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ISLAMIC BANKING AND FINANCE IN THEORY AND PRACTICE: A SURVEY OF STATE OF THE ART

MOHAMMAD NEJATULLAH SIDDIQI*

*The practice of Islamic finance significantly departs from its theory. The survey addresses the causes of the dichotomy and offers alternative research approaches and themes that may in the future facilitate convergence of the practice with the theoretical aspirations - a transformation from merely meeting the criteria of legality to that of achieving the objectives of Islamic law.***

1. INTRODUCTION

The contemporary practice of Islamic banking and finance is now 30 years old. However, Islamic banking theory is still not very well developed. The practice has focused on a few credit-based instruments. The overriding concern in inventing or adapting new financial instruments has been meeting the Shari[ah requirements legalistically while the *maqasid al*-Shari[ah (objectives of Islamic law) have not received due attention.

There is a felt need for evaluation of what has gone by during the last three decades in the field of Islamic banking and finance. More important than focusing on its growth, commercial performance and market share is the need for evaluating it in terms of its contribution to introducing and promoting the understanding of the economic and financial aspects of the overall Islamic way of life. “A survey of the state of the art in the field of Islamic banking and finance in theory and practice” is expected to fulfill that need.

This survey is made with a view to enabling the theorists and practitioners of Islamic banking and finance to take stock of the situation and plan for the future. Its focus is the current situation. It is not an historical account of the evolution of Islamic banking and finance in theory and practice. More attention is paid to

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* Former Professor, Center for Research in Islamic Economics, King Abdulaziz University, Jeddah. He is grateful to Professor Muhammad Anas Zarqa for many insights that were incorporated in this Survey. He also acknowledges that advice from an expert committee of the Islamic Research and Training Institute (IRTI) and research grant from IRTI has been helpful to him in writing this survey.

** The Internet resources cited in the paper were accessed by the author during 2005.

discovering points of weakness than to projecting the points of strength. It indicates the distinctive features of Islamic banking and finance that make it different from the conventional theory of banking and finance. It is in this context that it evaluates the current practice of Islamic banking and finance. Both the original vision of the Islamic economic system and the growing awareness of what is needed for meeting the challenges facing human society today are kept in view.

Why did Muslims launch a different project in the field of banking and finance instead of doing it the way everybody was doing? After all they did not feel the need for being different in the fields of transportation, communication, engineering and medicine, among others. Nor did they deny the market mechanism its central place in the economy. The answer, as evidenced by the literature on the subject, lies firstly, in the involvement of *riba* in the conventional system and secondly, in the perception that the conventional system is not geared towards achieving the goals of the Shari[ah. Prominent among these goals are justice and fairness and general welfare of the people. As a matter of fact it is justice and fairness that the prohibition of *riba* is perceived to be aiming at (Qutb: 2000, pp.48-52; Siddiqi: 2004a, Chapter 1; El-Din: 2002b).[1]

Muslims think that *riba* (which they generally and correctly thought included bank interest) makes the banking and financial system unfair and incapable of ensuring the best interests of people. Islamic economists as well as Muslim scholars in general tried to establish this point in the third quarter of the last century and onwards (Hameedullah: 1936; Qureshi: 1946; Maududi: 1961; Al-Arabi: 1965). The same period witnessed two developments that many perceive to be in opposite directions. Firstly, the world, especially the advanced industrial countries, enjoyed phenomenal growth in wealth and, to a great extent, in welfare too. Banking and finance are rightly seen to be a contributing factor. Secondly, dissatisfaction with the conventional system continued to grow as many saw it as one of the causes of increasing inequality in the distribution of income and wealth within nations as well as between nations.

The last two decades of the twentieth century also witnessed much volatility in currency values and economic instability. The fact that the same period saw many instances of social strife, conflict and corrupt practices in accounting and corporate management, fueled that dissatisfaction.

The above is important not only as an historical fact but also in understanding the progress of Islamic banking and finance and people’s interaction with it. It will continue to form an important basis for the self-image and internal evaluation in the broader community of Islamic finance, including not only its theorists and practitioners but also the Muslim peoples in general. This point needs to be kept in view while we evaluate the progress of Islamic banking and insurance over the last three decades.

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[1] In the last mentioned, see also the comment by Mabid Ali Al-Jarhi [pp.218-20].

In what follows we first note the early developments then state the theory of Islamic banking and its macroeconomic implications. This will be followed by a survey of what is going on under that banner. While we do highlight the strong points of the current practices in the Islamic financial industry our main focus will be on evaluating these practices, mostly though not only, in the light of the challenges facing it in meeting the needs of society while keeping close to its vision as noted in the previous section. The next section focuses on *fiqh* issues still unresolved. These relate to *usul* (methodology) as well as to *fru[* or specific contracts. The following section spells out the research priorities while the Conclusions muses on who should rise up to the challenge and how.

2. THEORY OF ISLAMIC BANKING AND ITS MACROECONOMIC IMPLICATIONS

Early Beginnings

The earliest writings on the subject of Islamic banking and finance date back to the forties of the twentieth century (Siddiqi: 1981, pp.29-30) and the earliest practice can be traced to early sixties (Ahmad: 1995, pp.21-23). The literature showed ambivalence between the model of an intermediary designed after conventional commercial banks and one like an investment company serving individuals seeking profits as well as the community needing development. Models of commercial banking based on two-tier *mudarabah* came from economists aspiring to build an alternative to a system of banking and finance hinged on interest. Some of them placed the issue in the larger context of the struggle between capitalism and socialism in which Muslim intellectuals projected Islam as having a different approach resulting in a distinct economic system with its own financial institutions. Community initiatives looked forward to something workable while avoiding interest.

The nineteen-sixties saw the establishment of an interest-free bank in Karachi, that of Tabung Haji in Malaysia, and saving-investment banks in Mit Ghamr in Egypt, that were based on sharing profits and avoided interest. Only Tabung Haji (Tabung Haji:1995) survived, thanks to its roots in the community, its narrow focus, official blessings and clear structure as a business. Early in the nineteen-seventies came the Dubai Islamic Bank, taking deposits in current as well as investment accounts and engaging in profit-making activities directly as well as through working partners. The Islamic Development Bank, which started operations in 1975, was designed to serve Muslim countries and communities by arranging finance for trade and development on non-interest bases. By late nineteen-seventies there were half a dozen more banks in the private sector in Egypt, Jordan, Kuwait, and the Gulf. The following decade saw a rapid expansion bringing the number of banks to dozens by the end of the decade. To banks were now added non-bank financial institutions, like investment companies and insurance companies (IAIB: 1997).

The Theory

What can be characterized as the ‘theory’ of Islamic banking was, till the end of the nineteen-seventies, largely a plea for replacing interest in bank lending by profit sharing. This would change the nature of financial intermediation, making the fund owners as well as the financial intermediaries share the risks of enterprise with the fund users. Early literature’s main emphasis was on fairness. Making the fund-user-entrepreneur bear all the risks of business and allowing fund owner and bank claim a predetermined return was regarded to be unjust. The environment in which productive enterprise was conducted did not guaranty a positive return, so there was no justification for money capital claiming a positive return irrespective of the results of enterprise, it was argued. (Ghanameh: 1973, p.66; Hameedullah: 1970, paragraph 372; Siddiqi: 1968, vol.1, p.173-75). It was also argued that most, though not all, the other problems of capitalism were rooted in the practice of lending on interest. Among these problems were unemployment, inflation, poverty amidst plenty, increasing inequality and recurrent business cycles (Uzair: 1955; Maududi: 1961, pp.85-89; 194; Ahmad: 1972, pp.13-14; Hameedullah: 1970, pp.140-68; Hameedullah: 1936, p.221). These problems could be solved by abolishing interest and replacing it by profit sharing. It was not until the next decade that Islamic economists were able to fortify these claims by sophisticated economic analysis, especially at the macroeconomic level. The focus at this stage was largely on pointing out the deficiencies of capitalism and linking them to the institution of interest, among other things. With this went the arguments showing that it was possible to have banking without interest and that it would not adversely affect savings and investment (Maududi: 1961, p.110; Maududi: 1969, p.270; Qureshi: 1946, p.218; Siddiqi: 1969, pp.180-90). Some argued that abolishing interest would boost investments leading to increased production (Mannan: 1970, p.169).

Notably missing were theoretical arguments to assure the fund owners regarding the safety of their monies, beyond the general argument that some kind of ‘mutual insurance’ will take care of the problem (Egyptian Study: 1972, p.43). Also, little attention was paid to what later came to be called ‘trade based modes of finance’ (Ismail: 2002, Hasan: 2005).

New Developments During The Nineteen Eighties

The most significant development during the late nineteen-seventies and early eighties was the advent and proliferation of *mur**a**ba**h**ah* or cost-plus financing. What the businessman got from the Islamic bank under this arrangement is the commodity he needed purchased by the bank at his request, with the promise to purchase it from the bank at a price higher than its purchase price, to be paid after a period of time. Each *mur**a**ba**h**ah* transaction created a debt. Compared to funds supplied on a profit-sharing basis, funds invested in *mur**a**ba**h**ah* transactions were safe. Within a couple of years of the introduction of *mur**a**ba**h**ah* in late nineteen-seventies, it conquered the landscape of Islamic finance, assigning *mu**da**rabah* or profit-sharing to a corner accounting for less than ten percent of the operations. Security of capital invested rather than magnitude of returns to capital ruled the roost, insofar as the fund owners were concerned. However, the proliferation of *murabahah* did give a big boost to Islamic finance during the coming decades. Their total number by year 2004 may have exceeded 200, spread over more than fifty countries.

