks and customers are allowed to bargain and agree on the terms of specific transactions.

C. Financing is mostly carried out through non-PLS modes.

On average, Islamic banks operate through the less-risky, shorter-term non-PLS modes, notably: markup, leasing, and lease-purchase transactions typically related to trade financing. The most recent available aggregate data indicate that, in 1996, non-PLS modes accounted for 75.2% (72.8% in 1995) of total utilized lines of credit made available by the Islamic Development Bank to the forty-eight member countries to promote Islamic banking.[42]

D. Discretion exists with regard to collateral.

Islamic banks are allowed to use a degree of discretion in deciding if collateral is needed before granting their facilities, including the PLS modes of financing.

As a result of the above practices, the element of uncertainty needed to legitimize the bargain for possible profits has been substantially reduced and, in some cases, eliminated. Moreover, PLS modes of financing have been made similar to non-PLS modes through the reduction of their risk element. Therefore, it can be concluded that, for all practical purposes, Islamic banking is currently carried out in a hybrid way that is somewhere in between the paradigm version and conventional banking. The degree of divergence from the paradigm version is specific to each country where Islamic banking principles are followed and need to be assessed on a case-by-case basis.

The more current Islamic banking practices diverge from the paradigm version, the more Islamic banks lose their distinctive features and tend to resemble conventional banks. Hence, supervisory standards and best practices developed by the Basle Committee on Banking Supervision become increasingly applicable to Islamic banks and should be implemented accordingly. Therefore, each argument discussed in Section III needs to be re-evaluated and given the appropriate emphasis in light of the circumstances and the specifics of Islamic banking practices prevailing in any one country at any one point in time.

By way of illustration, Table 3 indicates how the shift from the paradigm version to current practices should affect the focus of banking supervision in an Islamic framework.

TABLE 3. ISLAMIC BANKING IN PRACTICE: SHIFT IN THE FOCUS OF BANKING SUPERVISION

Issue	**Paradigm Version of Islamic Banking**	**Islamic Banking in Practice 1/**
Robustness to absorb external shocks. 1) Liquidity risks 2) Insolvency risks	Higher Less likely Less Likely	Lower More likely More likely
Relative importance of:		
Assessment and management of operational risks: 1. Reliance on appropriate procedure and adequate infrastructure; 2. Reliance on human technical expertise.	Higher Higher	Lower Lower
Prudential standards	Relevant; to be assessed on a bank-by-bank and country-by-country basis	Crucial
Information disclosure requirements	Higher	Lower

1/ Depending on the degree of divergence from the theoretical model. At the end of the spectrum, Islamic banking may coincide with conventional banking, except for the terminology.

Islamic banking is expanding outside the traditional borders of Muslim economies into western countries, notably the United Kingdom.[43] This situation is unprecedented both for western supervisors and for authorities (and banks) of countries where Islamic banking principles are followed, at least to some extent. It underscores a number of supervisory issues that can be summarized as follows.

First it should be kept in mind that western supervisors have responsibilities, under the law, to apply current principles in an even-handed way to all banks operating in their countries to ensure that all banking facilities, whether Islamic or not, are in accordance with national supervisory and regulatory frameworks aimed at protecting the interests of depositors. In particular, western supervisors must be satisfied that an applicant institution, whether

Islamic or not, has adequate capital, adequate liquidity, and adequate control over large exposures. This means, from an operating point of view, that the applicant institution must have adequate risk management procedures, a realistic business plan, and adequate systems for internal control and that its management must be adequate in breath, depth, and experience to run the business in a competent manner. Moreover, western supervisors will need to be satisfied that the applicant institution is subject to *effective consolidated supervision*, most notably that the home country takes prime responsibility for supervising the applicant bank as a whole.

There may well be some areas in the operation of Islamic banking which might be viewed by western supervisors (as well as potential counterparties) as difficult to understand. These areas include the following:

E. Uncertainties in Classifying Islamic Funds in Western Legal Terms

The problem is to understand to what extent and how funds are placed in an Islamic institution as capital are certain, thus falling into the definition of a bank deposit and/or to what extent they are participating in a collective investment scheme, thus falling under the definition of an equity investment (for example, in the United Kingdom, in the former case, the Banking Act would apply; otherwise, the Financial Services Act). Section II may contribute to shed some light on this issue.

F. Lack of Uniformity in Accounting and Auditing Practices

This problem has already been pointed out when discussing capital adequacy. To reduce it, current efforts made by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to produce new accounting standards should be enhanced. To help assuage western concerns, the work of the AAOIFI should be increasingly publicized and discussed in international forums attended also by western supervisors, representatives of the Accounting and Auditing professions, and interested potential counterparties.

The United Kingdom appears to have been chosen as the preferred western market in the development plans of institutions operating according to Islamic precepts. Thus far, no formal request for a banking license has been presented to the U.K. supervisory authorities by a bank operating according to a paradigm version of Islamic banking. If it were, the U.K. supervisory authorities would tend to adopt the following approach:[44] (1) set the capital adequacy ratio on the basis of an assessment of the portfolio of risks of each individual Islamic bank, subject to the minimum Basle Committee standards; (2) require that Islamic banks, whose earnings portfolios are viewed as tending toward the longer-term and the illiquid, hold higher levels of overall liquidity than conventional banks;[45] and (3) expect that credit decisions be taken by experienced bankers. In addition, supervisory authorities in the United Kingdom would consider as a fundamental prerequisite for the granting of a banking license the establishment of a satisfactory operational understanding with the home country authorities on how and on what basis Islamic banks are supervised in their respective countries vis-à-vis standards laid down by the Basle Committee.

VI. CONCLUSION

In this paper it has been argued that prudential supervision on banks is just as necessary in an Islamic system as in conventional systems. It has also been argued that Islamic banks have special characteristics that should be recognized and addressed to help make the conduct of banking supervision more effective. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure issues than it is normally the case in conventional banking. To help develop such a regulatory framework, a CAMEL rating system adapted to an Islamic environment has been proposed and discussed. Other building blocks, such as legal foundations, information disclosure requirements, and licensing procedures adapted to an Islamic environment have also been discussed.

A better understanding of the fundamental features of Islamic banking as they are presented in the theoretical literature has been the starting point of the discussion. Based on this understanding, it has been shown how Islamic banking in its current practices diverges from the paradigm version and how the focus of banking supervision should shift accordingly.

Moreover, it has been stressed that Islamic banking is no longer an interesting experiment, but a growing reality which is expanding outside the traditional borders of Muslim countries into western economies where conventional banking is followed. This unprecedented situation underscores a number of supervisory issues that have also been discussed.

The main message of the paper is that, in order to establish a closer integration with other banking systems, supervisory authorities of countries where Islamic banking is followed should acknowledge the need to set up a regulatory framework that, while consistent with Islamic precepts, would, at the same time, be pragmatic and flexible enough to meet internationally accepted prudential and supervisory requirements. In this process, the establishment and implementation of effective prudential supervision on Islamic banks in their home countries appears to be a key factor. On their part, supervisory authorities in conventional systems ought to approach Islamic banking with an open mind realizing the potential gains that this already sizable and growing market could bring to the global economy in general and to selected counterparties in particular. Some issues underscored here are still to be dealt with; others need further analytical work. Hopefully, the discussion developed in this paper can help generate action on this much-needed agenda.

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[2] Banking supervision in this paper refers to the assessment and permanent monitoring of banks' financial performance and position. Banking supervision is carried out through an effective regulatory framework aimed at reinforcing banks' operating environment, internal governance, and market discipline.

[3] These countries are: Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin, Brunei Darussalam, Burkina Faso, Cameroon, Chad, Comoros, Djibouti, Egypt, Gabon, The Gambia, Guinea, Guinea Bissau, Indonesia, Islamic Republic of Iran, Iraq, Jordan, Kuwait, Kyrgyz Republic, Lebanon, Socialist People's Libyan Arab Jamahiriya, Malaysia, Maldives, Mali, Mauritania, Morocco, Niger, Oman, Pakistan, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, Syrian Arab Republic, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Republic of Yemen, and West Bank and Gaza (WBG).

[4] In this paper, the term "conventional" defines an interest-based bank or banking system.

[5] Iqbal, 1997.

[6] The Basle Committee on Banking Supervision has issued a consultative paper, *Core Principles for Effective Banking Supervision* (April 1997), which provides a comprehensive analysis of best principles and practices.

[7] For a fuller discussion on the theoretical aspects of Islamic banking, see Mirakhor, 1988; Khan and Mirakhor, 1986 and 1993; Kazarian, 1993; and Presley, 1994.

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[8] Section IV discusses how Islamic banking in current practice diverges from the paradigm version and assesses implications for banking supervision.

[9] These two analytical models of banking in an Islamic framework are considered to be fully consistent with Islamic rules and guidelines. For a fuller discussion, see Khan and Mirakhor, 1993.

[10] Traditionally, banks operating with the two-tier *Mudaraba* scheme have kept substantial reserves against demand deposits (even if they were not considered as *Amanat*) and little (sometimes none) on investment deposits.

[11] Another school of thought maintains that such form of discretion by banks should not be possible. This approach would further strengthen the paper's arguments and conclusions.

[12] The term "investment company" defines an entity that pools shareholders' funds to provide shareholders with professional investment management. An investment company sells its capital to the public, invest the proceeds to achieve its investment objectives, and distribute to its shareholders the net income and net gains realized. Investment companies include open-ended funds, or mutual funds. These have outstanding redeemable securities of which they are the issuers. The unit ownership is represented by units of investment, such as shares of stock or partnership interests to which proportionate shares of net assets can be attributed (see *Guide to Audits of Investment Companies*, American Institute of Certified Public Accountants, 1996.)

[13] See *The Organization of Investment Companies and The Investment Company Act*, 1940, Section 13(a), United States Securities and Exchange Commission.

[14] On this point see also Khan and Mirakhor, 1989; and Iqbal, 1997.

[15] In some Islamic countries a significant portion of the banking sector is state-owned (in the case of Iran, all banks). Prudential supervision of state-owned banks, however, is equally as essential because any deterioration of their financial position would ultimately affect the State budget. Such deterioration could develop progressively, remaining unnoticed for a long period, because there would be no concern about banks' solvency. When finally discovered, such deterioration would materialize in the form of a need for recapitalization, at the State's budget expenses.

[16] See Core Principles for Effective Banking Supervision (April 1997).

[17] Of course, in the typical case of a restricted *Mudaraba*, the bank seeks to stipulate in the *Mudaraba* contract certain conditions that it considers essential for a successful outcome. However, this is done ex-ante and the contract's terms and conditions cannot be altered during the life of the contract except with the mutual consent of the parties.

[18] By contrast, Khan and Mirakhor, 1993, contend that banks have direct and indirect control over the agent-entrepreneur through both explicit and implicit contracts. This is so because banks could refuse further credit or blacklist the agent-entrepreneur and (an important consideration in the Islamic ethos) because the agent-entrepreneur puts at stake his credibility and respectability; therefore, a strong deterrent to irresponsible behavior would be put in place. However, it still remains a matter of fact that the bank has no legal means to intervene in the management of the current enterprise while the agent-entrepreneur is running it.

[19] Khan and Mirakhor, 1989, argue that the shortage of expertise in PLS financing in commercial banks is one of the most important reasons explaining the slow growth of PLS modes of financing in Iran.

[20] It should be noted, however, that, in principle, a deposit insurance arrangement, whereby a third party (excluding the central bank, the government, and the interested deposit bank) agrees, against the payment of a price, to ensure investment depositors is possible in an Islamic banking framework.

[21] The above approach has been adopted by the authorities of countries where all banks and financial institutions operate according to Islamic principles (i.e., Iran, Pakistan, and Sudan), as well as a number of countries where Islamic banks operate alongside conventional banks (for example, Jordan, Malaysia, Egypt, and United Arab Emirates).

[22] For more details on the CAMEL rating, see *Bulletin 97-1*, Comptroller of the Currency Office, January 3, 1997 and *Notices*, Federal Register, Vol. 61, n. 245, December 19, 1996.

[23] Most major OECD banks have capital ratios on the order of 10-12%.

[24] By contrast, it may be argued that operations of Islamic banks are less risky than conventional banks for the very reason that part of the risk is transferred to depositors. Also, in an Islamic system, income is accounted on a cash basis and not on accrual basis. This may reduce the danger of accumulation of nonperforming assets. Moreover, the ability of Islamic banks to reduce the capital value of investment deposits in case of a loss, may be argued to be tantamount to an automatic setting aside of provisions against loan losses. However, these arguments seem to be based on the assumption that individuals should not be concerned about the principal value of their deposits and that the integrity of the banking system as such does not need to be protected. This can hardly be the case even in a paradigm version of Islamic banking.

[25] See also Dziobek et al., 1995.

[26] This underscores the need for greater standardization in Islamic banking accounting practices as an important factor for further growth of Islamic banking.

[27] Other types of risk also should be considered, for example, investment risk, exchange rate risk, and concentration risk. The Basle Committee methodology, however, focuses on credit risk, while discretion has been left to national supervisory authorities to build in certain other types of risk.

[28] Of course, *Mudaraba* and non-PLS modes are and remain very different transactions even if they may be viewed within the same broad category of current facilities to customers.

[29] Assignment of a risk weight lower than 100% can be argued on the grounds that Islamic banks cannot rely on collateral when they extend their PLS facilities, including *musharaka* and direct investment. This can enhance Islamic banks' risk taking capabilities (for example, see Iqbal, 1997). By contrast, a risk weight higher than 100% may be warranted because of the factors that make the management of investment risk more difficult in Islamic banking than in conventional banking (see above).

[30] However, it should be noted that this issue is currently under consideration in several countries following Islamic banking.

[31] The issue of how to design short-term financial instruments compatible with Islamic precepts is beyond the scope of this paper.

[32] Reserve requirements can also be viewed as monetary instruments, means to facilitate interbank settlements, and as a form of taxation.

[33] As noted in Section II, the two-tier *Mudaraba* arrangement (Scheme A) does not mandate specific reserves requirement on both demand and investment deposits.

[34] However, *Mudaraba* or *musharaka* contracts between the central bank and the commercial banks could be designed whereby banks could share in the profits accrued from the central bank's use of RR.

[35] A simple and effective way of disclosing relevant data and information is the publication and distribution of prospectuses, in addition to the usual banks' financial statements and annual reports. In case this proves to be too expensive or complex to handle, because of the large numbers of depositors involved, prospectuses may be published on widely circulated newspapers, and/or placed in all branches and made available for free consultation. Appropriate control over the content of prospectuses would need to be exerted by supervisory authorities. However, this activity should not extend to guarantee or endorse the content of prospectuses.

[36] For Islamic banks the term "securities" defines any note, stock, certificate of interest or participation in any profit-sharing arrangement.

[37] The "filtration" process ensures that the operation, and capital structure of each business an Islamic bank invests in is compatible with Islamic law, hence excluding companies engaged in prohibited activities – that is, the production of goods and services which contradict the value pattern of Islam, such as gambling – and those whose capital structure relies heavily on debt financing.

[38] *Shari'ah Boards* are composed of Islamic scholars and jurists. They ensure that Islamic banks' operations conform to Islamic precepts. All banking facilities should receive their clearance before being offered to the public.

[39] Iqbal (1997) reports that Islamic funds are already in operation. Their current market size is estimated at about US$1 billion. These funds invest mainly in equity, commodity, and leasing and issue tradable certificates backed up by their investments in shares, metals, and leases, respectively.

[40] For a fuller discussion, see Lindgren, Garcia, and Saal, 1996.

[41] In one case, indications are that the central bank would stand ready to subsidize the difference between the indicative, ex-ante rate of return announced by banks to depositors and the realized, ex-post rate if the latter were lower than the former.

[42] Islamic Development Bank, Annual Report 1995/96.

[43] In this paper, the term "western" defines countries where conventional banking is followed.

[44] Useful conversations on this topic with Michael Ainley of the Bank of England are gratefully acknowledged.

[45] This could affect Islamic banks' profitability compared with conventional banks.

Islamic Finance in Malaysia

A Tax Perspective

Walid Hegazy*

ABSTRACT

In order to promote the role of Islamic finance in their robust economy, Malaysian lawmakers have passed several pieces of legislation providing incentives for the users of Islamic financial instruments and abetting the creation of a competitive, innovative, and active Islamic financial market. The Malaysian tax laws were recently amended to address the tax treatment of Islamic financial instruments. This article examines these amendments in an attempt to evaluate the efforts of the Malaysian tax legislator to provide the practice of Islamic finance with a suitable tax environment. In addition, this article offers an introductory analysis of the tax treatments of various Islamic financial instruments in Malaysia. It concludes that Islamic financial instruments deserve special tax treatment, and that the tax amendments discussed are too general to handle the diverse structures of Islamic financial instruments.

I. INTRODUCTION

Throughout the 1990s, Malaysia has enjoyed a robust economy joined by a high sustainable growth. This economic growth has set the Malaysian financial market as one of the world's most attractive markets. Islamic banks, along with conventional[1] banks, have participated actively in achieving this high rate of growth.[2]

In order to promote the role of Islamic finance in the economy, Malaysian lawmakers have passed several pieces of legislation providing incentives for the users of Islamic financial instruments. Constant revision of banking, investment, and tax legislation was introduced to create a competitive, innovative and active Islamic financial market.[3] For example, in 1983, the Islamic Banking Act (IBA) was passed to regulate the practice of Islamic modes of finance.

In 1993, the Malaysian central bank, Bank Negara, introduced new guidelines on the Interest-Free Banking Scheme (IFBS). The IFBS, in essence, is an open invitation for conventional banks in Malaysia to participate in the Islamic financial market. As a result of this policy, approximately 40 conventional banks are now offering Islamic financial instruments within their own framework.

More recently, tax laws were amended to address the tax treatment of Islamic financial instruments. This article examines these amendments in an attempt to evaluate the efforts of the Malaysian tax legislator to provide the practice of Islamic finance with a suitable tax environment. In addition, this article offers an introductory analysis of the tax treatments of various Islamic financial instruments in Malaysia. However, it is appropriate first to give a brief background of Islamic finance as a new and modern phenomenon.

II. ISLAMIC FINANCE: GENERAL BACKGROUND

Islamic finance is the application of different contractual and financial techniques to mobilize funds in the economy according to the principles of Islamic law. The criterion used to judge whether a transaction conforms to Islamic rules is the extent to which it involves one of the following "evils":

1. *riba* (interest);
2. *gharar* (speculative risk);
3. *akl al-mal bil-batil* (unjust enrichment); and
4. *ghubn* (damage, injury, fraud, lesion).

The contemporary history of financial institutions in most Muslim countries can be divided into three overlapping stages: imitation, disguise, and renaissance.[4]

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The first stage began after the demise of the Ottoman Empire and continued into the colonial period. An effort in Muslim societies to mimic Western financial techniques, without any consideration for the pre-existing social, economic and cultural institutions, is observed.

During the second stage, Islamic financial institutions that emerged after the post-independence movements tended to cloak unchanged Western financial instruments in Islamic garb by using Islamic names. In short, there was no concrete effort to change the actual environment in which such Islamic practices were to be implemented.

The third stage is still in its formative course. There exists a sincere effort to return to true Islamic economic practices through new exploration of traditional Islamic financial doctrines. Also, there have been efforts to probe into modern and sophisticated financial techniques used by Western institutions.

Currently, Malaysia is considered to be in transition between the second and third stage. Attempts to reach the third stage are evident in the government's efforts to furnish Islamic financial institutions with appropriate tax regulations.

III. Amendments Addressing Islamic Finance

Malaysian tax legislators introduced different amendments to address the tax treatment of Islamic financial instruments. The amended tax laws are the Income Tax Act 1967 (ITA), the Stamp Act 1949 (SDA) and the Real Property Gains Tax (RPGT) Act 1976. The amendments are attempts by the Malaysian tax legislator to remove tax discrimination between the application of conventional instruments and Islamic instruments. These amendments and their impact on the tax treatment of Islamic instruments are examined below.

A. Amendments to the Income Tax Act

Section 2(7) was included as a new provision to address the tax treatment of Islamic income and income generated from Islamic financial instruments. Section 2(7) of the ITA states that:

> Any reference in this act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah.[5]

Section 2(7) affects the tax treatment of Islamic income from the charging, deduction, tax exemption, and withholding tax perspectives.

First, the charging section of the ITA, Section 4, defines the scope of charge of the ITA as follows:

> Subject to this Act, the income upon which tax is chargeable under this Act in respect of:
>
> (a) gains or profits from a business, for whatever period of time carried on;
> (b) gains or profits from an employment;
> (c) dividends; interest or discount;
> (d) rent, royalties or premium;
> (e) pensions, annuities or other periodical payments not falling under any of the foregoing paragraphs;
> (f) and gains or profits not falling under any of the foregoing paragraphs.

Prior to the amendment of Section 2(7), profits or gains received from Islamic investments were covered under Section 4(a) in the case of business income. Gains or profits derived from a non-business Islamic source were taxed under Section 4(f) because they did not fall under any other categories. After the amendment of Section 2(7), gains or profits from Islamic business sources are still taxed under Section 4(a), while gains or profits from non-business Islamic sources are now taxed under Section 4(c) and are given the same treatment of non-business interest income.

Second, according to Section 33(1), a person can deduct from his gross income from a source all outgoings and expenses wholly and exclusively incurred in the production of that income from that source.[6] Interest expenses are specified in Section 33(1)(a) as deductible expenses if the money borrowed is employed in the production of gross income from that source, or laid out on assets, or used or held for the production for that income from that source. Similar to interest expenses and based on Section 2(7), expenses incurred in producing income from Islamic sources (or "Islamic financing expenses") are tax deductible. Therefore, a person can deduct from his gross income from an Islamic financial instrument, all outgoings and expenses wholly and exclusively incurred during the production of that income from that instrument. Even prior to the introduction of Section 2(7), "Islamic income expenses" were covered under the general language of Section 33(1). In addition, as a result of Section 2(7), the restriction of Section 33(2) will apply to the deductibility of "Islamic financing expenses"; hence, if the money or asset obtained through Islamic financial instruments for business purposes is partly used for non-business operations, only the expenses on the portion used for the business can be deductible against gross income, and the other proportion of expenses applicable to the non-business operations is deductible against gross income from that non-business source.[7]

Deductibility of "Islamic financing expenses" is also subject to the 1989 guidelines issued by the Inland Revenue Department on the application of interest restrictions and the deductibility of interest expense. Applying the guidelines on "Islamic financing expenses," funds or assets obtained through Islamic financing will be divided into income producing sources and non-income producing sources. Deductibility of such expenses will be restricted to income producing sources. Also, according to the guidelines, expenses on Islamic income will be restricted if any part of the financed funds or assets is reinvested for non-business purposes. The following formula will be used in calculating the amount of restricted "Islamic financing expenses":

Amount of restricted "Islamic financing expenses" =

$$\frac{[A \times B]}{C}$$

Where:

A	=	funds used for non-business purposes
B	=	monthly installment[8]
C	=	total amount of Islamic funds or assets

Third, from the tax exemption perspective, gains or profits from an Islamic source are granted the same exemptions applicable to interest income such as:[9]

1. the exemption granted in respect of interest from savings certificates issued by the government;
2. the exemption granted in respect of interest earned by a non-resident from banks and finance companies licensed under the Banking and Financial Institutions Act, 1989 (BAFIA)—this exemption is important given that conventional banks, regulated under the BAFIA, are now allowed to offer Islamic instruments; and
3. the exemption granted to "approved loans" which include among other items:
   a. loans or credits made to, or guaranteed by, the government, or a state government; and
   b. loans made by any person in an amount exceeding MYR 250 million.

Also, gains or profits from Islamic sources are subject to special income tax exemptions including:

1. profits from a deposit of MYR 5,000 deposited in any savings account with Bank Islam Malaysia Berhad (BIMB) granted by the Income Tax (Exemption)(No. 4) Order 1989; and
2. with effect from the 1997 year of assessment, exemption in respect of gains or profits from (i) a deposit of MYR 100,000 in any savings account for a calendar year, or (ii) a deposit in any investment account for a period not exceeding 12 months, under the IFBS with a bank or finance company licensed under the BAFIA or the IBA.

Fourth, according to the ITA, interest derived from Malaysia and paid or credited to a non-resident is subject to a 20% tax withholding deducted from interest. Interest paid to a resident is subject to 5% tax withholding. After the amendment of Section 2(7), this rule is applicable to gains and profits from Islamic sources.

B. Amendments to the Stamp Duty Act

Stamp duties are imposed on a large number of documents and contracts including a charge or a mortgage, and a conveyance, assignment or transfer. Generally, stamp duties are imposed on an *ad valorem* basis although specific stamp duties are levied on certain documents.

Item 32 of the First Schedule SDA lists the *ad valorem* rates levied on a conveyance, assignment, or sale; Item 27, on a charge or mortgage.[10] The tax base for a conveyance, assignment or sale is the value of the consideration or the market value of the property concerned; for a charge or mortgage, the amount of the financing or loan. The *ad valorem* rates for a charge or mortgage are generally lower.

Most of the Islamic financing in Malaysia involves back-to-back sale contracts. For instance, a *bai‘ bi-thaman ajil* (BBA) transaction is done in two steps: first, the Islamic financier purchases a property from the customer for cash price, and second, sells the same property back to the customer for a deferred higher price. In an attempt to streamline the tax treatment of both conventional financial instruments and Islamic financial instruments, the SDA was amended. Section 14A states that:

> Where it is shown that a principal or primary security secures the repayment of moneys provided under a scheme of financing made according to the Syariah, duty chargeable thereon shall be calculated on the principal amount provided by the financier or financing body.

Section 14A is effective from 1 October 1989; accordingly, Item 27 of the First Schedule was also amended to include an "agreement for financing under the Syariah." This means that Islamic financial instruments are treated in the same way as their counterpart conventional financial instruments, i.e. as a charge or mortgage rather than as a conveyance, assignment or sale.[11]

In addition, with effect from 1 January 1996, the stamp duty on Islamic hire-purchase agreements is restricted to a fixed rate stamp duty of MYR 3.

To encourage the use of Islamic financial instruments, effective 1 January 1996, all instruments executed in connection with the conversion from conventional financing to Islamic financing are exempt from stamp duty taxes.

C. Amendments to the Real Property Gains Tax Act

According to the RPGT Act 1976, gains derived from the disposal of real property, or the disposal of shares in real property companies, are subject to RPGT. However, if the taxpayer's business is dealing in property, his gains from such business are subject to income tax and not RPGT.

In order to increase the attractiveness of the Islamic financial system, paragraph 3(g) was inserted into Schedule 2 of the RPGT Act to exempt the gains from the disposal of real property, as defined, by a person (i.e. customer) to an Islamic bank where that person is being financed by that bank "in accordance with Syariah."

However, the RPGT Act does not state whether the disposal of the same real property back to the customer, in the context of, say, a BBA transaction, is also exempt from RPGT. It could be argued that the BBA transaction should also be treated in the same manner as a charge or mortgage.[12] Accordingly, the difference in price between the two sale contracts (representing the bank's profits) should be taxed under the ITA as business income and should not be subject to RPGT.[13]

IV. Current Tax Treatment of Islamic Financial Instruments

From a tax perspective, the prevailing Islamic instruments in Malaysia can be divided into three different categories:

1. instruments based on the concept of sale: Islamic sale contracts such as *bai‘ bi-thaman ajil* (credit sale), *murabaha* (mark-plus sale) and *istisna’* (pre-manufacturing sale);
2. instruments based on the concept of lease: Islamic lease contracts such as *ijara* (lease) and *ijara wa l-iqtina’* (hire purchase agreement); and
3. instruments based on the concept of partnership: Islamic partnership contracts such as *musharaka* (partnership) and *mudaraba* (sleeping partnership).

A. Islamic Sale Contracts

This category includes primarily three important contracts: BBA, *murabaha*, and *istisna’*. Significantly, more than 90% of Islamic financing in Malaysia is structured under BBA and *murabaha* contracts.

<u>1. General</u>

a. Bai‘ Bi-thaman Ajil

A BBA is a deferred payment sale under which a financier sells a product or equipment to one of its customers for a deferred price, usually higher than the market price, to be paid in the future on an installment basis or as a lump sum. In practice, however, many Islamic banks in Malaysia use a special structure of BBA as a legal artifice, Hila, to circumvent the prohibition of *riba*. This BBA structure involves a double sale in which a bank purchases a product from its customer for cash and then resells the same product back to the customer for a higher price on credit. It is clear that the aim of using this legal artifice is to achieve an unlawful result, that is, lending on interest. This structure is very similar to a type of sale known in Islamic doctrine as bay' al-'inah, which is prohibited under the Hanafi, Maliki, and Hanbali schools.[14]

> Example 1
> Mohammed Rafi who owns a piece of land (L) approaches Bank of Islam (BOI) to finance the construction of a MYR 1,000,000 textile factory on (L). BOI agrees to finance the construction of the textile factory under a BBA arrangement. According to this arrangement, BOI purchases (L) from Mohammed for MYR 1,000,000 paid in cash. Then BOI sells (L) back to Mohammed for MYR 1,200,000 to be paid in the future on an installment basis. In this BBA transaction, BOI earned a total amount of MYR 200,000 as profits, while Mohammed's expenses or costs of financing are MYR 200,000.

b. Murabaha

Murabaha is a mark-plus sale in which a bank acquires a specified product for the purpose of reselling it to one of its customers for a price that reflects the cost of acquiring the product plus a reasonable amount of profits for the bank. Usually, *murabaha* is associated with a BBA contract. This simple form of *murabaha* exposes the bank to great risk if the customer refuses to fulfil his promise to buy the product. To overcome this problem, a more practical form of *murabaha* known as *murabaha lil al-amer bil shira'* has developed. According to this arrangement, the customer is bound by his promise to buy the product from the bank. If the customer fails to fulfil his obligation to buy the product, it will have to compensate the bank for whatever damages are caused by its refusal to purchase the product. In most modern *murabaha*, banks pass their obligations arising from ownership to their customers.

> Example 2
> Mohammed Rafi approaches BOI to finance the purchase of specific textile equipment under the terms of *murabaha*. BOI purchases the specified equipment from the market for MYR 100,000. Subsequently, BOI resells the equipment to Mohammed, after adding to the price the shipping expenses plus a marginal amount of profits, for MYR 120,000 to be paid on an installment basis. In this *murabaha*, BOI's profits are MYR 20,000, while Mohammed's costs of financing are MYR 20,000.

c. Istisna'

Istisna' is a transaction in which a person (i.e. the buyer) places an order with a manufacturer (i.e. the seller) to produce, build or manufacture a specified product in exchange for a predetermined price. Once the product is manufactured according to specifications, the buyer will be bound to pay the manufacturer the predetermined price.[15] It should be noted that the manufacturer might appoint or assign others to manufacture the product. The interest-free bank can play either the role of a money supplier or a manufacturer on behalf of its clients.

Istisna' aids in financing industrial projects by serving as a legal vehicle for the sale of future products, which is otherwise forbidden in Islam. Recently, some scholars such as Zarqa, Al-Salous and Zohiaili, have emphasized the significant role of *istisna'* as an additional long-term financial instrument.

> Example 3
> Mohammed Rafi approaches BOI to finance the construction of a housing complex for the workers of his textile factory. The total cost of the project is assumed to be MYR 1,000,000. BOI agrees to finance the project under the terms of *istisna'* in exchange for MYR 1,200,000. BOI appoints the Malaysia Engineering Company (MEC) to construct the complex for the price of MYR 1,000,000. After completion of the complex, Mohammed acquires the complex and pays BOI MYR 1,200,000 on an installment basis. Usually, the buyer pays at the beginning of the contract a small part of the price, 10% to 20%, as an advance payment to the bank.

2. Income tax

a. The Position of the Financier

As mentioned above,[16] Section 2(7) ITA grants profits and gains derived from conducting transactions in accordance with Islamic principles the same treatment as interest income.[17] Therefore, according to Section 4(a) ITA, the profits made by BOI in Examples 1, 2, and 3 will be taxed at the rate of 30% of chargeable income.

b. The Position of the Customer

According to Section 2(7) ITA, expenses incurred in producing income from Islamic investments are given the same treatment of interest expenses under the ITA. According to Section 33(1)(a) and Section 33(2), interest payment on borrowed money is a deductible expense if it is employed in the basis period in the production of gross income or laid out on the purchase of assets used, or held, for the production of gross income. As a result, Mohammed Rafi can deduct from his gross income the amount of money incurred as expenses in conducting any of the above-mentioned transactions provided that the conditions of Section 33(1)(a) and Section 33(2) are satisfied.[18]

In calculating the cost of financing, or the expenses that are deductible from the gross income from the relevant instrument, the following methods can be used:

1. In Example 1, the financing expenses consist of the difference between the price of (L) charged by the seller BOI in the second purchase agreement and the financing price paid for (L) by BOI in the first agreement.

   BBA's deductible financing expenses =
   Sale price – financing price =
   MYR 1,200,000 – MYR 1,000,000 =
   MYR 200,000

Mohammed Rafi, the buyer, can deduct MYR 200,000 as financing expenses incurred from producing business income from the textile factory.

2. In Example 2, the deductible expenses incurred by Mohammed Rafi, the buyer, is MYR 20,000 which is equivalent to the markup margin paid over the market price of the equipment.

   Murabaha's deductible financing expenses =
   Mark-plus price – market price =
   MYR 120,000 – MYR 100,000 =
   MYR 20,000

3. In Example 3, the deductible expenses will be the difference between the manufacturer price charged by the BOI and the cost price paid to MEC, the construction company, for the product.

   *Istisna'*s deductible financing expenses =
   Manufacturer price – cost price =
   MYR 1,200,000 – MYR 1,000,000 =
   MYR 200,000

3. Stamp Duty

In Example 1, the BBA transaction is considered to be an "agreement for financing under the Syariah." Accordingly, the stamp duty on this transaction is levied under Item 27 of the First Schedule SDA, and it will be imposed on the financing price (i.e. MYR 1,000,000). No further duties will be imposed on this transaction. The same rule is applicable to Examples 2 and 3.

4. Real Property Gains Tax

As mentioned above,[19] the RPGT Act was amended to exempt the disposal of an asset by a customer to an Islamic bank under the financial scheme "in accordance with the Syariah law."[20] Furthermore, in Example 1, it is arguable that BOI's gains from the disposal of (L) to the customer will also be exempt from RPGT, and they will be regarded as business income subject to income tax under the ITA.

B. Islamic Leasing Contracts

The category includes two important contracts: *ijara* and *ijara wa l-iqtina'* (hire-purchase agreement).

1. General

a. Ijara

According to most schools of thought, *ijara* is a contract under which a person (i.e. lessor) leases to another (i.e. lessee) a corporeal and determined object.[21]

Example 4

BOI leases ten agricultural machines worth MYR 1,000,000 to the Farming Company (FC) for a ten-year period against MYR 80,000 paid annually over the leasing period on an installment basis.

b. Ijara Wa l-Iqtina'

Ijara wa l-iqtina', known also as hire-purchase contract, is a lease with an option for the lessee to buy the leased object at the end of the leasing period. In practice, the lessor invests the installment amount in a portfolio account to allow the lessee to use the profits of this account to purchase the leased object at the end of the leasing period.

Example 5

BOI leases MYR 1,500,000 worth of agricultural machines to FC for a ten-year period against an annual rental of MYR 70,000. BOI keeps MYR 50,000 as rent and invests the remaining MYR 20,000 for FC in its leasing portfolio. This amount is invested according to *mudaraba* terms under which BOI is entitled to 30% of the profits and the other 70% is FC's share of profits. The average return on this investment is 10%. By the end of the ten-year rental period, FC will have paid an amount of MYR 500,000 as total rent. In addition, the investment account will have made MYR 200,000, the total return on investment during the ten-year period. This MYR 200,000 will be shared as MYR 140,000 for FC and MYR 60,000 for BOI.