The seventies also saw Pakistan officially committing to interest-free Islamic banking, followed by Iran and Sudan in the eighties. Meanwhile Malaysia developed a new approach of introducing Islamic banking and finance under official patronage, while the main system continued along conventional lines (Archer and Karim: 2002).[2] Indonesia followed in early nineties. This pattern later became the model for certain countries in the Gulf, like Bahrain, Qatar and the UAE. With the spread of Islamic financial institutions across the globe and enlargement of the size of funds managed by them, came the involvement of big players in the international financial arena like Citibank, HSBC and ABN AMRO.

Theory Following Practice?

In the development of theory of Islamic finance and banking, the late seventies and the eighties saw many significant contributions. *Murabahah* or cost plus financing, acknowledged only grudgingly in documents such as the Islamic Ideology Council of Pakistan Report on Elimination of Interest from the Economy,[3] earned full recognition as well as respectable rationale. The controversy around its legitimacy (Al-Masri: 1408H; Al-Masri: 1995; Vogel and Hays: 1998; p.9, p.143 and pp.241-44; Warde: 2000, p.133-34; Muhammad: 1996; Attiyah: 1407H)[4] or its efficacy (Al-Suwailem: 1998, pp.98-100) hardly had any impact on the speed with which it conquered the landscape of Islamic finance.

Practitioners of Islamic finance report they tried to push through sharing based finance but the results were not encouraging (Attiyah: 1407H, pp.108-12). The laws of the land did not (may be, could not) offer the financier same protection from false reporting of profits by the users of funds, even against outright fraud and deception, not to speak of delay in payment, as was offered to borrowers in a

[2] See especially, p. 132.

[3] Council of Islamic Ideology: 1980. See the Preface, and pp.8-9, Paragraph 1.16 & 1.17. Council of Islamic Ideology is a constitutional body in Pakistan. The importance of this report lies in its being the first of its kind in which a modern state addresses itself to the task of reshaping its financial system in accordance with Islamic teachings.

[4] Instructive indeed is the following from one of the leading Shari[ah scholars: “It should never be overlooked that originally, *murabahah* is not a mode of financing. It is only a device to escape from ‘interest’ and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of Islamization of the economy. And its use should be restricted only to those cases where *mudarabah* or *musharakah* are not practicable.” Usmani: 1998 pp.104-05.

lending contract. There seemed to be no room for collaterals. On top of all this there were projects to be financed that simply defied profit-sharing finance, like long term municipal plans to lay sewage-pipes in a city. In this case, ‘returns’ to the finance would accrue over many decades in the future while costs had to be met in the present. In the absence of a market on which shares could be floated, even medium term ‘*muqaradah* bonds’ designed to finance development of *waqf* property did not succeed (Khairallah: 1994). Recourse to trade based modes of finance became necessary. This happened with privately established Islamic banks in the Gulf area as well as with the Islamic Development Bank. By the early nineteen-eighties, *murabahah* had become the dominant mode of Islamic finance everywhere. As pointed out above, early theory had failed to pay due attention to trade based modes of finance and to the issue of capital protection. *Murabahah* seemed to fill the gap.

Meanwhile, the macroeconomic implications of Islamic banking were still being worked out on the assumption that it would be largely based on profit sharing. It was argued that financial intermediation based on profit sharing rather than lending will contribute to greater stability in the economic system in general and the financial markets in particular. It was also argued that such a system will be more efficient than the conventional system.

Analytical Developments

Analysts pointed out that the problems of moral hazard and adverse selection in sharing contracts with variable returns put them at a disadvantage as compared to debt contracts with fixed returns. That was the reasons behind the dominance of debt contracts with fixed returns, despite the promises of sharing (Khan: 1985; Khan and Mirakhor: 1987; Ali: 2001; Bashir: 2001).[5] It was also shown that a financial system based on profit sharing will be more stable than one dominated by debts. This was an addition to the earlier argument in favor of an interest-free system based on profit-sharing that focused on justice and fairness, one that had more resonance in a world experiencing great instability. By its very nature, the claim could not be supported by empirical evidence in a world where the conventional interest based system held sway leaving no exceptions.

By far the most impressive argument in favor of Islamic finance has been that it integrates the financial sector with the real sector. The debt propelled conventional system fails to do so. In the Islamic financial system there is an existing or potential real asset corresponding to every financial asset. Not so in the conventional system in which financial assets based on or derived from other debt-based financial assets go on multiplying, making the system more vulnerable to speculation leading to instability. Instability originating in the financial sector spreads to the real sector affecting balance of payments, employment, production and living standards. The theory is strong as a critique of the conventional system

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[5] Also, in the last mentioned, see comments on pp126-33, in the same volume.

but it could not make a head way in supporting the hypothesis that Islamic system will be more stable due to integration of financial and real sectors. The empirical evidence needed to boost its credibility can possibly come only if people convinced of it demonstrate it in a country or region. But can they?

Problems facing variable returns modes of finance were subjected to serious analytical scrutiny in the following decades. It was pointed out that in a market with both fixed return and variable return investment alternatives, the later would suffer from adverse selection, that the moral hazard involved in agency relations was sought to be faced with the help of fixed return modes and that the disadvantages of the variable option would lessen in repeated trial scenario as distinct from one shot trial. The reasons lay in the high monitoring cost necessitated by moral hazard and lack of social institutions supporting relationships requiring trust (Khan: 1985; Sadr and Iqbal: 2002; Al-Mudawi: 1985). Also came in focus innovative restructuring of profit-sharing contracts, such as replacing a uniform flat ratio by a graded one, the working partner's share increasing with the rate of gross profits (Kazarian: 1991; Haq and Mirakhor: 1987).

A great argument in favor of Islamic finance was its possible contribution to stability (Siddiqi: 1983b, pp.86-88). This was seen to come by way of synchronizing payment obligations of financial intermediaries with their revenue accruals. On the liabilities side this was based on a *mu**da**rabah* contract between the depositors into an Islamic bank's investment account. On the assets side the synchronizing characteristics would be maintained to the extent advances to businessmen were based on partnership or profit sharing. This synchronization made Islamic finance capable of absorbing external shocks far better than the conventional system was able to do. But this presumed sharing not debt relations (Mirakhor: 1995; Khan: 1995; Chishti: 1985; Zarqa: 1983; Khan: 1986).[6] What would happen to it in a system dominated by *mur**a**ba**h**ah*? It was argued that the flexibility that was crucial for the ability to absorb shocks rested mainly on the liability side that remained based on sharing. Introduction of *mur**a**ba**h**ah* on the assets side is not going to deprive Islamic financial system of all of its capacity to absorb external shocks as long as the liability side was based on sharing (Siddiqi: 2004, pp.97-100).

The advent of Islamic economics and the spread of Islamic banking and finance had widespread impact on the academia. Research centers, academic journals, seminars, conferences, introduction of teaching courses, even establishment of departments of Islamic economics in universities and writing of hundreds of doctoral dissertations, in the western universities as well as in the Islamic world. All announced the arrival of a new player on the world scene. The new development evoked responses, both critical and sympathetic, from eminent

[6] For an empirical study and references to earlier empirical studies, see: Hassan and Mazumdar: 2002, pp.13-25.

economists and social thinkers. From modest beginnings barely three decades ago, the Islamic financial industry was reported to be managing hundreds of billions of dollars by the year 2004.

It was not the theoretical developments, however, that shaped the further progress of the Islamic financial industry during its rapid development. That role was played by the market, which has its own dynamics. While theory aspired to prove Islamic finance was *different* from the conventional one, practitioners were busy searching for ways to make it *similar* to it. Convergence rather than divergence was the order of the day. Starting sometimes during the nineteen eighties, Shari[ah advisors focused mainly on designing ‘Shari[ah-compliant’ substitutes for financial products with which the market was familiar[7] (One can hardly resist the temptation to note that it was the time big Western players entered the field!). The way it is done is described in the next section.

3. CURRENT PRACTICES: STRENGTH AND CHALLENGES

Islamic Financial Products

We can divide Islamic financial products on the basis of their returns into variable return products and fixed income products. There is another division according to their being based on investment or on trade/sale. The two divisions would generally coincide, but exceptions exist.

The earliest Islamic financial product to appear on the scene was investment deposit with an Islamic bank or investment certificate issued by an Islamic investment company. (IIBI: 1995, pages 196; 24-27; 161-63 and 270) Both were based on profit-sharing/ *mudarabah* between the depositor/certificate holder (*rabb-al-mal*) and the bank/investment company (*mudarib*).