FC's total payment =
Total rent + return from *mudaraba* account =
MYR 500,000 + MYR 140,000 =
MYR 640,000

If FC decides to exercise the option to buy the leased machines, it will need to pay another MYR 110,000 (i.e. MYR 750,000[22] – MYR 640,000).

2. Income Tax

In general, leasing income received by an individual or a company, of which the scope of business does not include leasing, is taxed under Section 4(d) ITA. Leasing income received by a leasing company is taxed under Section 4(a) ITA as business income at the rate of 30%. Before the amendment of Section 2(7), leasing income received by a financial institution, not in the leasing business, was taxed as non-business income under Section 4(d).

Section 2(7) ITA provides that gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah, are treated in the same way as interest income. Therefore, leasing income or expenses received or incurred by a financial institution from conducting *ijara* or *ijara wa l-iqtina'* should be taxed under Section 4(a) as business income.

a. The Position of the Lessor

Before the inclusion of Section 2(7), BOI's leasing income was assessed under Section 4(d). Accordingly, the expenses incurred in producing that income were deductible from that leasing income alone. Based on Section 2(7), BOI's leasing income from *ijara* and *ijara wa l-iqtina'* is treated as business income and, therefore, assessed under Section 4(a). There are two important consequences for considering leasing income as business income—where leasing income is assessed as non-business income, the lessor cannot carry forward losses to offset against income of subsequent years; in addition, the lessor cannot claim capital allowances.

b. The Position of the Lessee

In Example 4, Mohammed Rafi is allowed to deduct the rentals against his income from FC, for which the leased assets were used provided that the conditions of Section 33(1) are satisfied.

According to the theoretical model of *ijara wa l-iqtina'*, the lessee is not obligated to purchase the leased asset at the end of the leasing period. Assuming that case in Example 5, Mohammed Rafi will be allowed to deduct the rentals against his business income provided that the conditions of Section 33(1) are satisfied. In practice, however, some hire purchase agreements contain provisions to eliminate or minimize the lessee's option to refuse to purchase the leased asset at the end of the leasing period. In these types of hire-purchase agreements, the lessor loses the right to depreciate the leased assets.[23]

3. Stamp Duty

If *ijara* is considered to be an "agreement for financing under the Syariah," stamp duty is levied under Item 27 of the First Schedule SDA.

A fixed duty of MYR 3 is levied on *ijara wa l-iqtina'*.

C. Islamic Partnership Contracts

1. General

a. Musharaka

This is a mode of financing based on equity participation in which the partners jointly use their capital to generate profits. The partners freely decide the percentage of profit or loss to be shared. Unlike *mudaraba*, *musharaka* allows both parties to participate in the management of the partnership. Currently, *musharaka* is not an attractive mode of financing for Islamic banks. According to the principles of *musharaka*, the partner providing the capital, the financier, cannot demand collateral to guarantee his capital. This exposes Islamic banks to the risk of losing their capital in case the company fails.

> Example 6
> Mohammed Rafi and BOI enter into a *musharaka* agreement to form a joint company for producing agricultural products. Under the terms of the agreement, BOI provides MYR 500,000, which is 100% of the capital required to found and operate the company. Mohammed Rafi, on the other hand, provides the land on which the company is to be established. The profits generated from the company are to be shared between Mohammed Rafi and BOI in the ratio of 65% and 35%.

b. Mudaraba

This is a sleeping partnership in which the supplier of capital gets to share a specific percentage with the entrepreneur or user of capital. The user of capital uses his expertise, ideas, or skills to maximize profits. In case of losses, however, the supplier of capital will have to share in these losses whereas the user of capital provides his time and effort. The bank can act as both the supplier of capital on one side and user of capital on the other side. Similar to *musharaka*, *mudaraba* implies profit- and loss-sharing between the financier (sahib al mal), the bank in this case, and the entrepreneur (*mudarib*)—a relationship not admitting a demand for collateral.[24]

> Example 7
> Mohammed Rafi decides to invest an amount of MYR 2,000,000 in a *mudaraba* account with his bank BOI for a one-year period. Profits generated from the *mudaraba* account are to be shared between BOI and Mohammed Rafi in the ratio of 30% and 70%. At the end of the year, the return on the account was a total amount of MYR 500,000. BOI's share is 150,000, while Mohammed Rafi's share is 350,000.

2. Income tax

a. Musharaka

The ITA does not treat a partnership as a separate taxable entity. Consequently, each partner will be assessed separately on his share of the partnership income. The partner's share will be computed under Section 55(5) ITA. BOI can argue that the partnership constitutes an instrument of financing in accordance with Syariah. Therefore, according to Section 2(7), the profits received in respect of that instrument should be treated as interest income for ITA purposes. Based on the same argument, Mohammed Rafi, the customer, can claim the right to treat the expenses incurred in this transaction as deductible interest expenses.

b. Mudaraba

The MYR 150,000 of profit received by BOI will be treated as interest business income and therefore taxed at a rate of 30%.

The tax treatment of the MYR 350,000 of profit received by Mohammed Rafi will vary as follows:

1. If Mohammed Rafi is a non-resident individual and BOI is a bank or a finance company licensed under the BAFIA, the income will be exempt from any taxes.
2. If Mohammed Rafi is a resident individual and the MYR 2,000,000 were invested in a savings account for a calendar year under the IFBS, only the interestdividend (i.e. return) attributable to the principal sum of MYR 1,900,000[25] is taxable under Section 4(c) as non-business income as follows:

Principal amount	MYR 1,900,000
Taxable return @ 25%	MYR 475,000
Mohammed Rafi's share of taxable return @ 70%	MYR 332,500

3. If Mohammed Rafi is a resident individual and the MYR 2,000,000 were invested in an investment account for a period not exceeding 12 months under the IFBS, the return from this investment will be exempt from income tax.

3. Stamp Duty

If the *musharaka* and *mudaraba* contracts in Examples 6 and 7 are considered to be "agreement[s] for financing under the Syariah," stamp duties should be levied under Item 27 of the First Schedule SDA.

V. Conclusion

In spite of existing difficulties, Islamic finance has grown rapidly within a very short period. The main challenge for Islamic finance as a new phenomenon is the lack of integration between its theoretical background and its implementation. In other words, Islamic finance suffers from the lack of a comprehensive strategy to connect theory with practice by providing the proper environment in which it can expand.

Islamic financial instruments are genuine alternatives to interest-bearing financial instruments based on economic equity, justice, and social-moral values. The function of these alternatives requires the implementation of a distinctive framework, including banking and tax regulations. Each Islamic financial instrument needs to be examined differently from the accounting and tax perspectives.

Malaysia has undergone important steps to provide Islamic finance with appropriate banking and tax regulations. These regulations have succeeded in presenting the Islamic financial system as a strong competitor to the conventional financial system.

However, the tax amendments that address Islamic finance are rather too general to handle the diverse structures of Islamic financial instruments. Islamic financial instruments deserve special tax treatment which cannot be provided through general provisions such as Section 2(7) ITA or Section 14A SDA.[26] For example, Section 2(7) does not provide a special treatment for Islamic financial instruments; rather, it ignores the different and inherent nature of Islamic instruments by treating them in the same manner as interest-bearing instruments.

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[1] Or "secular."

[2] Malaysia has a dual banking system, which consists of Islamic banks and conventional banks.

[3] Pakistan is another example of an innovative Islamic financial market.

[4] The practice of Islamic banking in modern times is approximately 30 years old. The first Islamic bank was established in a small town in Egypt called Mit Ghamr in 1963. This bank worked as a social welfare organization of which the basic tools were interest-free loans granted to the poor when faced with exceptional expenses caused by illness, weddings, or funerals. Saleh, Nabil, *Unlawful Gain and Legitimate Profit in Islamic Law* (London: Graham & Trotman, 1992), at 108.

[5] Editorial note: This is the spelling used in Malaysia's legislation, although the spelling is *Shari'ah* in the general literature.

[6] Sec. 33 provides that:

(1) Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all expenses

wholly and exclusively incurred during that period by that person in the production of gross income from that source, including –

(a) subject to subsection (2), any sum payable for that period (or for any part of that period) by way of interest upon any money borrowed by that person and
  (i) employed in that period in the production of gross income from that source; or
  (ii) laid out on assets used or held in that period for the production of gross income from that source;

(b) rent payable for that period (or for any part of that period) by that person in respect of any land or building or part thereof occupied by him in that period for the purpose of producing gross income from that source ...

[7] Singh, Veerinderjeet. Malaysian Taxation, Administrative & Technical Aspects (Malaysia: Longman, 1993), at 504.

[8] In most popular Islamic financial instruments, financing expenses are paid on an installment basis.

[9] Such exemptions were not available for customers of Islamic finance before the inception of Section 2(7).

[10] This includes an agreement for a charge or mortgage, especially in the case when the security is a piece of real property for which separate title has not been issued.

[11] According to the explanation of Sec. 14A SDA provided by Fadzil Yusoff, the General Manager of BIMB, the stamp duty will be imposed only once on the amount stated in the first agreement (i.e. the financing price) and not on the amount stated in the second purchase agreement (i.e. the sale price = the financing price + the bank's profits). Yusoff, Fadzil, "The Legal Aspects of Islamic Banking in Malaysia," *Symposium of the Malaysian Experience in Islamic Banking* (Kuwait: March 1996), at 12.

[12] This is the treatment accorded by the SDA. *Supra* III.B.

[13] *Supra* III.A.

[14] The Shafi'i is the only school that allows this sale by focusing on the validity of the form and disregarding the intention of the parties. Al-Mawsu'ah Al-Fiohiyah, Chapter 9, *Wazarat, Al-Awqaf wa-al-Shuun al-Islamiyah*, 1993, at 95-97.

[15] According to Abu Yusif, a Hanafi scholar, *istisna'* is a binding contract for both parties.

[16] *Supra* III.A.

[17] Gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Islamic law are accorded the same treatment as interest earned or incurred for the purposes of Sec. 4(a) and Sec. 4(c), as the case may be.

[18] These conditions are: that the money borrowed is employed in the basis period in the production of gross income from that source; or that the money borrowed is laid out on assets used or held in that period for the production of gross income from that source.

[19] *Supra* III.C.

[20] Sched. 2, Para. 3(g) RPGT Act.

[21] Ibn Rushd considers Ijara as a sale of usufruct of a corporeal object for a specific period. See *supra* note 4, at 120.

[22] The machines are depreciated at the rate of 5% p.a. Hence, MYR 1,500,000 – [5% p.a. x 10 years x MYR 1,500,000] = MYR 750,000.

[23] In Pakistan, a depreciation is allowed to the lessee on the initial value of the assets (the amount for which the assets would have been sold for cash).

[24] For instance, Faisal Islamic Bank in Egypt commonly financed projects during the 1980s through *Mudaraba* contracts. Because the *mudarib* did not have to guarantee the acquired funds, Faisal Bank was often deceived by the *mudarib* into taking full responsibility for a loss whenever the latter claimed that the invested capital had been lost. As a result of numerous losses during the 1980s, Faisal Bank shifted from using *Mudaraba* contracts to Murabaha contracts, which were considered less precarious.

[25] Being MYR 2,000,000 – MYR 100,000.

[26] In this regard, Pakistan can serve as a model for other countries to follow. The Pakistani legislator was aware of the need to address Islamic financial instruments on a detailed level. For example, the Pakistani Income Tax Ordinance, 1979 contains special provisions addressing the income tax treatment of some Islamic instruments, such as *Mudaraba* and Ijara.

Islamic Finance

Evolution and Challenges

Iqbal Ahmad Khan[*]

Abstract

This paper discusses the evolution of Islamic finance, the limits to growth, and its future potential. The first half is concerned with the evolution of the industry, and begins with a discussion of the different stages that various countries are at in their implementation of Islamic finance. The industry as a whole is then tracked across a three-stage timeline consistent of 1970-1980, 1980-2000, and 2000 onward. The second half highlights challenges to the success of Islamic finance: asset management, cooperation/collaboration, consolidation/critical mass, culture/creativity, harmonization of best standards and practices, and authentic presence. If Islamic finance is to meet these challenges successfully in the period after 2000, it must achieve critical mass, with mainstream relevance, in Muslim countries, and have niche status elsewhere.

I. Introduction

I would like to share with you my thoughts on the evolution of Islamic finance, and on the local challenges and global opportunities it faces today. The first half of this paper is concerned with the evolution of the industry. It begins with a discussion of the country spread of Islamic finance: how different nations in the Muslim world have evolved in the period during which they have been focusing on Islamic finance. It then tracks the evolution of Islamic finance as a whole across a continuing timeline. The second half of the paper highlights five key challenges to the success of Islamic finance—leading to the achievement of critical mass with mainstream relevance in the OIC world and a successful niche-product status in the rest of the world. In this regard I will focus particularly on the challenge of asset management, which to me has always been the biggest limiting factor for the growth of this industry. I will also touch upon the challenges of cooperation and collaboration, consolidation and critical mass, culture and creativity, harmonization of best standards and practices, and authentic presence and mainstream relevance.

II. Evolution

A. Country Spread

One way to examine the evolution of Islamic finance is to review the five stages of development the various countries find themselves in today. Stage 1 is the point at which Islamic finance is a concept. This concept is being studied today in countries such as Singapore, China, Uzbekistan, Azerbaijan, and Hong Kong. It is important to keep in mind that many Stage 3 or 4 countries were at Stage 1 25 or 30 years ago. Stage 2 is where we see some high-net-worth individuals and retail investors coming into Islamic finance, and we see a few *takaful* (insurance) or Islamic asset management companies being set up. Countries at this stage include Oman, Algeria, Syria, Lebanon, and the United States. Islamic finance is still a niche product at this point. In moving to Stage 3, we see the actual establishment of Islamic financial institutions in countries that are larger players in Islamic finance. Nations in this stage include Brunei (with the Islamic Bank of Brunei), Indonesia, Morocco, Turkey, Tunisia, Qatar, and Palestine (where there are now three Islamic financial institutions).

By Stage 4, we see that mutual funds are launched and that the industry is seeing a major new shift in its evolution. At this stage we have Malaysia, Kuwait, Bahrain, UAE, Saudi Arabia, and Egypt. What we are witnessing at this point is a broadening and deepening of the Islamic finance market. Islamic finance, as an emerging product and an emerging market, is actually building a critical mass of its own, representing an industry sized at somewhere around US$100 billion and growing at 15% per annum. With a revenue spread of around 1.9 to 2.0%, this means a revenue size of about US$2 billion. This is clearly an industry in the process of evolution and transition. It is important to note that we still do not have the framework that the industry needs to flourish. Stage 5,

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at which we see no countries at this time, is the stage in which Islamic finance is provided with such a framework and succeeds as a mainstream reality in OIC countries while maintaining a niche status in the rest of the world.

B. Timeline

If examined on a timeline, there are three distinct stages in the evolution of this industry. The first was from about 1970 to 1980. At this point, the concept of Islamic finance was being translated into reality by a group of pioneering Islamic financial institutions, such as Kuwait Finance House, the Islamic Development Bank, Dallah Albaraka, and Dar Al-Maal Al-Islami. Mostly short-term, trade-related, low value-added, and documentation-related businesses were introduced. Serious industry and macroeconomic impediments prevented the further growth and evolution of Islamic finance at this time.

The current period of 1980 to 2000 is where we see Islamic finance evolving, gaining momentum as a growth industry, and establishing itself as a niche product. We are seeing the tenures of deals stretching—three-year, five-year, and seven-year deals are now being done—a lot of covenant-based project finance, and Islamic tranches in big-ticket deals (e.g., KFH recently structured a large deal with Citicorp on a large Kuwaiti project). A number of new products are also coming out, there is tremendous improvement in documentation capabilities, and we see more *istisna'*, *bai' salam*, and *ijara* transactions. In this period, equity has opened up as an asset class to us, giving tremendous opportunities for Islamic financial investors. This period is also seeing the gradual liberalization of the economies of the OIC world. The rulebook for capital markets is being written.

In the period of 2000 and beyond, we can look to a focus on infrastructure and venture capital, giving Islamic finance increasing mainstream relevance in the OIC world and a niche-product status in the rest of the world. From stage to stage, this is an industry that is in transition and is evolving along with the markets in which it operates. IDB, at this year's World Bank meetings, announced the creation of the first Islamic countries' infrastructure fund, a US$1.5 billion fund targeted specifically at Islamic countries. This fund will hopefully increase the embedded capital of Muslim countries. In the coming period, we will witness asset securitization, the creation of secondary markets, the mobilization of long-term funds, the creation of new and hybrid instruments, and the achievement of mainstream relevance for this growth industry.

III. Challenges

A. Asset Management

Before it can reach mainstream relevance, however, Islamic finance must overcome a number of challenges. The first and the foremost of these is the challenge of asset management. Good asset management begins with asset allocation and sound ALCO policies. The asset allocation model of Islamic financial institutions should be managed in a dynamic manner, and should be spread across all eligible asset classes. This model should have the ability to switch between different asset classes. The guiding principle for this model should be authentic liquidity management and risk preference for local-currency assets. Local-currency asset portfolios have the benefit of nearness to the risk and therefore better risk-selection opportunities. The foreign-currency component used for cross-border financing should be carefully capped as a percentage of the overall balance sheet. This asset-allocation model should be diversified across risks, sectors, and the yield spectrum.

Asset origination is very important as well. A proactive, market-driven transaction origination strategy should work to originate, underwrite, and distribute Islamically acceptable transactions in line with the asset-allocation model. An Islamic financial institution should review information at both macro and micro levels on the business it potentially wants to finance. These institutions should build stress models and regularly undertake scenario planning on the risks they want to finance.

Asset structuring is likewise of great significance. Asset structures should stay as close as possible to the *Shari'ah* dictates of value-creation potential. These financings should be cash-flow based and not just asset- or covenant-based. It would be worthwhile to check where this potential financing would sit on the balance sheet of the issuers.

As far as asset documentation is concerned, inter-creditor issues need to be looked at very carefully, and Islamic financial institutions should insist on providing as many as possible associated services linked to the financing. In asset documentation, the complete opinion of *Shari'ah* scholars, including full legal counsel opinions, should be taken into account. Issues like liquidated damages and other potential inter-creditor items should be clarified early on.

To me, asset monitoring is as important as asset origination or its structuring. It is therefore time to bring asset monitoring forward as a priority frontline function. Islamic financial institutions would be well advised to emphasize asset monitoring as an important career path within their organizations. Their incentive systems and career plans should reflect the policy. In any case, asset monitoring can be a source of valuable fee income.

In the interest of improving the asset quality of Islamic financial institutions, three initial value propositions come to mind. First, the balance sheet of Islamic financial institutions is not there to be tied up, it is there to be turned over. Second, the balance sheet is not there to generate income, it is there to generate customers. Third, Islamic financial institutions are in both the risk and the services business. They should preferably take risks for only those customers who also take their corresponding services. Taken together, these value propositions suggest an asset-management strategy that can lay the foundation of a sound, diversified, and balanced asset portfolio.

B. Cooperation and Collaboration

For Islamic finance to succeed and grow further, it is also important to move toward collectivism rather than individualism. Islamic financial institutions will have to talk to each other, for we clearly need more collaboration and cooperation within the sector. This requires partnering with asset managers and private banks that have proven track records and a demonstrable commitment to Islamic finance. This relationship should be used to do more research and development and encourage new product creation.

I would like to pay a tribute to the Islamic Development Bank for its continued leadership in this regard, particularly for its creation of the Islamic Banks' Portfolio, Unit Investment Fund, and the IDB Infrastructure Fund. However, more needs to be done. For instance, IDB should seriously consider creating a fund that would take significant equity stakes in Islamic financial institutions. IDB could potentially also float an Islamic Financial Institutions' *mudaraba*. Such an approach could lay the foundation for greater consolidation and the achievement of critical mass in this sector.

We have all heard about the problems of fragmentation in this industry. There is an urgent need to achieve consolidation. Merger within the Islamic finance industry is not a matter of choice, it is a matter of necessity. But merger has to be based on synergy, economies of scale, and compatibility. Mergers within the industry are the only way to achieve critical mass in an increasingly competitive and rather turbulent world economy.

Critical mass is the ability of Islamic financial institutions to go out and bid for business of any size in any of their focus markets. It needs to be built across products, people, systems, management, and earning power.

C. Culture and Creativity

The drive to achieve critical mass should be closely linked to the building of culture and creativity. Islamic finance is different from conventional finance, and that has to be reflected in its culture. This culture is critical because it is possible to replicate the tangibles, but we cannot replicate the intangibles. Culture should be nurtured, and it needs time.

Islamic financial institutions will have to rigorously ensure that they have a highly professional corporate culture. This requires a credit culture in which line management takes independent decisions after doing its own diligent and rigorous analysis. It also means a customer-driven orientation, a service-driven culture, and profit performance as a value.

We also need to have strong shared values based on clearly articulated mission statements and statements of strategic intent. Strong and consistent leadership based on the heritage and tradition of Islamic commerce is needed to head this effort—leadership that understands the past and the present and has a vision of the future of their own institutions as well as of the Islamic world at large. Finally, we need more innovation through *ijtihad*, *ijma'*, and *qiyas* under the guidance of *Shari'ah* scholars.

D. Harmonization of Standards

The harmonization of best standards and practices is the next challenge at hand. The Accounting and Auditing Organization for Islamic Financial Institutions as well as central banking authorities like the Bahrain Monetary Agency, the UAE Central Bank, and the Kuwaiti Central Bank are already playing a very important role in ensuring high accounting and auditing standards and setting up new fiduciary standard benchmarks for Islamic financial institutions. The law firms associated with these institutions are also working to help with the appropriate documentation, and the *Shari'ah* scholars are likewise working on *Shari'ah* standards. In all these efforts, we need to be rigorous with each other in order to set up new standards for benchmarking and rating Islamic financial institutions. Similarly, we need risk management that is both independent and vigilant.

E. Authentic Presence

Finally, we need to have an authentic presence. Authentic presence requires an authentic commitment to *Shari'ah* in its totality. It can be achieved through a code of ethics, a self-regulatory mechanism that many Islamic financial institutions today follow. A *Shari'ah*-allegiance statement is also desirable in this regard, as is the commitment to recruit and retain the best. Investing in training and career development is imperative: people are the key to the future of this industry.

IV. Conclusion

The future of Islamic finance depends on how it works toward achieving mainstream relevance by increasing the embedded capital of OIC member countries, by participating in more infrastructure and merchant banking activities, and by servicing the need of its customers in the rest of the world. The future is not some place where we are going, but one that we are all creating with our clients, with our *Shari'ah* scholars, with our shareholders, with our regulators, and with our team members. The future will be built on our heritage and traditions. The task of giving mainstream relevance to Islamic finance will bless both the makers and its destination.

Financial Engineering in Islamic Finance

Zamir Iqbal*

ABSTRACT

This paper examines the scope of financial innovation and engineering within the context of an Islamic financial system. It discusses the significance of innovation in Islamic financial markets, the process and scope of introducing new products in the market, and an Islamic form of asset-securitization, and evaluates the structure of a commodity swap transaction to determine its validity. The paper concludes that contrary to common belief, the system offers the basic building blocks that can be used to build more complex instruments to enhance liquidity and offer risk management tools. With the introduction of asset securitization and swap transactions conforming to Islamic principles, the issues of secondary markets and risk management can be dealt with.

I. INTRODUCTION

Islamic financial markets have earned due recognition from international financial markets in the past decade by demonstrating the viability and practicality of banking compatible with the principles of Islamic finance. Their phenomenal success and growth is the result of increased demand for Islamic financial products reciprocated by financial intermediaries. The long-term presence of Muslim and non-Muslim financial institutions in the market is a vote of confidence and a sign of recognition. Islamic banking is not confined to the boundaries of Muslim countries anymore but is gaining roots in non-Muslim countries as well. Furthermore, its clientele base is no more restricted to Muslims only.

The market is currently facing the major task of how to maintain upswing momentum and to achieve sustainable growth. Market size, both in terms of asset base and annual turnover, is still considered far below its true potential because the market is plagued by a lack of depth and breadth, which are characteristics of a market with a limited set of instruments. The process of innovation is complex and sensitive, as it requires multi-disciplinary considerations involving a deep understanding of Islamic jurisprudence. All these factors make the process of innovation slow. Today's market is exhibiting a great demand for innovate instruments to enhance market liquidity, develop a secondary market, and perform risk management.[1]

Section I discusses the significance of innovation in Islamic financial markets. Section II discusses the process and scope of introducing new products in the market. Section III illustrates an Islamic form of asset-securitization as an example of financial engineering. Section IV evaluates the structure of a commodity swap transaction to determine its validity. Finally, section V concludes the discussion.

II. SIGNIFICANCE OF INNOVATION IN ISLAMIC FINANCIAL MARKETS

The 1980s witnessed rapid introduction of financial innovations in international financial markets. Financial innovations transformed the traditional financial and banking markets into highly sophisticated markets featuring high degree of liquidity and wide-array of instruments to share and transfer various sources of risk. The trend occurred in both domestic and international financial markets. Demand for liquidity enhancing and risk management instruments was prompted by increased volatility in financial assets prices due to the breakdown of fixed exchange rate system, the oil shocks, excessive government spending, and inflationary policies. The innovation and growth in financial markets was further induced by advances in the financial theory, breakthroughs in the information processing and communication technology and deregulation of financial markets.[2]

Bank for International Settlement (BIS) identifies three types of financial innovation activities with the most significant impact on the markets—innovations to enhance liquidity, to transfer risk (price and credit), and to generate revenues (from credit and equity).[3] Marketability, negotiability and transferability of financial claims create liquidity by expanding the menu of options available to market participants. Derivatives apart from risk-sharing make markets more complete and create important additional social benefits such as the dissemination of

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uniform prices upon which investment decisions can be made, and the lowering of transaction cost in the capital markets.[4] In the long run, financial development and innovations exhibited a positive impact on the economic growth of the countries.

Presently, Islamic financial markets are deficient in both liquidity and risk management tools. Basic building blocks in Islamic financial system are geared toward promotion of trade and partnership because Islam encourages trade, entrepreneurship, and risk sharing. Current market composition is dominated by number of short-term traditional trade (cost-plus financing/*murabaha*) and sales (markup or leasing/*ijara*) financial transactions whereas size of equity-based instruments for medium- to long-term is relatively small. Short-term trade and sales related instruments constitute approximately 85-90% of all transactions while the rest are equity-related transactions. Table 1 provides market composition as of early 90s.

TABLE 1. PORTFOLIO DISTRIBUTION OF ISLAMIC BANKS

Instrument	1989	1990
Short Term *Murabaha*	75.4%	75.6%
Mutagra and Real Estate	15.4%	15.5%
Medium-term Investment	5.4%	5.4%
Equity Participation	1.4%	1.4%
Long-term Islamic Investment	2.1%	1.3%
Social Lending	0.3%	0.3%

Source: Data compiled by International Association of Islamic Banks.[5]

The demand for medium-term financing is met by profit-sharing agreements (*mudaraba*) and equity partnership (*musharaka*) instruments. Although both profit sharing and equity participation are also used for long-term financing, these choices are limited. Even when such choices are available, investors exhibit less enthusiasm and are hesitant to commit funds and resources due to difficulties and cost associated with liquidating the asset at times of need.

Secondary markets in Islamic financial markets are shallow, under-developed, and inefficient.[6] Lack of efficient secondary markets and liquidity in the Islamic financial markets has indirectly limited the range of maturity structures available to the investor. Due to absence of liquidity, Islamic bankers can not easily expand portfolios across capital markets and are restricted to limited opportunities for portfolio diversification. This presents a challenging opportunity to develop highly liquid instruments to satisfy demands of the investors and the users of funds seeking medium- and long-term maturity structure with the flexibility of adjusting portfolios at the lowest cost.

Risk management products are still foreign to Islamic financial markets. This is not because Islam does not recognize the need for risk management but is due to lack of research in this area. In reality, Islam imposes greater responsibility of prudent identification and sharing of risks. It is obvious that further growth of Islamic financial markets will largely depend on the development of secondary markets and introduction of innovative products to enhance liquidity and risk management.

III. PROCESS AND SCOPE OF FINANCIAL ENGINEERING

The process of financial engineering can be viewed as a process of building complex instruments utilizing basic building blocks or unbundling and repackaging different components of existing financial instruments, e.g. return, price risk, credit risk, country risk, etc. Today's highly liquid instruments and derivatives are nothing but a structure based on simple and basic set of instruments. A close scrutiny of instruments underlying Islamic financial system reveals that such instruments have similar characteristics of many of today's basic building blocks and it is matter of designing more complex instruments without violating any of the boundaries defined by the Islamic system.

The process of introducing a new product is subject to several rules governing Islamic economic and financial system defined by Islamic law (*Shari'ah*).[7] The process of determining the legitimacy of a new product involves approval by religious boards representing different schools of thought in Islamic jurisprudence. Each financial institution has a special board of religious scholars to whom all new products are referred for approval.[8] The religious board may seek the approval of the Supreme Religious Board in countries where it exists and this board may confer with the International Association of Islamic Banks (IAIB) in its decisions.[9]

From legal point of view, any instrument is acceptable as legitimate financial instrument provided it does not incorporate certain elements considered unlawful in Islam. An Islamic financial contracts or instruments must be free of *riba* (a fixed and pre-determined return similar to interest), *gharar* (existence of asymmetrical information and uncertainty), *qimar* (gambling) and *ikrah* (coercion). Prohibition of *riba*, a term literally meaning 'an excess' and interpreted as 'any unjustifiable increase of capital whether in loans or 'sales' ' is the central tenet of Islamic financial system.[10] More precisely, any positive, fixed, pre-determined rate tied to the maturity and the amount of principal (i.e. guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited.[11] *Gharar* in a contract arises where there is lack of knowledge or there is a reasonable doubt in the control of either party to the contract over the completion of exchange.[12] *Qimar* refers to gambling, bets, and wagers. The essence of gambling is that of taking a risk deliberately, created or invited, which is not an accessory to the economic activity, to gain thereby.[13] *Ikrah* is coercion or imposing a contract or a condition on an unwilling party.

It is important to recall that while Islam prohibits pre-determined fixed returns such as interest, it in no way denies a rate of return from legitimate economic activity. The demarcation between interest and return is critical. Islam forbids a fixed, or a pre-determined return, on financial transactions but allows uncertain rate of return such as that represented by profits.[14] Concepts of time value of capital and the use of an expected rate of return or a pseudo discount rate based on the riskiness of the asset for financial valuation is by no means un-Islamic.[15] Finally, the notion of cash flows collateralized against an underlying asset—another essential tool of financial engineering—is very much compatible with the principles of Islam who promotes investment in real sector.

Although, understanding of *Shari'ah* approved financial instruments is important for any form of financial engineering in Islam, it is also very critical to understand the laws governing the contracts in Islam. Individuals have wide freedom of contract and the contracting parties are free to engage in any transactions not prohibited by the *Shari'ah*. In other words, any transaction is permissible so long as it does not contain any of above-mentioned elements of *riba*, *gharar*, *qimar*, and *ikrah.* In addition, it is extremely critical to distinguish between the sales contracts and financial contracts. While the instruments of sales transactions such as *murabaha*, installment sales or *salaf* may resemble an interest-based transaction are allowed and recognized by *Shari'ah* but the same is not true when it comes to investments or raising of capital which should be on the basis of profit-sharing.

Modern finance theory and subsequent financial innovations are pivoted on the concept of pre-determined 'interest', which has become integral part of all major asset-pricing models. Any attempt of financial engineering to create a new instrument without any reference to 'interest' appears a challenging task. Two different approaches can be taken to apply financial engineering in Islamic finance. First, is to take an existing instrument in conventional system and make an evaluation of each component to find the closest substitute from the set of basic Islamic instruments. This approach is synonymous to reverse engineering. Extreme care is required in this approach to avoid any misidentification of close substitutes. Also, this approach may be used only for determining the legitimacy of a product for approval purposes. Second approach is to design and invent new instruments using Islamic instruments by applying principles of financial engineering. The result will be new array of instruments with each having unique risk-return profile. Since this approach requires deep understanding of the Islamic economic and financial system as well as the risk-return characteristics of each basic building block, it is a long-term solution and requires extensive research and commitment.

Next two sections present a case for asset securitization and commodity swaps to illustrate the application of financial engineering in Islamic financial system.

IV. Securitization

Formally, the term 'Securitization' is often referred to the process of enhancing marketability, negotiability, and liquidity of an otherwise dormant asset. It allows hitherto relatively illiquid securities to be transformed into risk-diversified, high return vehicles for intermediating funds.[16] It involves packaging a pool of homogeneous assets that are normally not traded into tradable securities. This has been done either by using the original assets as collateral for a new tradable security that is issued (collateralized obligation) or by issuing a new tradable security that is being serviced by the proceeds of the original asset (pass-through security).[17] The most prevalent forms of successful securitization in Western financial markets are securities backed by mortgages, car loans, leases, and receivable from inventory, credit cards and service centers like health care providers.

The securitization process involves five primary parties: the originator, the purchaser (typically an affiliated trust), the structurer or the underwriter, the guarantor and the servicer. The originator is the original owner of the financial asset who desires to liquidify the asset by taking the asset off the balance sheet. The originator benefits by getting the asset off the balance sheet while other parties earn fee income for their respective role. The structurer normally establishes purchaser of the asset in the form of a Special Purpose Vehicle (SPV) to serve as a trust. The asset side of the SPV's balance sheet reflects the securitized asset and the liability side contains the certificates or notes issued against such assets. Special Purpose Vehicle (SPV) is setup in the form of a trust or in any other form that may be suitable considering the tax and accounting application of the deal. Guarantor plays the role of the credit enhancer to stamp the certificates with the investment grade credit rating. Finally, the function of servicing of the asset—often kept to itself by the originator—is performed for a per-determined fee.

Let's examine the mapping of the securitization process in conventional system to the framework of Islamic finance. Leasing (*ijara*) is a well-established and recognized Islamic instrument with reasonable market size that offers medium- to long-term financing for capital goods and equipment required by projects. Leasing is a good candidate for Islamic asset securitization due to several reasons. First, leases are by definition asset backed so that investors are not exposed to any credit risk. Second, it provides a collateralized and steady stream of cash flows—a desired feature for successful securitization. Third, leases can be fixed or floating rate, hence offering more flexibility and opportunity for better assets-liabilities matching. Finally, there are similarities between Islamic lease and conventional lease that makes the instrument attractive to non-Muslim investors; thus expanding the investor base and strengthening the integration of capital markets.