The next to appear were based on sale. *Murabahah* is sale with a mark-up on purchase price, payment being deferred. *Ijarah* is sale of usufruct of an equipment or real estate owned by the seller. *Murabahah* proceeds on the basis of a purchase order by a client who commits to buy the commodity involved. Originally introduced as contracts between two parties both *ijarah* and *murabahah* ended up in the form of securities. Bypassing controversies around operating leases versus financial leases (Siddiqi: 2005b) the market seized upon ***sukuk***. *Ijarah* bonds are investment certificates indicating ownership of a real asset subject to a lease contract yielding predetermined rent yields (Adam and Thomas: 2004, pages 7 and

[7] This is yet to be substantiated by research into the history of Shari[ah advisement. What provokes me to make the above assertion is the content of the *fatawa* Shari[ah issued during the first ten/fifteen years of Islamic banking in Sudan, Egypt and the Gulf. Compared with them, those given during the last 10-15 years (often difficult to get by and have to be inferred from the resulting product approvals) are very different in focus.

110-16).[8] They are very popular in the Gulf, unlike the ***s**uk**u**k* based on *mur**a**ba**h**ah* receivables that are considered valid only in Malaysia.

Other sale-based modes in Islamic finance are *salam* and *isti**sna[*** Islamic banks started by using them as bases for extending finance to agriculture and industry respectively. As they had no interest in taking possession of the commodities or the manufactured goods involved, there was usually a parallel contract reversing the flow so that the bank ended up with cash, larger in amount than that paid by it in the first contract.

In their more developed forms, the Islamic financial market now has ***s**uk**u**k* based on *ij**a**rah*, *salam* and *isti**sna[***. The buyers of ***s**uk**u**k* periodically get a predetermined income over and above the privilege of redemption at par on maturity, as in case of conventional bonds. There are efforts to develop secondary markets on which these Islamic bonds could be traded. If and when these efforts succeed, the same markets could handle variable return *muq**a**ra**d**ah* bonds or ***s**uk**u**k* based on *mu**da**rabah/mush**a**rakah*. The big difference would be in there being no guaranteed value on redemption as these investors are vulnerable to losses too, unlike those who invest in fixed income ***s**uk**u**k* mentioned earlier.

We have to examine, first how trade based modes of finance got in, and second, how bond-like ***s**uk**u**k* were constructed. Later on, we go on to economics: the impact of fixed income financial products on an economy aspiring to be Islamic.

The Malaysian Innovation

Malaysia introduced sale of debt (*bay**[** al-dayn*) in Islamic finance. It also brought in ***[i**nah*, a way of obtaining cash now against a larger amount of cash to be paid after a period of time, on the basis of sale contracts on deferred prices followed by buyback contracts at lower cash prices.

The first Islamic bank to come up in Malaysia, Bank Islam Malaysia Berhad, started operations in 1983. It is now marketing 'about 50 innovative and sophisticated Islamic banking products and services, comparable to those of their conventional counterparts' (http://www.bankislam.com.my). A second Islamic bank, Bank Muamalat Malaysia Berhad commenced operations in 1999. The Central Bank of Malaysia also 'decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches.' 'The long term objective of BNM is to create an Islamic banking system operating on parallel lines with the conventional system' (http://www.bnm.gov.my). This involves some interaction between the two systems which is overseen and organized by the central bank, Bank Negara Malaysia, which has an in-house National Shari[ah Advisory Council. An Islamic Inter-bank Money Market launched in 1994 plays a significant role in this regard. There is also *Mu**da**rabah*

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[8].For earlier projects, see Ahmed and Khan: 1997, specially, chapters 5 to 10.

Inter-bank Investment facilitating interaction between deficit and surplus Islamic banks.

The back-bone of the whole structure seems to be the Government Investment Issue (GII). It was originally based on 'the Shari[ah contract of *qar**d** **h**asan*, the holder being given back only what he/she gave. 'Any return on the loans (if any) is on the absolute discretion of the government'. But, in 2001, the basis of GII's issuance was further enhanced to accommodate the need to develop further the secondary market activities of the Islamic money market. An alternative concept of GII based on Sell and Buy Back Arrangement was introduced in June 2001. Under this arrangement, the Government will sell its identified assets at an agreed cash price to the buyer and subsequently buy back the same assets from the buyer at an agreed purchase price to be settled at a specified future date (http://www.bnm.gov.my). Here is how it proliferates through out the system: 'In the primary market, the Government will offer to sell specified nominal value of its assets through a tender process. Interested parties may place their orders to purchase the Government's assets through participating financial institutions (PFIs). PFIs that offer the most competitive price will purchase the Government's assets and subsequently, the Government will buy back the assets from the PFIs at par price equivalent to the nominal value, which will be settled at a specified future date or maturity. The difference between the selling price and the purchase price (nominal value) represents the profit of the PFIs. The obligation of the Government to settle the purchase price is securitized in the form of GII and issued to the PFIs. At maturity, the Government will redeem the GII and pay the nominal value of the securities to the GII holders. The GII constitutes as one of the financial instruments that is actively traded in the Islamic Inter-bank Money Market.' In this market, 'Eligible banking institutions are allowed to trade in the designated Islamic financial instruments, such as Islamic accepted bills and Islamic debt securities among themselves. GIC[9] are non-tradable but the players may exchange the papers among themselves based on the price issued by BNM.' (http://www.bnm.gov.my) It is rightly asserted that GIIs are considered to be liquid assets as their value and redemption is guaranteed by the Government.

A close scrutiny shows that despite differences among Shari[ah scholars, the above instruments, the 'sell and buy back' arrangement, and securitization and marketing of certain kinds of debts is proliferating not only in South East Asian countries, which generally follow the lead of Malaysia in Islamic financial innovations, but also in the Gulf area.[10] This is further evidenced by the recent developments in the ***s**uk**u**k* market.

The Ṣukūk Market

***S**uk**u**k* are investment certificates. Sometime they represent 'ownership' in the

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[9] Government Investment Certificates.

[10] See for example, BMA: 2002, pp.76-77.

assets underlying the issue. Those with variable returns are based on *mudarabah* or *musharakah*. More popular are those with pre-determined, fixed incomes. The simplest of these is the one based on *ijarah*, i.e., lease or hire. A building (or an oil tanker) is purchased and rented out, the money capital for the purchase having been mobilized by selling certificates. Owners of these certificates would be entitled to receive a portion of the rent income. These certificates can be traded in the market. There are ***sukuk*** based on *salam* or *istisna[* contracts. Also there are hybrid issues whose underlying assets are mixtures of these. *Murabahah* receivables being debt obligations are not considered fit for ***sukuk*** issue. But they have been accepted in such a mixture as long as they are in a minority. The ***sukuk*** market has recently gotten a boost by the entry of the Islamic Development Bank with its first issue, which is a hybrid that includes *murabahah* receivables (IDB: 2004; also see http://www.menafn.com/qn_news_story_s.asp?StoryId=97560).

In evaluating ***sukuk***, we have to look at three different dimensions: nature of the underlying assets, the contracts involved in structuring the issue and, the economics of it, i.e. how far these instruments serve the efficiency, equity and stability objectives of Islamic finance.

To begin with the obvious, all prohibited assets, like liquor, pork and casinos, are ruled out. Real estate, vehicles or equipment, etc., that are rented out, pose no problem as bases of *ijarah* bonds. Agricultural produce or manufactured goods to be available in the future may form the basis of *salam*/*istisna[* bonds. In case of *ijarah* bonds, a predetermined return can be promised on the basis of the lease contract already in effect. In case of the later also it is possible to do so if sale of the goods involved is allowed before taking possession, and, in effect, before their production. The case of *murabahah* receivables is, however, different. They are debt obligations that can be exchanged only at par value. They do not qualify as assets on the basis of which tradable bonds can be issued. Since this implied keeping the huge volume of *murabahah* receivables illiquid, a way around the disqualification was found by issuing of hybrids in which *murabahah* receivables form a minority. This brings these debt obligations into the Islamic financial markets everywhere. Previously they were being traded only in the Malaysian market. But it is not a ‘solution’ guaranteeing readily available liquidity to debt obligations, as their volume may be too large to be accommodated as minority components of hybrid ***sukuk***.

As practiced, a series of contracts have to be stitched together for launching ***sukuk***. A minimum of three contracts form the core of the structure to which two more are added because of the need to have a ‘special purpose vehicle (spv)’, which is generally a limited liability company, to handle an issue. The need for guarantee may bring yet another contract, and so on. The three contracts which form the core are: (1) between the owner of an asset and the certificate holders (investors) who purchase the asset from its original owner, thus providing the finance, (2) between the user of the asset who takes the asset on lease from its (new) owners, the certificate holders, and pays rents that are the source of investor's income, and (3) the institution intermediating between the two, first in transfer of ownership and then in effecting a lease agreement, collecting the rent and distributing it as returns on investment to certificate holders. (As we see later, in general the original owner of the asset and the user/lessee are the same entity). It is the financial intermediary that mobilizes funds by selling certificates, acquires the asset and puts the asset on lease. This last mentioned act generates the revenue from out of which come the returns earned by the certificate holders and profits/fees earned by the financial intermediary. Changing perceptions about the future prospects cause the market values of these ***sukuk*** to vary from time to time creating capital gains and bringing in the speculators.