For the origination phase, Islamic financial institutions who wish to securitize can collect homogeneous lease contracts, i.e. auto or equipment leases with similar maturities into a pool. Given the current size of the market, institutions may not hold assets individually which can permit cost effective securitization but collectively, a large sized pool can be launched through a form of syndication. A *mudaraba* (Islamic form of trust financing) formed as a trust to undertake a special task can easily substitute the role of Special Purpose Vehicle (SPV). Different forms of *mudaraba* can be formed to optimize functionality with the applicable tax and regulatory implications. The structure of the balance sheet of the *mudaraba* will be identical to the balance sheet of SPV, i.e. pool of leases on the assets side and certificates issued to the investors on the liabilities side.[18]

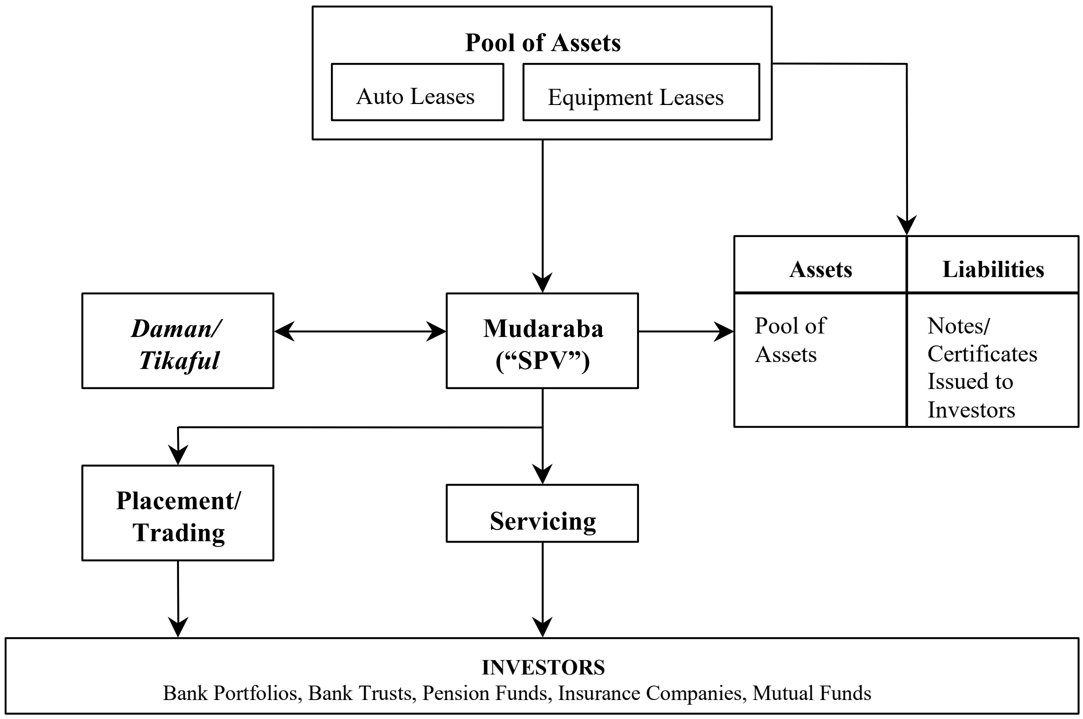
The element of credit enhancement or underwriting in conventional securitization may not have an exact substitute in Islamic securitization. Also, finding an exact substitute is not the objective. The whole notion of credit enhancement in conventional securitization is very critical as it stamps the secured certificates with investment grade rating. Similar function in Islamic finance can be emulated through an instrument based on the principles of Islamic guarantee (*daman*) or suretyship (*kifala*) or insurance (*takaful*).

Daman is a form of contract by which one person joining himself to another person, and binding himself also to meet the obligations which accrues to that other person.[19] Similarly, *kifala* relating to financial claims implies an obligation to pay in the event of the principal debtor's inability to honor his obligation.[20] Appropriate form of guarantee for securitization will be the guarantee of property whereby a person becomes guarantor for the payment at present or at a future date. In the case, where several persons constitute themselves as sureties for one debtor and for one the same debt, the creditor can only claim from each co-surety the amount each has given guarantee for unless they have constituted themselves jointly and severally liable.[21] Critical assumption is that the contract of *daman* (guarantee) which is applicable to a person can be extended to an entity with limited liability such as a corporation.

Alternatively, *takaful*, Islamic insurance, can also provide the function of credit enhancement but in a different way than *daman* (guarantee). A *takaful* fund can be established to cover future losses or inability to perform. A fee charged as part of servicing the asset can finance this fund and any surplus or residual after deducting costs can be distributed back to the subscribers as the maturity approaches. The remaining parts of securitization, i.e. placement, trading and servicing can be replicated in Islamic finance without requiring any special instrument. Based on the analysis in the preceding section, it is clear that securitization of assets can be implemented in Islamic finance. Typical applications of assets securitization can be in the area of leasing, commodities, equities, and trade and export receivables.

Figure 1 illustrates the structure of lease securitization within the framework of Islamic finance.

FIGURE 1. STRUCTURE OF ISLAMIC ASSET SECURITIZATION



V. COMMODITY SWAP

The phenomenal development of the swap market is undoubtedly one of the most significant development in international capital markets over the past decade. Incomplete markets and market inefficiencies are often put forth as arguments to explain the economic rationale for swaps.[22] More recently, market integration and high degree of interlinkages across segments of financial markets, internationalization of financial markets, increased volatility in security prices and increased demand for off-balance-sheet instruments to perform asset/liability management are cited for this rapid growth. Bulk of volume in swaps markets is consists of interest rate and currency swaps with extensive variations followed by relatively small fraction of commodity and equity swaps.

Swap deals are not practiced in Islamic financial markets mainly because the instrument is suspected to incorporate 'interest'—a prohibited element in Islamic finance. This objection is understandable in case of interest rate and currency swaps, however one can argue that the case of commodity swaps is different. Discussion below demonstrates that simple form of commodity swap could be recognized as valid contract which does not violate any *Shari'ah* rules and therefore could be considered acceptable by Islamic financial markets. Acceptance of commodity swap can be of great significance as oil producing Muslim countries of Persian Gulf can utilize the instrument to hedge against unexpected and unfavorable price movements and can achieve price risk managing, forecasting and planning for the future. This can ultimately lead to better policy management and stability in balance of payment.

Commodity swap is a term utilized to refer to a special class of financial exchange transactions in which counterparties agree to exchange cash flows related to commodity prices with the objective of managing commodity price risks.[23] One of the basic or plain vanilla type of commodity swap is a 'fixed-for-floating' commodity price swap where an end user (producer) fixes the purchase (sale) price of its commodity relative to an agreed established market pricing benchmark for the commodity for an agreed period of time.[24] The purpose of the swap is to hedge against future price risk. Coverage of commodity types includes crude oil, marine fuel, heating oil, naphtha, gasoline, natural gas, precious metals (gold, sliver and platinum), base metals (copper and aluminum) and variety of agricultural products such as wheat. Most of these commodities are non-perishable for which there are published price indices, a liquid market in the physical products and a variety of both buyers and sellers. Also, exchange-traded futures markets already exist for many "swappable" commodities.[25]

In order to examine the legitimacy of commodity swap, one needs to understand the structure and the pricing mechanism of a simple 'fixed-for-floating' price commodity swap to evaluate if it violated any *Shari'ah* rules. In terms of the structure, like any swap, a commodity swap is nothing but a portfolio of forward contracts of different maturities. Each forward contract is a sales or purchase agreement to sell or purchase specified quantities of commodity to be delivered in the future at a pre-determined price and pre-determined date. Given that swap is a series of forward contracts, a commodity swap can be priced as portfolio of forward contracts on the commodity [utilizing forward prices].[26]

The forward price of a commodity is an assessment of the future price of underlying commodity at delivery based on today's information and market expectations. In this capacity, forward markets serve the purpose of 'price discovery'—the process of determining the equilibrium prices that reflect current and prospective demands for current and prospective supplies, and making these prices visible to all.[27] Major factors determining theoretical [an arbitrage-free and equilibrium] forward price of a commodity are the spot price, the yield curve "carry" cost and storage/holding/transportation costs.[28] Inclusion of the yield-curve "carry" in the model is purely to demonstrate that the forward price is arbitrage-free. As oppose to theoretical price, actual future price of commodity is greatly influenced and is determined by future demand/supply, price expectations, and price/volume elasticity of the commodity.

A "fix-for-floating" commodity price swap can also be viewed in Islamic finance as series of sales *contracts* for future delivery with varying periods. In simple words, it is a 'price fixing' contract where user and producer of the commodity mutually agree to exchange pre-determined quantity of commodity at a pre-determined price for a period of time in the future. Islamic sale contract *bai' salam* is the closest substitute for the forward contract.[29] *Bai' salam* is a sale contract in which either advance payment is made to the seller or the rate is fixed at conclusion of contract for deferred supply of goods.[30] There is unanimous consensus on permissibility of *salam* but differences exist on actual execution and implementation of the contract.

General conditions governing *salam* are that the commodity should be delivered on a specific future date after signing the contract, amount of principal [price times quantity] paid should be known, principal should be paid in advance, place of delivery should be specified, the contract should not allow options, principal paid should be in the form of money, and the two transacted items should not be of the kind whose exchange would lead to *riba*.[31] In early days of Islam, *bai' salam* was restricted to a number of selected commodities. However, the later jurists unanimously treated it as a permissible mode of business and extended the list to all those commodities that could be precisely determined in terms of quality and quantity.[32]

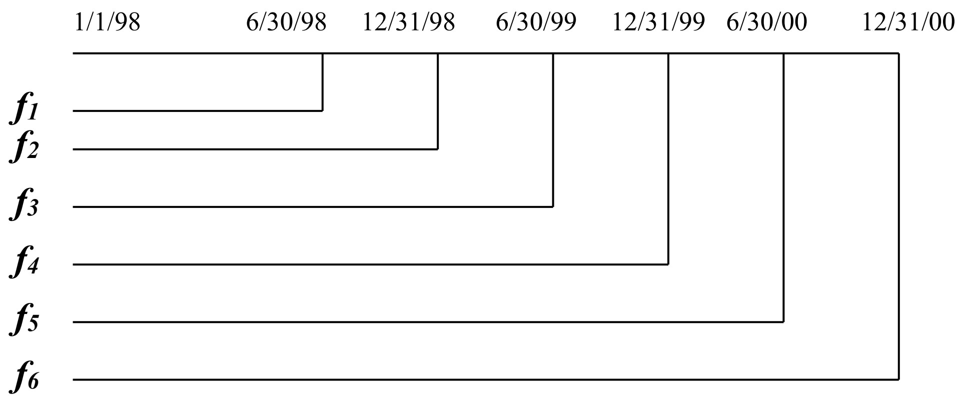
In spite of this acceptability, *bai' salam* is not popular in Islamic financial markets, mainly for two reasons. First, it is required that as opposed to the conventional forward contract, full payment is made at the time of agreement in case of *bai' salam*.[33] Delaying payment or payment in installment voids the contract. Second, it is considered that since interest is incorporated in the pricing model of forward price, it is synonymous to paying or receiving interest as prohibited by Islam. One can argue that the first condition can be satisfied in different ways subject to acceptability by *Shari'ah'*. Depositing received principal with the counter party is permissible implying that a *salam* seller may deposit the amount of principal he receives with the same bank that he deals in *salam* with.[34] Therefore, simply establishing a non-interest bearing margin account with the Bank may satisfy this requirement. One can also argue that condition of making full payment at the time of contract can be met through a *daman* (a guarantee) by a financial institution undertaking the responsibility of performance and payment of principal on demand.[35]

As far as the objection of incorporating *riba* in forward contract is concerned, one needs to view forward from a different angle by considering it purely as a valid (legal) contract of sale. First, it is a legitimate right of the producer and the user of commodity to agree on a fixed price of exchange where price for future delivery can be different from spot. A misunderstanding arose when early Arabs rationalized and believed that interest (*riba*-in-debt) is similar to gain in trade exchanges (*riba*-in-barter) without realizing that the price and the profit concluded or agreed to in the original contracts of exchange, in particular the deferred contracts of exchanges, is not the same as *riba*.[36] Second, in an efficient market forward price is only an unbiased predictor of the future price. Unlike other derivatives such as currency or interest rate futures where pricing is direct function of interest rate, forward price of a commodity depends on multiple factors with complex relationships. Third, since forward is a sales contract to be executed by genuine need of hedging, the question of indulging in payment or receipt of interest will not arise.

Finally, any other pricing model based on time series or regression that does not refer to any interest rate may be used.

Figure 2 illustrates replication of a 3 year, semi-annual resets, for 100k barrels of oil swap settling on 1/1/98 using Islamic instruments:

FIGURE 2. REPLICATION OF FIXED-FOR-FLOATING COMMODITY PRICE SWAP AGREEMENT



Each f_n is a (*bai' salam* + *daman*) for the nth maturity. The price for each f_n can be mutually determined by the counter parties.[37]

VI. CONCLUSION

Financial engineering has clearly reshaped western markets in the last two decades by introducing highly sophisticated and liquid secondary markets and derivative products. Contrary to common belief, Islamic financial system also provides basic building blocks and the flexibility to construct innovative financial products. The survival and further development of Islamic financial markets largely depend on the nature of financial innovation introduced by market players. Long-term sustainable growth can be achieved by developing a well functioning secondary market and introducing liquidity enhancing and risk-sharing products. Securitization will help the development of a secondary market and the introduction of negotiable and marketable financial instruments. A well developed secondary market and the availability of derivatives would also strengthen the integration of Islamic markets with other markets as there will be common tools to conduct financial transactions. In the absence of financial innovations, Islamic financial markets may lose the current growth momentum and may not be able to achieve their true potential.

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[1] Hossein Askari and Zamir Iqbal, 'Opportunities in Emerging Islamic Financial Market,' *Banco Nazonaile De Lavaro Quarterly Review*, September 1995.

[2] Philippe Jorion and Marcos Da Silva, *The Importance of Derivative Securities Market to Modern Finance*, (Chicago: Catalyst Institute, 1995), p 5.

[3] Bank for International Settlement, *Recent Innovations in International Banking*, (Basle: Bank for International Settlement (BIS), April 1986), pp. 130-139.

[4] Philippe Jorion and Marcos Da Silva (1995:3).

[5] Farah G. Fadil, 'Central Banks and Interest Free Banking: Some Theoretical and Practical Underpinnings,' *Proceedings of Islamic Banking and Finance Conference in Dubai*, p. 15.

[6] Askari and Iqbal (1995).

[7] In Islam, any activity—economic, social, political, religious—is governed by the set of Islamic laws known as *Shari'ah*. *Shari'ah* is constituted from three sources: the Qur'an, the *Sunna*, and the *ijma'*. The Qur'an is the divine law whereas *Sunnah* comprises of the sayings, the actions and the practices of the Prophet Muhammad (PBUH), or his acknowledgments or implicit approval of certain actions. *Ijma'* (collective reasoning) is the unanimity of consent by Muslim theologians and the experts on the knowledge of Islamic jurisprudence (*fiqh*). The process of interpretation of jurisprudence in light of the Qur'an, the *Sunnah*, and the *ijma'* is called *ijtihad*.

[8] The role of *Shari'ah* Council in most of Muslim countries is only of an advisory nature and the institution of *Shari'ah* Council at government level is non-existent in almost all the non-Muslim countries. Therefore, the Council's capability to maintain Islamic injunctions is dependent upon its legal status and the extent of implementation of its opinions. As a simple generalization, many Islamic banks belong to the International Association of Islamic Banks (IAIB).

[9] Hussain Lawai, 'The Role of *Shari'a* Council in Developing Banking Products,' *Proceedings of Islamic Banking and Finance Conference in Dubai*, 1994.

[10] For further discussion of *Riba* and Islamic economics system, please refer to Abbas Mirakhor, 'General Characteristics of An Islamic Economic System,' *in Essays on Iqtisad: The Islamic Approach to Economic Problems*, ed. Baqir Al-Hasani and Abbas Mirakhor, (Nur Corp., MD, USA), pp.45-80. Mohsin S. Khan and Abbas Mirakhor, 'Islam and The Economic System,' *Review of Islamic Economics*, Vol. 2, No. 1 (1992), pp 1-29.

[11] All schools of thought agree that Riba is not simply usury as often perceived by some. There is now a consensus that this prohibition covers all forms of interest, including excessive interest and the indexing of capital.

[12] Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law*, 2nd ed., (London: Graham and Trotman, 1992).

[13] Aqdas Ali Kazmi, 'Islamic Financial Instruments,' *Journal of Islamic Banking and Finance* 11, (Jan.-Mar. 1994), pp. 42-43.

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[15] Mohammed Anas Al-Zarqa, 'An Islamic Perspective on the Economics of Discounting in Project Evaluation,' in *An Introduction to Islamic Finance*, ed. Shaykh Ghazali Shaykh Abod, Syed Omar Syed Agil, and Aidit Haji Ghazali, (Kuala Lumpur: Quill Publishers, 1992), pp 94-125.

[16] Sylvester Johnson and Amelia A. Murphy, 'Going Off the Balance Sheet,' *Federal Reserve Bank of Atlanta Economic Review,* September/October 1987, p. 30.

[17] International Monetary Fund, *International Capital Markets: Developments, Prospects, and Policy Issues*, (Washington, DC: International Monetary Fund, 1988). p. 36.

[18] Zamir Iqbal, 'Scope of Asset Securitization in Islamic Finance,' *Journal of Islamic Banking and Finance*, (Oct.-Dec. 97).

[19] The Mejelle, Book III, Arab Law Quarterly, 1987, p. 158

[20] S. M. Hasanuzzaman, 'Islamic Law and Finance,' *Encyclopaedia of Islamic Banking and Insurance*, London, 1995, p. 82.

[21] Abdur Rahman I. Doi, *Shari'ah: The Islamic Law*, (Ta Ha Publishers, London, 1984), p.369.

[22] D. Wall and John J. Pringle, 'Alternative Explanations of Interest Rate Swaps: A Theoretical and Empirical Analysis,' *Financial Management*, (Summer 1989), pp 59-70.

[23] Satyajit Das, *Swap and Derivative Financing*, (Irwin Professional Publishing, Chicago, 1994), p. 492

[24] Satyajit Das (1994:491).

[25] Satyjit Das, Forward March, Risk, vol. 60, no. 2, February 1993, p. 41.

[26] Satyajit Das, (1994:502)

[27] Philippe Jorion and Marcos Da Silva (1995:2-6).

[28] Satyajit Das, (1994:503)

[29] For a detailed review of *Bai' Salam*, please consult Umar, Mohammad Abdul Halim, *Shari'ah, Economic and Accounting Framework of* Bai' Salam *in the Light of Contemporary Application*, Islamic Research and Training Institution Research Paper No. 33, (Jeddah: Islamic Research and Training Institution, 1997).

[30] Rayner, S. E., *The Theory of Contracts in Islamic Law*, 1st ed. (London: Graham and Trotman, 1992), p. 134.

[31] These conditions are according to Hanafi school of thought. For further details and comparison, see Mohammad Abdul Halim Umar (1997), pp. 27-28.

[32] S. M. Hasanuzzaman (1992:225).

[33] Commodity sold in a *salam* contract results in debt burden on the seller and principal received from the buyer becomes a financing vehicle for the seller. Therefore deferring the payment of principal will lead to exchange of debt against debt, which is prohibited. See Mohammad Abdul Halim Umar (1997), p 21.

[34] Mohammad Abdul Halim Umar (1997), pp. 33-34.

[35] This is based on assumption that one is allowed to combine a *salam* contract with a guarantee. M. Akram Khan makes similar argument in *Commodity Exchanges and Stock Exchange in an Islamic Economy*, p. 315.

[36] Abdul Halim Ismail 'Deferred Contracts of Exchange in Al-Qur'an,' in *An Introduction to Islamic Finance*, ed. Shaykh Ghazali Shaykh Abod, Syed Omar Syed Agil, and Aidit Haji Ghazali, (Kuala Lumpur: Quill Publishers, 1992), pp. 284-313.

[37] Another form of *salam* known as *istisna'* can also be considered to emulate a commodity swap. *Istisna'* is a contract according to which the buyer asks a manufacturer to produce something for him against a given price. There is no condition of making full payment at the time of contract. Generally, *istisna'* is applied to a contract of manufacturing something according to a given specification.

Accounting and Auditing Standards for Islamic Financial Institutions

Rifaat Ahmed Abdel-Karim[*]

ABSTRACT

The accounting practices of different Islamic financial institutions today vary greatly, and financial reporting in Islamic financial institutions lacks self-regulation and standardization. It is thus imperative that high and common accounting and auditing standards be developed and implemented across Islamic financial institutions. The Accounting and Auditing Organization for Islamic Financial Institutions, established in and based in Manama, Bahrain, has played a pioneering role in developing and promoting these standards. It has brought together a common *Shari'ah* Board, worked with regulatory as well as financial institutions to implement its standards, and to date made a total of eighteen pronouncements on accounting and auditing standards for Islamic finance.

I. INTRODUCTION

At this stage of their development, Islamic financial institutions are looking forward to being perceived as an industry in the process of becoming mature. This would require the establishment of some basic infrastructure, including greater standardization of products and the development of accounting and auditing standards that enhance the credibility of financial reporting by Islamic financial institutions. This paper focuses on the latter and gives a brief account of some of the differences in the accounting practices of Islamic financial institutions, the efforts that have been exerted to develop the institutional arrangements for self-regulating financial reporting by Islamic financial institutions, and the pronouncements of the body that was established to self-regulate this financial reporting as well as the auditing practices of their external auditors.

II. CHALLENGES

Islamic financial institutions have to abide by the precepts of the *Shari'ah*, which among other things prohibit the payment and receipt of interest in all business transactions.[1] This requires that the financial accounting and reporting done by Islamic financial institutions (or indeed any Islamic business organization) also be developed and practiced in accordance with *Shari'ah* principles. Such a task is likely to open a new dimension of challenges facing accounting academics and practitioners, professionals who are usually conversant only with Western theories and practices. From an auditing perspective, shareholders and investment account holders likewise expect Islamic banks' auditors to deliver a more comprehensive audit that takes *Shari'ah* compliance into account.

At present, the accounting policies adopted by Islamic banks in the preparation of their financial statements are to a large extent unregulated. This seems to have encouraged almost every Islamic financial institution to develop its own accounting policy for the various contracts that govern its work. Such a process is usually based on deliberation between the external auditor and the management, as well as the bank's in-house religious supervisors (*Shari'ah* Supervisory Board, or SSB) in many cases. This process focuses on whether or not the accounting standards adopted by the Islamic financial institution's host country are in agreement with the underlying *Shari'ah* principles of the institution's contracts. Indeed, in some Islamic financial institutions accounting policies are developed by reference to the *Shari'ah* whenever departure from adopted accounting practices is felt necessary.

The present practice of setting their own accounting policies has, however, resulted in a variety of accounting practices across Islamic financial institutions. For example, Islamic financial institutions use at present at least six methods to recognize profit generated from *murabaha* transactions.[2] I have also been made to understand that some Islamic financial institutions use more than two methods to recognize *murabaha* profits in the same financial period. As another example of variance, there are major differences in how institutions allocate profits between investment account holders and shareholders constitute. The variations also include the use of

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different measurement attributes for the same transactions, the disclosure of information in different forms and degrees, and the classification of financial statement items in a dissimilar manner.

Such variations seem to be mainly due to the fact that there is no perfect match between the accounting treatments proposed in the international accounting standards on which many Islamic financial institutions tend to rely in preparing their financial statements and the *Shari'ah* characterization of the contracts used in their business transactions. In addition, these variations also tend to arise because of different interpretations of *Shari'ah* rulings.

These differences are bound both to render financial statements of Islamic financial institutions difficult to compare and to weaken their credibility in the eyes of international market players. In addition, such differences offer a legitimate platform on which a case for the regulation of the financial accounting of Islamic financial institutions can be made.

III. AAOIFI

In 1991, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established by Islamic financial institutions and other interested parties to set international accounting and (recently) auditing standards for Islamic financial institutions based on *Shari'ah* precepts. AAOIFI's pronouncements are intended to serve Islamic financial institutions in the various countries in which they operate.

The organizational structure of AAOIFI includes a general assembly. To date, fifty-six institutions from fifteen countries have joined as members of this general assembly. AAOIFI also has a board of trustees and an accounting and auditing standards board each consisting of fifteen part-time members, a *Shari'ah* committee consisting of four part-time members, an executive committee, and a secretary-general who is a full-time executive and heads the general secretariat.

AAOIFI finances its activities from the proceeds of a *waqf* (endowment) and charity fund (developed from the membership fees paid by institutions joining AAOIFI), annual subscription fees, grants, donations, bequests, and others sources.

To date, AAOIFI has issued two financial accounting statements relating to the objectives and concepts of financial accounting for Islamic financial institutions, ten accounting standards, five auditing standards, and a code of ethics for accountants and auditors of Islamic financial institutions (see Part IV of paper). This brings the total number of AAOIFI's pronouncements to eighteen. You may also like to know that we are currently working on three new standards. This is an impressive record of achievement that deserves to be supported and encouraged by all concerned parties.

AAOIFI has also taken on board another important issue for the Islamic banking industry. Early this year it published a discussion memorandum on the calculation of the capital adequacy ratio for Islamic banks. We are very encouraged by the responses we received in this regard. As a result, the Committee in charge has issued an exposure draft statement on this issue.

AAOIFI has an extensive due process that governs the production of its accounting and auditing standards. The due process includes the vetting of the juristic suitability of the proposed standards by AAOIFI's *Shari'ah* Committee. It also provides interested parties with the opportunity to express their opinion on the standards before the Board finally approves them. This is made possible by the holding of public hearings to discuss the exposure drafts. In 1997, we held two public hearings, one in Bahrain and the other in Malaysia. This year we again held two public hearings, one in Bahrain and the other in Pakistan.

The public hearing is also meant to increase awareness of AAOIFI's standards amongst the financial community. Furthermore, it is intended to enhance confidence in the financial statements of Islamic financial institutions on the part of the users of these statements. AAOIFI is very much encouraged by the number of central banks, Islamic financial institutions, and professional accountants who attended the public hearings. Members of the accounting and auditing committees in our organization who are responsible for drafting the standards have benefited tremendously from the useful discussions that took place in these public hearings. It is hoped that through such a process AAOIFI will issue standards that help in providing relevant and reliable information and hence play an instrumental role in developing and enhancing Islamic capital market activities.

AAOIFI is endeavoring to produce high quality standards and to keep them up-to-date to meet the needs of the users of the financial statements of Islamic financial institutions. However, such efforts can only bear fruit if the standards are implemented.

The implementation of AAOIFI's standards is indeed very important and I would even say imperative for the Islamic banking industry. Knowing these standards does represent an important factor in the implementation process. AAOIFI endeavors to fulfil this by organizing conferences and seminars in order to inform the industry about the standards it has issued. However, this is not enough. We ask the people in the industry to take part in debates and discussions through every possible media to highlight the positive benefits that will flow from the implementation of these standards.

At present, AAOIFI does not have the power to force Islamic financial institutions to implement the standards it promulgates. AAOIFI has therefore pursued a strategy of having its standards implemented by cooperating with the concerned governmental and professional agencies—namely, the central banks and bodies responsible for implementing accounting standards. We are very pleased that some countries (e.g., Bahrain and Sudan) have made it mandatory for Islamic banks to adhere to AAOIFI's standards, while others (e.g., Malaysia, Pakistan, and Qatar) have taken practical steps to enforce our standards. Additional efforts are being exerted to increase the number of Islamic financial institutions that adhere to AAOIFI's standards. These include working closely with the securities exchange commission in countries in which Islamic financial institutions operate so that all listed institutions engaged in Islamic banking be required to adhere to AAOIFI's standards.

Despite AAOIFI's lack of power in enforcing its standards, other players in the market, (e.g., international rating agencies) are gradually recognizing its standards. Although we are very delighted and encouraged by these developments, we are aware that the growing acceptance and implementation of these standards, will require a high degree of cooperation between us as standard-setters and national regulatory bodies.

AAOIFI also seeks the acceptance of its accounting and auditing standards around the world by cooperating with the International Accounting Standards Committee and the International Federation of Accountants.

Let me close by briefing you on a major development we have been able to participate in: the formation of a *Shari'ah* board which comprised of fifteen *fiqh* scholars from among the members of the SSBs in Islamic financial institutions. The formation of this board is in response to varying and sometimes inauthentic *fatawa* issued by different SSBs. Such variations did import some of the standards issued by AAOIFI—e.g., the *murabaha* standard.

IV. AAOIFI'S PRONOUNCEMENTS

A. Financial Accounting Statements

1. Objective of Financial Accounting of Islamic Banks and Financial Institutions
2. Concepts of Financial Accounting for Islamic Banks and Financial Institutions

B. Financial Accounting Standards

1. General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions
2. *Murabaha* and *Murabaha* to the Purchase Orderer
3. *Mudaraba* Financing
4. *Musharaka* Financing
5. Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders
6. Equity of Investment Account Holders and Their Equivalent
7. *Salam* and Parallel *Salam*
8. *Ijara* and *Ijara Muntahia Bittamleek*
9. *Zakat*
10. *Istisna'* and Parallel *Istisna'*

C. Auditing Standards

1. Objective and Principles of Auditing
2. The Auditor's Report
3. Terms of Audit Engagement
4. *Shari'ah* Supervisory Board: Appointment, Composition, and Report
5. *Shari'ah* Review

D. Ethics

1. Code of Ethics for Accountants and Auditors of Islamic Financial Institutions

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[1] The *Shari'ah* is the sacred law of Islam. It is derived from the Qur'an (The Muslim holy book), the *Sunna* (the sayings and deeds of Prophet Muhammad), *ijma'* (consensus), *qiyas* (reasoning by analogy), and *maslaha* (consideration of the public good or common need).

[2] *Murabaha* is broadly defined as credit sale at cost plus an agreed upon margin of profit.

Challenges Facing Islamic Banking in the 21st Century

Fuad Abdullah Al-Omar and Munawar Iqbal*

ABSTRACT

Despite its considerable achievements over the last twenty years, Islamic banking faces a number of serious challenges to its viability and growth in the 21st century. In order to meet the challenge of conventional Western banks entrance into the industry, incumbent Islamic banks will have to build strategic alliances and consolidate into larger institutions. The Islamic banking industry as a whole also needs to engineer new and more sophisticated financial products and diversify from just fixed-return to variable-return modes of Islamic financing. It must also determine *Shari'ah* compliance more efficiently and support R&D and the training of new talent. The success of Islamic finance further depends on the establishment of equity institutions to provide equity capital and the development of secondary and inter-bank markets. Finally, a strong legal and institutional framework is necessary for accounting, supervision, and to provide a lender of last resort.

I. INTRODUCTION

Twenty-five years ago, Islamic banking was considered wishful thinking. However, serious research in the past two and a half decades has shown that Islamic banking is not only feasible and viable, but an efficient and productive way of financial intermediation as well. A number of Islamic banks have also been established during this period in heterogeneous social and economic milieu. The successful operation of these institutions and the countrywide experiences in Pakistan, Iran, Sudan and partly in Malaysia are sufficient to show that Islamic banking offers an alternative method of commercial banking. The fact that many conventional banks, including some major multinational Western banks, have also started using Islamic banking techniques is further proof of the viability of Islamic banking. Islamic banks have succeeded in mobilizing large amounts of funds. While the estimates about the exact magnitude of the Islamic banking market vary, it can be safely assumed that it presently exceeds US$100 billion and is poised for growing further in the future. However, it will require much more strenuous efforts to maintain a reasonable rate of growth in the future.

The commendable achievements during the last twenty years should not lead us to ignore the problems that Islamic banking is facing, and there is no dearth of these. While many of them are a result of the inappropriate environment in which Islamic banks are working, there are others which have arisen from the practices of Islamic banks themselves. Islamic banks must have a critical look at their activities, correct their mistakes, identify their long run comparative advantage, and exploit it to the fullest possible extent. It must be realized that in the long run, Islamic banking has to rely on its strength as an alternative model for its viability and survival, rather than on the sympathies of its clients or government support. It is in this spirit that we discuss below the major challenges facing Islamic banking as it enters the twenty-first century.

II. INCREASED COMPETITION

So far, Islamic banks have had a fairly large degree of "monopoly" over the financial resources of the Islamically motivated public. This situation is changing fast. Islamic banks are now facing ever-increasing competition. An important development in Islamic banking in the last few years has been the entry of some conventional banks in that market. Although it is difficult to know with certainty how many conventional banks around the globe practice Islamic banking techniques, even a randomly selected short list may contain some of the giants of international banking business such as Chase Manhattan, Citibank, ANZ Grindlays, and Kleinwort Benson, along with others such as Union Bank of Switzerland, Girozentale of Australia, and ABC International. In addition to these, several commercial banks are offering Islamic banking services in many Muslim countries. Bank Misr in

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Egypt and National Commercial Bank in Saudi Arabia have opened Islamic branches. In Malaysia, commercial banks have been permitted to open Islamic banking windows.

This development is a clear recognition of the viability of Islamic banking as an alternative model, but has at the same time increased competition. Does it augur well for the future of Islamic banking? The answer will depend on how Islamic banks react to this development. In general, competition is supposed to be good for the growth of any industry. It forces inefficient firms to either shape up or ship out. It reduces costs and improves services to consumers. It promotes innovation and brings improvements in product quality. There is, however, one exception to this rule. This is the well-known infant industry argument which claims that small firms in their infancy may be protected from harsh, ruthless competition until they can stand on their feet and be able to face competition from their bigger counterparts. One can argue that Islamic banks may well deserve this treatment. The conventional banks and particularly the western banks have a large advantage over Islamic banks in terms of their size, experience, market coverage, and long standing in the industry. This makes Islamic banks vulnerable to unequal competition.

While it may be difficult to settle the point on theoretical grounds, the stark reality is that even if one could invoke infant industry entitlements for Islamic banks, there is in practical terms no institutional arrangement to put those into operation. Governments usually offer infant industries benefits such as tax breaks or subsidies. No such possibility exists at present. Therefore, the survival of Islamic banks essentially depends on their own efficiency and performance.

III. Building Bridges and Strategic Alliances

The competition from conventional banks is expected to increase further in the near future due to globalization. Due to liberalization, world markets are rapidly converging into a single market place. To benefit from the opportunities offered by globalization, Islamic banks need to improve the quality of their services and develop suitable products.

Technological innovations are also playing an important part in financial integration and globalization. Electronic banking and the widespread use of computers in banking have transformed the way banking is done. The communication revolution through electronic correspondence has reduced the cost of international communication. The globalization of financial markets has led to a greater and greater integration of capital markets. The liberalization of foreign exchange markets has further reinforced this trend. Paper currency is being replaced with plastic cards and electronic ledgers are replacing accounts books. The saving of one country can now be invested in other countries by the click of a mouse. The day is not far away when customers will be able to “navigate” on the Internet between competing banks, unit trusts, mutual funds, and even business firms.

Islamic banks cannot remain aloof to these developments. They must carefully watch these developments and adjust their strategies accordingly. In order to operate in global markets, they have to form strategic alliances with other banks. It will also be useful to build bridges between existing Islamic banks and those conventional banks that are interested doing banking on Islamic principles. Such strategic alliances will benefit both sides. Islamic banks will benefit as the western banks bring their efficiency, market research, innovative capabilities, sophisticated banking, and result oriented approach to Islamic banking, which may lead to the development of new products and the provision of better services to consumers. On the other hand, the conventional banks will benefit from the indigenous infrastructure, closer consumer contacts, and Islamic credentials of Islamic banks.

It may be worthwhile to point out here that there are some genuine concerns about the operations of large multinational banks in Islamic banking practices. Naturally, their motives are purely commercial: they view it as a lucrative business opportunity. That is fair enough. However, doubts have been expressed as to whether conventional banks are playing by the rules of the game and whether they are able to follow the percepts of Islamic banking correctly. In all major Islamic banks, there is a *Shari‘ah* board which regularly reviews the operations and contracts of the bank to determine their compliance with the requirements of the *Shari‘ah*. Such elaborate arrangements do not exist in conventional Western banks in most cases. Even if some of them have *Shari‘ah* advisors, a credibility gap remains. Alliances with well established Islamic banks might help remove this gap. Irrespective of whether these doubts are in fact true are not, common perceptions have important implications for business. Conventional banks stand to benefit significantly in this respect by working together with Islamic banks.

IV. Need to Increase the Size of Islamic Banks

Size is an important variable in determining the efficiency of a bank. It determines the scale and scope efficiencies. Economists have shown that larger banks are in a better position to reach the optimum mix and scale of output. As a result, they are more efficient than smaller ones. The estimates with respect to the saving in costs due to scale economies range from 20% to as high as 50%. The literature on banking and finance indicates that there are substantial scale inefficiencies for small banks. Full efficiency has been found at a level of US$500 million in assets. The inefficiency loss for banks below US$100 million in assets amounts to about 10%. Scope diseconomies for small banks have been found to range between 10% and 20%, with huge scale economies for larger banks.[1]

The available data shows that Islamic banks and financial institutions are significantly below optimal size. The average size in assets of these institutions[2] was US$395 million in 1996. This figure is misleading, however, because of extreme variations between the maximum size (US$8.6 billion) and the minimum size (only US$72,000). The standard deviation works out to be US$1.2 billion (about four times the average) which points to the presence of extreme values in the data. In order to see a better picture, Table 1 summarizes the position of Islamic financial institutions (IFIs) in a frequency distribution in terms of size in assets in 1996.