Sell and buy back became involved in this process for a number of reasons. One of these reasons could have been the need for an asset to be there before certificates/***sukuk*** based on it could find customers (So, the spv, a financial intermediary, acquires ownership of the asset in order to be able to sell certificates based on the ownership). Yet, another could be the fact that finance obtained through sale of ***sukuk*** was intended for development related to the very asset that formed the basis of those ***sukuk*** As in the quote from Malaysian central bank above or in the launch of ***sukuk*** by the states of Bahrain (BMA: 2002, pp.76-78: Also http://www.ameinfo.com/66300.html) and Qatar,[11] an existing asset (A piece of land, in case of Qatar) owned by the state is sold to spv for cash (which is used for building a hospital, for example). The state takes back the land on lease (as it is needed to build the hospital) and the rental it pays is the revenue of spv from out of which the ***sukuk*** holders get their returns. Since the land on which the hospital is built is needed on long term, the state buys it back at the end of the lease period, as agreed in the very beginning at the time the land was sold in the first instance. In case of the Qatar issue, the buy back was at the original sale price after a period of seven years during which 'rent' is paid biannually for the same land. The point worthy of note is that the buy back contract does not belong to the three core contracts mentioned above. (Meaning, the lessee/user need not necessarily be the original owner) It is necessitated by other needs, including the need of the seller, the original owner, to have continuous control over the asset. That makes sale lease-back sale-back the standard in the current practice of ***sukuk*** based on *ijarah*.

The ***sukuk*** play a positive role in mobilization of savings on a vast scale. They benefit investors as well as those who have projects to finance that bear the promise of eventually generating sufficient revenue to meet the costs yet leave a surplus. Their proliferation increases the efficiency of the financial system. Also, they are capable of meeting credit needs of government and businesses in a manner

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[11] The Incorporation document can be accessed in pdf form through Google Search for Qatar Global Sukuk QSC. Also see, Adam and Thomas: 2004, pages.13; 87. For the state of the market in general and for future developments, see, Al-Amine: 2001 and Haneef: 2005.

that keeps credit supply linked with real assets. But are they equitable? The answer depends on the terms involved.

Islamic economists do not favor increasing role of debt-finance in the system. The greater the role of debt the less will be the ability of the financial system to absorb real shocks. It also limits the ability of monetary authorities to take corrective actions because of fear of instigating widespread defaults- as is the case of the USA in recent days. The proliferation of debt-securities also creates more room for speculation. This argument works against the inclusion of *murabahah* receivables in hybrid *sukuk*. It also works against the sell and buy back model of securitization. An obligation to sell back a purchased asset and the fact that this selling back has to be at a pre-agreed price, forces one to focus on the two 'prices', the one paid for the first sale and the other paid for the sell-back. The fact that the asset is to be taken back by the seller confers only a temporary ownership on the buyer. The fact that the second sale is done on a pre-agreed price (in the Qatar case it is equal to the first price) makes one focus on the two amounts of money, the one paid at sale time and the one paid at the time of sell back. The asset going back to the seller on lease makes the rent paid appear being paid not against the asset but against the cash paid for it. It is money now for money in the future, periodical payments being made by the beneficiary during the intervening period. In the Qatar case the land remains under the control of the state, first as owner then as lessee, then, following the buy-back, again as owner. It is only during the technical gap between selling (to svp) and taking the land back on lease that control vests in another entity. The fact that this entity is created by the state, and that the svp is committed to lease back the land, plus the buy back agreement, makes the whole procedure akin to lending a sum of money for an annual payment till the capital is paid back. With an asset in between, fixed or variable return *sukuk* (of the type currently in practice) replicate the conventional bond based on lending and borrowing relationships. The fact that the paper results from a series of distinct but stitched together contracts of sale and lease makes a difference in law. But it is hardly of any effect on economics. The economic role of *sukuk* would be similar to that of conventional bonds. The difference in economic consequences, if any, has to come from the involvement of real assets in the process. We proceed to examine this aspect more closely.

There are a number of problems with the conventional bonds:

First, the return paid to the bondholders bears no relation with the actual productivity of the capital raised through the bonds. Second, no real asset may correspond to the financial asset called bond. Third, separation of return from actual outcome opens the door to corruption as it misaligns the interests of the financiers and the project owners, i.e., the business that is being financed.

Fixed as well as variable income *sukuk* share the first feature with bonds. They may not share the second feature, depending on the nature of underlying assets. It is an advantage for *sukuk* to correspond to real assets. This is in consonance with the characteristics of Islamic finance to integrate the financial sector with the real sector. This feature of Islamic finance contributes towards greater stability. But the first feature, that returns to *sukuk* bear no relationship with actual productivity of the funds raised through their sale, is a disadvantage. In fact it must be regarded as a retrogressive feature as it impinges on the most important of the three objectives of Islamic finance noted above, equity.

Cash or money capital itself has no productivity. It is the goods and services acquired by spending it that are productive, though this productivity is surrounded by uncertainty. Should *sukuk* be representing goods and services they would represent something productive, capable of yielding a return. If the return to *sukuk* is a function of the actual productivity, it may be characterized as a fair arrangement. If the return is independent of the actual productivity its fairness is not assured. Even when no production takes place, and therefore there is no profit to be distributed, *sukuk* holders will be given the returns written into the contract. This arrangement makes the users of real assets bear all the uncertainty involved in productive enterprise. They have to bear all the losses. A system in which those who supply money capital are assured of profits but those who use money capital, converting them into goods and services needed in productive enterprise, bear all losses if there are losses, is not just and fair. Justice and fairness requires that uncertainties attending upon productive enterprise be shared. Justice and fairness require that losses, if and when they occur due to these uncertainties, be borne by those who claim the profits when there are profits. If the arrangements under which productive enterprise takes place are not fair the social fabric is damaged. In the long run an unfair and unjust arrangement produces conflicts and disrupts peace.

At the present it is not possible to conduct empirical studies on the effect of *sukuk* on the fairness of a system as *sukuk* form an insignificant part of capital markets. But since this particular characteristic is shared with conventional bonds, conclusions about bonds drawn in this respect can be applied to *sukuk* as well.

Sale of debts at market determined prices amounts to treating them as goods and services. But they are not. Debts are sums of money, to be paid at a future date. Sale and purchase of debt is like sale and purchase of cash now against cash at a future date. That is *riba* prohibited in Islam for reasons of equity and human felicity discussed elsewhere (Siddiqi: 2004a, Chapters 1-4). A financial system that allows sale of debts at market determined prices is no different from a financial system that allows exchange of money now with a different amount of money at a future date. Such a financial system can hardly bring in the advantages on account of efficiency and stability that are hallmarks of Islamic finance.

Murabahah receivables are also debts. But they differ in their origin from debts incurred by borrowing cash. They originated as deferred prices of specific goods and services. There are goods and services corresponding to these debts unlike a debt resulting from lending cash to which no real asset corresponds. Should they be treated like debts incurred by borrowing cash, insofar as their marketability is concerned? *Murabahah* receivable are traded in the Malaysian market but not in the Gulf.

Sukuk based on *murabahah* receivables were not generally acceptable in the Islamic financial markets. But now *murabahah* receivables have been brought into the market as minority components in hybrid ***sukuk***. Even if acceptable in Islamic law it may not be good economics. It is part of an approach that accords liquidity very high priority, to the neglect of other dimensions of financial markets and real economies, especially their stability. Liquidity is good as long as it serves production and exchange. But it can easily become an instrument of speculation if it is not constrained by regulations like prohibition of *riba*.

Tawarruq[12]

Conventional financial system has the capability of providing cash for those who want it, provided they are willing to give back more than they borrow and are able to provide a collateral or guarantee. Islamic financial system as projected in its early theoretical phase does not have this facility. Since loans cannot carry interest, they are regarded as an act of charity. Charity can hardly form part of a market driven financial system focused on generating profits, so it was left to the voluntary sector comprising *zakat/sadaqat* and *waqf*. But in view of convenience, the need was seen for locating such a provision within the financial system. It was suggested that interest free banks enjoying the privilege of using part of the demand deposits for profitable investments be obliged to provide some loans free of interest (Siddiqi: 1983 b, pp.61-64).[13]

But the practice of Islamic finance during the last 30 years failed to respond to this need in this way. Instead they were advised by some Shari[ah scholars to take recourse to a method used earlier to ease out individual difficulties.[14] One who needs cash first buys an item on credit then sells it for cash. Done independent of one another, the one who bought the item for cash being a different person than the seller on credit, it seems a needy person's method of last resort and would probably be quite old in practice. But in its current practice in a section of Islamic financial market it has assumed an institutional form. The client approaches the Islamic financial institution (IFI) with a wish and a collateral and comes back with the desired cash after signing a number of papers. One signature would attest his or her purchase on credit, through the agency of the IFI, a motor vehicle or a certain

[12] Not much literature is available on the subject. But the following can be read with benefit Kuwait, Ministry of Awqaf: 1984, vol. 14, pp.147-48; Elgari: 2004; 2002; Zarqa: 2004b; Al Suwailem: 2004; 2003; Al-Sharif: 2002; Saati and Muhyuddin: 2002; Hafiz, et al.: 2003 and El-Gamal: 2005.

[13] For some recent proposals for solving this problem, see Zarqa: 2004a and Elgari: n .d.