TABLE 1. ISLAMIC FINANCIAL INSTITUTIONS BY SIZE OF ASSETS (1996)

Assets (US$ Millions)	Frequency Distribution
0-50	39
51-100	13
101-200	4
201-300	3
301-400	8
401-500	1
>500	10
TOTAL	78

Source: *Directory of Islamic Banks and Financial Institutions*, 1996 (Jeddah, Saudi Arabia: International Association of Islamic Banks)

It may be observed that only eleven institutions are above the average figure. If we then exclude Tabung Haji, Malaysia, which is a special purpose institution, only ten financial institutions can be considered to be of optimal size from an economic point of view. More than 60% of the institutions are below even the critical minimum size of US$100 million. From these statistics, it can easily be concluded that Islamic banks and financial institutions have not reached an optimal size to be able to achieve efficiency.

There are more reasons than just efficiency to advocate larger size. A large capital base is one of the important factors influencing positive credit rating. It reflects shareholders' commitment to their business. That comes handy in the case that a bank wants to raise additional capital. The small size of Islamic banks is also a major factor contributing to the lack of portfolio diversification. The resources at their disposal are not sufficiently large to minimize risk through portfolio diversification.

In order to increase the level of efficiency and deal more effectively in financial markets, it is thus desirable that the size of Islamic banking operations be substantially increased. In this regard, serious consideration should be given to mergers.

V. FINANCIAL ENGINEERING

Financial markets are becoming more sophisticated and competitive. In order to exploit the quickly changing market environment and to face increasing competition, financial engineering and innovation are imperative. Financial experts have to keep an eye on the needs of various types of individuals and businesses on both the demand and supply sides. They also need to consider varying tastes for risk. Since the needs and tastes vary from person to person, a wide variety of products need to be developed to cater for all needs and tastes. In an Islamic framework, they must also observe *Shari'ah* rules and guidelines.

Until now, Islamic financial tools have essentially been limited to classical instruments developed centuries ago and their variants. These classical instruments were developed to meet the needs of the societies in which they were developed. While they may serve as useful guidelines for Islamic contracts, there is no reason to be restricted only to them. In the Islamic theory of contracts, parties are free to agree on any terms as long as known Islamic rules and principles are not violated. There is a well-known *Hadith* stating:

> "Muslims are free to determine the conditions of their contracts except a condition that make something that is permissible forbidden, or something that is forbidden permissible."[3]

Islamic *fiqh* has laid down general guidelines for *ijtihad*, or dealing with new situations. In the present context, the principles of *istihsan* (taking the easier way from those permissible), *masalih mursalah* (safeguarding public interest), *raf' al-haraj* (elimination of hardship) and *darura* (granting concessions in case of necessity) are particularly relevant. In addition to these principles, *ijtihad* must be guided by the need to preserve the basic objectives of *Shari'ah*. Within that overall objective, those principles, provide guidelines for dealing with issues arising from the unfolding complexities of applying the rules of *Shari'ah* to new situations. It may be appropriate to add that *ijtihad* can be practiced only by highly qualified *Shari'ah* scholars, who are aware of its concept and methodology and must remain within the general spirit and objectives of *Shari'ah*.

In light of the principles of *ijtihad*, a "needs approach" to financial engineering is desirable—of course within the known principles of Islamic finance. In this regard, the example of *bai' salam* is very important to remember. In general, it is not allowed to sell anything that is not in one's possession. But in the case of *salam*, the Prophet (PBUH) allowed such a sale because of the "need" of the people, but laid down clear rules to protect the interests of both parties. The financial needs of both individuals and businesses have changed. Engineers in modern finance have designed several new instruments such as mortgage, options, derivatives, hedging, insurance pension plans, and credit cards, to meet these needs. We must examine what needs are being fulfilled by these instruments. If the needs are genuine (Islamically speaking), then we must either adapt them for our purposes or invent Islamic alternatives for them. The process of adaptation is well recognized in Islamic *fiqh* and has never stopped. However, its speed needs to be greatly enhanced. Classical contracts have been modified in a number of cases to meet current needs. The most potent example of this is the initiation of Islamic banking on the basis of *al-mudarib udarib* principle, which provides that a *mudarib* (agent) may himself appoint another agent to actually run the business. Islamic banking is not modeled strictly on the conditions of the classical contract of *mudaraba*. A number of these conditions were found to be impractical. Therefore, the basic principle of *mudaraba* was used while modifying its conditions in light of the current situation.

The principle of *al-mudarib udarib* essentially allows for sub-contracting. If the principle is acceptable, there is no reason to restrict it only to *mudaraba*. Contracts can similarly be designed on the basis of *al-muajjar uajjir*, *al-mustasna yastasna*, etc. In other words, the original contractee may arrange to fulfill the obligations under the contract through third parties. That the principle is acceptable from an Islamic point of view is unquestionable. A number of examples of its application can also be given. For example, in the *istisna'* (construction on orders according to agreed specifications) contract, a constructor may accept to do work against a certain price and offer the work to someone who would carry it out for a lesser price and/or with more efficiency. In leasing, the lessee who possesses the usufruct may sell these against a higher price (rent). In a delivery-deferred (*salam*) trade, the intermediary, before taking delivery of the commodity, may enter into a counter-contract with another party parallel to the first one. Again, the role of an intermediary is quite evident.

While it is possible to modify classical contracts to suit modern conditions, a much broader scope for financial engineering exists in developing new contracts. These contracts could be hybrids of old contracts or may be entirely new. However, the approach to examining the "*Shari'ah* compatibility" of new contracts must change. There is no need to insist in the process of this examination that a contract fulfill all the requirements of, say, a *mudaraba* or *salam* contract as contained in classical *fiqh*. The contract should be taken on its own. What is important to check is that no conditions of the contract violate any Islamic rule. A checklist of such rules may be prepared and given to financial engineers. This checklist would include things like the prohibition of *riba*, *gharar*, and a few other do's and don'ts. The scope for financial engineering—and for that matter, for innovations in other fields—is quite wide. It is important that those experts who know the needs and niceties of the trade take up this task.

VI. *SHARI'AH* ASPECTS

Because of the religious dimension of Islamic banking and finance, no new product can be adopted until it is cleared by *Shari'ah* scholars. Even after a new product is put into use, *Shari'ah* auditing of the operations of financial institutions is very important to ensure that the actual practice complies with the requirements of *Shari'ah*. This is important not only for religious reasons but also for purely business considerations because the clients of Islamic banks will not have confidence in their operations unless *Shari'ah* scholars clear their activities. With this backdrop in mind, the expertise of *fiqh* scholars in understanding the prerequisites of modern financial products and in evaluating these products becomes very important.

Almost all Islamic banks have their own *Shari'ah* boards or *Shari'ah* advisers. A survey of the members of these boards would reveal that hardly any of these scholars has formal training in modern finance. This puts a serious constraint on the ability of *Shari'ah* scholars to issue well-informed rulings on financial products and activities. The *Shari'ah* scholars are themselves conscious of this difficulty. They are using a number of ways to acquire the necessary background information before issuing a *fatwa*. One of these ways is to discuss an issue in meetings or workshops attended by both *Shari'ah* scholars and financial experts. Institutions such as the Islamic Research and Training Institute and Islamic universities are playing an active role in organizing such workshops. However, these workshops have no mandate to issue a *fatwa*. For this purpose, the meetings of *fiqh* academies, the most prominent among which is the OIC *Fiqh* Academy in Jeddah, play a more important role. These academies also commission a number of studies by specialized experts on specific issues before discussing them and making a decision. In the absence of the required expertise in the field of finance among *Shari'ah* scholars, this approach of "group *ijtihad*" or *ijma'* is playing an important role in safeguarding against serious mistakes in adopting doubtful instruments.

The situation is, however, far from ideal. As any participant of the workshops and meetings of *fiqh* academies can easily notice, the interaction between *fiqh* scholars and experts of modern economics and finance does not proceed smoothly. The two groups have such different backgrounds and speak such different technical languages that communication between them is very difficult. It is therefore understandable that *Shari'ah* scholars are cautious in giving rulings. As a result, the decision-making process has become very slow and tends to be over-conservative.

The past record shows that *Shari'ah* bodies have done a commendable job in evaluating the applications of traditional contracts and safeguarding against the use of some and the misuse of others. When it comes to evaluating modern financial contracts or Islamic substitutes for them, however, *Shari'ah* bodies have found it quite difficult to issue verdicts. This is basically due to an acute shortage of scholars with dual specialization or at least a working knowledge of both modern finance and *Shari'ah*.

VII. TEACHING, TRAINING, RESEARCH, AND DEVELOPMENT

Teaching, training, and research are the wherewithal for the development of any discipline. This is all the more so for a discipline like Islamic banking and finance that is still nascent. As mentioned above, there is a serious shortage of scholars who possess even a working knowledge of both Islamic *fiqh* and modern economics and finance. Similarly, most managers of Islamic banks are not very well trained in the use of Islamic modes of finance. Unfortunately, very little effort has been made to meet these requirements.

In the area of teaching, Islamic universities in some Muslim countries, particularly Pakistan and Malaysia, have initiated some teaching programs to produce graduates with this dual specialization. However, a close examination of their curricula would reveal that they are not well designed to achieve this objective. This may also be confirmed by the fact that the Islamic banks have not been able to find a reasonable number of suitable managers from the graduates of these universities, nor could anyone of them find a place in the *Shari'ah* board of any Islamic bank. Similarly, hardly any of the graduates of these universities has produced any research that has found favor in practice.

In the area of research, neither Islamic banks as a group nor any of they individually spend any sizeable funds on research. Some Islamic banks have small units for research, but none of this research activity is designed toward product development. It is therefore not surprising that the speed of development of new financial products within the Islamic banking industry is very slow. Islamic universities and the few research institutions working here and there have not received any financial assistance from Islamic banks, nor has there been any coordination between Islamic banks and the seats of higher learning for any worthwhile research project.

Another very important component of useful and scientific research is the availability of authentic information. This has not received much attention from Islamic banks. Some attempts have been made in this regard but have not received active support, either financial or otherwise, from Islamic banks. As a result, there is no consistent data series on the activities of Islamic banks for a reasonable number of years available anywhere. Whatever little information is available is also subject to a number of qualifications.

In the area of training, a small effort was made in the 1970s by establishing a training institute in Cyprus. Due to certain reasons, this institute has been closed. The managers of Islamic banks may be attending short-term courses either on the job or elsewhere, but there are not many formal training programs meant to prepare the employees of Islamic banks for the needs of the system. Most of the employees of Islamic banks, including their managers and financial experts, come from conventional environments and lack the necessary expertise in and commitment to Islamic banking. An institution is what its employees make it. It is therefore extremely important to have people with the right kind of skills and commitment to run Islamic banks.

VIII. Need for Diversification in the Use of Islamic Modes of Finance

The Islamic financial system has presented a number of financial instruments. Broadly speaking, they may be classified into fixed return and variable return or profit sharing modes.[4] Each of these categories has its merits and demerits. In practice, however, the use of profit-sharing modes has been very limited. For reasons mentioned below, it would be desirable over the long run period to gradually diversify the use of various modes, especially increasing the share of profit sharing modes.

Theoretical discussions on Islamic banking and finance have established that a system based on profit sharing is not only viable but also has a number of advantages over the interest-based system:[5]

1. A fixed charge on capital is unjust since the results of a productive enterprise in which capital is invested are uncertain. It would be more just if capital shared the actual profits of the enterprise.
2. Allocation based on profit sharing pays more attention to investment profitability, while allocation based on interest pays more attention to credit-worthiness. We can therefore expect the former to be more efficient than the latter.
3. A system based on profit-sharing will be more stable than a system based on a fixed charge for capital since the cost of capital in a sharing system automatically adjusts itself to variations in productivity under changing business conditions. A shock to the assets position is automatically absorbed on the liabilities side when both of them are based on profit sharing.
4. Since assets are created in response to investment opportunities in the real sector of the economy, it will be the real sector that determines the rate of return to the financial sector rather than the other way round.
5. Money creation in a profit-sharing system would be based on investment, thus preventing an oversupply of money. This will keep inflation in check.
6. A switchover from interest to profit sharing is more conducive to economic growth, as this would increase the supply of risk capital as well entrepreneurship. New entrepreneurs will be encouraged because of the possibilities provided by risk sharing.

Some scholars have argued that the almost exclusive reliance on fixed-return modes is one of the most serious problems facing Islamic banking as an alternative model that is distinguished by risk sharing. Nejatullah Siddiqi, for example, laments:

> "We cannot claim, for an interest-free alternative not based on sharing, the superiority which could be claimed on the basis of profit-sharing. What is worse, if the alternative in practice is built around predetermined rates of return to investible funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It so happens that the returns to finance provided in the modes of finance based on *murabaha*, *bai' salam*, [and] leasing and lending with a service charge are all predetermined as in the case of interest. Some of these modes of finance are said to contain some element of risk, but all these risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. A financial system built solely around these modes of financing can hardly claim superiority over an interest-based system on grounds of equity, efficiency, stability, and growth."[6]

He considers this problem to be the main problem of contemporary Islamic banking, so much so that it can be characterized as an identity crisis of the Islamic financial system.

There are several reasons why fixed-return modes have become more popular than variable-return modes in practice. They have a number of desirable features such as simplicity, convenience, and safety. Banks further prefer fixed-return modes (i) due to moral hazard and adverse selection problems in all prinipal-agent contracts (e.g., there is need for closer monitoring of the project in the case of *mudaraba*—this requires project monitoring staff and mechanisms, which increase the costs of these contracts); (ii) the structure of deposits of Islamic banks is not sufficiently long-term on the liabilities side—discouraging bankers from getting involved in long term projects; and (iii) profit-sharing contracts require a lot of information about the entrepreneurial abilities of the customer, and this may not be easily available to the bank. There are many corresponding reasons due to which businessmen do not prefer profit-sharing contracts. These include, among others: (i) the need to keep and reveal detailed records, (ii) it is difficult to expand a business financed through *mudaraba* because of limited opportunities to reinvest retained earnings and/or raise additional funds, (iii) the entrepreneur cannot become the sole owner of the project except through diminishing *musharaka*, which may take a long time.

While it would be desirable that the predominance of fixed-return modes, such as *murabaha* and leasing, on the asset side be moderated in order to have a more diversified portfolio, the problem should however not be blown out of proportions so as to label it as a crisis of identity. Nobody denies that *murabaha* and leasing are permissible modes of financing. It may also be noted that if these modes are used properly, some risk sharing is involved. The fact that these risks are insurable and are actually insured against should not bother anyone. Insurance itself is a scheme for the wider sharing of risks and uncertainties. The owner of an asset shares in the ultimate risk by paying the insurance premium. The only thing one should ensure is that the cost of insurance is borne by the owner of the "asset."

It needs to be emphasized that, under present circumstances, tools like *murabaha* are indispensable: they provide investors high liquidity with low risk. Until the proper institutional setup is built and needed products—including those for managing risk—are developed, it may not be advisable to drastically increase the use of risky modes. *Murabaha* is serving a useful purpose; however, several problems have been noted in the way it is being used. Serious attempts should be made to cleanse the "quasi-*murabaha*" being practiced by some banks at present of its undesirable features in order to make it "genuine" *murabaha*.

Nevertheless, an overwhelming use of these fixed-return modes by Islamic banks in the absence of other Islamic financial institutions which could provide more profit sharing opportunities has led to some undesirable results for the Islamic finance scene. These include:

A. Defaulters and the Issue of Penalties

By using fixed rate modes of financing, Islamic banks have been able to minimize the impact of business risks on their cash flows. But precisely because of the same reason, i.e., the use of debt as compared to equity, they land themselves in a serious problem. *Murabaha* deals create debt obligations against buyer firms. Now while it is permissible to charge a higher price in credit sales as compared to cash sales—the wherewithal of *murabaha* mode of financing—this creates a fixed liability once the deal has been entered. If the buyer then defaults on his payment, banks cannot charge anything extra because that would mean taking *riba*. There is thus a built-in incentive for immoral buyers to default.

Islamic jurists have been discussing this problem. It is generally agreed that penalties, both physical and financial, can be imposed against defaulters but that the bank cannot benefit from these penalties. Some contemporary scholars have argued that the banks can be compensated because the defaulter has caused a damage and that Islam permits, rather encourages, the compensation of damages. However, the issue still remains unresolved due to a lack of consensus among jurists.

B. Illiquidity of Assets

Another problem caused by the predominance of debt-based modes of financing is that it is difficult to transform these financial modes into negotiable financial instruments. Once a debt has been created, it cannot be transferred to anyone else except at par value. This renders the whole structure of Islamic financial market highly illiquid. This is one of the major obstacles in the development of secondary markets in Islamic financial instruments. Unless equity-based modes become more popular or other negotiable instruments are developed, Islamic financial markets will remain undeveloped. Some attempts are being made to develop negotiable instruments based on *ijara*, *salam*, and *istisna'*. However, these have not been used to any significant extent so far. The major hope for developing Islamic secondary markets lies in a wider application of equity-based financial instruments and the securitization of some of the existing instruments.

C. Short Term Asset Structure

Banks everywhere prefer short-term investments. This is so because they work on the basis of small reserves. They need to have the ability to liquidate their assets fairly quickly if the need arises. In the case of Islamic banks, the short-term structure of their assets is even more pronounced. This also has to do with the predominance of *murabaha* among the modes of finance. *Murabaha*, a trading practice, is by its very nature a short-term contract. When turned into a financial instrument, it does not lose that character. Even though it is conceivable to design an installment sale *murabaha* contract spreading over many years, the needs for which the *murabaha* contract can "genuinely" be used are mostly short-term. Therefore, *murabaha* deals entered into by Islamic banks have been and are going to be largely short-term ones. Since *murabaha* comprises a very large percentage of Islamic banks' investments, the structure of their assets has also become short-term.

Is this a problem? This may not be so as far as the banks themselves are concerned. Because the liabilities of the banks are short-term, it makes sense to have short-term assets. From the point of view of the financial system as a whole, however, there are needs for financial resources on a long-term basis (e.g., venture capital). In the conventional framework, these needs are met by other financial institutions such as securities markets. In the absence of such institutions in the Islamic framework, Islamic banks are looked upon to provide an alternative not only to commercial banking activities but also to the need for securities markets. There can be no interest-based bonds in Islamic banking. The Islamic financial system has to provide an alternative for them. For this purpose equities need to be a major activity in the Islamic financial market. The problem assumes a more critical dimension in view of the fact that in most of the Muslim countries, the major domain of Islamic banks, well developed securities markets do not exist. Unless the use of profit sharing modes is increased, Islamic finance cannot fulfill its promise of eliminating interest from the financial markets. But is it the sole responsibility of Islamic banks?

IX. NEED FOR ESTABLISHING EQUITY INSTITUTIONS

It must be emphasized that providing the above-mentioned needs is the responsibility of the Islamic financial system as a whole. It is unfair to expect that Islamic banks should provide an alternative for all kinds of needs. In all businesses there is a need for long term finance. In the conventional system, this is provided through long term bonds and equities. Securities markets and specialized equity institutions perform this function. In addition to the general public, the most important sources of these long-term investments are investment banks, mutual funds, insurance companies, and pension funds.

Unfortunately, in most Muslim countries, which are the overwhelming domain of Islamic banking, security markets are not well established. Similarly, the number of specialized equity institutions and other institutions that traditionally provide equity capital through stock exchange—i.e., pension funds, mutual funds, and insurance companies—is negligible. Recently some mutual funds and *mudaraba* companies have been established in some Muslim countries, but there number is very small and they are not well known to the general public. Moreover, information about their performance is extremely limited.

Pension funds are mostly restricted to the public sector. There are hardly any private or even corporate-sector pension funds. The number of Islamic insurance companies is less than a dozen throughout the Muslim world. Islamic banks have shied away from big exposures in equity investments for practical reasons that cannot be ignored. In view of the importance of long term capital for economic growth, the establishment of institutions providing equity capital is a prerequisite for the survival and success of Islamic finance.

It may be mentioned here that even in conventional finance, there is an increasing trend toward the use of equities as a source of business finance. All over the world, savers are deserting traditional bank accounts and low yielding government bonds by the thousands and moving en masse into equities. As a result, stock markets are witnessing high rates of growth as well as substantial increases in stock prices. A massive reallocation of wealth is taking place. Institutions like mutual funds and pension plans are ballooning.

Savers are now increasingly recognizing the benefits of profit-based instruments. The appeal of rate-based investment is waning. Although stock market investments have not become any less risky over the years, savers are beginning to accept the historical evidence that in any five year period since World War II stocks have with one exception produced higher returns than bank accounts, bonds, or bullion. There is now a worldwide trend for establishing equity institutions such as mutual funds. Islamic financial markets have to take note of these recent developments in international financial markets.

The situation is also ripe for establishing equity-based institutions and instruments. There is an historic opportunity for taking advantage of the privatization programs going on in many Muslim countries. A number of public companies, many with good track records and bright prospects, are being offered to private parties. Islamic banks and financial institutions can take advantage of this opportunity. It must be noted, however, that leading *Shari'ah* institutions have ruled that it is not permissible to take equity stake in companies who deal in interest in even small proportions. While this rightly reflects the serious concern that Muslims must garner against the use of interest, this puts a serious constraint on the placement of funds. It closes an important market to Islamic banks and also exposes many big corporations in Muslim countries to foreign ownership. The matter needs serious consideration with a view to find an acceptable solution on the basis of a common need.

X. ESTABLISHMENT OF SECONDARY MARKETS AND INTERBANK MARKET

Banking thrives on the existence of a secondary financial market. Commercial banks invest in very short-term financial papers, which they can convert into cash very quickly at negligible conversion cost. There are several ingredients of a secondary financial market: financial papers, dealers, and financial institutions. Various kinds of financial papers such as securities, bonds, shares, debentures, commercial papers are the financial instruments. Merchant banks, investment banks, mutual funds, investment funds, etc. are the financial institutions. Steps need to be taken for establishing and/or strengthening secondary markets.

Most Islamic banks exist as single entities. The strength of commercial banking is derived not from individual institutions but by taking all banks together. Interbank transactions among Islamic banks are minimal because in most countries the number of Islamic banks is very small. The evolution of short-term financial assets that Islamic bank may hold and transact among themselves shall go a long way toward making an Islamic money market a reality.

Islamic banks lack such short-term instruments in which they can profitably invest for very short periods. Modern commercial banks can lend each other millions of dollars even for a day. They can also calculate interest on a per day basis. An Islamic alternative to the very short-term placement of funds has yet to evolve.

XI. APPROPRIATE LEGAL FRAMEWORK AND SUPPORTING POLICIES AND PROCEDURES

The commercial, banking, and company laws in most Islamic countries are fashioned on the Western pattern. Hence these laws may contain provisions that are in conflict with Islamic banking methods. Even if parties structure their agreements according to an Islamic contract, the laws that govern the interpretation and enforcement of these agreements usually are wholly ignorant of this form. It is simply impractical for parties to incorporate into their agreements all the relevant Islamic rules, making Islamic contracts more costly to conclude. In case any disputes arise, the local laws will usually be enforced, which in many cases would involve the violation of some Islamic rules. In this context, one of the most serious problems is the lack of a proper legal framework to deal with cases of delayed payments and bad loans. These conditions, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. Even in those Islamic countries that do not opt for a complete Islamic banking system, it is necessary to enact some laws to facilitate the operation of a mixed system.

It should also be mentioned that the successful operation and healthy growth of Islamic banking requires not only an appropriate institutional framework but also a correct policy-mix from the government. Muslim governments need to do more to create a more congenial environment for Islamic banks. In many cases there are practical obstacles in the way of Islamic banking. Structural adjustments, particularly in fiscal and monetary areas, are needed to provide Islamic banking enough room to operate effectively.

A. Supervisory Framework

The supervision of Islamic banks is as important as that of the conventional banks. There are three main reasons why the regulation and supervision of banking industry are important: to increase the information available to investors, to ensure the soundness of the financial system, and to improve control of monetary policy. Asymmetric information in financial markets exposes investors to many risks and hazards. It can also lead to the widespread collapse of financial intermediaries, referred to as financial panic. Because depositors may not be able to assess whether the institutions holding their funds are financially sound or not, they may want to pull their funds out of both sound and unsound institutions if they have doubts about the overall health of the financial intermediaries. The possible outcome is a financial panic that produces large losses for the public and causes serious damage to the economy.

Asymmetric information also leads to the problems of moral hazard and adverse selection in financial markets. In this regard, there is the need to make the activities of banks as transparent as possible. The present situation of Islamic banks leaves much to be desired in this respect. In many cases the most essential information is not made public. More transparency in various aspects of the activities of Islamic banks will increase the confidence of clients and will help avoid panics.

To protect the interests of the public and the economy from financial panics, most governments have created elaborate regulatory bodies. As a matter of fact, the banking industry is one of the most heavily regulated industries all over the world. Against this background, let us see the supervisory framework of Islamic banks.

In most countries, Islamic banks are put under the supervision of the central bank of the country and are given the same treatment as given to normal commercial banks. There are only a few instances where special Islamic banking legislation was approved to define a new relationship between an Islamic bank and the central bank.[7]

Most Islamic banks in the contemporary world operate in a mixed environment in which interest based banks function side by side with Islamic banks. The central banks subject Islamic banks to the same controls, conditions, and regulations that they apply to interest based banks. As long as the instruments of regulation and control used by the central banks remain free of interest, no objection may be advanced against them, at least on Islamic grounds. There are certain factors, however, that require that Islamic banks be treated on a different footing. Some of these factors are the following:

1. Islamic banks, like all other commercial banks, are required to keep some of their deposits with central banks. Central banks usually pay interest on those deposits which Islamic banks cannot accept. An alternative is needed to ensure that Islamic banks get a fair return on their deposits with the central banks.
2. Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most Islamic banks function under the supervision of a central bank, they cannot benefit from such a facility because funds are usually provided on the basis of interest.
3. Legal reserves imposed on deposits with conventional banks are meant to meet possible withdrawals whose rates vary between demand, saving, and time deposits. This may apply to the same extent to Islamic banks only in the case of demand deposits. The saving and investment deposits of Islamic banks, however, are of such a nature that withdrawal before their term is not as common as in conventional banks. They must therefore be subjected to reserve requirements at ratios lower than those imposed on their counterparts with conventional banks.
4. Islamic banks do not enjoy the stability provided by deposit insurance. In most developed countries, the deposits of commercial banks are insured. Hence a depositor at an Islamic bank bears a greater risk in the sense that if an Islamic bank collapses then the depositors will lose all their money because deposits are not insured. It is true that Islamic banking is based on the concept of *mudaraba,* where the provider of the capital (*rabb al-mal*) has to bear all the loss in the case that the business venture in which the *mudaraba* funds are invested fails. Under such circumstances, one may argue that any insurance scheme would be against the very idea of Islamic banking. However, nobody would argue that Islamic banks should expose themselves as well as their depositors to unnecessary risks that can otherwise be taken care of. In fact, the very fact that other commercial banks, which operate in the market, have deposit insurance puts Islamic banks at a disadvantaged position when it comes to competition between conventional and Islamic banks.
5. In countries where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of the interest-based nature of the securities bought and sold. Islamic banks are thus constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks.
6. A lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for the rather inappropriate policies of central banks toward Islamic banks. This is particularly true of *musharaka* and *mudaraba*. In debt financing, the granting of a loan by a bank is a one-time activity, no matter what the size of the loan. But *musharaka* and *mudaraba* are ongoing activities, and the participation of an Islamic bank in these activities continues as long as the project financed is in operation. This may have important implications for the reporting as well as control and regulation of Islamic banks by central banks.

B. Accounting Standards

Islamic banks function in different types of social environments and heterogeneous economic milieu. They have to put up with different types of official requirements regarding accounting practices. This results in a dissimilarity of accounting practices among different Islamic banks, to the extent that any meaningful comparison between the balance sheets or profit and loss accounts of two different Islamic banks becomes a very difficult task if not an altogether impossible one. Furthermore, the concepts used in the balance sheets or profit- and loss-statements are not rigorously defined.

During the last few years some headway has been made to overcome this problem. In order to introduce standardization in the accounting practices of Islamic financial institutions, some Islamic banks have, under the guidance of the Islamic Development Bank, established a technical cum juridical organization called "Accounting and Auditing Organization for Islamic Financial Institutions" (AAOIFI). The organization, now functional and based in Bahrain, is composed of a supervisory committee and a Financial Accounting Standards Board responsible for preparing, issuing and amending the accounting standards of those Islamic banks and financial institutions that have agreed to apply the standards set up by the Board. However, it will be sometime before any perceptive change in the accounting practices of Islamic banks is observed unless the banks pay more attention to this aspect.

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[1] See Allen N Berger, William C. Hunter and Stephen G. Timme, Berger and Humphrey 91, P. W. Bauer and D. B. Humphrey, "Efficiency And Productivity In U.S. Banking," in H. O. Fried, C. A. K. Lovell and S. S. Schmidt, eds., *The Measurement of Productive Efficiency: Techniques And Applications*," Oxford University Press, Oxford, 1992.

[2] Reference is being made here only to Islamic banks in the private corporate sector. Banks in Pakistan, Iran, and Sudan are excluded due to their special position in view of countrywide Islamization processes in these countries.

[3] Tirmidhi, Part 3, Kitabul Ahkam.

[4] It should be noted that the fixed return modes of finance being used by Islamic banks are clearly distinguishable from conventional, interest-based modes. Transactions of the former modes are always done through real commodities, while in the latter they are carried out through intertemporal exchanges of money.

[5] For a more detailed list of benefits of profit-sharing system, see, Abbas Mirakhor, "Progress and Challenges of Islamic Banking", *Review of Islamic Economics,* vol. 4, No.2 (1997)

[6] M.N. Siddiqi, *Issues in Islamic Banking*, The Islamic Foundation, UK (1983), p.52.

[7] This was done in the cases of the establishment of Jordan Islamic Bank and of Bank Islam Malaysia Berhad.

The Realities and Challenges Facing Islamic Equity Funds

Islamic Bankers Are Missing the Point

Tariq Al-Rifai*

ABSTRACT

While the Islamic equity-fund industry has grown impressively, it mainly serves wealthy individuals and largely ignores the immense market of one billion Muslims worldwide, some of them middle-class professionals. Furthermore, the true size of the G.C.C. private-banking market that is open to Islamic banking is smaller than it at first seems, partly because there is so much competition to manage rich investors' money. Islamic banks' novelty, small size, and lack of reputation retard their competition with Western private banks. The Islamic fund industry remains primitive by Western standards: many Islamic banks are mere middlemen between fund managers and investors. A mass market for investment funds exists, but Islamic funds must adopt simple solutions to exploit it: increase the market size through investor education about the benefits of long-term investing; open the industry to competition; and provide full disclosure to investors.

I. INTRODUCTION

The growth of the Islamic equity fund industry over the past few years has been impressive. The industry was virtually non-existent before 1994, except for a few funds scattered across the globe. Today, there are at least 35 Islamic equity funds managed by some of the top fund-management companies in the world, such as Citibank, Deutsche Bank, and Robert Fleming and Company.

Merrill Lynch, one of the largest U.S. financial services firms, has begun an aggressive campaign to capture a larger slice of the Middle East private banking market. A study conducted by Merrill Lynch in 1996 estimates that Middle East private investors are worth US$800 billion, of which about half is held by Saudi individuals.[1] Islamic bankers and private bankers could not have been more pleased to hear the news. Islamic and Western financial institutions with Islamic finance departments are now vying to capture some of those assets. Some Islamic bankers claim that this presents an $800 billion market potential for Islamic asset management. Assuming that the study is accurate, since the study's methodology was not revealed, what percentage of these assets are looking for Islamic financial services?

It is important to note that Merrill Lynch's study included assets of high-net-worth individuals only, which is its target market. Islamic bankers are also after the same market as European and American private banks. Why? Is the purpose of Islamic banking to cater to a few wealthy individuals or to work for the benefit of Islamic society?

Other questions come to mind as well. Why are conventional banks and asset management companies entering the field? Why haven't these issues been discussed before? Failaka Investments, Inc. conducted research on these questions and suggests a common-sense, market-oriented solution.

II. THE $800 BILLION MARKET

Under ideal conditions, one can conclude that $800 billion of private assets are waiting to be managed Islamically, since the majority of people in the Middle East are Muslims. In reality, the true potential size of the Islamic private-banking market is much smaller. How much smaller? There is no data available that suggests an accurate size. Furthermore, the Merrill Lynch study focussed on the assets of high-net-worth individuals regardless of their investment preferences.

High-net-worth investors in the Gulf and elsewhere in the region are sophisticated individuals with knowledge of world financial markets. Many are indifferent to Islamic versus conventional investment products simply because conventional institutions are well established and have solid reputations in the market. They also view Islamically prohibited activities, such as the charging of interest, as necessary evils in order to achieve ones investment objectives.

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For example, many Swiss private banks have been around for over 100 years. They have brand-name recognition in the market, a reputation for service, and provide a sense of prestige for investors. Islamic banking, on the other hand, is relatively new, seen as a developing system, and has been associated with several scandals in the past, such as BCCI (which in fact was not an Islamic bank) and more recently, the newly-created Dubai Islamic Bank.

III. Everybody Is Chasing the Same Market

The term "high net worth" is often heard at Islamic banking conferences. It refers to the wealthiest segment of investors that nearly every Islamic and conventional banker is after. This segment represents approximately 1-2% of the world Muslim population.

Chasing such a segment is no doubt lucrative, but there are too many players after a small market. Conventional banks and asset-management companies saw this growing market niche years ago and are being rewarded for their early efforts. Conventional banks that have dedicated Islamic banking departments and subsidiaries, such as ABN AMRO, ANZ Investment Bank, and Citibank, deserve much credit for putting the industry on the map and developing innovative products to meet the market's needs. However, if Islamic investing is to go to the next level of catering to a broader clientele, there must be radical change in the mentality of Islamic financial institutions.

IV. Market Potential

There are over one billion Muslims worldwide, more than the combined populations of North America and the European Union. Of the Muslim population, there are a large number of middle-income professionals, many of whom live in developed countries. However, there have been minimal efforts to attract such investors to the Islamic banking system. Part of the reason is that there are virtually no investment alternatives for these investors; they are forced to seek conventional financial instruments to meet their investment objectives. However, a few exceptions exist, most notably the *Halal* Mutual Investment Company, based in Ireland. It has developed a system to invest small amounts of Muslims' savings (minimum £250) into short-term trading facilities acting similar to money market funds. The fund is open to European residents and is the only fund of its kind at the moment.

Fund companies have made some efforts to attract a wider spectrum of investors by lowering the minimum investment requirements, from as high as US$150,000 to as low as $10,000 in some cases. Two major problems, however, continue to restrict the growth of Islamic funds: investor education and disclosure policies. Islamic financial institutions, it seems, do not want to spend the time or the money managing the assets of the "average" Muslim. The concepts of long-term market penetration and economies-of-scale do not even appear on their radar screens.

V. Industry Bottlenecks

The growth of the U.S. mutual fund industry proves that a mass market for investment funds exists. In 1982, the size of the mutual fund industry was about $300 billion. Today, total mutual fund assets total more than $5 trillion. Fidelity Investments, the largest fund-management company in the world, managed $3 billion in assets in 1975, pennies by today's standards. By 1997, Fidelity was managing in excess of $500 billion, more than double the GDP of the G.C.C. countries.[2] One of the factors leading to this phenomenal growth was the successful attempt by fund-management companies at educating the population at large on the benefits of long-term investment strategies. Comprehensive disclosure requirements by the Securities and Exchange Commission (SEC) were another factor. SEC requirements not only opened the door to criticism of shady investment practices, they also provided investors a sense of security in knowing that their assets were being managed appropriately.

Islamic funds, on the other hand, provide limited education to attract new investors, and disclosure requirements are virtually non-existent. Failaka Investments recently began publishing quarterly performance data on Islamic equity funds. Of the estimated 35 funds, less than half agreed to provide information on a quarterly basis.

The Islamic fund industry remains primitive by Western standards. Many Islamic banks simply act as middlemen between fund managers and investors. For example, an Islamic bank wanting to launch an equity fund would seek an investment advisor and/or fund manager, *Shari'ah* advisors, a custodian and sometimes even an administrator for back-office operations. Thus, most day-to-day activities of fund management are outsourced and the bank is left collecting fees without any added value. Very limited operations remain in-house, mainly marketing.

Why can't Islamic financial institutions manage their own funds? Conventional banks are more than willing to manage assets for them, which brings up another problem. Several *Shari'ah* scholars have mentioned that equity funds, so far, are not serving their purpose. Islamic equity funds today are restricted by several *Shari'ah* screens and purification processes in order to fall within the acceptable limits dictated by the *Shari'ah*. Companies whose securities are held by Islamic funds no doubt are involved in some types of unacceptable activities, such as paying and receiving interest. However, since they fall into the acceptable limits of the *Shari'ah* (i.e. *haram* activities are minimized), they are approved for inclusion in an Islamic portfolio.

As such, *Shari'ah* scholars argue that one of the goals of equity funds is to "Islamize" companies' activities and making them 100% compliant with the *Shari'ah*. What incentives do conventional financial institutions have in "Islamizing" public companies? Many of the securities in conventional fund managers' Islamic portfolios are also included in their conventional portfolios. Until the time arrives when Islamic financial institutions manage their own funds and voice their opinion regarding the way companies are managed, they will continue to be no more than fee collectors.

VI. Conclusion: Common-sense Solutions

The solutions to the Islamic fund industry's problems are simple: to increase the market size through investor education, to open the industry to competition, and to provide full disclosure to investors. The purpose of Islamic funds is to serve the needs of the community at large and not of a select few. Today, the industry is very small, and very little information is offered to investors. One of the reasons is fund managers' fear of losing large investors from the already limited market size. However, a market of one billion people for Islamic financial services is much larger than one can imagine. Until there are billion dollar funds on the market, bottlenecks will remain.

The terms "let's not reinvent the wheel" and "let's not duplicate our efforts" come up frequently at industry meetings and conferences. These terms simply mean "let's not compete and improve ourselves." If one had invented a square shape and called it a wheel, it would obviously need to be reinvented because it would not work properly. Given the current state of the Islamic fund industry, the wheel needs to be reinvented. Reinventing and/or redesigning products and services should not be a one-time event; it should be an ongoing process.

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[1] Source: MEED, 16 January 1998.

[2] Source: Mutual Funds Magazine, August 1997.

PART IV

COMMERCIAL PRODUCTS, BUSINESS MODELS, AND OTHER

Introduction

Gohar Bilal*

The Islamic banking industry is not confined to any one geographic area, although it is currently concentrated in certain regions (e.g. G.C.C. countries). The geographic location of participants, their historical involvement, and their diverse experiences are reflective of the growing demand for products that fall under the rubric of "Islamic finance." In the last five years, western countries such as the United States and United Kingdom have also started to show signs of interest in this area. In the U.S., the Islamic Legal Studies Program of the Harvard Law School, the Harvard Islamic Finance Information Program, and Rice University's Islamic Studies Program are examples of academic programs providing a platform for research in this field. The Oxford Center for Islamic Studies in Britain is another such example.

An important quest for the Muslim community is to make Islamic principles a part of every aspect of their lives, from daily prayers to commercial activities. These sentiments have created an increasing need to develop Islamic financial products, both for individuals and large corporations that want to incorporate their beliefs in the boardroom. Financial institutions such as Citibank, Dar Al-Maal Al-Islami, American Express, and HSBC are some of the large firms offering Islamic finance products. Consequently, such needs necessitate an awareness of what is available in the market and why it is called "Islamic" rather than "conventional."

Although modern Islamic banking began in the 1970s, it is the last decade that has seen the unprecedented growth of Islamic finance. Majority banks, financial institutions, and *mudaraba* (investment) companies have only established full-fledged operations in the last five years. They provide numerous financial products to the Muslim community. In Asia, banks providing Islamic financial services offer deposit products based on profit- and loss-sharing and finance facilities to borrowers predominantly on a *murabaha* basis. Several investment funds set up in the last five years enable Muslim investors to participate in the stock market or real estate ventures. These funds are fashioned according to *musharaka* and/or *mudaraba* principles. The success of new Islamic products lies not only in meeting consumer needs but also in understanding how these products fulfill the religious and other needs of the Muslim community. What principles do these products preserve? What are the tangible and non- tangible benefits they bring to society?

The commercial products and business models section of the Second Harvard University Forum on Islamic Finance was carefully planned to contribute toward developing an understanding of consumer finance and introducing some of the products existing in today's market. Sessions on Islamic consumer finance products and the like covered a wide array of subjects, from real estate finance and car leasing to hedge funds and private banking services. As part of the bigger picture, some papers highlight various forms of corporate structures and alliances helpful to offering Islamic products in the market, the implementation of these facilities, and the challenges faced.

One session highlighted some companies we see in Islamic finance today and the issues they face. Compared to a "banking" platform, which as per the central bank is defined as "an intermediary that accepts deposits from customers and lends them to borrowers," the experiences of various institutions indicated that Islamic finance could more appropriately be offered by a "financial services company." Why is this so? Banking institutions are governed by the central bank, which mandates that deposits be insured up to a certain amount and that a certain level of reserves be maintained in the form of financial instruments such as Treasury bills. Insured deposits essentially mean that customers reap interest based, guaranteed, and fixed returns with little risk. Additionally, returns on deposits are at times affected by the interest earnings on maintaining mandatory reserves in interest-paying instruments. Islamic banks most often provide an indicative rate on their deposit products and maintain either cash reserves (with the central bank providing them a fixed return) or put their money into unit trusts that in turn invest in capital markets. But how can the central bank promise a fixed return? Presently, the global financial system is such that central banks earn their revenues by lending to other institutions or investing in other instruments. These involve interest-based mechanisms, and as such interest disguises it self and creeps into returns offered by both Islamic and conventional banks. This is one of the many reasons that Islamic products can not be truly offered under the current banking scenario.

Alternatively, Islamic financial products could more appropriately be offered under the "financial services company" umbrella, as these institutions are not subjected to the constraints on banks and are outside the central

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bank regulations. In his paper, Basil Al-Ghalayini provides insights on the types of cooperation we see in banking today, as well as on some of the issues that participants in Islamic finance specially face. He also discusses various legal forms, such as informal cooperation, letters of understanding or intent, the degree of investments, joint ventures/partnerships, franchising, and mergers and acquisitions. He sheds light on issues pertaining to these areas, specifically regarding the influence of the *Shari'ah*.

An area of keen interest to financial institutions is financial instruments for the securities market, such as company shares (stocks), bonds, mutual funds, hedge funds, and infrastructure funds. *Shari'ah* scholars have declared guidelines for Muslim investors and financial institutions continue to make strong efforts to innovate capital market instruments that will enhance investment avenues for the Muslim community. An interesting topic related to this subject is asset securitization.

Presently, other than company stocks (which must comply with stringent *Shari'ah* guidelines), there are no tradable (investment) instruments in the capital market for the Muslim investors. Generally, *Shari'ah* scholars do not approve of investments in bonds, swaps, options, and currency trading. Ideally, in this case asset securitization would provide an additional avenue for investment and a product could be structured for trading in accordance with the *Shari'ah*. It would be a *halal* (Islamically acceptable) investment mechanism, and seems to be the next logical step in the development of Islamic finance. Tradable instruments could be issued to the public and backed by *halal* assets yielding *halal* returns. For example, securities could be issued that are backed by, say, a commercial building, which is leased out to various companies conducting *halal* business (gambling-, pork-, and alcohol-related business is not allowed, of course). If, for example, a group of investors pooled funds to acquire this commercial building, they could share the rental earnings from the leased space. Investors can choose to issue tradable instruments (securities) that are backed by the building (asset). The shares can be traded at any value, depending on the market value of the property. Its businesses and rental income could also be passed on to investors. As all investors are like co-owners, they can choose to sell their shares to another investor at a price usually determined by market forces.

An interesting real-world project is discussed in the paper by eminent scholar M. A. Mannan, who writes of the "New Frontiers of Islamic Banking in the 21st Century with Special reference to Non-formal and Voluntary Sector Banking." His paper focuses on a case study of forming a social investment bank, a concept or banking model established in 1995 in Dhaka, Bangladesh. His presentation at the Forum reflected the true Islamic spirit of responding to socioeconomic problems by providing guidelines not only for individuals but also for the larger benefit of communities and societies. The "Islamic man" is obliged to act within the framework of the totality of human situations—that is, at an earthly level as well as at the spiritual level. The thrust of economic development in Islam does not lie in the integration of development and social justice via distribution, or in viewing development with social justice as an adjustment. It lies in treating distributive considerations as the fundamental basis for the allocation, use, and maintenance of resources, both human and non-human. This emphasis is considered to be crucial in understanding the Islamic concept of banking, finance, and development.

The case study of Social Investment Bank Limited (SIBL) in Bangladesh that Dr. Mannan presents is an enlightening example of the application of Islamic ideals in upgrading individuals and the society. The objective of the bank is to direct its group lending program in urban and rural settings at a grassroots village and local level. The program is aimed at land-less laborers, marginal farmers, fishermen, small artisans (e.g., blacksmiths, carpenters, potters, and handicraft producers), the urban unemployed, small traders, small and rural industries, and small- and medium-scale business enterprises. Working in an environmentally friendly business program with the small traders of Tokai (mainly street children of distressed parents), the recovery rate is a commendable 100%. The *Shari'ah* board of the bank guides banking operations to ensure conformity with the *Shari'ah*.

Housing finance is another area of high demand by the Muslim community. Two papers below discuss this: those by Pervez Nasim of the Islamic Cooperative Housing Corporation (ICHC) and Yahia Abdul-Rahman (with his colleague Abdullah Tug) of LARIBA Finance House. Each highlights the services their respective organizations provide. For example, the housing finance product ICHC offers is an excellent one for the Canadian Muslim community: it is fair and flexible in providing an opportunity for Muslims to own homes in a relatively short time, compared to conventional finance. Additionally, ICHC provides an avenue for young Muslims to make *halal* investments for their future. Such facilities are not offered by other institutions. Products like car leasing (offered by LARIBA and ICHC) are other examples of consumer finance products offered to the Muslim community in Canada and the U.S. To prevail and succeed as a small Islamic institution is a difficult uphill battle. The success of Islamic institutions in a non-Muslim environment depends greatly on community trust in the institutions, and that success is a two-way street. It also depends on the institutions' adherence to the *Shari'ah*, the Qur'an, and the *Sunna*, and on individuals deeply motivated by their faith.

On a larger scale, venture capital and project finance are areas of potentially high growth in Islamic finance. Infrastructure funds are venture capital products in which *Shari'ah* principles could perhaps most appropriately be applied to provide additional investment avenues to Muslim investors or large concerns. *Shari'ah*-compliant products in this area would provide a means of raising funds for massive projects, such as power plants or telecommunications networks, that could not possibly be financed by a single entity. They are, however, meant for long-term investment, as infrastructure projects take a long time to complete and subsequently provide returns. Issues in venture capital include assessment of the demand for long-term investment opportunities, the comfort level of Muslim investors in such ventures, and an evaluation of the risk specific to the ventures.

Project finance is another suitable area for the application of Islamic finance principles. This subject was discussed at length at the Second Harvard Forum. Project finance is essentially non-recourse financing in which the lender bears the risk of a project's performance and relies on the project's cash flows for repayment. Project finance and Islamic finance have some close similarities. For instance, unlike conventional finance, which is primarily concerned with the size of the collateral, Islamic finance (at least in theory) is mainly occupied with a project's viability and profitability. Theoretically, it provides more opportunities for entrepreneurs to set up new ventures.

Capital market and real estate funds launched for investors are products that have shown the greatest development in the last five years. Since 1995, sixteen Islamic equity funds (based on the *mudaraba* concept) have been launched. Based on an individual's risk appetite, such funds allow people to invest, sell, and purchase Islamically acceptable commodities and equities. Besides flexibility and choice of investment, such funds provide comfort to Muslims' consciences, as the portfolio is reviewed to comply with *Shari'ah* guidelines. Most *Shari'ah* scholars approve investment in companies whose interest-based debt is less than 33% of overall debt and whose interest income does not exceed 10% of total income. Of course, investment in companies engaged in *haram* activities is forbidden.

Hedge funds were another product discussed in detail. In the last few years, hedge funds have been a very popular investment vehicle, similar to mutual funds, as Arif Kamal Siddiqui explained. Both types of funds are used for investment in equities, but hedge funds aim for higher returns for investors and money managers. Siddiqui covered aspects such as the regulatory framework governing hedge funds, associated costs, client focus, market segment, and in particular the Platinum Hedge Fund, which was specifically launched for Muslim investors. He also discussed the *Shari'ah* filters used, along with difficulties such as the absence of a comparable or an appropriate benchmark for such a product.

Islamic finance continues to progress on many fronts, from capital market instruments to consumer finance products, from banks to financial institutions, from individual investors to multi-institutional deals. The steady growth of this specialized field, the dedication of individuals, growing academic research, and the formation of more Islamic banks and financial institutions is a clear sign that this area of finance is here to stay.

Islamic Finance Information Superhighway

Taha Abdul-Basser*

ABSTRACT

The "information technology (IT) revolution," though often over-hyped, promises the ability to manipulate information with a speed and ease humans have never known. It raises several questions for Islamic banking and finance (IBF). Discussion can be focused by looking at an innovative information-collection, -processing, and -dissemination effort at Harvard University, the Harvard Islamic Finance Information Program (HIFIP), and its original database software, the HIFIP *DataBank*. HIFIP and its *DataBank* occupy a unique position in the drive to integrate IT into IBF. The *DataBank* is a composite of nine component databases on various aspects of Islamic banking and finance. Islamic financial institutions must integrate IT into their operations on all levels, for it is inconceivable that they can compete with non-Islamic, conventional ones otherwise. Moreover, IT can be useful in re-educating Muslim bankers, financial professionals, and consumers on IBF.

I. INTRODUCTION

Hardly a day goes by in which we are not bombarded with descriptions of the marvels of the Information Age. We will be able to purchase things (which we do not need) more easily than ever before, we are told. We will be able to speak to our toasters and describe, in wondrous detail, how dark we would like our bread to be. We will be able to make reservations for our favorite restaurants from our television sets.

No doubt, the Internet, the World Wide Web, and other aspects of the "information technology (IT) revolution" are often over-hyped and over-rated. Yet, the promise of the Information Age is real. Nearly every aspect of our lives is likely to be affected by the ability to manipulate information with a speed and ease never before experienced by humanity.

This development raises several questions that concern Islamic banking and finance (IBF). What role does IT play in IBF today? What role might it play in the future? In particular, discussion can be focused through an examination of an innovative information-collection, processing, and dissemination effort at Harvard University, the Harvard Islamic Finance Information Program (HIFIP), and its original database software, the HIFIP *DataBank*. The Harvard Islamic Finance Information Program is a unique example of the meeting of IT and IBF. Its first-of-its-kind database on Islamic finance, the HIFIP *DataBank*, offers a hint of the benefits that IT holds for Islamic finance.

The ingress of IT into IBF has been discussed in various forums in recent years. Of particular note is the 4th Annual Meeting of the Islamic Banking and Finance Forum, which took place in Manama, Bahrain, in December 1997. At this conference, an entire session was dedicated to the issue of IT in IBF. The Harvard Forum on Islamic Finance continues the positive trend of exploring this very important topic.

II. INFORMATION TECHNOLOGY: ISSUES AND ACHIEVEMENTS

The issues involved in the integration of IT into IBF are complex. They can be encapsulated, however, in the following observations. First, the ability to procure, store, transfer, analyze, and otherwise manipulate large quantities of data goes to the very heart of contemporary banking and finance because of the importance of both qualitative and quantitative data to this field. Second, it is inconceivable that Islamic finance institutions can compete with non-Islamic, conventional institutions without fully integrating information technology into their operations. Third, the conventional banking and finance sector is itself undergoing a transformation in the face of the rising importance of IT. Finally, the success of the IBF sector, in particular, rests on the re-education of Muslim bankers, financial professionals, and consumers themselves. IT is likely to play a key role in this information campaign.

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More specifically, the issues involved in the integration of IT into IBF include network security, document management, internetworking, open systems, e-commerce, e-banking, localization/internationalization, legacy software, banking software customization, accounting software, and data warehousing.

Several people, in various capacities and each in their own ways, have been notable supporters of the integration of IT into IBF. They include Prince Mohamed Al Faisal Al Saud of Dar Al-Maal Al-Islami Trust in Geneva, Switzerland; Dr. S. Nazim Ali at the Harvard Islamic Finance Information Program in Cambridge, Massachusetts, U.S.A.; Mr. Muazzam Ali at the Institute of Islamic Banking and Finance (IIBF) in London, England; and others. The IBF sector is very much in the embryonic stages of its embrace of IT. However, there is evidence that Islamic banks and financial institutions are taking up this challenge.

Several of the better-known achievements are of note. The Faysal Islamic Bank of Bahrain has developed its own customized banking software, called IBS. This software may become the standard banking software for the Islamic financial sector. The IT staff of a prominent Islamic financial corporation, Dallah Albaraka of Saudi Arabia, should also be mentioned as a leader in the area of software customization. The Islamic Development Bank's research wing, the Islamic Research and Training Institute, has been working for some time on its ambitious network, dubbed OICS-Net. This network was designed to connect OIC member states, providing them with access to information on Islamic law, economics, finance, and other matters of mutual interest. Finally, a technology group in Malaysia, Silverlake System Berhad, has developed banking software for the Malaysian dual banking system.

The activities of the various research and training institutions in the field of IBF, such as IRTI, IIBF, and BIRT (Malaysia) also fall within the realm of IT. Their efforts to disseminate information on IBF are a crucial part of meeting the IT challenge. At this point, it is useful to introduce the Harvard Islamic Finance Information Program and its associated software product, the HIFIP *DataBank*, since it occupies a unique position in the drive to integrate IT into IBF.

III. The HIFIP *DataBank*

The HIFIP *DataBank* is the world's first comprehensive electronic information retrieval tool in the field of Islamic banking and finance. Because of the wide-ranging scope of its sources, it corresponds to no single printed source, as is often the case for many CD-ROM and online databases. Along with free-text searching, the *DataBank* offers users the ability to print and export data to Microsoft Excel and ASCII text.

The *DataBank* is a composite of nine component databases on various aspects of Islamic banking and finance: *Shari'ah*, Publications, Financial Institution Profiles, Who's Who in Islamic Finance, Deals and Transactions, Education and Research, Islamic Funds, Macroeconomics, News. A discussion of the individual databases follows.

A. *Shari'ah* Database

The *Shari'ah* database is designed to offer access to basic texts that form the theoretical and ideological bases of both classical Islamic financial transaction jurisprudence (*fiqh al-mu'amalat*) and contemporary Islamic finance. It is divided into 5 sub-databases: Qur'an, *Hadith*, *Fiqh*, *Fatawa*, Glossary, which in total have around 750 records.

Since the last version of the *DataBank*, the *Shari'ah* database has changed significantly. The most apparent change is that the user interface for the *Shari'ah* database is the same integrated user interface used by the other sub-databases of the *DataBank*. Thus, the user is no longer required to view entries or search the database in the Adobe Reader environment. The development of a universal *Shari'ah* database entry template for the data entry template software facilitated precise data entry.

Other than the Qur'an database, all of the other sub-databases have undergone significant expansion and restructuring in content. The *Hadith* database consists of about 100 entries, with each entry containing a mean of 3.5 independent reports. The database therefore features approximately 400 Prophetic *Ahadith* of financial relevance. The core *Ahadith* of the database are those reports included by Ibn al-Hajar al-Asqalani in the K. al-Buyu` in his work *Bulugh al-Maram*.

The *Fiqh* database consists of 15 entries, with each entry dedicated to a fundamental concept or instrument in Islamic finance (e.g. *riba*, *bai'*, *gharar*, *qimar*, *salam*, etc.). Each entry provides classical definitions of terminology, a concise discussion of salient legal rulings across the *fiqh* schools, and a section on the role of the entry topic in contemporary Islamic finance.

The *Fatawa* database contains around 100 entries. Each entry features an English-language translation of a contemporary *fatawa* issued by a notable *fiqh* authority such as the OIC *Fiqh* Academy or the Dallah Albaraka-sponsored Conferences on Contemporary Islamic Economic Issues. Dr. Saleh J. Malaikah, of the Dallah Albaraka

Group, greatly aided the developers of the *Shari'ah* database by providing HIFIP with the Arabic texts of *fatawa* compilations as well as other sources.

The Glossary contains nearly 100 entries, with each entry featuring the definition of a basic term in Islamic finance.

Throughout the *Shari'ah* database, an effort was made to follow scholarly methods by providing citations, consistent transliterations, and a balanced presentation of this vast field.

B. Publications Database

The Publications database has been restructured; presently it includes three sub-databases: Articles, Books, and Conference Papers, comprising 3500 records altogether. In the Articles sub-database, the most extensive of the three, the procurement and preparation of articles to be abstracted is an area of primary urgency. The hundreds of articles already entered have been found in library databases and in the resources of the Islamic Legal Studies Program. What currently needs to be done is to actually visit libraries and photocopy articles. Furthermore, HIFIP should subscribe to the core journals in Islamic economics and finance. As HIFIP grows in reputation, publishers may be willing to send HIFIP issues free of cost in exchange for the recognition of being placed on HIFIP's core list.

Regarding the composition of abstracts and reviews, it seems necessary to create a tiered system of writing and editing. There should perhaps be a staff member with special expertise in economics (such as a Ph.D. candidate) whose sole job would be to edit abstracts for their level of scholarly understanding. Even the authors of abstracts should be individuals with strong economic expertise. Also, no individual should be the sole editor of his own work.

Consistency in spelling and names should be maintained by following the Library of Congress transliteration formats. Presently, all existing resources at Harvard University's Library are being used to verify and prepare abstracts for publication. Reuters and Euromoney are being contacted for inclusion of their news items into the *DataBank*.

Similar efforts need to be extended for the procurement of books and monographs, which need to be described in the database in the form of a summary and table of contents. The alternative scheme is to spend time in Harvard University's Widener Library, Law Library, and Baker Library by student researchers capable of summarizing these books.

Previous conference and seminar papers entered in the database must be acquired by contacting the individual authors (which is a tedious and time-consuming activity). For future conference papers, HIFIP must participate or HIFIP's representative must be at the conference to collect the papers. Past experience has revealed that conference organizers will not bother to entertain any such request.

A unique list of Terms is being developed so that terms may be assigned to each entry in the Publications database. This will help users find information on any given topic. References to articles and the table of contents of books are not included in the database. This is due to the shortage of time, the extensive efforts needed to undertake the overall task, and absence of a professional full-time staff.

C. Financial Institution Profiles Database

The HIFIP management staff has spent a great amount of time and efforts in developing the Financial Institution Profiles (FIP) database, which contains approximately 280 records. In spite of HIFIP's many reminders and telephone calls, several institutions have entries that lack information, particularly banks from Indonesia, Iran, Malaysia, and Sudan. In order to fill this gap, HIFIP has designed a questionnaire and circulated it to various banks. More field research and personal visits to target institutions would facilitate the collection of bank annual reports and rating reports.

The FIP database is composed of seven sections for each institution with an entry: Summary, General Info, History, Business, Ratings Management, and Financial Statements.

<u>1. Financial Statements</u>

One challenge posed by the FIP database results from the Program's adoption of the Accounting and Auditing Standards for Islamic Financial Institutions. Individual banks' balance sheets have to be transferred to this standard format. At the Fifth Meeting of the HIFIP Operating Board (in October 1996), it was recommended that HIFIP contact an external agency, such as Price Waterhouse or Ernst & Young, to help HIFIP formulate the financial statements according to AAOIFI's standards. Ernst & Young agreed in principle to help the Program. This is a major undertaking and requires a professional accountant dedicated for this task. In the meantime, HIFIP is presenting the data of financial statements in the bank's own format, for multiple years, and in its own currency. A conversion facility to U.S. dollars is being incorporated in the user interface, whereby the user can display the financial statements in bank's own format and in its own currency or convert figures to U.S. dollars.

2. Financial Highlights

HIFIP has made every attempt to obtain data from primary sources to complete the financial highlights of Islamic financial institutions. The International Association of Islamic Banks' (IAIB's) Directory of 1995 has been used to complete the missing information for some institutions. Similarly, the data for financing methods and sectoral activities is taken from IAIB's publication.

3. Ratings

Several ratings agencies, both American-based and foreign ones, are actively involved in rating Islamic financial institutions worldwide. The most prominent of them Moody's Investors Service, Standard and Poor's, Capital Intelligence, Thomson Bankwatch, and IBCA. This database does not attempt to evaluate the respective agencies or their ratings; it merely aims to reproduce the most recently available ratings information offered. Although all ratings seek to measure essentially the same variables—bank security, ability to withstand external disruption, ability to make timely repayment, etc.—different agencies apply different procedures or standards to the rating process. Additionally, their ratings scales differ and cannot be interpreted interchangeably. In the user interface, reference is made to the original source of ratings information for complete explanations of rating methodology and an interpretation of the ratings themselves.

4. Management Information

In the current user interface, the Board of Directors, Religious Board, Management, and Bank Officials are listed in a hierarchical manner, with links to the Who's Who database so the user can easily view the biographical information associated with each board member.

5. Bank Reports

Of the 175 institutions in the Islamic finance sector, only 50 have responded to our request for data. Yet another round of letters has been sent to all the financial institutions, accompanied by our new brochure, requesting them to forward us their annual reports. In any case, the bank reports database is simple and straightforward in content, and the information is presented as it appears in its original format. Some improvements will be made to the viewing environment so the end result is more legible and attractive.

D. Who's Who in Islamic Finance Database

Over 2500 individuals are listed in the Who's Who database. Of these, less than 20% have accompanying biographical information, though all entries, spanning business and academia worldwide, contain a name, affiliation, and contact information. HIFIP has surveyed existing sources and contacted various institutions and individuals in search of the necessary information. HIFIP will continue this task by re-contacting the appropriate sources. The Program will also consult conference brochures and other publicly available data.

E. Deals and Transactions Database

The Deals and Transactions database has expanded rapidly to the point where it contains 850 entries. Each deal, in which Islamic financial institutions have participated, has an entry that features information on the year, country, and region in which the deal was closed, a list of banks participating in the deal, and a brief description of the transaction.

Euromoney's Loanware software has been very helpful in allowing HIFIP to utilize the data of Islamic finance as well as conventional banking deals in OIC member countries. The monthly magazine *Islamic Banker* has also been a good source of information. A short questionnaire was circulated to all Islamic financial institutions to get data on their deals and transactions. HIFIP received a good response from IICG and ANZ Grindlays about their deals and transactions. We will continue to press individual institutions to provide similar data.

The Financial Institution Profiles and Deals and Transactions databases will have a similar search engine with advance searching options. Searches can be performed by institution, date, amount, and region. One can also search for institutions as the Arranger, Lead Manager, Facility Agent, or Participant in a given deal. The total value of the deal is uniformly presented in American dollars as well as in original currency. A comprehensive market focus index has been designed to facilitate access to data on any trade.

F. Education and Research Database

The Education and Research database, with about 150 records, is a full-text reference and directory database. Information included here is not covered by any existing database. This is useful for academics and researchers, and for their convenience is divided into four sub-categories:

1. information on associations, foundations, law firms, and other types of companies involved in Islamic finance;
2. courses and academic programs offered in Islamic economics and finance;
3. research centers and universities conducting research in Islamic economics and finance; and
4. a core list of journals and magazines fully devoted to Islamic economics, finance, or related areas.

G. Islamic Funds Database

With approximately 70 records, the Funds database is a full-text reference and directory type database that lists funds alphabetically by name and provides the details of each fund, including fund manager(s), launch date, type of fund, and description.

H. Country Info Database

The Country Info database is composed of two secondary databases: the Macroeconomics database and the Regulatory Procedures database. The Macroeconomics database provides information on the 52 OIC countries. For each country, information is presented on the following categories: Background Data, Economy, Transportation, Communication, Exchange Rate, Ministry of Finance, Central Bank, Major Banks, Stock Exchange, and Insurance Companies. The Regulatory Procedures database is a full-text database of regulatory procedures governing the banks in OIC countries, with particular reference to Islamic finance. So far the following nations' central bank regulatory procedures are included in the *DataBank*: Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Pakistan, Turkey, and Saudi Arabia. All central banks in OIC countries have been contacted for their regulations; we will re-contact monetary authorities that do not respond to our request.

I. News Database

The News database contains approximately 2000 internationally published news items on Islamic banking, economics, and finance. News items featured here come from periodicals printed in Western countries and the Muslim world from 1990 to the present. HIFIP has been granted copyright permission to reproduce news items from the following sources: Euromoney, Gulf Daily News, Khaleej Times, Gulf News, Sudanow, The Saudi Gazette, Arab News, Business Malaysia, Middle East Economic Digest, Islamic Banker, New Horizon, The Banker, and Business Today.

IV. CONCLUSION

The IT challenge that faces the IBF sector is straightforward, yet, in some ways, sublime. Islamic financial institutions must integrate IT into their operations on all levels: internal operations, customer relations, and so on. They should strengthen their IT staff through aggressive hiring and training. Essentially, they should use IT as a tool to make their operations more efficient.

This last point is crucial. The integration of IT into IBF is unlikely to add something to the sector that does not presently exist in concept. It should, however, aid the IBF sector in achieving its goals and allowing its institutions to function better and faster.

Strategic Alliances in Islamic Banking

Basil Al-Ghalayini[*]

ABSTRACT

Strategic alliances are a critical component of the Islamic banking community's effort to become increasingly competitive and responsive to consumer demand as well as further integrated into world markets in the 21st century. There are numerous legal vehicles through which cooperative action is possible, each with varying degrees of control and cooperation between the allied parties. The natural synergies between Islamic banking institutions and conventional banks are both plentiful and obvious. Conventional banks investing in sectors requiring knowledge of the *Shari'ah* can enter into various forms of partnerships with Islamic banks that possess expertise in the *Shari'ah* as well as extensive knowledge of the localized economy and culture. Similarly, Islamic banking institutions seeking to invest in non-Islamic countries or communities can form synergistic relationships with conventional banks possessing the appropriate expertise and knowledge.

I. Overview of Strategic Alliances

Strategic alliances may be thought of as any form of joint cooperation where two or more parties involved seek to pool resources toward a common objective. Joint cooperation may take many forms. The distinctions lie in areas such as the rights and responsibilities of the respective parties, control, and commitment to the relationship. Commitment relates to the risks involved, time involved and the extent to which other resources are devoted.

Some of the primary forms of cooperation are discussed below. While the list is not comprehensive, it presents a useful starting point, beginning with those relationships that generally require the lowest level of commitment.

A. Informal Cooperation

Informal cooperation is a relationship wherein the legalities have not been reduced to writing, although certain legalities may still be implicated (e.g. oral contracts, implications of past dealing and/or implied contracts). An examples of this type of relationship would be the relationship which develops between the treasury department of an Islamic bank with its primary conventional counter-party.

B. Contractual Alliances

A contractual alliance is where a written contract is executed addressing the scope and limitations of the relationship as well as what is expected of each party. The contract may or may not be very specific in all aspects of the relationship. An example of this type of relationship would an asset manager based in the United States which, pursuant to a contractual agreement, serves as the Investment Advisor to a range of Islamic mutual funds sponsored by an Islamic institution.

C. Minority Investments

Minority investments entail an equity infusion in the strategic partner. Often a board seat is obtained or some form of input into the strategic direction of the alliance is granted. Control is typically not obtained since the investment, by definition, is a minority stake. There is significant potential for *Shari'ah* complexities in the event Islamic and conventional entities seek to promote an alliance through this form where the minority investment is made in the conventional entity.

D. Joint Ventures

In a joint venture, the allies create a separate business entity in order to conduct a joint activity in pursuit of a common objective. Joint ventures are a good way to share ideas where the allies view each other as equals. An example of this structure would be a Private Bank and Islamic specialist working together to form an entity which delivers Private Islamic banking services.

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E. Franchising

The characteristic that distinguishes franchising from other forms of cooperation is primarily the control aspect. When a business looks to expand, it may decide to branch out and "go it alone," ally itself with a partner in those locations it seeks to expand into or buy an existing enterprise. The franchising concept generally allows expansion in a manner that allows more control over the new activity than in a strategic partner and requires fewer resources than acquiring an ongoing business. Franchising combines reduced utilization of resources with somewhat reduced risk. A relevant example of franchising would be a conventional bank acquiring a comprehensive Islamic product offering from an Islamic service provider in order to access the Islamic marketplace in a more efficient manner.

II. Who Participates in Strategic Alliances

Islamic institutions must function within the guidelines of the *Shari'ah*. Accordingly, Islamic institutions have generally committed more resources to addressing *Shari'ah* aspects than have participants who are not purely Islamic providers. Capturing the *Shari'ah* knowledge of an Islamic provider is one of the primary impetuses to forming strategic alliances. In terms of institutional providers, the most active and substantial participants in strategic alliances are Islamic retail Banks, Islamic Investment banks, specialty wholesalers and Islamic divisions/units of conventional banks.[1]

III. Why Participants Seek to Establish Alliances

Generally, participants seeking to engage in strategic alliances in the context of Islamic banking are not terribly different from traditional strategic alliances. For instance, the reasons behind the merger between Daimler-Benz and Chrysler includes areas such as obtaining access to desirable markets, bringing together complementary and innovative skills, efficiencies of scale through lower costs, and pre-empting competition in a competitive environment. However, determining which types of combinations could be most beneficial to the respective participant(s), requires understanding the profile of today's Islamic banking market. This understanding also helps in understanding how and why some conventional benefits are more or less valuable in the context of Islamic banking. The rationale for participants choosing the strategic alliance route often includes one or more of the following:

A. Advance the Interests of Islamic Banking

The Islamic banking industry serves as a medium for Muslims to satisfy their banking needs in a manner that satisfies certain religious concerns. In terms of strategic alliances, this form of banking requires reconciliation with the conventional banking system in order to prosper and achieve its objectives (e.g. fair distribution of wealth). From a global perspective, many participants seek to engage in strategic alliances in order to strengthen and support Islamic banking toward the advancement of its viability and growth.

B. Penetrate and Participate in a Growth Sector

A great deal of attention has been focused on the Islamic banking industry in the last several years. New participants not already entrenched or recognized in this niche market must determine the best approach to penetrating the market. Often a strategic alliance is the solution of choice in order to facilitate access to the market. By reducing entry barriers, strategic alliances create increased competition in the marketplace.

C. Shared Expertise and Complementary Skills

Many Islamic institutions, especially those domiciled in the Middle East, do not have the resources to keep pace with the likes of financial engineers and asset managers located in London, New York and other major financial centers. Similarly, those entities not "on the ground" in traditional Islamic markets often lack an in-depth knowledge of *Shari'ah* law, Islamic structuring, follow-up capabilities or market knowledge. An alliance creates synergies that produce a product that meets the needs of the marketplace. The terms "Islamic credibility" and "perceived value" are used by some to characterize the value-added brought to the relationship by the Islamic participant.

D. Level of Commitment and Timing

The extent to which an enterprise wishes to devote and direct its resources will be a factor in determining whether the strategic alliance route should be taken. Certain forms of strategic alliances allow for relatively low costs with a corresponding lower risk. Participants entering into a strategic alliance are typically better served by committing to a long- term view. An alliance allows for quicker entry into the marketplace, reducing costs and pre-empting competition. Lastly, an alliance may well help a conventional bank retain or increase its market share in a geographic location where growth in Islamic banking is the most pronounced.