[14] One is reminded of a similar response to some other 'difficulty' earlier. See the literature available on *Bay' al-Wafa*, especially: Kuwait Ministry of Awqaf: 1984, vol.9; Also, Al-Lubnani: 1986, p.223 and pp. 67-68.

quantity of a precious metal. A second signature will assign the IFI the task of selling that same vehicle or metal on behalf of the client. The third signature will witness that the sale has been effected and the proceeds handed over to the client. As we observed in case of a certain type of ***s**uk**u**k*, it is money obtained now for more money to be paid later. The real asset involved in the process is no more than a dummy. In actual practice too, the same asset facilitates numerous such transactions with no depreciation suffered.

Whatever the legal opinion, the economic role of the transaction can hardly be different from that of lending and borrowing money. As the credit price on which the client buys the asset is invariably higher than the cash price on which the asset is sold, *tawarruq* (as the method is called) is functionally identical to interest based lending and borrowing. Islamic economic analysis has shown that, even in the case of a loan for business purposes, exchange of money now with more money later is unfair because of the uncertainty that accompanies the passage of time. Money needs being converted into goods and services before it can enter the process of production---the source of possible growth/value increase. The results of the process of production have to be reconverted into money before money can be paid back to the one who gave it in the first instance. This amount of money, resulting from conversion of the product into money, may be more than, equal to or less than the original amount of money.

A system that arranges for exchange of money with more money will suffer from the inequity that this exchange involves. We have also seen that the matter does not stop here. A system built around such exchanges will be un-stable. The money the bank practicing *tawarruq* advances to its clients comes from out of the deposits made with it. Whether it is withdraw-able on demand or is in the nature of a time deposit, it has to be paid back. It can be paid back only when the clients payback to the bank (whom they owe the 'price' of the asset on the purchase and sale of which *tawarruq* was based).The important point is, there is no synchronization between the two payment schedules. From the macroeconomic point of view, the position of Islamic banks practicing *tawarruq* is exactly the same as that of the conventional banks giving (interest based) loans to their clients. They lack the shock absorbing capacity that would have come if their operations were based on profit sharing. Given its inequity and instability, a *tawarruq* based system will also be inefficient. Like interest based debt financing there is no integration between the real sector of goods and services and the financial sector. No real asset corresponds to an interest bearing loan .In the same manner, no real asset corresponds to the debt obligation created by the first of the three transactions completing a *tawarruq* deal. As we have noted above, a single piece of real asset can form the basis of innumerable successive *tawarruq* deals.

Economic Matters

Islamic law in matters related to market transactions and the like has always taken the economic consequences into consideration. This is because economic consequences are an essential part of *maslaha*. If the stitching together of a number of contracts, each valid on its own, results into consequences specifically declared to be unwanted in Islam (as evidenced by prohibition of other deals leading to the same consequences) one must look back. This writer feels those who introduced *tawarruq* failed to take the economic consequences into account as did those who launched ***s**uk**u**k* in whose case the involvement of real assets is nominal. The matter does not end on evaluation of individual instruments. Each wave of convergence towards conventional finance needs to be evaluated in the light of equity, stability and efficiency for which Islamic finance stands. Predominance of *murabahah* in bank financing, proliferation of ***s**uk**u**k* with nominal links with real assets and introduction of *tawarruq* as means of financing consumers and working capital needs of business would result in the same debt-ridden environment from which Islamic finance was supposed to rescue by introducing sharing and asset-based instruments. Instead of moving away from debt proliferation and financing unrelated to real assets we are moving towards debt proliferation and asset unrelated financing. Islamic finance does need extension of Islamic financial services to all sectors of the economy, including the consumer sector. But this is to be done within the paradigm of Islamic economics focused on justice and human felicity not at the cost of it. That is the real challenge, not the replication of conventional debt instruments under Arabic names.

This leads us to the need for a redefinition of the term 'Shari[ah-compliance'. It should not be confined to analogical reasoning and matching new with old, approved contracts. Considerations of *maslaha* and *maqasid al*-Shari[ah should be an essential part of the comprehensive definition. Shari[ah advisors educated in traditional Islamic sciences only can hardly do so as it requires a grasp of economic analysis, micro as well as macro. Ad hoc consultation of trained economists by Shari[ah Advisory Boards or *Fiqh* Academies has failed so far to serve the purpose. A stronger involvement of trained economists and social scientists is necessary. The involvement of the financial community as well as those whose interests are involved, i.e., investors and customers, is also a must in an assessment of *masalih*. The institution of Shari[ah advisement needs an overhauling after a thorough examination of the issue. Nothing can be a substitute for free open academic discussion in this regard.

Islamic Insurance

Islamic insurance companies appeared on the scene as early as the second half of nineteen seventies, as a necessary complement to Islamic financial institutions that wanted to make profits by going into business, including imports and exports (Fisher and Taylor: 2003). But their expansion into other sectors was hampered by a traditional approach focused on microeconomics of the contracts involved (Siddiqi: 1983a; Fadel: 2002).[15] Modern insurance is based on the idea that what is

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[15] Early controversies have been noted elsewhere, see Siddiqi: 1981, pp.26-28.

uncertain with respect to one entity may cease to be uncertain with respect to a very large group of similar entities. The challenge is how to take advantage of this property of our environment. Experience till date gives us the lesson that exclusive reliance on any one method, e.g., social insurance, state insurance, cooperative insurance is no good. There is a role for commercial insurance too. However, as Kenneth Arrow has pointed out, this kind of 'insurance is a very subtle kind of contract; it is an exchange of money for money payable contingent on the occurrence of certain events' (Arrow: 1992, p.221). It is this subtlety that has been causing problems with contemporary Islamic jurisprudence that lacks the conceptual tools to handle macro phenomena. In order to avoid endorsing contingent payments which obviously involve *gharar* (albeit of a special kind), they have tried to model insurance (*takaful*) on altruistic giving (*tabarru[*). *Takaful* companies have filled the gap created by rejection of commercially organized life insurance (Fisher and Taylor: 2003; Moore: 1997, pp.60-66; Billah: 2003). But reciprocity (give in order to take) is so obvious in the *tabarru[* (donation) based model of *takaful*/insurance, that it runs the risk of losing credibility as a clean Islamic contract, joining the ranks of *tawarruq* and the newest Islamic bonds/*sukuk*. As a matter of fact, the property of our environment which makes *takaful* possible and effective is the same as behind all kinds of insurance (i.e., the kind of cooperation relied upon in *takaful* would not solve any problem without the property of human environment conceptualized by the law of large numbers). The form of organization chosen to take advantage of the law of large numbers does not change the reality. We can make insurance a not-for-profit activity (provided we can ensure efficient management), but that does not change the essential nature of what is being done.

There is some basis for suspecting something foul going on in the name of insurance (Arcy: 1994). Gambling-like practices in the insurance industry have not been uncommon. The history of insurance is a history of the society, through regulators, trying to prevent gambling in the garb of insurance. The process still continues. But humanity can hardly afford to lose an opportunity of risk management only because it is vulnerable to misuse.

Part of our problem is the failure to realize the crucial difference between what is gambling and what is not[16] (even though it may be possible to manipulate it so that it becomes gambling). Gambling inheres into games of chance played for a gain. The activity is created or voluntarily entered into. It is not like the chances one has to take in the ordinary business of life, i.e. the risks and uncertainties attending upon sale, purchase, investment and production, even upon travel,

[16] On this crucial distinction see, Rosenthal: 1975, "…gambling is assumed to be restricted to contracts between two or more humans beings which involve the exchange of money or other valuables upon the uncertain outcome of a staged event." "Staged" is the crucial word in this definition pp.1-2. On this point as well as on the subject as a whole, see, Bakar: 2002, pp.233-53. See also the comments by Kamali [pp.254-58] and Zarqa [pp.259-62].

choosing a career or choosing your doctor. The unambiguous examples of gambling are bets in horse race, in games of cards or on spinning a roulette wheel. The financial risk involved in gambling could have been avoided if the gambler wanted to do so, by not playing the game. Not so in the case of risks in productive enterprise, investment or traveling, for to avoid financial risks in these cases one has to give up not a game but the 'ordinary business of life'.

3.1 Unresolved *Fiqh* Issues

We have already alluded to many controversies surrounding *fiqh* rulings about certain Islamic financial products like ***s**uk**u**k* and *tawarruq*. In this section we wish to deal with the *fiqh* of Islamic finance at a more fundamental level. There are three issues to be noted. Firstly there is the methodology issue which in effect boils down to analogical reasoning based on contracts already discussed in *fiqh* books of the old versus giving a ruling based on *ma**s**laha*—the benefits involved. Second comes the problem caused by the changing concepts of certain terminology used in *fiqh* literature like *milkiyat* (ownership) *gharar* (hazard; uncertainty, deficient information), etc. Thirdly, there are specific issues like delay in payment, supply of cash to those who need it, investments in which capital is protected, sale of debt, financing education, etc., etc. It is beyond the scope of this survey, and the limited capability of this writer, to attempt a thorough discussion of these issues. We will, however, try to highlight the main points involved in order to facilitate further discussion.