IV. ALLIANCES BETWEEN ISLAMIC AND CONVENTIONAL BANKS

The Islamic banking industry is not restricted to any particular geographic area. However, the bulk of Islamic banking is concentrated in certain geographic regions (e.g. G.C.C. countries). The geographic location of the participant and its historical involvement or past experiences can be critical, since Islamic solutions often need to be tailored to local preferences.

A. Potential Synergies

Conventional and Islamic banks in strategic alliances create numerous synergies in terms of product offerings to the Islamic marketplace. The Islamic participant brings an understanding of *Shari'ah* law to the relationship. Part and parcel with this understanding is the ability to structure transactions and create Islamic solutions. The Islamic participant also brings localized knowledge of the Islamic marketplace. The conventional participant often has skills such as asset management, financial engineering and administrative services. These attributes are often developed over a long period of time at significant cost. Thus the conventional participant's core competencies are an integral component to the innovative Islamic solution.

The alliance creates a bridge between Islamic banking and conventional financial services. This bridge is necessary to the prosperity and growth of the Islamic banking industry as it is doubtful the Islamic banking system can reach its full potential without some measure of integration into the world markets.

V. SHARING OUR EXPERIENCES

TII is a Kuwaiti-based wholesale Islamic Investment Bank listed on the Kuwait Stock Exchange. As of December 31, 1997, the Company had approximately $2.5 billion in assets held in trust or in a fiduciary capacity. TII's overall strength lies in providing creative and efficient access to the expanding Islamic financial marketplace. TII's strength builds upon its structuring expertise and knowledge of the Islamic market and its distinct structuring requirements. The Company's activities include the following three primary categories:

1. Corporate finance (including project financing, mergers and acquisitions, start-up ventures, etc.);
2. "Franchising" of Islamic banking capabilities and solutions, including providing investment products and a comprehensive range of services; and
3. Advisory services, generally of a long-term strategic nature.

A. Franchising

In general, franchising is characterized as furnishing certain intellectual and tangible physical property in a turnkey fashion to an operator. The franchiser often maintains control of the quality and other aspects of the operation. The intellectual property may include the use of a trademark as well as the methodology for production or performance.

An Islamic wholesaler may equip a conventional bank for the purpose of allowing the latter to effectively compete in the Islamic financial services marketplace. TII selects top tier banks, which are sophisticated in terms of staff and system development and have a well-developed distribution network. The relationship can include a wide array of products and be expanded to areas such as consumer financing, Islamic credit cards, and Islamic mortgages. For the conventional bank, franchising is a low-cost approach to entering a segment of the overall banking population that would not otherwise be able to reach effectively.

B. Advisory

This area has a number of attributes. It may consist of a real estate developer seeking to tap the Islamic market, requesting assistance in developing a structure that meets the requirement of *Shari'ah*. It may also include the asset manager that seeks to develop an Islamic equity fund. TII can add value in its advisory capacity in the following ways:

1. Furnishing an appropriate Islamic index;

2. Providing consultation with regard to investment criteria and guidelines;
3. Assistance with dividend cleansing;
4. Due diligence review – compliance opinions;
5. Cash/liquidity management support;
6. Portfolio management tools; and
7. Furnishing other relevant information as appropriate.[2]

VI. Conclusion

Strategic alliances are a critical component of the effort on the part of Islamic banking institutions to become more competitive and further integrated in the world market in the 21st century. There are natural synergies between Islamic banking institutions and conventional banks. Conventional banks investing in sectors requiring knowledge of the *Shari'ah* can enter into various forms of partnerships with Islamic banks. Similarly, Islamic banking institutions seeking to invest in non-Islamic environments can enter into synergistic relationships with conventional banks possessing the appropriate expertise.

[1] Others who are contributing to this industry in one form or another, and in no particular order, include: (1) investors/depositors, (2) conventional banks, (3) private bankers, (4) governments, (5) project developers, (6) venture capitalists, (7) brokers and distributors of products, (8) financial engineers, and (9) asset managers.

[2] A few additional topics that have not been discussed but are important to note include: (1) evaluating and selecting an ally; (2) creating strategic synergy; (3) understanding and overcoming cultural differences; (4) corporate and individual compatibility; (5) obtaining top-level policy commitment; and (6) developing effective relationships within the overall relationship.

New Frontiers of Islamic Banking in the 21st Century with Special Reference to Informal and Voluntary Sector Banking

M. A. Mannan*

ABSTRACT

This paper seeks to develop an understanding of as well as unfold some key issues involved in exploring the new frontiers of the Islamic banking paradigm in the 21st century, at both theoretical and operational levels, with special reference to informal and voluntary sector banking. In this context, it is relevant to provide a historical overview of the rediscovery of Islam in the contemporary period. As a case study, the operational thrust of the Social Investment Bank, a 21st century participatory three-sector banking model established on November 22, 1995 in Dhaka, Bangladesh, is reviewed to provide an empirical basis for an in-depth understanding of this alternative paradigm of Islamic banking. At the end, an Agenda for Action for Islamic banks, for at least the first quarter of the 21st century, is offered.

I. Statement of the Problem, Hypotheses, and Objectives[1]

Islamic banking and finance in the 21st century needs "discontinuous leaps"—changes in paradigm to clear the backlog of history. A paradigm that refers to a given set of premises, views, conventions, and beliefs will have to change to meet the requirements of new social puzzles and economic realities.[1] The serious theoretical works of Islamic economics, banking, and finance during the last forty years, the establishment of the Islamic Development Bank (IDB), and the number of Islamic banks and investment companies with interlocking relationships in both Muslim and non-Muslim countries in the last thirty years indeed constitute one of the major historic developments of our time. It is felt, however, that there is a profound and disturbing gap between this theory and the practice of Islamic banks on the ground, particularly when the intended object of Islamic reform is the feudal capitalist system found in many Muslim countries today. A thorough restructuring of the educational system through curricular change is needed as a long-term solution to this problem. In the mean time, humble attempts are being made to provide an example in social behavior on a voluntary basis and on both individual and community levels.

There is, however, a clear need for banks to perform a historical role in refurbishing the pattern, direction, and strategy of existing banking principles, policies and practices that are based largely on a neo-classical Western worldview. As a result, the Islamic corporate formal sector banking is perhaps gradually losing its distinctive character. It appears that it is getting submerged in the wave of the market economy. There is indeed a risk of destroying its distinctive character by marginalizing its social and ethical ingredients. This is not to suggest that the market mechanism is not acceptable in Islamic economics, banking, and finance.

Moreover, it is to be recognized that there is hardly any work done to understand the dynamics of Islamic non-corporate informal and semi formal finance and the role of social capital in developing Muslim countries. It can transfer power to the powerless. Recent studies showed that the non-corporate sector accounts for 30% to 70% of the labor force in some developing countries. Practically no attempt has been made so far to monetize Islamic voluntary sector banking and the consequent securitization of its capital market. We need Islamic banking for all by all. Informal and voluntary sector banking can help the mobilization and capitalization of social savings and investments, reinforce the basic values and ethics of a society, and stimulate civil society. Social capital is perpetual in nature indeed.

It is therefore felt that Islamic banking in the 21st century will face considerable challenges but can create great opportunities as well for both Muslim and non-Muslim countries if and only if it works to develop a participatory economy beyond the market. It needs to arrest the present trend toward the globalization of poverty coupled with rising corporate power, pervasive corruption, secularization, and the concentration of ownership and beneficiaries of Islamic banking and finance. It needs to redefine the role of Islamic formal corporate finance and rediscover the role of informal and semiformal finance through developing tailor-made credit packages for the re-empowerment of families of both the rich and the poor at the grass-root level. In sum, it needs to help the

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development of voluntary sector social banking for the mobilization and capitalization of social savings and investments.

At this stage, it is desirable to shed some light on the underlying assumptions on which this paper is based.

II. Seven Key Conceptual and Operational Assumptions

1. Beyond Common Ideas: The Distinctiveness of the Islamic Response to the Economic Problem

This study is based on the fundamental assumptions that there are Islamic responses to socioeconomic problems and that the underlying assumptions on which the neo-classical or Marxist-radical paradigms are based are either inappropriate, inadequate, or incapable of explaining the Islamic concern in socioeconomic matters.[2] The fact is that in every system of thought, there are some assumptions and ideas in common with other systems of thought. It is through emphasis, de-emphasis, or rejection that an identity is established. Therefore, Islamic economics, banking, and finance will have its own hypothesis. In the course of scientific investigation, it may reject, accept, modify, or alter them irrespective of social and economic systems.

2. Beyond Positive Economics

The study of Islamic economic behavior as a distinct branch of knowledge owes its origin to the very ideology of Islam derived directly or indirectly not only from the Qur'an, *Hadith*, (sayings of the Prophet Muhammad (PBUH)) and *Sunna* (traditions of the Prophet), but also from *ijma'* (consensus based on agreed practice), *qiyas* (analogy), and *ijtihad* (fresh thinking) as sources of Islamic law. To Muslims, the Qur'an is "revealed knowledge"; it is given. While this "revealed knowledge" is beyond the scope of positive economics, acquired knowledge may be subject to test and critique.[3] This view of "Islamic man" is indispensable for the functioning of Islamic economics, banking, and finance within the framework of human situations at an earthly macro level and for a dual notion of accountability (i.e. life on earth and life hereafter) on the spiritual level.

3. Beyond the Market

The free market mechanism based on effective demand is linked to the affluent, making resources available to those who can buy them and not necessarily to those who need them. The market is moreover either inefficient, ineffective, or indifferent in providing for all aspects of basic needs with which the Islamic market is concerned. Thus neither perfect competition nor perfect cooperation models meet the goals of an Islamic economy. An optimal mix of "supervised" competition, induced and voluntary cooperation, and critical control may provide a better basis for Islamic economic analysis. There is in fact no rule for the optimal mix or tradeoff between the three C's (i.e., Cooperation, Competition, and Control).[4] This paper presupposes the existence of a vast non-corporate and voluntary sector in most of the Muslim states beyond market.

4. Beyond Corporate Power: Empowering the Powerless

The paper also presupposes the existence of corporate power. Despite their ostensible support for open economic competition, multinationals use elaborate strategies to retain their preeminent economic positions. They tend to obstruct the entry of the poor and inexperienced coming from nations having little or no link with this global elite and access to global finance. Most of all, they benefit from their participation in the global corporate elite and its networks of mutual obligation. Islamic finance and credit should transfer power to the powerless, cover those who remained uncovered.

5. Beyond the Integration of Distributive Considerations

The key thrust of economic development in Islam lies not in the integration of development and social justice via distribution, nor in viewing development with social justice as an adjustment, but in treating distributive considerations as the fundamental basis for the allocation of resources—both human and non-human—and their use and maintenance.[5] This emphasis is crucial to understanding the Islamic concept of banking, finance, and development.

6. Beyond the Replacement of Interest

The mere replacement of interest by profit sharing may not initiate the process of authentic Islamic banking and development in the 21st century. On the contrary, there is a real danger that the replacement of interest by the profit-sharing system may actually increase the level of economic exploitation of the poor by the rich. At the heart of Islamic banking, finance, and development lies a change in attitude from individualistic behavior in economic transactions to an Islamic egalitarian group notion, reflected in the basic consumption behavior, production priorities, and distribution strategies.

7. Beyond the Form of Islamic Financial Modes

The paper presupposes that it is not the form but the content and substance of all Islamic financial technique and contracts that matter most. All the modes of Islamic financing as practiced by Islamic banks should exhibit the interconnectedness of economic, social and ethical dimensions at their operational level. The crucial distinctiveness of Islamic banks' operations should lie not only in integrating economic, social, and moral dimensions in every transaction, but also in controlling their results and managing and directing their consequence to achieve their desired economic justice.

The above-mentioned seven crucial assumptions are not exhaustive, yet they can provide a framework for developing an understanding of Islamic economics, banking, and finance for the years to come. In addition, an in-depth understanding of the context and social setting for the operation of Islam and Islamic banking in the 21st century requires cognizance of rising expectations and the signs of a revival of the Muslim world.

III. Rediscovery of Islam in the Contemporary Period

The rising expectations and signs of revival of the Muslim world should be studied objectively with reference to at least five basic historical facts: (a) the ideal Islamic system as developed in the early Islamic period; (b) the legacy of Islamic civilization; (c) historical decline and successive stages of several centuries of colonization of the vital areas of the Muslim world, resulting in the progressive neglect of the role of *ijtihad* (i.e., fresh thinking), an increasing susceptibility to juristic hairsplitting and legal frictions, and disregard for the life-giving spirit of Islamic socioeconomic values during this period; (d) the preservation of basic Islamic values and institutions at the grassroots level of Muslim societies and the emergence (return) of most Muslim states and institutions in recent times.

Without going into a detailed analysis of each of the five factors, it can be said in the first instance that any study of contemporary Muslim societies must be made with reference to the ideal Islamic economic and political system. This system was established under the guidance and leadership of Prophet Muhammad (PBUH) in Madinah in the early seventh century, and was then successfully developed and consolidated by the early Caliphs and Muslims rulers. This was also when cultures and backgrounds as different as Byzantine empire, Persian empire, North Africa, Central Asia, India, and Spain all entered the fold of Islamic empire, and the people of these different regions lived in relative peace and harmony.

Second, this consolidation of political authority laid the solid foundation of Islamic civilization and culture, the legacy of which may be viewed as a part of the common heritage of mankind. Some of the socioeconomic innovations and inventions from this legacy include:

1. Muslim traders' contributions to the development of international trade and commerce through the introduction of a host of goods and services to Europe such as sugarcane, oranges, cotton, rice, lemons, watermelons, apricots, peaches, and cucumbers, as well as irrigation in agriculture over a thousand years ago;
2. the evolution and introduction of custom duties and tolls in the seventh century during commerce with neighboring countries;
3. the evolution of banking in Baghdad in the middle of eighth century (and for the first time in history), allowing a merchant to write a check in one part of the Islamic world and having it cashed in a distant place;
4. the setting up of professionals and trade guides in various parts of the Islamic world to promote the specialization of skills;
5. the minting of coins (i.e. gold *dinar* and silver *dirham*) for facilitating the exchange of goods and services;
6. a network of roads, canals, and shipping in the open sea through the use of the compass;
7. the introduction of postal services in the mid-7th century, similar to the Pony Express used in the United States nearly 1200 years later;
8. the introduction of Arabic numerals (i.e., 1,2,3) to replace Roman numerals; and
9. Muslim doctors' use of herbs and plants to treat diseases and to help understand wide range of contagious and non-contagious diseases (as well as introducing five volumes of Ibn Sina to medical students in Europe, who used these as their text-books for over 500 years).

Furthermore, although the fundamental principles of Islamic economics and consequent Muslim economic behavior owe their origin to the ethical and the moral foundation of the Qur'an and the *Sunna*, the interpretation and reinterpretation of these principles by a number of Islamic scholars from the very beginning of Islam provides the operational basis of Islamic economics, banking, and finance. Muslim scholars such as Abu Yusuf (731-798), Yahya Ibn Adam (d. 818), al-Hariri (1054-1122), Tusi (1201-1274), Ibn Taymiyyah (1262-1328), Ibn Khaldun (1332-1406), Shah Waliullah (1702-1763), not to mention Abu Darr Ghifari (d. 654), Ibn Hazm (d. 1064), al-Ghazzali (1059-111), Farabi (d. 950), and many others contributed to the development of the science of economics. These Muslim scholars in general and Ibn Khaldun in particular can be regarded as precursors to mercantilists, physiocrats and classical (e.g. Adam Smith, Ricardo, Malthus) and neoclassical writers (e.g. Keynes) of modern economics. Their work governed a variety of subjects such as value, the division of labor, the price system and concept of "fair price," the forces of demand and supply, consumption and production, population growth, government expenditure and taxation, the role of the state, trade cycles, monopoly, price control, and household income and expenditure. These economic ideas have direct implications for contemporary Muslim society.

The fact is that this momentum of Islamic social and economic ethics and their creative values of new ideas, technology and institutions with the ability to alter the "status quo" received a serious setback with successive stages of several centuries of colonization and the cultural domination of vital areas of the Muslim world. Despite the fact that Muslim themselves must share their part of the responsibility for the loss of this Islamic momentum, the process of colonization indeed contributed to a great extent to bring about the de-Islamization of contemporary Muslim societies to varying degrees.

Nevertheless, the basic Islamic values and injunctions on economic behavior (i.e., payment of *zakat*), establishment of *awqaf*, granting benevolent loans without interest, implementation of the Islamic law of inheritance to ensure the equitable distribution of wealth, internalization of socioeconomic values arising out of Quranic verses emphasizing God's sovereignty over all the resources between heaven and earth, and many other popular phrases relating to socioeconomic issues) continued to guide succeeding Muslim generations, particularly at the grassroots level of Muslim societies. This aspect of the internalization of Islamic values among the masses of Muslim societies today needs to be understood for obtaining insights toward the sustainable development of Islamic banking and finance in the 21st century.

Lastly, events and trends such as the establishment of the Organization of Islamic Conference (OIC) with fifty-three Muslim states, the consequent establishment of IDB in which fifty-one Muslim countries are now members, the growing links of Muslim majority Central Asian Republics with the OIC, IDB and neighboring Islamic countries coupled with the resurgence of Islam there, the setting up of a number of local Islamic banks since the seventies with the objective of conducting their activities in conformity with the principles of Islamic values, the setting up of Islamic Chambers of Commerce, the creation of an Islamic Solidarity Fund of the OIC and the call for the establishment of an Islamic Common Market, Islamic Monetary System, and Islamic Dinar, etc., all confirm the hypothesis that a serious process of revival and rediscovering of Islamic has begin. It does not, however, follow that all contemporary Muslim countries or societies today are necessarily Islamic in the actual operation of their economies.

In this context, it must be recognized that the motivational properties of the economic premises of Islamic economics tend to be significantly different from either a market or command economy. As such, the common tools of economic analysis such as scarcity, choice, opportunity cost, marginal efficiency of capital, discount rate, profit, rent, wages, and a host of other concepts will have uncommon meanings in Islamic economics, banking, and finance. It is therefore extremely important to develop an understanding of the depth of the ethical and moral foundation to the economic premises of Islam today at the grassroots level. We must also understand the structure of vested interests of a group of local people who are foreigners in their own countries, linked to the global elite and its network of mutual obligations. It is equally important to take advantage of the revolution in information technology and to seize this great opportunity to initiate unprecedented forces of economic cooperation for sustainable economic development and social peace in the 21st century, given the relative advantage of Western knowledge and know-how in science and technology along with the strategic significance of the vast human and non-human resources in most contemporary Muslim societies. Any misstep will lead to a historic distortion of priorities and a misallocation of resources. This is what we should together try to avoid for a better and caring society. Understanding real people and putting real masses of people to work in a socially and culturally acceptable environment is the critical need of our time. This significant aspect of a *participatory economy* calls for urgent attention. This is where the roles of Islamic banking in general and the Social Investment Bank[6] in particular assume special significance.

IV. Dilemma of Islamic Banking in the Corporate Sector: An Overview

Before discussing of the key issues involved in the operation of informal banking in non-corporate finance and voluntary sector banking in the mobilization of social savings and investments, it is desirable to shed some light on the operation of Islamic banks in the corporate sector in the contemporary period. As indicated earlier, the establishment of IDB and a number of local Islamic banks and investment companies help constitute a major historical development of the last quarter of 20th century. Even if their point of contact has been the feudal capitalist system found in many Muslim countries, the impact of these Islamic banks has been felt in Muslim as well as several Western countries. A number of Western conventional banks, including some multinational giants such as the World Bank and IMF, have taken serious note of Islamic financing techniques and gathered considerable experience in this area.

The comparative advantage of conventional Western Banks over Islamic banks in terms of their systems, management experience, and techniques of product innovation are expected to bring competition, resulting in the sharpening of the techniques and procedures of Islamic banking modes. In the process, profitability rather than profit constraint is gaining dominance in Islamic banks' operations. The Western conventional banks that have Islamic windows lack an understanding of the ethical and moral foundation of Islamic finance. The Islamic banks in the corporate sector are running the risk of being submerged in the wave of market economy and marginalizing the social and ethical elements of Islamic finance.

While this point of convergence may bring efficiency to their operations, it is expected to bring at least five dilemmas for Islamic banks in the corporate sector:

1. an increasing concentration of ownership and beneficiaries of Islamic banking and finance having links to the global elite and its network of reciprocal obligations;
2. the crucial neglect of the vast masses of people in Muslim countries incapable of entering the market;
3. an increasing trend toward the secularization of Islamic economics, banking, and finance;
4. the marginalization of the social, ethical, and moral ingredients of Islamic modes of financing; and
5. a developing barrier to the growth of perpetual social capital, which expresses the shared values of a society, reinforces them, and stimulates the growth of a caring society.

Each of the above five hypotheses is a good subject for empirical studies. It is worth discussing in some detail the frontiers of both informal and voluntary banking, which can complement existing Islamic banks and help solve some of the dilemmas for Islamic banks in the corporate sector.

V. The Frontiers of Islamic Informal Banking

Generally, informal banking deals with informal finance in the non-corporate sector. The popular view of informal sector activities is that they are primarily those of petty traders, street hawkers, and shoeshine boys, and confined to employment on the periphery of main urban areas. On the contrary, informal activities are characterized by:

1. ease of entry;
2. reliance on indigenous resources;
3. family ownership of enterprises;
4. small scale of operation;
5. labor-intensive and adapted technology;
6. skills acquired outside the formal school system; and
7. unregulated and competitive markets.

An important characteristic of the formal sector is its relationship to government. Economic activities that are formally and officially recognized obtain the benefit of access to credit, foreign exchange concessions, work permits, and a formidable list of benefits that reduce the cost of capital in relation to that of labor. Partly because of its privileged access to resources, the formal sector is characterized by large enterprise sophisticated technology, high wage rates, high average profits, and foreign ownership.

The informal sector, on the other hand, is sometimes ignored, in some respects helped, and in others harassed by the authorities. Enterprises and individuals within it have no access to formal credit institutions. The evidence suggests that the bulk of employment in the informal sector is economically efficient and profitable, though small in scale. This non-corporate sector, which covers small scale producers and enterprise traders, small farmers, and low and middle income groups, accounts for 30-70% of the labor force in some developing countries.

Changing the focus from top income groups to the working poor would result in new types of labor-intensive investments in both urban and rural areas. This should not only generate demand for the products of the informal sector but also encourage innovations in labor-intensive techniques in this sector. This is where Islamic banks must make conscious and planned intervention. The difference of wealth and income between urban and rural areas draws migrants toward urban concentrations but not to the spread of wealth.

A small farmer or entrepreneur having no access to an institutionalized source of credit establishes semi-permanent relations with suppliers and buyers, frequently at the expense of his profit. He becomes hesitant to innovate, particularly in agriculture, for he cannot afford failure. These characteristic behavioral responses are not inherent in the informal sector but adaptive responses to low income.

In this context, it becomes imperative for the Islamic bank to work in the non-corporate sector. There are number of approaches which have been tried elsewhere and can be adopted or adapted by Islamic banks. Two that will be discussed here are group lending schemes and rotating saving and credit associations.

A. Group Lending Schemes

Group lending is one of the most popular forms of informal finance. The funds for group lending schemes can come from a commercial bank, a government development bank, or private institutions. The role of the group varies. The idea behind these schemes is that by joining together, small borrowers can reduce the costs of borrowing and improve their access to credit. The two most common means of providing group accountability are (a) joint and several liability and (b) limited liability.

Experience indicates that successful family empowerment credit programs or group lending schemes under the informal banking of Social Investment Bank Ltd. (SIBL, or the Bank) work well with groups that are homogeneous and jointly liable for defaults. The practice of denying credit to all group members in case of default is found to be the most effective and least costly way of enforcing joint liability. Group lending arrangements *without* collateral are less subject to the dangers of portfolio concentration because bank is diversifying its lending by serving a varied clientele in different areas under its family empowerment credit arrangement.

The Bank is also ensuring the joint liability of wife and husband in the case of lending to family or groups of families. This will humanize families and discourage internal immigration. Any attempt to decompose families through various credit and financing schemes is in its ultimate analysis bound to generate forces of family disintegration, internal migration, child delinquency, social alienation and social conflict. Any credit program that does not manage its socioeconomic consequences can not alleviate poverty.

The Bank has already introduced Rotating Family Savings, Credit Net and Group Installment Credit Scheme for any group of individuals. In light of this experience, SIBL is in the process of developing programs to assist agriculture cooperatives in providing tailor-made credit package to achieve their objectives in rural settings.

B. Rotating Savings and Credit Associations

Rotating savings and credit associations (ROSCAs) are a popular form of informal finance. They have various aliases: *tanda* in Mexico, *pasanaku* in Bolivia, *san* in the Dominican republic, *syndicate* in Belize, *gamaiyah* in Egypt, *isusu* in Nigeria, *susu* in Ghana, *tontine* in Niger, *hagad* in Somalia, *zitique* in Mozambique, *arisan* in Indonesia, *paluwagan* in the Philippine, *chit* in India and Sri Lanka, *pia huey* in Thailand, *hui* in China, *kye* in Korea, and *ko* in Japan.

ROSCAs intermediate in the most basic way. A small number of individuals, typically six to forty, form a group and select a leader who periodically collects a given amount (a share) from each member. The total money collected (the fund) is then given in rotation to each member of the group. In some countries such as India and Cameroon, ROSCAs have evolved into formal banks. Three types of ROSCAs are found in many countries. In common ROSCAs, the leader receives no special consideration (other than possibly getting the first fund). Commission ROSCAs pay their leaders, who in return may assume liability for defaults. Promotional ROSCAs are used by merchants to sell goods, especially consumer durables.

Loans are interest free in most common and promotional ROSCAs. The popularity of ROSCAs among low- and middle-income groups shows that people like to save even under trying circumstances. The popularity of such arrangements shows the potential for pooling individual savings among small farmers or micro entrepreneurs. In England and elsewhere, building societies—which later became an important part of the formal financial system—often began as ROSCAs.

From the preceding discussion, it is evident that Islamic banks should chart a clear course and mode of intervention in the non-corporate sector, primarily by financing family empowerment credit programs through group lending schemes or by organizing ROSCA-type credit management.

Islamic banks' strategy should focus on supporting policy for the alleviation of poverty and the promotion of income-generating activities for the poor with micro-enterprises and small scale enterprises targeted at poor families in urban as well as rural areas. Such a strategy would provide the graduation of selected beneficiaries who have been regular clients of micro-credit schemes to upscale their business. It would also provide support to clients who, having benefited from ongoing skill development and training programs, are interested in starting new enterprises.

IDB expressed the wish to start a microcredit program on a three-year pilot basis. An IDB mission visited Bangladesh recently, and plans to work out the financial plans, terms and conditions, and possible mode of intervention by IDB in the micro-enterprise sector in Bangladesh in the near future. This is a move in the right direction.

VI. Monetizing the Islamic Voluntary Sector

The real glory of the Islamic voluntary sector lies in the fact that it has a rich legacy, culture, and history. It is indeed an area where thousand flowers can bloom furthermore given the revolution in information technology. It is the right time for the globalization of the Islamic voluntary sector's activities. In this process, Islamic banks in the 21st century can play a very vital role in reactivating and institutionalizing the role of Islamic socioeconomic institutions and various voluntary and obligatory tools of income redistribution through innovative financial instruments and the management of funds such as *waqf* properties development bonds, cash *waqf* certificates, *zakat* certificates, *hajj* saving certificate, trust funds, and so on.

Despite the fact that many of the activities of the Islamic voluntary sector—including institutions such as *zakat*, *awqaf*, mosques, the *hajj*, and Islamic non-profit charitable trusts and foundations—do not come under the conventional calculation of GNP, these institutional activities need to be reviewed and analyzed in light of the challenges and change Muslim societies are facing today. There has been a great transformation in relationship of East and West resulting from (a) the emergence of a formidable economic block in Europe, (b) the collapse of communism, (c) the rise of Muslim republics in the Central Asia, d) the widening economic gap between North and South, and (e) the severe economic backwardness, under-development, and poverty of OIC countries despite their potentialities and vast resources, and (f) the rise of ethnic militancy and the growing threat to Muslim minorities in non-Muslim countries. In the wake of this transformation, there is perhaps an urgent need to restore these institutions of the voluntary sector to their true spirit and utilize them fully for promoting the moral, spiritual, social and economic welfare of Muslim societies—indeed, mankind as a whole. The crucial question before us is how to operationalize and institutionalize these activities of the voluntary sector so that they can be integrated into the mainstream of economic activity, resource mobilization, saving, and investment.

Viewed from this perspective, every Islamic bank should establish a *zakat* fund and actively explore the possibility of using this *zakat* fund in lawful *mudaraba* projects as a financial partner. *Zakat* revenue redistributes wealth into consumption flows for the poor, raises their productivity, reallocates *ex ante* saving by checking the tendency to hoard idle cash, and stimulates production through the intersectoral allocation of resources.

Zakat has a tremendous humanitarian potential and can generate the forces of altruistic behavior in a Muslim society. The need to educate people into accepting obligatory income sharing voluntarily is a critical need of our time.

Similarly, the *hajj* should be viewed as one of the significant socioeconomic institutions of Islam, an area where Islamic banks can work by managing *hajj* affairs. In this context, attempts will be made to analyze the activities of the Pilgrims Management and Fund Board of Malaysia, more popularly known as *Tabung Haji*, identifying the factors responsible for its success and drawing on its experience for other OIC members and the resulting policy implications.

The institution of *waqf*, too, is of great importance. It has historically played a significant role in furthering the cause of Islamic education, health, and research through the establishment of schools, hospitals, *madrasas*, mosques, and public libraries.

In the context of the 21st century, Islamic banks must work for the securitization of the Islamic voluntary sector. In this connection, Social Investment Bank Ltd. is in the process of organizing a Voluntary Capital Market Operation for the mobilization of necessary funds, and is in the process of developing the following financial instruments with different sets of rules in conformity with the *Shari'ah*:

1. *waqf* properties development bonds (specific and general)
2. cash *waqf* deposit certificates (specific and general)
3. family *waqf* certificates
4. mosque properties development bonds (specific and general)
5. mosque community shares
6. *qard hasana* certificates (specific and general)
7. *zakat*/*ushr* payment certificates
8. *hajj* saving certificates
9. non-Muslim trust properties development bonds (specific and general)
10. municipal properties development bonds (specific and general)

The value of all the bonds and the *qard hasana* certificate are guaranteed by the Bank against surrender of the instrument on maturity.

A. Cash *Waqf* Certificate Scheme

As a part of extending three-sector model banking services toward the achievement of the corporate objectives of Social Investment Bank Ltd., it has already introduced the Cash *Waqf* Certificate Scheme. This is part of the process of the first organization of voluntary sector capital market in the history of banking. It is intended to empower the family heritage of the rich for the benefit of society at large.

As we know, *waqf* generally means the permanent dedication of any property by a Muslim for any purpose recognized by Islamic law as religious, pious, or charitable. Generally, *waqf* is known to be related to the endowment of any property of a permanent nature.

A research study entitled "Structural Adjustments and the Islamic Voluntary Sector with Special Reference to *Waqf* in Bangladesh" (Mannan, 1995) and published by IDB showed that the concept of cash *waqf* has also appeared in Islamic history. Its use can be traced to the Ottoman era, and Turkey has one of the longest histories of *awqaf* administration. Egypt, which also has a long history of *awqaf* management, allowed bank credit as a subject of *waqf* endowment. The study showed that the cash *waqf* can be used as a financial instrument and a new product line in the banking sector.

The introduction of SIBL's Cash *Waqf* Certificate Scheme is intended to monetize the Islamic voluntary sector for the first time in history for the mobilization and capitalization of social saving. It promises to be perhaps be the most effective and perpetual mode of deposit mobilization with use of its profit going toward perpetual social investment and benefits.

Its introduction is also highly suggestive in the context of the present fiscal system of Bangladesh, which is heavily dependent on indirect taxation (i.e., 85% of total tax revenue in 1995-1996). A great part of direct taxes can be privatized and converted to social assignment, and the Cash *Waqf* Certificate can substitute a substantial part of the income tax for financing social projects in education, health, and social welfare activities. All that is needed is political will: a new beginning can be made for a participatory economy and a caring society.

The guidelines governing the operation of the Cash *Waqf* Certificate are as follows:

1. Cash *awqaf* shall be accepted as endowment in conformity with the *Shari'ah*. The Bank will manage the *waqf* on behalf of the *waqif*.
2. *Awqaf* are done in perpetuity and the account shall be opened in the title given by the *waqif*.
3. The *waqif* will have the liberty to choose the purpose(s) to be served by the *waqf*, either from the list of thirty-two purposes identified by SIBL as given below or any other purpose(s) permitted by the *Shari'ah*.

TABLE 1. THE PURPOSES OF *WAQF*

Category	Examples
Family Rehabilitation	1. Improvement of the condition of the absolutely poor living below the poverty line 2. Rehabilitation of the physically handicapped and disadvantaged 3. Rehabilitation of beggars 4. Rehabilitation of destitute women 5. Uplift of urban slum dwellers
Education and Culture	1. Education of orphans (i.e., supplying books free of cost) 2. Expansion and development of appropriate education for skill development 3. Informal education facilities for children at home (i.e. mothers' educational programs, children's literature) 4. Physical education and sports facilities 5. Support of local culture and heritage and art promotion 6. *Da'wah* activities 7. Education of deserving students through scholarships 8. Vocational education in general 9. Education in a specific area 10. *Madrasa*/School/Colleges of a particular area. 11. Education of deserving descendants 12. Any projects in the area of education, research, religious and social services in the memory of parents or ancestors. 13. Establishment of an academic chair.
Health and Sanitation	1. Village health care and sanitation 2. Supply of pure drinking water (to households, schools, mosques, slums, etc.) 3. Establishment of hospitals, clinics, and health care programs, especially for the poor. 4. Health research grants; research on particular diseases.
Social Utility Service	1. Settling disputes (e.g., village litigation) 2. Legal aid to deserving women to establish their lawful rights. 3. Assistance for arranging dowryless marriages to poor women. 4. Maintenance of public roads and tree planting in villages 5. Assistance to peace-loving non-Muslims to solve their problems 6. Creation of social awareness to prohibit gambling and other social vices such as theft and other anti-social activities 7. Construction, installation, and development of public utility services 8. Maintenance of specific mosques with income generating projects 9. Maintenance of specific graveyards with income generating projects 10. Maintenance of specific *Eidga(s)* with income generating projects

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1. The cash *waqf* amount will earn profit at the highest rate offered by the Bank from time to time.
2. The *waqf* amount will remain intact and only the profit amount will be spent for the purpose(s) specified by the *waqif*. Unspent profit amount will automatically be added to the *waqf* amount and earn profit to grow over the time.

3. The *waqif* may also instruct the Bank to spend the entire profit amount for the purpose specified by him/ her.
4. The *waqif* will have the opportunity to create cash *waqf* at a time. Otherwise he/she will declare the amount he/she intends to build up and will start with a minimum deposit of Tk. 1000/= (one thousand) only. The subsequent deposits shall also be made in thousand or in multiple of thousand.
5. The *waqif* shall also have the right to give standing instructions to the bank for the regular realization of cash *waqf* at a rate specified by him/her from any other a/c maintained with SIBL.
6. Cash *waqf* shall be accepted for a specified endowment, and a receipt voucher and certificate for the entire amount shall be issued as and when the declared amount is built.
7. The principles and rules of the Cash *Waqf* Account are subject to amendment and review from time to time.

VII. Achieving Results on the Ground: Social Investment Bank Ltd. for All and by All

At this stage, it is important to give a brief review of the operations of Social Investment Bank in order to provide on empirical basis of understanding this alternative paradigm of Islamic banking in the 21st century.

Social Investment Bank Ltd. (SIBL) presents a concept of 21st century banking for all and by all, intended to cover all sections of Bangladeshi society. SIBL, which came into operation on November 22, 1995, is a participatory three-sector banking model in one: in the formal sector, it works as an *Islamic participatory commercial bank* with a humane approach to credit and banking on the basis of profit- and loss-sharing; it is *informal banking for the poor* in the non-corporate sector, dealing with informal finance and credit packages that empower and humanize poor families, create local income opportunities, and discourage internal migration; it is a *development bank* intended to monetize the voluntary sector, committed to financing the development and management of over 155,000 *awqaf*, mosque properties, as well as non-Muslim trust properties.

At the operational level, all three sectors' activities are mutually interdependent and collectively reinforcing. Contributions to the Social Fund and Social Assignment Schemes are linked to Social Entitlements, thereby making all these activities economically, socially and ethically transparent once they are operationalized.

SIBL has already established its Social Fund by mobilizing voluntary social saving and linking it to its entire formal, informal, and voluntary sector banking operations. Contrary to popular belief, SIBL has within a very short time been able to mobilize a surplus Social Fund for social investment purposes in family empowerment action programs and social education fellowship program in the health and social services sectors. A modest beginning has already been made; one step forward is the beginning of a journey of a thousand miles.

The Social Fund aims for the capitalization of social savings and the socialization of capital by varying the price of capital by target group. This social subsidy or social loan will generate further savings for investment purposes. The Social Fund pools together individual voluntary contributions for planned social investment and brings social meaning and transparency to financial and banking transactions, thereby linking social entailments to social assignments.

The operational thrust of these activities will eventually lead to the development of new school of negotiated and new participatory economics. It is expected to give birth to a triple revealed preference theory of social income, social distribution, and social peace for a caring society. This will also lead to writing a new social contract based on the assumptions that man is born with obligations, and that as such, his duties should define his rights. The fulfillment of his obligations may be deferred, though. It is here that financial/economic entitlements should be linked to social assignments. In this context, it is worth reproducing a table from SIBL's Second Annual Report:

TABLE 2. SUMMARY OF THE INTERDEPENDENT AND MUTUALLY REINFORCING STRATEGIES OF THE SECTORAL OPERATIONS OF SOCIAL INVESTMENT BANK

Scope of Sectoral Operations	Formal corporate sector	Informal/non-corporate sector	Voluntary/third sector
Basic Objectives	Humanize the formal sector	Socialize the informal sector	Monetize the voluntary sector
Basic Strategies of Operations	Provide corporate finance through the competitive market mechanism to the relatively richer section of society	Provide informal/non-corporate finance through custom-tailored microcredit packages to the urban and rural poor	Provide both corporate and non-corporate finance to develop the third sector of the economy
Location of Operations	Primarily urban	Both urban and rural	Both urban and rural
Key Emphasis and Guidelines of Operations	• Triple preferences: economic, social, and moral preferences to be "transparent and revealed" in all operations • Link financial/economic entitlements to social assignments • Duties should define rights	• Triple preferences: economic, social, and moral preferences to be "transparent and revealed" in all operations • Link financial/economic entitlements to social assignments • Duties should define rights	• Triple preferences: economic, social, and moral preferences to be "transparent and revealed" in all operations • Link financial/economic entitlements to social assignments • Duties should define rights
Effect of Overall Operations	Stronger family and family chain for a better future generation	Empowerment of the family by creating income opportunities for the poor	Re-empowerment of socioeconomic institutions for redistribution of income and human fulfillment
Ultimate Goal of Overall Operations	Participatory economy and sustainable social peace for a caring society	Participatory economy and sustainable social security for a caring society	Participatory economy and sustainable institutional development for a caring society

Indeed, Social Investment Bank Ltd. does represent a change in the paradigm of banking. To the best of our knowledge, this is the only commercial bank in Bangladesh that operates on the basis of this integrated three-sector model: formal, informal, and voluntary. This is the only bank in the country that starts with the very phrase "Targeting Poverty" in the objectives of its Memorandum of Association, aiming for a participatory economy for a caring society. Clearly, this Bank intends to operate far beyond the scope of market economics. Where market economy ends, participatory and negotiated economy begins. SIBL is committed to implementing the principles of participatory economy with a humane approach to credit and banking on an interest-free basis, with a view to empowering the family as the basic social unit. The real value addition of this Bank lies the power of its ideas.

2. Scope of Three-sector Operations: An Overview

In the formal corporate sector, this Bank would offer the most up-to-date banking services through various types of deposit and investment accounts, trade financing, letters of guarantee, letters of credit, collection of bills, domestic and international transfers, leasing of equipment and consumers' durables, hire purchase and installment sale for capital goods, investment in low-cost housing and management of real estate, and participatory investment in various industrial, agricultural, transport, educational and health projects.

In the informal non-corporate sector, it would be involved in opening and introducing various savings, microcredit investment, and custom-tailored group programs designed for small entrepreneurs, marginal farmers, landless laborers, unemployed educated youth, and semi-skilled labor.

In the voluntary, or third sector, it would be involved in the development and management of *waqf* and mosque properties, management of inheritance properties, joint-venture projects for management of *hajj* affairs, development and management of non-profit foundations, charitable trusts and organizations, and the development and management of funds involving the welfare of women and non-Muslim minorities.

In addition, social banking special services for Bangladeshi expatriates would include managing their foreign currency accounts, providing express home remittance services, and introducing Cooperative Investment Schemes and the Foreign Wage Earner's Rehabilitation Scheme.

3. Formal Banking with a Human Face

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In addition, social banking special services for Bangladeshi expatriates would include managing their foreign currency accounts, providing express home remittance services, and introducing Cooperative Investment Schemes and the Foreign Wage Earner's Rehabilitation Scheme.

4. Operations of Informal and Voluntary Sector Banking: Transferring Power to the Powerless under Microcredit and Microenterprise Family Empowerment Schemes

In line with its corporate objectives, Social Investment Bank is directing group-lending programs in urban and rural settings. At a grassroots village and local level, the Bank's program is directed toward landless laborers, marginal farmers, fishermen, small artisans (e.g., blacksmiths, carpenters, potters, and handicraft producers), the urban unemployed, small traders, small and rural industries, and small and medium-scale business enterprises.

In the case of informal and voluntary sector banking operations, it is the Bank that goes to the clients and organizes and motivates them into becoming viable income generating groups. In an effort to achieve the corporate objectives of SIBL, the Bank has started implementing (a) the Environmental Friendly Business Program with the small traders of Tokai (mainly street children of distressed parents), with recovery rate of 100%, (b) the Real Life Tokai Informal School of Management, and (c) empowering and humanizing family credit programs. This last project differs in approach from Grameen Bank and other NGOs in terms of (i) providing much cheaper credit, (ii) extending savings and deposit services, (iii) linking basic societal values to credit, and (vi) managing the consequences of credit in terms of reinforcing family values and social integration. A serious beginning has been made: more than 36% of the investment partners of SIBL are from the informal sector, indicating the Bank's commitment to reaching poor families at the grassroots level.

5. Overall Performance and Basic Facts of SIBL at a Glance

SIBL was opened on 22 November 1995 in Dhaka, Bangladesh. Initial losses were due primarily to preliminary overhead expenses, heavy capital expenditure, and depreciation. The Bank is now making good progress. It has been making a net profit since January 1998. The growth rate in the formal sector in terms of deposits stood at 54.54% in 1997; the expected growth rate of 1998 was to be over 100%. Considering our present business position, we expect that the operational results of 1998 will offset past losses, and that dividends could be declared for 1998.

Banking with the poor (i.e., mainly with street children and poor families) through microcredit and microenterprise under our family empowerment credit programs is increasing very rapidly.

Last but not least, the *Shari'ah* Board of the Bank was also reconstituted and its bylaws have already been approved by the Board. It will provide scholarly guidance to the operations of the Bank in conformity with *Shari'ah*.

VIII. Common Agenda

It becomes abundantly clear that considerable in-house preparation by Islamic banks is needed in developing distinctly Islamic corporate, non-corporate, and voluntary sector financing. In the case of the corporate sector, the key thrust lies in the greater participation of local people both in terms of ownership and as beneficiaries of the Bank's investment. It means a greater network of mutual obligations among Islamic banks, and greater transparency in highlighting the social, ethical, and moral ingredients of various Islamic modes of financing. In the case of the non-corporate sector, the thrust lies in conscious planning and developing credit programs that reinforce family values and stimulate civil society. In the Islamic voluntary sector, the thrust lies in developing a social capital market for the mobilization and capitalization of perpetual social savings and investment. The composite thrust of these three sectors' financing lies in comprehensive participatory banking with a human face beyond the market for the benefit of Muslims and non-Muslims alike. Seen from this perspective, the following few proposals are put forward for appropriate intervention by Islamic banks in the 21st century.

1. Ensuring Family Empowerment Credit Programs for at Least 10 Million at the Grassroots Level of Muslim and Non-Muslim Countries in Every Decade

The many current credit programs directed and organized by various NGOs at either toward women as opposed to men, or toward the poor as opposed to the rich, or to children as opposed to parents. These credit programs are expected to destroy family values and the basic foundation of our society. Each Islamic banks should voluntarily make its own allocation for such a credit program to be coordinated by a volunteer Islamic bank volunteer or by regional rotation among Islamic banks. Social Investment Bank Ltd. can act as a volunteer in this field.

2. Global Mobilization and Creation of a US$1 Billion Fund by 2010 Through the Sale of Cash *Waqf* Certificates to Support Education, Health, and Research

Throughout the history of Islam, *waqf* played a significant role in promoting education, health, arts and architecture, and research. The 21st century must rediscover Islamic philanthropy.

Turkey perhaps reached a peak during the Ottoman era, where *awqaf* properties were estimated to constitute three quarters of all arable land in 1925. In 1983, a Ministry of *Awqaf* was reestablished after its abolition in 1924. Recently, a *Waqf* Bank and Finance Corporation have been set up to mobilize *waqf* resources to finance various types of joint venture projects. One half of arable land in Algeria in the mid-nineteenth century was dedicated to *waqf*. Similarly: one third in Tunis (1883), one seventh in Egypt (1935), and about 15% in Iran (1930) of all arable land was endowed to *awqaf*. The accumulation of such extensive land under *awqaf* prompted many countries to introduce reforms. In India, the statutory control of *awqaf* started with the passing of the Mausalman *Waqf* Act of 1923 during the pre-partition days. During the post-partition era, several acts were enacted and ordinances promulgated in Pakistan, which were adopted in Bangladesh as well.

Seen from this perspective, a US$1 billion target for Cash *Waqf* Certificate sales should not be difficult to achieve given the rich Islamic legacy, culture, and history of endowments. Currently, Americans are perhaps the most generous people in the world. For example, Americans gave nearly US$2 billion to international causes in 1997. Last year, according to figures by *Giving USA*, Americans donated US$143 billion to non-profit organizations. Just over three-quarters of this came from living individuals (US$109 billion); the rest from foundations (US$13 billion), bequests (US$13 billion), and companies (US$8 billion). The non-profit portion of the US economy accounts for 8% of GDP, a figure that has more than doubled since 1960. It employs nearly 10% of the American work force—more than the federal and state governments combined.[7] Perhaps Muslim philanthropy in the 21st century can match American philanthropy in the 20th. What is needed in the coming years is to rediscover Islamic socioeconomic values and revive Islamic institutions.

3. Globalization of Islamic Voluntary Sector Activities

The creation of the Islamic Soldiery Fund and its *waqf* under the umbrella of the OIC is the right move. There is an urgent need to reinvigorate its activities. Instead of the fund merely extending charity, Islamic banks should in one form or other be involved in planning and implementing social investment programs. In this context, the successful experience of *Tabung Haji* of Malaysia needs be disseminated in the various Muslim languages. IDB's Technical Assistance Program can be extended to those countries interested in establishing such organizations in their own countries. A one-day annual seminar and workshop on *Tabung Haji* in cooperation with the Government of Malaysia can be organized in which the heads and members of *hajj* missions from different Islamic countries can be invited to attend. The private sectors of OIC member countries should also be encouraged to take initiative and set up a *Hajj Management Bank* in their own country.

4. The Trading House of the Islamic *Umma* and the Islamic Dinar

It seems appropriate to suggest that under the umbrella of the OIC, a Trading House of the Islamic *Umma* be established in cooperation with the Kingdom of Saudi Arabia, under which each member country or Muslim community be given a permanent space to exhibit and sale their products. At the end of the pilgrimage, all pilgrims and other Muslims who came to *'umrah* during the whole year can make an arrangement for an optional visit. This House of the Islamic *Umma* can serve as one of the important building blocks for the eventual formation of an Islamic Common Market. Once established, this House can also provide scope for the exchange of information relating to investment in co-financing and joint venture projects among Islamic banks. These can eventually lead to the formation of an Islamic multinational corporation or an Islamic *umma* cooperative in various fields such as petrochemicals, textiles, leather, and electronics. Since the exchange of different currencies into local currency and vice versa are taking place throughout the *hajj* and '*umrah* sessions of the year, attempts can be made for the further operationalization of the Islamic *dinar*.

5. Establishing the Three-Sector Model of Social Investment Bank Ltd. in other Countries

The model of Social Investment Bank Ltd. is flexible and can be implemented in other Muslim and non-Muslim countries for the alleviation of poverty, economic cooperation. Given appropriate examples of individual social behavior and successful experiments at the institutional level in Bangladesh, this can also effect the eventual evolution of interstate and intercommunity industrial relationships and markets within the framework of *commonwealths of communities* and *human societies*. This unique participatory, integrated, commercial, investment, and anti-poverty oriented Bank is a new experience in Bangladesh; it calls for the special support of the government and the political will of leaders and people from all spectrums of society committed to alleviate poverty and develop a better society.

Ideas that can change the course and direction of human endeavors and society may seem impossible to achieve at first. Such ideas die without institutions. Social investment Bank Ltd. intends to provide an institutional framework for the implementation of such innovative ideas. A new beginning can be made for a participatory economy and a caring society. SIBL can volunteer to work on any assignment on the alleviation of poverty entrusted by this Forum.

6. Establishment of a World Social Bank in the Private Sector

There further appears to be an urgent need to establish a World Social Bank in the private sector for the global mobilization of social saving and investment that reinforces basic family and societal values and stimulates civil society at the grassroots level. As indicated earlier, the establishment of the Islamic Development Bank in the public sector is indeed an important event of our time. Since IDB must work through the governments of the member countries, however, it has great limitations. Its potential is great, but its impact is marginal.

Besides, a pervasive corruption that is the reflection of deep socioeconomic and moral decay is noticeable in some Muslim countries, Bangladesh included. The banking sector is not an exception to this condition. Poverty is purposefully used as a business in many developing countries like Bangladesh. It is unfortunate that the conventional branch banking based on the British model is aggravating poverty in the country. Never in history have so few exploited so many. According to a recent estimate, 40% of bank loans in Bangladesh are lying with 156 defaulters, and 75% of total bank loans were held back by 1800 persons. Similar examples can be cited for some other Muslim countries. The proposed World Social Bank of the Islamic *umma* must address the issues involving the globalization of poverty and the pervasive corruption in some Muslim countries. The private sector of the Islamic *umma* should move forward to create a fund for the establishment of this Bank. The headquarters of such a Bank could be located in one of the so-called least developed Muslim countries.

IX. Conclusion

Islamic banking in the 21st century must play a more aggressive role. Islam means *peace*; Islamic banks have an enormous responsibility in mobilizing and allocating resources which contribute to the participatory economics of peace. The proposed common agenda for action is only indicative. Its suggestions are by no means exhaustive.

The key thrust of Islamic banks should be directed toward the development of an authentic participatory economy beyond market economics that empowers the families of both rich and poor in the context of their social settings. Understanding real people and putting real masses to work in a socially and culturally acceptable environment is the critical need of our time. This aspect of a participatory economy calls for urgent attention. This is where the operations of Islamic banks should assume their significance in the 21st century.

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[1] This paper is expected to add to Mannan's earlier following major works, which the author has revisited in writing this paper: *Islamic Economics: Theory and Practice* (Hodder and Stroughton: Kent, U.K., 1986); *The Making of Islamic Economic Society* (International Association of Islamic Banks: Cairo, 1984); *The Frontier of Islamic Economics* (Idarah-i-Adabiyat-Delhi: Delhi, 1984); *Economic Development and Social Peace in Islam* (Ta-Ha Publishers: London, 1989); *Understanding Islamic Finance: A Study of the Securities Market in an Islamic Framework* (Islamic Development Bank: Jeddah, 1993); *Structural Adjustment and Islamic Voluntary Sector with Special Reference to* Awqaf *in Bangladesh* (Islamic Development Bank: Jeddah, 1995). Here, the words "Islam" and "Muslim" are used interchangeably.

[1] Thomas Kuhn: *The Structure of Scientific Revolutions*, The University of Chicago Press, Chicago, USA (1964)

[2] M. A. Mannan, *The Making of Islamic Economic Society,* IAIB Press, 47 Qraba Str. Heliopolis, Cairo, Egypt 1984, pp-3-4

[3] M. A. Mannan, *Islamic Economics: Theory and Practice,* Revised Edition, Hoddar and Stoughton Ltd., Mill Road, Dunton Green, Sevenoaks, Kent, UK, 1986, PP-5-9, 25-39

[4] M. A. Mannan, The Frontiers of Islamic Economics, Idarah-i Adabiyat-i, Delhi 2009, Qusimjan Street, Delhi-6, India 1984-P-1-16

[5] M. A. Mannan, Economic Development and Social Peace in Islam, Ta ha Publishers, 1, Wynne Road, London SW9 0BB, UK (1984) PP 1-16

[6] A three-sector unique model bank which began operations on November 22, 1995 in Dhaka, Bangladesh, whose operations will be reviewed later on

[7] *The Economist*, 30 May 1998.

Key Concepts of Islamic Finance

Their Relevance to Consumer Finance Products

Pervez Nasim[*]

ABSTRACT

The Islamic Cooperative Housing Corporation (ICHC) of Canada is one of the oldest non-banking financial institutions providing the Canadian (and to some degree the American) Muslim communities investment and finance avenues consistent with Islamic principles. Canadian Muslims established the institution 18 years ago with a farsighted vision, and the results to date have been commendable. One of the key products ICHC offers is house financing, which it bases on the *musharaka* concept. Some key concepts of Islamic finance are discussed, as is how ICHC has successfully implemented *musharaka* to provide home financing to Muslims. The track record of the corporation, its present performance, and other financial products offered to the Muslim community in Canada are also covered.

I. INTRODUCTION

Many financial institutions and organizations already operate on an interest-free basis. Some people are trying to find out how they can start such institutions and to learn the underlying principles of an interest-free Islamic finance product. From the Muslim perspective, humans are only trustees of God, the Owner of all that exists. Because humans are responsible for any breaches of the trust that Muslims believe God has placed in them and for any abuse, misuse, and injustice they cause while on earth, in the field of Islamic finance it is important that practitioners understand the fundamental concepts of Islamic finance. Only by starting on the right foot can Islamic financiers end up successful.

One way they can avoid causing wrong or injustice to other parties is to remain conscious of the realities and to have a sense of accountability. Furthermore, they should keep the basic principles of Islamic finance in mind every time they negotiate a transaction or design a product. The cardinal principle, of course, is the prohibition of *riba* (interest). There is no issue on which the Qur'an is more specific than this one: God has declared war upon those who do not shun dealing in interest. The Qur'an clearly condemns all dealings with *riba* as well as participation in and witnessing such transactions. The sayings of the Prophet Muhammad are full of similarly severe warnings.

II. ISLAM AND BUSINESS ETHICS

Despite the clarity of Islamic injunctions on interest, a misconception among Muslims as well as non-Muslims is that "interest-free banking" means using conventional banking while replacing the word "interest" with "profit." However, a conventional bank that makes the simple semantic change from interest to profit does not necessarily become Islamic. Moral and ethical responsibilities are involved as well. For example, a bank may finance a business and later find that its client has run into a genuine problem that makes it difficult for him or her to fulfill the original terms of the contract with the bank. In this case, a compassionate bank should be willing to renegotiate the contract.

While regular businessmen wish to maximize profits, there is a difference between the intentions and behavior of Muslims and non-Muslims in the business world. For instance, Muslims in business believe in acting truthfully and avoiding deception. Ideally, they are also honest and perform their jobs and duties with integrity. Because of the Islamic stress on the hereafter, Muslims may expect blessings and rewards from God in addition to monetary profit. Similarly, an awareness of the social and environmental effects of actions may weigh more heavily on Muslims than on others in business. Muslim businessmen, therefore, have an added responsibility: in addition to maximizing profit, they must be aware of the requirements of their religion.

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III. Islamic Finance

Islamic finance, consequently, consists of more than removal of the word "interest." It is based on Islamic norms such as morality, fairness, reasonableness, and justice. To an Islamic financial institution, social responsibility to the community should be more important than maximizing the return on investments. Islamic finance also involves a willingness to share the consequences: participants may reap gains as well as bear losses according to a pre-determined ratio. Therefore, an honest intention to take responsibility is the cornerstone of any Islamic business deal. A description of the four most common interest-free financing models, based on the above principles and on the *Shari'ah*, follows.

A. *Ijara*

Ijara, or leasing, is very common in the conventional financial system. The main difference between Islamic and conventional leasing involves the determination of the lease cost or rental. In conventional leases, the prevailing interest rate is used to determine the lease payments, while in Islamic finance they are determined by the profitability of the underlying product. For instance, the Islamic Cooperative Housing Corporation (ICHC) of Canada financed a chicken slaughterhouse in which the key issue was the determination of the profit shares of the financed party (lessee) and ICHC. Because the abattoir's profit depended on the number of chickens in the slaughterhouse and the volume of sales, it and ICHC agreed that the profit would be linked to the number of chickens slaughtered. The lessee would pay more to the lessor if it used more equipment (i.e., killed more chickens), and vice versa. This experience provides one example of how a business and an Islamic financial institution can comply with the concept of sharing, which is one of the key elements of Islamic commercial law.

B. *Murabaha*

Islamic financial institutions commonly use *murabaha*, or installment purchase. *Murabaha* is simple and easy to structure, but has limitations when long-term financing is considered because once the installment period is fixed, it cannot be changed. Neither can there be a discount for paying an installment early. For instance, a *murabaha* contract for a house purchase can not be modified or annulled once entered into. A house buyer cannot always be expected to complete the contract in 2-5 years; it may take 10-15 years to do so. If the client's job moves to another city or family outgrows the original house, he or she is stuck. Although limitations such as these make *murabaha* impractical for housing finance, Muslims have flexible alternatives such as *musharaka*.

C. *Musharaka*

Musharaka, or partnership financing, is a well-known concept, especially in Islamic finance. A *musharaka* contract, unlike a *murabaha* one, can have a fixed or flexible term: mutual agreement between the parties decides this and the profit- and loss-sharing ratio.

In Toronto, ICHC adopted the *musharaka* model to incorporate a housing cooperative 18 years ago. It started with US$17,000 from the local community, which promised to participate in a program through which it could purchase houses without interest. Although this group could more easily have banded together to help itself only, it chose to set up an institution that would serve others as well. ICHC initially consisted of 7 voluntary members. Today, it employs a professional staff of 5 people.

D. *Mudaraba*

Mudaraba (labor- and capital-partnership) is similar to *musharaka*. The difference between the two is that in *mudaraba* one party contributes labor, the other capital. The capital provider bears the loss in case it occurs, while the labor provider loses his or her opportunity cost only.

IV. ICHC's Housing Finance Model

The housing finance product of ICHC is formed on a decreasing partnership concept. A member of the cooperative initially contributes a fraction, such as 20%, of the value of the house he or she would like to purchase. The coop contributes the remaining portion of the required capital. After the prospective member has chosen the desired house, which may be anywhere in Canada, he or she and the coop determine the rental value of the house. The new member pays rent on the newly purchased home in proportion to the coop's equity ownership. Members are free to increase their equity at any time, and the rent decreases as a member's equity increases and the coop's ownership decreases.

A. Categories of Members

Coop members are motivated by several reasons and fall into several categories. Some members initially purchased houses through conventional (interest-based) mortgages and later approached the coop to convert their home financing to extricate themselves from interest. The coop also provides an opportunity to members to invest in interest-free institutions and earn Islamically acceptable income in the form of dividends from the rental income of the coop. Some parents have made their children members so the latter can save money they earn while off school, invest it, and in the future use it for educational or housing expenses. Several Islamic centers are also members of ICHC.

B. Commitments of Members

Members are required to pay US$75 to join and must buy, every year, at least 6 shares in the coop at $100 each. To qualify to buy a house, members must put up a minimum of 20% for the first $100,000 of the home price and 40% of the next $100,000. By the time the member owns 100% of the home, it is appraised and the gain or loss is shared between the buyer and coop. The coop is akin to a sleeping partner, as individual owners maintain the property they have stakes in. Therefore, if the property appreciates, the coop takes only 10% of the net gain; the remaining 90% remains with the owners. If the property depreciates compared to its original price, the coop takes 90% of the loss; the owner bears only 10%.

C. The Growth of ICHC

ICHC began with 16 members in 1980 and had 1700 members by 1998. Although they are spread across Canada, the vast majority is in Ontario. Foreign members are in the United States and elsewhere. Several North American communities have copied ICHC's housing finance model, including Montreal, New Jersey/New York, St. Louis, and San Francisco. As of 1998, the coop's assets were over $23 million and the total number of housing units purchased stood at 288. Rental income for 1996 passed the $1 million mark. The coop restricts itself to spending no more than 20% of rental income on operating expenses; the remaining income is a dividend to shareholders, investors, and members who are investors and are waiting to qualify to buy a house. Members received a $6 per share (6%) dividend in 1986. The dividend was as high as $10 per share at one time. In 1997, ICHC declared a dividend of $7 per share. The coop has expanded beyond its original domain of housing finance into car-purchase plans and interest-free retirement saving. ICHC has also financed a retail plaza and the purchase of business equipment, health care, a medical building, and a walk-in medical clinic. A deal involving a rehabilitation center is in progress.

V. Conclusion

Although Islamic law provides various mechanisms that can be used as financing vehicles, realistically there are only two modes of Islamic finance: *musharaka* and *mudaraba*. Both allow individuals to participate through labor, money, or both in *halal* business ventures to generate profit on their investments. Losses are also shared according to the contract signed between the parties. ICHC has successfully implemented the *musharaka* concept in providing a housing finance facility to Muslims in Canada and the United States. The company's track record to date is clear evidence that a process based on a simple Islamic finance concept can work efficiently in the current environment and regulatory framework of Canada. ICHC's concept has already been a model for similar organizations in the U.S. and Britain. This will assist not only today's Muslims, but those of future generations as well.

LARIBA (Islamic) Mortgage Financing in the United States

Providing an Alternative to Traditional Mortgages

Yahia K. Abdul-Rahman and Abdullah S. Tug*

ABSTRACT

This paper describes LARIBA mortgage financing and proposes a model for its viability and success in the United States. It can only be successful if marketed at the local grassroots level to the estimated initial market of 7,500 households requiring about US$200 million of financing. Modeled as an alternative to traditional mortgages, LARIBA is a *halal* paradigm consisting of two parts. First, the equity stake is repurchased from the LARIBA financier by repaying the amount put forth to assist the buyer with the purchase. Second, payment is made to the LARIBA financier for leasing the portion of the home not yet owned by the buyer during the repayment period. LARIBA frees the buyer from debt much sooner than the traditional model. The LARIBA model not only complies with existing law in the United States, it will actually be more successful as a result of the strict regulation of the industry.

I. INTRODUCTION

The backbone of the major developed countries and societies has been the housing and automobile industries. The development of mortgage financing in England, Germany, and the USA has helped propel the economies both directly and indirectly: directly by increasing demand for the products, industries and services associated with building homes, and indirectly by satisfying the natural instinct of ownership in the citizen. Feeling that he owns a house makes the citizen proud of his citizenship, deepens the feeling of belonging to the country and enhances real estate values in general as owners strive to beautify their owned properties through continual maintenance and improvement. Finally, owning a home strengthens the feeling of responsibility toward the citizens' own families and the community at large.

Accordingly, major economic policies in developed nations have been designed to subsidize the mortgage industry and, to a lesser extent, the automobile industry. In the United States, a number of institutions were developed to act as catalysts in the promotion and facilitation of owning a home.[1] In fact one of the important parameters used by the Federal Reserve System, (the Fed) in its decisions regarding interest rate and monetary policy is the anticipated impact on the housing industry.

Finally, in an effort to encourage Americans to own homes through mortgage financing, the U.S. government has made *riba* (interest) paid through mortgage financing tax-deductible. It is now one of the few deductions left to the average citizen that helps in reducing taxes. This paper describes how LARIBA financing is a viable option in the strengthening of civil society.

II. HOME MORTGAGES IN THE UNITED STATES

Approximately 66% of the residential properties in the United States are owner occupied. They represent about US$7 trillion in value. Mortgage payments are the biggest monthly liability of a typical American household. A typical homebuyer borrows up to 85 to 90% of the purchase price of a home for a 30-year term. Because of the mobility of the US employment market and the continued needs of American families to move to larger and more modern homes in more attractive suburbs and neighborhoods, many of these mortgages are closed long before the end of the 30-year term. California Home Financing Association statistics on the characteristics of homebuyers and sellers in California in 1996 indicate that the average number of years of ownership of a particular home is approximately 8 years. As the homeowner moves to another home, he/she closes the old mortgage, pays off the loan, and applies for a new home mortgage. As interest rates have continued to decline in the past two years many homeowners have refinanced their homes more than once.

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III. The American Muslim Community and LARIBA (Islamic) Financing

The American Muslim Council (AMC) estimated that the population of Muslims in the United States ranges between 5 and 8 million.[2] In the United States, California has the largest Muslim population with at least 1,200,000 Muslims, followed by New York (4.7% of total state population), Illinois (3.6%), New Jersey (2.5%) and Indiana (3.2%). There are also significant Muslim communities living in Michigan, Virginia, Texas, Ohio, and Maryland.

Most of the Muslims in the United States have been integrated in the *ribawi* conventional banking system prevailing in the United States, including interest-based FDIC insured deposits in banks, loans or mortgages, credit cards as a source of long-term *riba*-based credit or take home equity *riba*-based lines of credit. *Fatawa* (Islamic legal opinions) based on Muslims being a minority and/or that *riba* is usury and not interest have been used by many community leaders to justify *riba*. Most affluent and upper middle class members of the community have become accustomed to the *riba* system.

For an emerging alternative system to prevail and succeed is a very difficult battle. Unless an individual is motivated deeply by the strict adherence to the Qur'an, *Sunna*, and *Shari'ah*, it is almost impossible to capture people's interest and imagination.

In all fairness, based on first hand experience and an in-depth knowledge of the grassroots level of the community, a large portion of Muslim middle-class households has accepted *riba* mortgages against its will. Many of these households would convert to LARIBA if available in a competitive manner. There are many people, Muslims and non-Muslims, who feel disenfranchised by traditional methods of financing, or who feel - correctly or not - that they do not have adequate access to credit, or that the terms of the credit available to them are morally objectionable or economically unfeasible.

IV. LARIBA (Islamic) Mortgages: The Market

The first and foremost market segment is the small minority of American Muslims who refuse to participate in *riba* under any circumstance. Many of these households have reasonable cash savings but not enough to buy a home. Their balance sheets are clean of any debt of any sort. It is the moral responsibility of the LARIBA (Islamic) bankers and investment/mortgage bankers to cater to the needs of this "Puritan" segment of the community.[3]

It is estimated that this segment represents approximately 1 to 2% of the professional segment of the community. If we assume that there are 1.5 million Muslim households in America and that 50% can afford buying and maintaining a home then the total number of households in the Muslim community that would buy homes is approximately 750,000 households. Further, if we assume that only 20% want to live according to *Shari'ah*, then the number of households drops to 150,000. If we further assume that 5 to 10% of this number are "LARIBA Puritans" dedicated to deal only in LARIBA, then the number of households which are in need of LARIBA financing is estimated to be between 7,500 to 15,000 households.

The profile of this market segment is unique. In particular, such households tend to have the following characteristics:

1. They are extremely pious;
2. They typically run a cash-only household;
3. They use the banks for safe deposits of fund and refuse to accept money market interest;
4. They carry no debt;
5. They fulfill their obligations;
6. They are extremely particular about the details of *halal* and *haram*;
7. They are devout members of the community.

These individuals can only be recognized if LARIBA (Islamic) bankers are true community workers at the grassroots level.

The median house price varies from state to state. It is estimated to be $250,000 in California and $120,000 in Texas. For purposes of this paper, we will use an average of $150,000. If we assume that 70% of the value of the home is to be financed using LARIBA (Islamic) mortgage, the mortgage would be $105,000. For a market of 7,500 households, it is estimated that the primary market size for LARIBA mortgages would then be $780 million. If one assumes a 25% turnover (which is a function of the term of finance assumed here to be 4 to 8 years), this primary market segment size is estimated to be approximately $200 million. As the concept gains credibility, we expect the concept of LARIBA mortgages to grow significantly to attract members of the middle class through refinancing, non-Muslims who are attracted to the concept and a new generation of youth that is more sophisticated in evaluating alternative mortgage concepts.

V. THE LARIBA LEASE PURCHASE MODEL

The LARIBA model consists of two parts:

A. Part I

The first part is the return of capital. If the house price is $180,000, the client pays $60,000 and the balance is financed by LARIBA. In this case the client owns 33.4% of the house and LARIBA owns 66.6% of the house. The client agrees to buy back the share of LARIBA over a period of 5 years in monthly installments of $2,000 per month. The title of the house is transferred directly to the client to minimize costs and taxes, with LARIBA becoming the lien holder. The client owns the house and handles his/her property in terms of maintenance, upkeep and renovation in the same way a traditional mortgage holder would.

B. Part II

The second part of the LARIBA model is the leasing of the house. The client agrees to lease the house for a period of 60 months, to run concurrent with the term of the payback. The lease is estimated based upon comparable lease rates of houses in the neighborhood and is negotiated on an ad hoc basis between the client and LARIBA. The lease income is distributed between the client and LARIBA. The client's portion of the lease is used in our computer model to expedite the buy back process.

VI. THE STRATEGIC APPROACH TO LARIBA (ISLAMIC) MORTGAGES

A. The Need for Grassroots Community Involvement

The primary market segment for LARIBA mortgages is large from the perspective of the American Muslim community, but $200 million is a "drop in the bucket" by American banking and financing standards. LARIBA (Islamic) banking and financing system does not yet have a proven track record in the United States. This requires that we rely upon localized grassroots community efforts at every community center.

B. The Law

When dealing with banking and financing matters in the United States, strict adherence to the letter of the law is required. Toying with financial, securities, and banking laws of America can be dangerous, with swift and irreversible punishment. Conversely, many components of the American system represent years of human experience that should not be thrown away. The Community Re-investment Act (CRA), the laws against usury, the equal lending opportunity laws, the Securities and Exchange Commission rules and regulations, the regulatory functions of the US banking regulators and the laws regarding full and complete disclosures are laws and regulations that reinforce basic human and Islamic values. Furthermore, the American financial, monetary and banking system is the most sophisticated and reliable in the world. Our efforts should concentrate on providing an alternative to that system, not a substitute. The reliability of the proposed alternative system is, in fact, enhanced by the tried and proven regulatory and legal system of America.

C. Matching the Competition

To be successful, LARIBA must provide a product that competes in the free market place equal to, if not better than, the traditional mortgage. Title and ownership should be given to the buyer without delay. Implied mortgage rates should be disclosed and explained in comparison to the market. Monthly payments should be within the ability of the customer and in line with the monthly apartment or house rent they are already paying. The terms of the LARIBA mortgage (5 to 8 years), being much shorter than that of the traditional mortgage (15 to 30 years), require explanation, with the pros and cons discussed in great detail. The administration and processing fees incurred in a LARIBA contract should be contrasted with the "points" charged by traditional mortgages. Capital gains realized from the sale of the property before the expiration of the term should be competitive with a traditional mortgage. Most importantly, the LARIBA Puritan homebuyer should not be punished by not being able to deduct the implied interest as done in traditional mortgages. A letter from the IRS may be a good incentive but not sufficient in comparison to the announced policies of mortgage-interest deductions.