Maqāṣid

Islamic Jurisprudence has two parallel but complementary methods of dealing with newly arisen situations not covered by textual laws: analogical reasoning and rulings based on *ma**s**laha*. Sometimes the recourse to the latter is necessitated by the fact that a ruling based on analogical reasoning violates the spirit if the Law, running counter to its objectives. There are ample examples of this in the literature along with convincing arguments on the primacy of the objectives of Shari[ah the *maq**as**id al*-Shari[ah (Siddiqi: 2004c; Attiyah, J: 2004; Ibn al [Ashur, M. al-Tahir: 1978; Adhami: 2005, Hashem: 1996). A glance at the novelty and complexity of modern finance should convince that *fiqh* rulings seeking to adapt modern financial practices to Islamic norms or replace them with Islamic alternatives would require frequent recourse to the latter method rather than the former, the one based on analogy. But as elaborated elsewhere (Siddiqi: 2004b) exactly the opposite has been true. With a few exceptions, *fiqh* rulings originating from he Shari[ah advisors to Islamic financial institutions have been based on analogical reasoning based on Islamic contracts discussed in old *fiqh* books. The consequences are not good. There are good reasons to believe that a revival of the second methodology will do lot of good to Islamic finance. Some of these will be hinted at in what follows.

One problem with social thinking a thousand year ago was its lack of macroeconomic concepts (as a matter of fact, many of these concepts presume a fully monetized economy).

Macroeconomic concepts deal with aggregates like total produce of a society, and rates relating to the entire population like savings, employment, etc. It so happens that the benefits to society of a particular financial dealing or institution cannot be ascertained without involving these concepts. The same applies to possible harms from a financial practice. A *faqih* called upon to judge the Islamic acceptability of a new financial dealing with no counterpart in received body of Islamic law would naturally tend to measure is *masalih* and compare them with any *mafasid* involved. But he or she cannot do so by focusing at the contracting parties only, i.e. at the micro level, as a number of social aggregates are also involved. Lack of macro tools make the *faqih* withdraw into the familiar territory of giving a ruling based on similarity to some known contract/practice, howsoever flimsy the similarity. It is urgently needed to remove this deficiency by equipping modern Islamic jurisprudence with newer tools adding to and supplementing rather than replacing the valuable tools we inherited from our rich past.

Redefining Concepts

Another issue relates to concepts that evolve over time and call upon review and updating of the rules given in old *fiqh* texts .One of the most thoroughly discussed concepts in Islamic jurisprudence is that of ownership/*milkiyah*, with its many types, e.g. perfect (*tam*) and imperfect (*naqis*), and categories, e.g. public and private, etc. But ownership goes on changing in meaning and scope with appearance of new things to be owned and other changes in environment. What does ownership of an ordinary share in a modern corporation mean? Does the meaning change when we move from a manufacturing firm to a consultancy, producing and selling nothing other than ideas? What does the ownership of a patent involve? Can time-sharing be adequately dealt with in the framework of *shirkah* rules?[17] And how best can people of the world benefit from the wealth under the oceans, which calls for heavy investments requiring involvement of private capital which may necessitate conferment of some kind of ownership rights. There is no limit to developments calling for redefining the concept of ownership and expanding it to accommodate new situations.

The concept of *gharar* provides another example of what needs to be redefined and broadened in scope and purpose. Generally translated as hazard, risk and uncertainty, it is mostly understood in the light of its examples found in the *sunnah* of what was actually regarded as *gharar* by the Prophet (pbuh). Selling fish while still in the pond, actual quantity of the catch unknown, or an unborn animal still in its mother’s womb, was prohibited. Lack of sufficient knowledge/information was

[17] See http://www.iifmc.com/presentations/16May/IIFM_-_Sokouk_a_Money_Market_Instrument_-_Kingdom_of_Bahrain.pdf

correctly regarded as the essence of a *gharar*-ridden situation. Since life is full of situations in which information is deficient, a distinction was made between small amount of *gharar* and large amount of *gharar,* as the latter was likely to result in disputes. Those involving the former were permitted in the larger interests of the people concerned. That solution served the cause of justice and fairness, the relevant *maqasid al*-Shari[ah, well for many centuries'. But modern life brought to light new kinds of *gharar* and new kinds of solutions. Among these is the kind it is possible to characterize as insurable '*gharar*'. In this case knowledge is deficient insofar as individual cases are concerned, but sufficient when large numbers of similar cases are considered together.

The third category of *fiqh* issues requiring further discussion and research comprises specifics like sale of debt, penalizing delay in payment, financing education, profitable investment with guaranty of capital, supply of cash to those who need it, etc. Some of these, like sale of debt, have already been discussed above, the others are briefly described in what follows.

3.2 Delay in Payment

The issue of handling delay in payment, whether of loans or *murabahah* and other receivables has been vexing enough, and with the introduction of *qard hasan,* for consumers as well as for business, it becomes very important to find an efficient solution. Those already on the table leave much to be desired (Siddiqi: 2005a; Chapra: 2000, p.302 and fn.116 on p.350).

3.3 Financing Education

It takes 12 years of schooling and another 4 to 8 years of college and advanced studies to equip a child to face the world with self- confidence that he or she can make a decent living out of his or her own earnings. Parents and guardians need reliable methods of using their savings to finance their children's or ward's education till the end, a period that might extend well beyond their earning lives. Contemporary practices are all based on interest, calling for an alternative that is free of *riba* and excessive *gharar*.

Student loans are a big need of a modern society in which college education and professional training is costly and takes a long time. Financed at the right time it is able to pay back with a return, but Islamic finance has yet to find a generally acceptable mechanism. Initiatives based on *murabahah* or *salam* in services need being examined and standardized.[18]

[18] Possibility of such initiatives was conveyed (by e-mail) to the author by the scholar Mohamed Ali Elgari, saying; "Theoretically, a financial institution can intermediate between a student and his college. A 'package' called education is purchased for cash (tuition) by the financial institution and sold to the student on deferred payment basis". A committee appointed by the Islamic Society of North America (ISNA) is currently looking into the possibilities. Reports that some IFIS brought some relevant products into the

3.4 Investing with Guaranteed Capital

Not everybody is in a position to take risks. Many savers cannot afford to take any risk with their meager resources hardly sufficient to support them till the end. Add to these social institutions like *waqf* that should not be taking risks with their trust monies. Retirees, widows with a savings nest, etc. need protection against losing their capital. In the past the need was realized with respect to *waqf* (charitable endowments), leading to the emergence of cash *waqf*s (Cizakca: 2000 and 2002). There is nothing in Shari[ah against the desire to protect one's capital yet aspire for some increment in one's wealth as long as one keeps away from lending with interest. There have been some weak efforts to explore the possibilities (Khan: 2003; Al-Tijani: 2003; Elgari: 2003) but we require greater efforts. One can also explore the possibility of investment funds that are managed on a 'no loss' basis. The permissibility of third party guarantee (Kahf: 1989) has opened the way for initiatives like the Royal Bank of Canada Shari[ah Compliant Investing.[19]

3.5 Cash for the Needy

In our critique of *tawarruq* we have acknowledged the need for a means to supply cash to those who might need it. Can Islamic finance handle the issue? Current thinking takes two routes, first a revival of the idea of obliging Islamic banks (and possibly other Islamic financial institutions) to devote a small part of their resources to giving interest-free loans- *qar**d** **h**asan* and second, some *zak**a**h* based arrangement. Since both methods were tried in the past, even though sporadically, we need study early experiments before proceeding further. It remains to be explored whether a linkage can be forged between modern Islamic financial institutions (IFIs) and the endogenous Islamic institutions of *zak**a**h* and *awq**a**f* (charitable endowments). This implies demolishing the walls of strict separation between profit seeking and charity that exists in the conventional environment. Assuming the two are not quite unrelated to one another in human psyche, it should be possible to have arrangements for consumer loans with no interest charged. Some current proposals envisage obliging Islamic banks to earmark a small fraction of their resources for supplying interest-free loans to consumers, repayment being guaranteed by a third party, let us say the central bank. Also any losses sustained on this activity are to be compensated out of a reserve built on charitable funds invited for the purpose (Zarqa: 2004; Elgari: n.d)

As regards loans for business, for working capital needs for example, they don't mix with charitable arrangements. The first step is, to identify business needs for which neither sharing nor *mur**a**ba**h**ah* and other sale based modes of financing can do, which can be met with cash only. Next we need design a *qar**d** **h**asan* for

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market need being checked. Also see www.alsilami.ae for Dubai Islamic Bank Fatwa #.41/12/719/2002 dated 11 Oct.2002.

[19] For details see<http://muslim-investor.com> or www.royalbank.com.

business' project in which all the three sectors, private sector, public sector and the voluntary sector are involved. An institution launched for the sole purpose of supplying *qar**d** **h**asan* to business may have its initial capital contributed by the state, the central bank and other IFIs. It may be authorized to accept donations from the public also. Guarantee against non-payment may be provided by another institution, funded, among other sources, by *zak**a**h* money. The institution may be allowed to invest its idle funds into government securities.

Social Relevance

One complaint against Islamic finance as currently practiced is that it fails to cater to the needs of the community and to contribute effectively to economic development of Muslim countries and communities. If the main problem of developing Muslim countries and communities is poverty, Islamic finance has had little to offer towards its solution. It is argued that guided mostly by the urge to make profits for its clients, most of the funds mobilized by IFIs end up in western financial markets. Some regard it as a proof that moral considerations can never guide business enterprise, that the opposing pulls and pressures of God and Mammon can never be reconciled (Kuran: 2004). Once again the challenge is whether the walls of separation between profit motivated activities and charitable or welfare oriented activities can be demolished. If it is the same people who make profits in business as well as make charitable endowments and give away part of their wealth to the needy, can we envisage institutions that accommodate profit motive and serving social goals within the same framework? Does history offer any clue? Do we have contemporary examples?

Even in the contemporary societies examples of 'mixing' moral and business motives abound. Socially responsible investment (SRI), ethical investment and environmentally conscious 'green' investments handle billions of dollars (Lewis and Warneyrid: 1994; Salmon and Helmut and Associates: 1998; Stark: 1995; Zamagani: 1995; Mansbridge: 1990; Powelson: 1998; Vackhani and Smith: 2004). We need to study their experience in detail. There seems no technical impossibility involved. It seems more like a matter of will and ingenuity. How can both be missing from the contemporary practice of Islamic finance? Without venturing to guess about the will, it is ingenuity that may pave the way out of the current impasse. An investment in poverty removal now may bring huge possibilities for profit making tomorrow as the market expands. There is a need for Islamic financial products that protect against risk of loss while motivating wealth owners to finance projects that empower the poor and improve their economic environment.

What shall we call it, an unresolved *fiqh* issue? A failure to realize *maq**as**id al*-Shari[ah in a changing environment? In any case it requires stepping out of the current framework of thinking to face new realities and accommodate new priorities. Even from within the known techniques, there are some like mutuality whose potential for meeting this challenge has yet to be fully discussed and tried.

3.6 Research Agenda for the Future

What follows is essentially a corollary of what has been noted in the survey above. But a few words are needed to provide a clearer perspective. Islam places a high value on life and regards wealth as a good instrument for life protection and enhancement. Knowledge as well as experience in the form of social and economic history has demonstrated the important role finance plays in wealth generation. Also, financial services cannot follow rigid patterns. They must evolve with changes in environment. The contemporary environment characterized by the revolutionary developments in communication and transportation and the consequent globalization of markets, including the financial markets, calls for quick and efficient responses from the Islamic financial community. It is not necessary for all responses to be based on analogical reasoning built on past *fiqh* rulings. *Maslaha* based reasoning and *maqasid* oriented arguments provide a wider scope. Either way the new rulings must pass the test of being in harmony with the Islamic economic paradigm and serve the vision of an equitable society.

The literature on Islamic banking and finance argued that Islamic economic paradigm and the Islamic vision of an equitable society favored modes of finance based on sharing. Hence sharing modes of Islamic finance deserve an in depth study. The problems faced in their actual practice during the past need be recorded with proper evidence. We need to see what of these are rooted in local laws, etc., and what are of a universal and long-term nature. The problems of adverse selection and incentive incompatibility inherent in agency relations of *mudarabah* type need analysis. What can be done to meet or mitigate these?

The issue of monitoring costs raised in earlier studies needs being compared with the possible gains in fairness. Suggestions relating to a graded scale of sharing ratios instead of a flat rate, of a third party guarantee of the principal in certain cases and of hybrid contracts having sharing and non-sharing modes as part of the same package, need be thoroughly examined. The research must also make a detailed survey of the contemporary practice of sharing modes in conventional framework and the legal details related to venture capital financing. It has been rightly noted that: ‘The original Islamic banking philosophy is fully consistent at once with the principles of the global economy equity orientation, market led growth etc., and the innovative logic of international finance. Insofar as partner ship finance was the initial *raison d’etre* of Islamic banks, its revitalization could provide Islamic banks with a significant competitive advantage.’ (Warde: 2000, p.201; Warde: 2002, pp.193-203).[20] It is high time efforts were made for a systematic enquiry into why this opportunity is being missed.[21]

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[20] On the disadvantages of moving in the reverse direction, see: Muljawan, ‘An Analysis of Potential Systemic Costs in an Islamic Banking System’ in Khan and Muljawan: 2006. Also in the same volume is the perceptive study by El-Hawary, Dahlia Anwar, Wafik Grais

The trade based modes of Islamic finance need looking into from economic viewpoint in order to ensure that they fit in the Islamic economic paradigm. Focus of attention should not be only microeconomic considerations of cost and efficiency, but also the macro-economic impact related to stability and equity. Furthermore we need clearer understanding of ***sukuk*** versus conventional bonds in terms of economics, irrespective of their permissibility.

It is also necessary to go deeper into the social and economic consequences of debt finance. Are Islamic economists correct in regarding debt proliferation in the economy to be the root cause behind the recurrent crises and the rampant speculation that characterizes the conventional economy? Are they correct in considering debt finance as essentially bad? Are we not projecting the values fit for a primitive agricultural society on to an advanced industrial, rather knowledge based, economy in which credit creates demand that propels production and employment that generates the income needed to pay off the debts incurred in the first phase? Does Islam have any aversion to proliferation of debt *per se*?[22] Is it possible to arrange easy credit for all sections of the population yet avoid proliferation of debt?

4. RISK MANAGEMENT

As addressed in Khan and Ahmed (2001), risk management in Islamic framework is probably the most important subject of research from a practical point of view. The reason is plain to see: the scope and nature of risk has undergone drastic changes with lengthening period of production, predominance of services over agriculture and manufacture, and globalization. Early precedents do not suffice, nor does *fiqh* literature offer much help. Most of the recent innovations in the financial services industry revolve round risk management. But Islamic finance is severely constrained by a timid approach to insurance and the inability to deal with *gharar* in a modern environment in a manner that serves the objectives of Islam as well as meets the demands of efficiency.[23] As at present, a wholesale rejection of modern techniques like hedging, futures, options, derivatives, etc., results in an inability to enter into long term commitments, trapping Islamic finance into short-term operations. This has damaging consequences not only for the Islamic financial community but for the Muslim peoples as a whole.

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and Zamir Iqbal, entitled 'Regulating the Islamic Financial Institutions: The Nature of the Regulated'.

[21] For the challenges involved, see: Al-Omar and Iqbal: 2000, pp.37-56.

[22] Few recent works address this issue directly. Among the ones who do, see Abdul Hamid: 2002, pp. 89-104; Kahf: 2003, p.173; Al-Suwailem: 1995.

[23] Some headway has however been made recently. See, Kamali: 2002, Ch. 8; Obaidullah: 2005 and 1999; El-Gamal: 2001; Al-Saati: 2003; Al-Suwailem: 2002, pp.15-30. See also comments by Monzer Kahf [pp.31-36] and Mohamed Ali Elgari [pp.37-39].

Risk and uncertainty are inalienable features of our life. They have always been so. Some risks are best handled by social institutions, like the family and the community (Kay: 2004, pp.234-46). Some other are taken over by, or handed over to, state. Some risks have a market, i.e., they are amenable to an exchange based solution, by way of insurance, commercial or mutual. But this division keeps changing over time. What is needed is an in depth study of all kinds of risks and all possible ways of dealing with them, and their macroeconomic consequences. We should look back to Islamic history, as well as to the history of other peoples to find out what can be learned from the past experience of mankind in managing risks. We must also examine all contemporary ways of risk management in order to arrive at solutions that suit the Islamic economic paradigm. Only then we can find the best ways to manage *financia*l risks in an Islamic framework.

The point to emphasize is, we cannot treat the subject of risk management in an ad hoc manner. It may not be sufficient to find Islamic ways of risk management by *purifying* conventional ways of risk management i.e. by ridding them of *rib**a*** and *gharar*. A comprehensive framework has to cover social as well as business arrangements and should not leave out any risks that people care about. I think this kind of research must be organized and funded by institutions like the Islamic Research and Training Institute as the ‘market’ is incapable of doing that (It is not in the interest of any one Islamic financial institution to invest resources in that kind of fundamental research. The relation of the outcome of the research with the practical issues in risk management facing the institution appears remote, sometime uncertain. It is a kind of ‘public good’. Beneficiaries can be called upon to cooperate in its provision, but someone has to organize its production). The poverty of Islamic economics today partly emanates from its failure to attend to this kind of need for fundamental research. Like other topics calling for fundamental research, research on risk management too has theoretical/analytical as well as historical and empirical dimensions. The subject cannot be exhausted in seminars and board meetings.[24]

4.1 Hedge Funds

The launching of Shari[ah Equity Opportunity Fund[25] in October 2004, after two years of intensive work and with the seal of approval from some of the leading Shari[ah scholars on finance, continues and reinforces the trend noted earlier: that of replicating conventional finance. This can hardly be characterized as bad by

[24] Attention paid to the subject lately has resulted in quite a few insights. One can usefully consult: Khan and Muljawan (eds): 2006. Special attention needs to be paid to the two areas which Khan singles out for priority research in the concluding paragraphs of his ‘Introduction’. These are: Foreign exchange risks and securitization. See also: Fadel: 2002, pp.82-88, and Khan and Ahmed: 2001.

[25] See the Banker Middle East (Dubai), 2003 in the issue for April 2003, available at www.bankerme.com; Also, <www.iiff.net> for the Panel discussion of Shari[ah scholars on 23 February, 2005.

definition, but the common perception that Islamic finance was there to correct the imbalances of conventional finance makes one look askance at every step towards convergence.