D. Marketing Approach

The marketing of LARIBA services, in general, and mortgages, in particular, cannot follow traditional marketing paradigms. At this stage of its product life it is a specialized product targeted toward meeting the needs of LARIBA Puritans. Using expensive media campaigns and other mediums is extremely expensive and may attract unqualified applicants who may take advantage of the general guidelines of LARIBA financing which do not believe in associating a time value with money. The LARIBA system focuses on serving local mosques (and later on churches and synagogues) in order to achieve adequate community penetration. This approach allows LARIBA officers to perform better due diligence and reduces costs as the percentage of non-performing loans approaches a negligible level. In its effort to promote its basic concepts, the LARIBA mortgage organization relies on personal contacts, recommendations of the leaders and active members of the community and, of course, all of the required due diligence tools of credit checking, salary confirmation, references, tax returns and financial statements. As a consequence, the major source of business eventually becomes referrals based on real experiences.

E. Education

Educating the public using simple and understandable language with facts about LARIBA versus traditional mortgages is a must. Not making an impact on the principal of the loan in a traditional mortgage should be publicized. Education is also needed to explain that paying rent to oneself is equal to investing in ourselves, tax-free, and realizing a return that is competitive with the average return on equities of approximately 10%. Familiarization with the mortgage schedules and the time value of money used in traditional mortgages are needed for many that are doing it to "go with the flow." The value of saving money for children in a trust account (or a Roth IRA account) to save for a sizeable down payment for their future home as they grow up and start a family needs to be explained to the community. These investments can be used to finance the mortgages of today and benefit future generations. All of these factors will bind the community together, increase mutual trust, and help in the economic development of the community.

VII. CONCLUSION

LARIBA financing offers many benefits for civil society and community in a world where many are excluded from credit and finance. Although there are initial concerns about the viability of LARIBA mortgage financing, if done strategically, even while satisfying the laws of the *Shari'ah* as well as those of the United States, LARIBA financing is a viable option. In order to reduce the risk of investment, LARIBA financing requires active involvement with local communities on the grassroots level. This will allow financing officers to gain insight into the reliability of individuals not found in traditional forms of due diligence.

Traditional mortgages lasting between 15 and 30 years may offer the buyer easier monthly payment, but they also serve to deepen the debt of clients. It is the responsibility of LARIBA bankers to counter this trend and rid their clients of debt in order that they may live freely. The LARIBA model helps pay off debt much faster, matching the lifestyle of contemporary America where families change residences every 5 to 8 years. Not only are LARIBA mortgages viable in the United States, they are actually *most likely* to be successful under the protection and scrutiny of the American banking, monetary, and financial laws.

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[1] Federal National Mortgage: was designed to provide ongoing assistance to the secondary market for residential mortgages by providing liquidity for residential mortgage investments, thereby improving the distribution of investment capital available for such mortgage financing.

Federal Loan Home: was chartered by the US Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of home ownership and rental housing. The company purchases first lien, conventional, residential mortgages, including both whole loans and participation interests in such mortgages.

Government National Mortgage Association or GNMA: provides pass through certificates which have an interest in a pool of single family home mortgages that are insured by the Federal Housing Administration (FHA) or by the Veteran's Administration (VA)

[2] From a popular survey published in December, 1992.

[3] It is important to note that the term Puritan is used here in American LARIBA on purpose. The term "Puritan" conveys the core principles of American democratic freedom and virtue through industriousness and property ownership.

The Hedge Fund

An Ideal Investment Vehicle for Muslim Investors

Arif Kamal Siddiqui*

ABSTRACT

Hedge funds are privately managed investment partnerships that use alternative investment styles to perform well in bull and (especially) bear markets. They are similar to mutual funds in some ways but differ in investment strategies, overhead, and target market. Because hedge funds are exempt from certain financial regulations, they can use more investment tools and incentives to manage risk and return, are specially designed, and focus on high-net-worth and institutional investors. The Platinum USA Fund, a *Shari'ah*-based growth fund whose highest priority is risk management, lets Muslims invest in equities in a *halal* manner. While *Shari'ah* restrictions bar short selling and taking a call option on the index, two common hedging tools, the limited regulations on hedge funds give Muslims freedom to run them according to the *Shari'ah*. The absence of an appropriate benchmark hinders the development and acceptability of *Shari'ah*-based hedge funds.

I. INTRODUCTION TO HEDGE FUNDS

A. Definition and Scope

Hedge funds are investment partnerships, which are not regulated by the U.S. Securities and Exchange Commission. They are privately-managed investment vehicles and acquired their name in the early 1960s because of the practice of managers who bought stocks and sold them short to hedge their risks. This technique is presently known as "market neutral" strategy. However, the term "hedge fund" today refers to investment vehicles using alternative investment styles, some of which may not hedge risks.

For the last few years, hedge funds have been very much in vogue, both as investment vehicles for investors seeking higher returns as well as corporate pedestals for bright and ambitious money managers to launch their independent careers.

In terms of their intrinsic characteristics, hedge funds are very similar to mutual funds, since both are investment vehicles focused primarily on equity markets and seek to ensure maximum returns to investors.

B. Size and Market Share

The number of hedge funds is estimated to be between 3000 to 5000. Their numbers have risen by about 20% per year for the last seven years, with an even greater rate of growth in the size of the assets, which exceed $300 billion. While hedge-fund assets have grown quickly, they amount to less than 10% of the mutual-fund industry's $3.5 trillion in assets.

C. Legal Framework and Regulatory Environment

Hedge funds are established as limited partnerships after claiming and qualifying for exemptions from the Investment Companies Act of 1940 and the Securities Act of 1933, which outline rules for the issuance of securities in the primary market.

It is both expensive and cumbersome to operate as an investment company under the Investment Company Act. Because hedge funds primarily invest in securities, they would invariably fall within the definition of an "investment company" and thus be subjected to a greater degree of scrutiny, control, and disclosure requirements. To save costs and to preserve the freedom to use alternative investment styles, hedge funds are therefore structured to qualify for and claim exemptions from this Act.

Exemptions from the 1940 Act were initially available to companies that had 99 or fewer investors. This number was subsequently increased to 499 by the National Securities Market Act of 1996. The exemption is available to companies only if they are not making a public offering of securities. The second exemption from the 1940 Act is only for funds that are held exclusively by "qualified purchasers."

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* Siddiqui is President and Chief Executive Officer of Platinum Asset Management, Inc., in Houston, Tex.

Similarly, hedge funds are exempt from the Securities Act of 1933 only if limited partnership interests are sold through a private offering rather than a public offering. While "private offering" is not defined in the 1933 Act, Regulation D has been enacted to facilitate the making of a private offering. An offering made pursuant to Rule 506 of Section D, will be deemed a private offering. Rule 506 also limits hedge funds from "general solicitation or general advertising" to attract investors. Furthermore, offerings should only be made to "accredited investors." An accredited hedge fund investor must have a net worth of at least $1 million (including any homes) or an income in the past consecutive two years of at least $200,000 if single, $300,000 if married.

D. Reasons for the Popularity of Hedge Funds

The primary reason behind the tremendous popularity of hedge funds is their ability to consistently perform well, in both bull and bear markets, by using investment techniques such as short selling, margin trading, and exercising call options on indices. Despite the tactical leeway they enjoy and the exotic instruments they can deploy, hedge fund managers usually try to control risk rather than simply to maximize returns. They are sharply focussed on investment strategies such as short selling, risk arbitrage, or dealing in equities in both long and short positions. The overriding goal of hedge funds is to perform whether the market goes up or down—this contributed to their success.

Another reason for hedge funds' popularity has been proposed by Fortune magazine: investors are realizing that abnormally large annual increases in the value of the stock market, on the order of 20% and 30% per year, can not be sustained, and that the market return should decline to its long-term average of 10%. Other press reports echo the theme that the hedge funds have much room to grow.

II. HEDGE FUNDS VERSUS MUTUAL FUNDS

As investment vehicles, hedge funds and mutual funds have many basic similarities. Both are companies whose primary role is to mobilize funds from investors and to invest those funds in various financial assets with a view to making profit for mutual gain. However, there are several major differences between the two types of funds. They include differences in the applicable laws, investment styles, overhead, intended market, and historical performance.

A. Legal Framework and Regulatory Environment

Mutual funds operate as open-ended investment companies incorporated under the Investment Companies Act of 1940, while hedge funds are limited partnerships with the fund manager as general partner. There is a quid pro quo. Mutual funds have stringent disclosure requirements and regulatory controls to which they must strictly conform. As a result, they are allowed full freedom to advertise and draw investment from a larger group of potential customers. Hedge funds, on the other hand, are allowed greater flexibility in management style and in deploying investment strategies, but they can approach only so-called "accredited investors" because only these informed people, who have a higher tolerance for risk, ought to be allowed to invest in hedge funds.

There is a general misconception that hedge funds are totally unregulated. This is not entirely true. While hedge funds operate in a looser regulatory environment and have greater flexibility than mutual funds, they are nevertheless required to make available a detailed disclosure document at the time of the private offering, outlining the full and complete details. These include the possible risks, the composition of the portfolio, strengths and weaknesses, and so on. Any deviation from the stated strategies and policies obviously puts hedge funds in a vulnerable situation respecting their clients. Moreover, hedge funds must meet the requirements of the state securities boards in the respective states in which they are based. They are required to submit periodic returns.

B. Differences in Investment Style

The most vital and basic difference between hedge funds and mutual funds arguably lies in what hedge funds can do with the assets the manage and mutual funds cannot. Hedge funds, because of the very nature of their charters, have the freedom and flexibility to employ virtually all the techniques of modern-day investment, which mutual funds are barred from. Hedge funds can sell short, trade in derivatives, buy and sell options, deal in futures and commodities, and leverage their portfolios through margin trading. They are therefore known as funds having "alternative investment styles."

C. Loads and Costs

Hedge funds owe their growing popularity among high-net-worth individuals and institutional investors to their cost and remuneration structures. Hedge funds do not charge any front-end or back-end loads and have no sales charge. They usually charge a management fee of 1% to 2% of the net asset value and share their profits with investors only if they have a positive performance. Usually this is 20% of the profit. Consequently, hedge-fund managers have an incentive to do well: they will be paid only when they make money for their investors. If the hedge fund loses money, its manager is not paid the performance fee. This also acts as an incentive to manage and minimize risk.

By contrast, mutual funds have a front-end load, back-end load, or a sales charge, ranging from 5% to 9% and deducted from the assets mobilized. The front-end load is deducted up-front. However, there are a growing number of no-load mutual funds. They apply what is known as a 12-b-1 charge.

D. Markets for Hedge Funds and Mutual Funds

In view of their regulatory environment, hedge funds are specially designed and inclined to focus on the upper end of the investment market. The minimum investment that an average hedge fund accepts is $250,000. Many accept less than that: there are some whose minimum is as high as $10 million. Mutual funds will take investments of a few hundred dollars. Hedge funds therefore focus their marketing on high-net-worth and institutional investors. These two groups form its typical client base.

Hedge funds are more exclusive than their high levels of minimum investment would warrant. Even if an investor agrees to the requirement to invest $250,000, his entry is not automatic. Hedge funds do not advertise and selectively accept investments, usually once every quarter. This is sometimes done to ensure that the cash flow of new investors does not dilute the returns of senior investors. Some accounting issues are involved as well. Conversely, mutual funds are open to almost all investors.

E. Performance of Hedge funds

According to a study of more than 1600 hedge funds for the five years ending December 1995, conducted by Van Hedge Fund Advisors Inc., global hedge funds have achieved higher returns than mutual funds with a lower risk of loss, when risk is measured similarly for both types of funds. In that 5-year period, almost all hedge-fund investment styles earned significant excess returns compared to mutual funds. However, the result of this and other such studies only point out the general trend; specific performance results require specific comparisons.

Hedge funds have, in the past, been especially effective in sudden bear markets. In 1987, the year the Dow Jones Industrial Average crashed in October, the S&P 500 rose 5.24%, growth mutual funds only 1.02%, and hedge funds 14.49%. In 1990, a time of uncertainty due to Iraq's invasion of Kuwait, the S&P 500 and growth mutual funds returned 3.11% and 3.82%, respectively, while hedge funds finished the year up 10.97%.

Hedge funds have a better risk and reward profile than mutual funds. Prospective investors are advised to compare the Sharpe ratio (a measure of risk-adjusted return) of the two types of funds. According to Morningstar, a major independent source of information on mutual funds, the typical growth mutual fund's Sharpe ratio for the past three years is 1.54%. A hedge fund's Sharpe ratio should generally be higher than this; otherwise, its manager must explain with a good reason. The two funds' beta coefficients and standard deviations are other important measures to watch.

F. Advantages and Disadvantages of Investing through Hedge Funds

Hedge funds benefit from professional management. The brightest minds in the financial industry work in this area. They also offer no-load investing, consistent with their lean nature and focus on profit and performance. Hedge funds charge performance fees only when they show good results for their investor. Since they deal with a small number of large customers, they provide efficient, client-focused, customized, and state-of-the-art services to their clients.

Other aspects of their structure also benefit investors. As hedge funds are limited partnerships, the liability of an investor is limited to the extent of his or her investment in the partnership. Double taxation is avoided, since the Internal Revenue Service, America's tax-collection arm, recognizes limited partnerships as pass-through entities that are not subject to the corporate income tax. Partners' profits are reported through K-1 and 1065 forms, similar to mutual funds'.

Finally, investments in hedge funds are not liquid investments. Most investments are accepted with a clear understanding of their horizon or maturity period. While the preferred investment horizon in stock market is three years, hedge funds usually accept investments for at least one year. A notice of 30 to 60 days is generally required prior to redemption. On the other hand, it is much easier and quicker to sell investments in a mutual fund. Consequently, investments in hedge funds have the characteristic of illiquidity. The customers of hedge funds generally support this because they tend to have surplus funds to invest.

III. THE PLATINUM USA FUND

The Platinum USA Fund is a *Shari'ah*-based fund, established to abide by both the letter and the spirit of the *Shari'ah*. It provides Muslim high-net-worth individuals and institutional investors with a window, through a corporate vehicle, to the equity markets of the world, particularly the U.S. equity markets. The Platinum USA Fund is a domestic equity fund, managed by Platinum Asset Management Inc. acting as its General Partner. Platinum Asset Management Inc is registered with the State Security Board as a Registered Investment Advisor.

It is a growth fund, having the S&P 400 as its benchmark. The Fund's philosophy is to invest primarily in mid-cap securities. While there is no clear-cut definition as to what constitutes "small cap," "mid cap," or "large cap," it is generally presumed that companies having a market capitalization of between $1 billion and $5 billion are considered mid-cap. Some components of the fund contain small-cap and large-cap securities.

Despite their flexibility to invest in any security and in any market, hedge funds in general and the Platinum USA Fund in particular are professionally and prudently managed. Risk management remains the Fund's highest priority, and toward this end the following strategies are employed to ensure better risk management:

1. well diversified portfolio of 40 to 45 securities;
2. primary portfolio in equities of companies having market capitalization of over $1 billion;
3. not more than 5% of the portfolio is invested in any one company, and this proportion will decrease as the size of the fund increases;
4. diversification among various market and industry sectors;
5. no leveraging or margin trading;
6. no investment in derivatives; and
7. nothing exotic.

Hedge funds tend to be lean organizations that keep a strict check on their cost structures. The salaries and wages of employees are not paid out of the fund. The only remuneration is the performance/incentive fee, payable once every year, if positive performance is shown. In addition, the Platinum USA Fund charges a management fee of 0.75% every quarter. To keep costs down without compromising quality of service, the Fund uses the services of some of the best names in the United States.

IV. *SHARI'AH* INVESTMENT PRODUCT

A. *Shari'ah* Filters

The Platinum USA Fund is dedicated to providing an investment vehicle by upholding the tenets of the *Shari'ah*. Consequently, it makes no investments in any *riba*-based products such as Treasury bills, Treasury bonds, intermediate bonds, municipal bonds, and Fannie Mae securities. It also avoids preferred stocks, corporate bonds, and convertible bonds and makes no investment in the equities of banks, insurance companies, entertainment firms, gambling-related businesses, casinos, and brewers/winemakers. The *Shari'ah* also prevents the Fund from engaging in margin trading and dealing with futures, options, companies in which interest-based debt exceeds 30% of total debt, and companies that derive more than 15% of total income from interest.

B. Hedge Funds: The most suitable investment vehicles for the Muslim investor.

There are no regulatory or statutory restrictions imposed on hedge funds that may impede adherence to the *Shari'ah*. Hedge funds are transparent entities and by far the only investment vehicle that can be fully customized to meet the *Shari'ah*'s requirements, without violating the letter or spirit of the applicable laws of the land. Furthermore, even the various interpretations of *fiqh* can be incorporated in the management philosophy of hedge funds because of the sheer size and depth of the equities available in the market. Anything contrary to the fund manager's faith and beliefs can easily be omitted. The stipulations of the *Shari'ah* guidelines can be clearly stated in the disclosure documents at the time of offering. This gives the hedge fund the freedom to incorporate all the strategies permissible under the *Shari'ah*, and screen out whatever is not allowed. In view of the flexibility it affords, a hedge fund is probably the most suitable investment vehicle for Muslim institutional and high-net-worth investors.

C. Problems and Difficulties

Hedge funds are known, theoretically at least, to perform well in both bull and bear markets. Their good performance in a bear market is attributable to the various hedging techniques they employ, such as short selling and taking a call option on the index, and the absence of an appropriate benchmark and index. However, since short selling requires the borrowing of securities and entails *riba*, and since *Shari'ah* scholars rule that options are inadmissible, the Platinum USA Fund is short of two commonly used hedging tools.

The absence of a comparable index or an appropriate benchmark is a major drawback in the development and acceptability of *Shari'ah*-compliant hedge funds. The use of existing benchmarks to compare the performance of *Shari'ah*-based investment vehicles is not financially appropriate; there is a need to develop at least 7 to 10 indices corresponding to the existing benchmarks being used by the hedge-fund industry in America. The benchmarks should be as close to the existing benchmarks as the weighting would permit. For example, the S&P 500 has a significant component of the conventional financial sector, which is a prohibited area for Muslim investors. That sector may be replaced with more of its remaining constituents. The *Shari'ah*-based indices must have international recognition, particularly on Wall Street.

APPENDICES

Appendix A: Second Forum Program of Events

Appendix B: Biographies of Speakers

Appendix C: About the Harvard Islamic Finance Information Program

Appendix A

Second Forum Program of Events

Day 1: Friday, October 9, 1998

8:00 AM **Registration**
Ames Court Room, Austin Hall, Harvard Law School

9:00 AM **Welcome Address**
Mr. Thomas D. Mullins, Executive Director, Harvard Islamic Finance Information Program, USA

Conference Chairman's Address
Professor Samuel L. Hayes, III, Jacob Schiff Professor Emeritus, Harvard Business School, USA

Keynote Speech – Islamic Finance
Islamic Finance and Investment: A New Era
Mr. Adnan Al Bahar, Chairman, The International Investor, Kuwait

Keynote Speech – The *Shari'ah*
Islamic Finance in View of the *Shari'ah*
Shaykh Nizam Yaquby, Shari'ah Advisor, Bahrain

Keynote Speech – Islamic Economics
Islam and Economic Development: A Discussion within the Framework of Ibn Khaldun's Philosophy of History
Dr. M. Umer Chapra, Senior Economic Adviser, Saudi Arabian Monetary Agency, Saudi Arabia

11:00 AM **Break**

11:15 AM Islamic Banking: a Global Perspective

Chairperson:
Professor Samuel L. Hayes, III
Jacob Schiff Professor Emeritus, Harvard Business School, USA

Speakers:

Challenges Facing Islamic Banking in the 21st Century
Dr. Fuad Abdullah Al-Omar, Vice President, Islamic Development Bank, Saudi Arabia
Dr. Munawar Iqbal, Chief, Islamic Banking and Finance, Islamic Development Bank, Saudi Arabia

Islamic Finance: Opportunities and Challenges in a New Global Environment
Mr. Shaukat Aziz, Executive Vice President, The Citibank Private Bank, USA

Islamic Finance: Evolution and Challenges
Mr. Iqbal Ahmad Khan, Managing Director, Global Islamic Finance, HSBC Group, UK

12:45 PM **Lunch**

2:15 PM *Shari'ah* Perspective on Islamic Financial Products

Chairpersons:

Shaykh Nizam Yaquby
Shari'ah Advisor, Bahrain

Professor Frank Vogel
Director, Islamic Legal Studies Program, USA

Speakers:

***Shari'ah* Precautionary Procedures in *Murabaha* and *Istisna'*: A Practical Perspective**
Shaykh Abdul-Rahman bin Aqeel, Chairman, Shari'ah Committee, Al Rajhi Banking and Investment Corp., Saudi Arabia

Linking Ethics and Economics: The Role of *Ijtihad* in the Regulation and Correction of Capital Markets
Dr. Taha J. al-Alwani, President, and Mr. Waleed El-Ansary, School of Islamic and Social Sciences, USA

Some Recurring *Shari'ah* Violations in Islamic Investment Agreements
Dr. M. A. Elgari, Director, Center for Research in Islamic Economics, King Abdulaziz Univ., Saudi Arabia

3:45 PM Break

4:00 PM Trends in Islamic Economics and Finance

Chairperson:
Dr. Saleh J. Malaikah
Chief Executive Officer, Al Baraka Investment and Development Company, Saudi Arabia

Speakers:

The Institution of *Zakat* and Its Economic Impact on Society
Mr. Marghoob Ahmed Quraishi
President, Associated Management Systems, Inc., USA

Accounting and Auditing Standards for Islamic Financial Institutions
Dr. Rifaat Ahmed Abdel-Karim
Secretary General, Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain

The Survival of Islamic Banking: A Micro-evolutionary Perspective
Professor Mahmoud El-Gamal, Chair of Islamic Economics, Finance and Management, Rice University, USA

New Frontiers of Islamic Banking in the 21st Century with Special reference to Informal and Voluntary-sector Banking
Dr. M. A. Mannan, Chairman
Social Investment Bank Ltd., Bangladesh

Islamic Finance Information Superhighway

Islamic Finance Information Superhighway
Mr. Taha Abdul-Basser, Harvard Islamic Finance Information Program (HIFIP), Harvard University, USA

6:30 PM Day One of the Conference Ends

8:00 PM Banquet, Lowell House – Banquet Address
Dr. Saleh J. Malaikah, Chief Executive Officer, Al Baraka Investment and Development Company, Saudi Arabia

Day 2: Saturday, October 10, 1998

SIMULTANEOUS SESSIONS

8:30 AM	SESSION A Islamic Asset, Securitization, and Government Instruments	SESSION B Islamic Funds and Capital Markets
	Chairperson:	***Chairperson:***
	Dr. Fuad Abdullah Al-Omar *Vice President (Administration and Finance),* *Islamic Development Bank, Saudi Arabia*	**Mr. Robert Friedman** *Senior Director and Chairman* *AEB Worldfolio Management Company* *American Express Bank, USA*
	Speakers:	***Speakers:***
	Islamic Banking: Issues in Prudential Regulation and Supervision *Dr. Luca Errico, Economist* *International Monetary Fund (IMF), USA*	**Designing a Unique Islamic Investment Product: Our Experiences** *Mr. Robert Friedman, Senior Director and Chairman* *AEB Worldfolio Management Company* *American Express Bank, USA*
	Why Securitization of Financing is Essential for the Development of Islamic Finance ***Mr. Syed Tariq Husain, Director and Head*** ***Global Islamic Finance, ANZ Grindlays Bank, UK***	**Islamic Equity Benchmark Index (KMS-S.A.M.I.™)** *Mr. M. Ali Khan, President and CEO* *Klein Maus and Shire, Inc., USA*
	The Role of Infrastructure Funds in Promoting Islamic Finance *Mr. Mumtaz Khan, Chief Executive Officer* *Emerging Markets Partnership, USA*	**The Realities and Challenges Facing Islamic Equity Funds: Islamic Bankers Are Missing the Point** *Mr. Tariq Al-Rifai, President* *Failaka International, Inc., USA*
	Financial Engineering in Islamic Finance *Mr. Zamir Iqbal* *Information Officer* *The World Bank, USA*	**The Hedge Fund: An Ideal Investment Vehicle for Muslim Investors** *Mr. Arif Kamal Siddiqui, President* *Platinum Asset Management, Inc., USA*
10:30 AM	**Break**	**Break**

10:45 AM	SESSION C **Islamic Monetary Policy and Resource Mobilization**	SESSION D **Islamic Real Estate and Consumer Finance**

SESSION C — Islamic Monetary Policy and Resource Mobilization

Chairperson:

Dr. Munawar Iqbal
Chief, Islamic Banking and Finance
Islamic Development Bank, Saudi Arabia

Speakers:

Resource Mobilization and Development Goals for Islamic Banks
Professor Masudul Alam Choudhury
University College of Cape Breton, Canada

Size, Profitability, and Agency in Profit- and Loss-sharing in Islamic Banking and Finance
Professor John Presley, Loughborough University, UK
Dr. Humayon Dar, Loughborough University, UK

Monetary Policy and Economic Growth: An Islamic Perspective
Dr. Abdel-Hameed M. Bashir, Asst. Professor of Applied Economics, Grambling State University, USA

A Short Outline of the Foundations of Islamic Economics
Dr. Usamah Uthman, Associate Professor of Economics
King Fahd Univ. of Petroleum & Minerals, Saudi Arabia

SESSION D — Islamic Real Estate and Consumer Finance

Chairperson:

Mr. Syed Tariq Husain
Director and Head
Global Islamic Finance, ANZ Grindlays Bank, UK

Speakers:

Financing Real Estate Transactions in the US According to *Shari'ah*
Mr. Abdulkader Thomas, General Manager
United Bank of Kuwait, USA

Key Concepts of Islamic Finance: Their Relevance to Consumer Finance Products
Mr. Pervez Nasim, President
Islamic Cooperative Housing Society of Toronto

LARIBA (Islamic) Mortgage Financing in the United States: Providing an Alternative to Traditional Mortgages
Dr. Yahia K. Abdul Rahman, Founder LARIBA, USA
Mr. Abdullah S. Tug, General Manager, American Finance House LARIBA, USA

Islamic Banking: Opportunities in Canada
Mr. Said Zafar, Chairman
Committee on Islamic Financial Institutions
Canada

12:45 PM **Lunch**

1:45 PM	**SESSION E** **Islamic *Shari'ah* and Legal Issues**	**SESSION F** **Islamic Project Finance**
	Chairperson: **Shaykh Abdul-Rahman Abdullah bin Aqeel** *Chairman, Shari'ah Committee* *Al Rajhi Banking and Investment Corp., Saudi Arabia*	***Chairperson:*** **Dr. Sabir Mohamed Hassan** *Governor, Bank of Sudan* *Sudan*
	Speakers:	***Speakers:***
	***Murabaha*, Sales of Trust, and the Money-value of Time** *Shaykh Yusuf Talal DeLorenzo, Director of Education* *Islamic Saudi Academy, USA*	**Integrating Islamic and Conventional Project Finance** *Dr. Muhammed-Shahid Ebrahim, Senior Lecturer* *Universiti Brunei Darussalam, Brunei Darussalam*
	Islamic Finance in Malaysia: A Tax Perspective *Mr. Walid Hegazy, Doctoral Candidate* *Harvard Law School, USA*	**Islamic Project Finance: Problems and Promises** *Dr. Don Babai, Center for Middle Eastern Studies* *Harvard University, USA*
	Practical Legal and Tax Issues in Islamic Finance and Investment in the United States *Mr. Isam Salah and Mr. W. Donald Knight, Jr.* *Partners, King & Spalding, USA*	**Strategic Alliances in Islamic Banking** *Mr. Basil Al-Ghalayini* *Managing Director, The International Investor Advisory Group, UK*
	Islamic Tradable Instruments: Basic Building Blocks *Miss Gohar Bilal* *Visiting Scholar, Harvard Law School, USA*	**Project Financing in Equity-based Economies** *Dr. Mahmud Rahman, Assistant Professor of Finance* *School of Business, Eastern Michigan University, USA* *Dr. Abdul Aziz, Center for Research in Islamic Corporate Finance, Humboldt State University, USA*
3:45 PM	**Break**	
4:00 PM	**Closing Remarks**	

Appendix B

Biographies of Speakers

TAHA JABIR AL-ALWANI

School of Islamic and Social Sciences, Leesburg, Virginia.

Taha Jabir al-Alwani is currently President of the School of Islamic and Social Sciences, which he founded in 1996. He is also the founding member of the International Institute of Islamic Thought (IIIT) and the president of the *Fiqh* Council of North America. Al-Alwani received his Ph.D. from Al-Azhar University. He has authored several books, including Al Razi's *Al Mahsul fi ilm al usl*, *Sources Methodology in Islamic Jurisprudence*, and *The Ethics of Disagreement in Islam*. Currently he is working on *Methodology for Approaching the Qur'an*.

WALEED EL-ANSARY

School of Islamic and Social Sciences, Leesburg, Virginia.

Waleed El-Ansary is currently affiliated with the School of Islamic and Social Sciences. His previous experience includes stints at the World Bank, Hal Consulting and Investment Group, and the Paper and Plastic Education Research Foundation of New York. El-Ansary holds an M.A. in Economics from the University of Maryland and a B.A. from George Washington University. He is currently working on a Ph.D. in human sciences at George Washington University. A paper of El-Ansary's, *The Spiritual Significance of Jihad in Islamic Economics*, recently appeared in the American Journal of Islamic Social Sciences.

ABDUL-RAHMAN ABDULLAH BIN AQEEL

Al Rajhi Banking and Investment Corporation, Riyadh, Saudi Arabia.

Abdul-Rahman Abdullah Bin Aqeel is currently a member of the Board of Directors of Al Rajhi Banking and Investment Corporation and its *Shari'ah* Board. He is a noted *Shari'ah* scholar and has spoken on numerous issues relating to it.

ABDUL AZIZ

Humboldt State University, Arcata, California.

Abdul Aziz is currently the Director of the Center for Research in Islamic Corporate Finance at Humboldt State University, which he established in 1992. Prior to this he was an Assistant Professor at the University of Texas at Arlington. Aziz has a Ph.D. in Finance from the University of Texas, Dallas.

SHAUKAT AZIZ

Citibank, New York, New York.

Shaukat Aziz is an Executive Vice President, presently responsible for Citibank's Private Bank worldwide. In his nearly 30 years with Citibank, he has held a variety of senior management positions, spanning several lines of business, and has directed the efforts of the corporation in more than 10 countries. Aziz is on the board of several Citibank-owned financial institutions, including Saudi American Bank, Citibank Bahamas, and Citibank Switzerland. Aziz is a frequent speaker on international finance. He holds an MBA from the University of Karachi, Pakistan.

DON BABAI

Center for Middle Eastern Studies, Harvard University, Cambridge, Massachusetts.

Don Babai is a Research Affiliate at Harvard's Center for Middle Eastern Studies (CMES). He is a research coordinator for the Harvard Islamic Investment Study. He was an Assistant Professor in the Government Department at Harvard University between 1984 and 1989 and since then has held research positions at several centers at the University. His research has focused on international financial institutions and policy reform in developing countries. He holds a Ph.D. in International Relations from the University of California, Berkeley.

ADNAN A. AL BAHAR
The International Investor, Safat, Kuwait.

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Appendix C

About the Harvard Islamic Finance Information Program

Thomas D. Mullins
Executive Director

S. Nazim Ali
Director of Operations

INTRODUCTION

The Harvard Islamic Finance Information Program (HIFIP) is now in its fourth year of operation as an academic research program on the field of Islamic finance and economics at Harvard University. Established by Harvard's Center for Middle Eastern Studies (CMES) and with the support of the Islamic Investment Company of the Gulf (IICG) Bahrain in December 1995, it has since then grown to develop relationships and support from throughout the Islamic finance community.

Harvard University has sponsored several related initiatives: the Islamic Legal Studies Program (Harvard Law School) was established for the study of Islamic law in 1991; the Harvard Islamic Investment Study (CMES, Harvard Law School, Harvard Business School) was completed in 1996; and Vogel and Hayes' *Islamic Law and Finance: Religion, Risk and Return* was published in 1998. The establishment of HIFIP, however, fills the need for a more comprehensive and focused look at the field of Islamic finance and economics.

HIFIP OBJECTIVES

The Harvard Islamic Finance Information Program was established for and operates with the following objectives in mind:

1. to become the premier information provider and clearinghouse of Islamic finance and economics;
2. to create and develop the HIFIP DataBank;
3. to promote research and development in Islamic finance and economics and sponsor research projects; and
4. to promote greater awareness of Islamic finance and economics through conferences and seminars.

HIFIP ACTIVITIES

In addition to organizing the Harvard University Forum on Islamic Finance, HIFIP has also been responsible for a variety of information management and research projects. The Program has released and continually updates the HIFIP *DataBank*, the world's first comprehensive software information tool on Islamic finance and investment. The *DataBank* at this point has the equivalent of over 12,000 pages of information in nine component databases ranging from industry data to published research to religious literature and more.

The Program also offers and hosts a variety of research opportunities. It has initiated a visiting scholars program for research projects at HIFIP, sends HIFIP researchers on research projects and internships in the Islamic finance industry, and responds to research and information referral requests worldwide. These opportunities for research at and through HIFIP have the further benefit of attracting university students to the field of Islamic finance and granting them valuable exposure to the industry.

INSTITUTIONAL RELATIONSHIPS

In order to successfully undertake these activities, HIFIP has had the cooperation of various research bodies (e.g., Islamic Research and Training Institute of the Islamic Development Bank), banking and regulatory institutions (e.g, World Bank, Accounting and Auditing Organization for Islamic Financial Institutions), and other secondary information providers (e.g., Islamic Bankier, Reuters) in the field. The Program has also had the crucial financial support of institutions throughout the Islamic finance community (please see our list of member institutions). These relationships not only allow HIFIP to better study the field of Islamic finance, but also enhance its role as an information clearinghouse for a more informed and connected Islamic finance community.

NEW DEVELOPMENTS

As HIFIP continues and expands on its current research and information service capabilities, it is also embarking on new projects. Our latest web initiative will bring a significantly expanded Web site, making it a forum for greater connectivity with the Islamic financial community. An abridged Web version of the HIFIP *DataBank*, presently accessible only on CD-ROM, will be available online, providing HIFIP members with access to the complete *DataBank* and all users with access to an abridged web version. Finally, a new membership structure that differentiates institutions by financial ability will allow for greater access to the benefits of the Program.

MEMBERS OF THE HARVARD ISLAMIC FINANCE INFORMATION PROGRAM

1.	ABC Islamic Bank	Manama, Bahrain
2.	Abu Dhabi Islamic Bank	Abu Dhabi, United Arab Emirates
3.	Albaraka Investment and Development Company	Jeddah, Saudi Arabia
4.	AlBaraka Islamic Bank	Manama, Bahrain
5.	Citi Islamic Investment Bank	Manama, Bahrain
6.	Faysal Bank Limited	Karachi, Pakistan
7.	Faysal Islamic Bank of Bahrain	Manama, Bahrain
8.	First Islamic Investment Bank	Manama, Bahrain
9.	HSBC Investment Bank Plc	London, United Kingdom
10.	The International Investor	Safat, Kuwait
11.	Islamic Development Bank	Jeddah, Saudi Arabia
12.	Kuwait Finance House	Safat, Kuwait
13.	Kuwait Securities House	Safat, Kuwait
14.	National Commercial Bank	Jeddah, Saudi Arabia
15.	Rice University	Houston, United States
16.	Saudi Economic and Development Company	Jeddah, Saudi Arabia
17.	Supreme Consultative Committee on the Implementation of the Provisions of Muslim *Shari'ah* Law	Kuwait
18.	United Bank of Kuwait	London, United Kingdom
19.	Universiti Brunei Darussalam	Bandar Seri Begawan, Brunei Darussalam

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