Hedging Contracts have assumed special importance in recent days. From a modest figure at the beginning of nineteen nineties, the number of hedge funds has grown to 8000 by the year 2004 (Horwitz 2004, p.xix).[26] They may be managing assets worth a trillion US dollars.[27]

The difference between hedging and gambling is clear.[28] But Hedging, described as: 'to enter a transaction intended to protect against financial loss through a complementary price movement' is different from hedge fund, described as: 'an operational investment company organized as a limited partnership using high risk speculative methods to obtain large profits'.[29] The relation between the two, hedging and hedge funds is difficult to understand. For Islamic finance the decisive factor should be: what *ma**s**la**h**ah* is served by hedge funds? Is it only making profits for investors, or there are systemic advantages too? One has to look into the details of Shari[ah scholars' arguments (not available to this author) to find out whether the economics of hedge funds has received due attention.

This is important as there are dissenting voices relating to the economic role of hedge funds that need being heard and heeded.[30]

4.2 Operational Issues

Life enhancement and wealth promotion are well-recognized objectives of Shari[ah. Expansion of financial services and risk management techniques serve both these objectives. As noted above, they deserve close attention by Islamic finance researchers.

A subject of practical importance needing closer attention in this context is micro-finance or supply of credit to the poor and the weak. This has to be done as a viable business rather than as a charity, even though the motives be charitable. Priority of micro-finance derives from the Islamic objective of poverty removal. (Hassan and Alamgir: 2002). Also important is economic development in general which demands a rising consumer demand to boost industrial activity. Demand for

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[26] See also, Saati: 1999.

[27] The Wall Street Journal, 19 September 2005, p.1.

[28] See the quote in fn.13 on page 88 in Fadel: 2002. Hedging is aptly characterized as 'creating a risk that offsets an existing risk', Shiller: 2003, p.237). However, 'Placing such risk-offsetting bets is not gambling because the bets offset a risky position that was already in place due to the nature of the business' ibid, p.238.

[29] Both descriptions are given in Webster's Dictionary (cited in Richard Horwitz, R: 2004, p.109. Also, on hedging, one can usefully consult, The New Palgrave Dictionary of Money & Finance (1992).

[30] See, for example, Bill Gross, Investment Outlook: 'Lemonade for Sale' in PIMCO Advisor, August 2004.

motor vehicles, particularly demand for the personal car, is a major part of consumer demand in advanced countries. The construction industry has a key role in maintaining high levels of employment for the poor and unskilled everywhere, including the poor countries. That calls for attending to home-finance. Contemporary Islamic finance has developed some rudimentary instruments for consumer credit in general and house finance in particular. Both deserve priority research. Part of this research should be directed to product development or instrument design, but another part should address a fundamental issue: Is the implicit aversion of Islamic economics to credit-financing of consumer items like home, the family car, and the whole range of house-hold gadgets well founded? Is it bad to be in debt, even for the essentials needed for an efficient living? The traditional notion of living within ones means needs rethinking in view of modern approach to increasing efficiency through early provisions based on credit.

5. WHO INVESTS IN FUNDAMENTAL RESEARCH?

I have already marked Shari[ah advisement as a priority research subject. The contemporary arrangements are a byproduct of the needs of the Islamic finance industry. There is a limit to what such market induced solutions can do. Much more is needed and a review is long overdue.[31] As I pointed above, a public goods approach to Shari[ah advisement has a great potential, especially because a multi disciplinary approach is needed for proper fulfillment of that need.

6. CONCLUSIONS

Lastly we should consider a truism: If Muslims have the same orientation and motivation in finance as everybody else, they will end up having the system that has resulted from other people's choices, the one we call conventional financial system. A genuinely distinctive system can emerge only out of a genuinely distinct orientation and motivation, a different set of norms. If Muslims don't have one, they do not need a different financial system. If they have one, we need research on what it is and how can it get translated into behavioral patterns and institutions. This is quite appropriate as Muslims themselves feel that their current motivations may not be what they ought to be. Now, that was a repeated theme in Islamic economic literature produced in the third quarter of the last century. But some thing must have been missing from it otherwise we would not be where we are, engaged in a fervent effort at replication of the conventional financial system.

As I suggested in my address to the Round Table on Islamic Economics organized by IRTI and API in May 2004, the missing element in our literature is an

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[31] For some reflections on the subject, see: Delorenzo: 2002, pp.63-65; 87-75. For some historical insights, see Kahf: 2003, pp.169-81. For comprehensive picture of the current state of affairs and references to studies available, see: Qattan, 'Comparative System of Effective Shari[ah Supervision of Banks' in Khan and Muljawan: 2006.

understanding of the objectives of Shari[ah the *maqasid*, as something higher than the specific rules of conduct and laws. The theory and practice of Islamic banking and finance has drawn upon the laws of Islam as laid down in *fiqh* literature but it failed to evaluate its findings on the criteria of *maqasid*, whether they served the objectives of Shari[ah in an environment different from the one in which the *fiqh* had developed. I think part of the failure is due to lack of macroeconomic concepts and appropriate tools for analyzing complex socio-economic phenomena.

I think recourse to *maqasid* would do many things. It may even call for restructuring the Islamic finance industry along different lines. But this is a vast subject to which justice cannot be done in this survey article. There is, however, one likely result of recourse to objectives that deserves focusing on: the need for reorientation of economic agents. I hasten to add that this does not imply unrealistic idealism, the hope that sermons can rid humans of all their so-called baser instincts. I also reject dictatorship. Totalitarian arrangements have no place in Islam. Nevertheless I suggest orientation and motivation has a big role in life in general and in economics and finance in particular. There is no justification for neglecting the possible role moral orientation can play in bringing about desired states of the world. That is the essence of a religious view on living: We aspire to do better than we may be doing at a particular time, in a particular situation. Better here means morally better, not only materially superior. Those who hammer on the impotence of moral values in economics and finance are plain wrong.

Who is to do the efforts needed for reorientation and a fresh motivation? How to inculcate in the Muslim customer and client Islamic norms relevant to finance? Apparently it seems a long shot for the Islamic financial industry to have a role in that exercise. But that is not true. The industry has high stakes in its *raison d'etre,* in the very reason for its existence.

Instead of addressing the Islamic financial industry as a whole I would rather address the sponsor of this Survey, the Islamic Research and Training Institute of the Islamic Development Bank. It should constitute a think tank to focus on the issues raised in this Survey. It should not stop at a review of the current products and practices in the Islamic financial industry. Rather it should take up the more fundamental issue of an alternative to the contemporary monetary[32] and financial system. Economists, western as well as Islamic, and Shari[ah scholars should engage with the matter on a long-term basis.

[32] This survey did not cover the monetary system, which would involve not only monetary policy and central bank functions but also the complex issues of nature of money and methods of its supply along with that of credit in a modern society where Muslims and others must share common space and transact in the same market. The relation of that subject with finance and banking is close enough to warrant such an effort separately.

There are a number of reasons why Muslim approach to banking and finance need be different from the conventional one (supposedly based on utilitarian considerations only). Three come to mind.

The first is spiritual, relating to our relation with Allah. Allah wants us to care, after ensuring our personal welfare, for His other creatures too, priority attaching to humans. Muslims should have different norms from the conventional ones (of self centered profit maximization) and should care for welfare of other human beings because that is what pleases Allah.

The second is moral, relating to the society of man. Humanity will be better off with everybody caring about everybody else rather than everybody pursuing exclusively his or her self interest, narrowly defined (Big informational issues are, no doubt, involved. Hence, the need of fundamental research).

Third reason is psychological, relating to the personality of the individual. Every individual will end up with a more contented life less prone to anxiety if Islamic norm of caring for others along with caring for one self takes root.

As noted above, these spiritual, moral and psychological considerations go not to supplant or replace the utilitarian considerations but to complement them.

All three have support in the Islamic Texts. The second can be, partially though, supported by historical and empirical evidence. It also calls for analysis linking possible morals to possible states of the market, hence to possible states of the world. The third too is capable of eliciting empirical support given some fieldwork. But little research has been done till now. That is one thing an institution like the Islamic Research and Training Institute can arrange.

Reorientation may require, besides research, some training.

I think an example will help us realize why Islamic finance needs the kind of research and training outlined above.

The problem of providing cash to those whose needs cannot be met with credit based on sharing or sale has defied any solution so far, as we reject *tawarruq* that takes us back to interest-based lending. *Qar**d** **h**asan* is a solution that presumes a paradigm other than the conventional one that limits financial institutions to profit oriented activities. But we cannot wish in a new paradigm at the institutional level. It has to have its roots in individual behavior and social consensus. There comes the need of reorienting individual wealth owners and evolving a non-dictatorial social consensus on the need to accommodate motives other than profit making in wealth management.

At the present there is nobody taking care of some of the challenges mentioned above. Many people express their dissatisfactions and frustrations on forums like IBF NET. Most of the practitioners rely on high profile conferences they help organize and bet on the prestige of their Shari[ah advisors. State level patronage of

Islamic finance tends to take the easier route of taking its clue from the market. Meanwhile the credibility of Islamic finance as the bearer of a new promise is at stake. Only fundamental research can remedy the situation.

In concluding this IRTI sponsored survey, I wish and pray that it gears up to perform this *far**d** kif**a**yah* for which it seems fully qualified and well equipped.

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