1 Islamic banking: an introduction and overview

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Introduction

From a situation nearly 30 years ago when it was virtually unknown, Islamic banking has expanded to become a distinctive and fast growing segment of the international banking and capital markets. There are well over 200 Islamic banks operating in over 70 countries comprising most of the Muslim world and many Western countries. Not included in these figures are the 50 Islamic insurance (*takaful*) companies operating in 22 countries, Islamic investment houses, mutual funds, leasing companies and commodity trading companies. Also excluded are the very largest Islamic banks engaged at a multilateral level. To these numbers must be added the many hundreds of small Islamic financial institutions such as rural and urban cooperative credit societies, Islamic welfare societies and financial associations operating at a local level and dealing with rural entities, small business firms and individual households.

Many people are interested in the phenomenon of Islamic banking and in the question of how it differs from conventional banking, yet, despite the expansion over the last 30 years, Islamic banking remains poorly understood in many parts of the Muslim world and continues to be a mystery in much of the West. Our aim in this volume is to provide a succinct analysis of the workings of Islamic banking and finance, accessible to a wide range of readers.

There is now a considerable amount of research on the topic and, in what can be considered as a companion to this volume, we have collected together some of the most significant previously published articles on the subject covering the last four decades (Hassan and Lewis, 2007). Inevitably, however, there were large gaps in the coverage of topics (notably in the treatment of operational efficiency, marketing, project finance, risk management, mutual funds, the stock market, government financing, multilateral institutions and financial centres) and a narrow number of themes were pursued in these journal articles written, in most cases, for specialist researchers in the field.

This volume seeks to bring the research agenda and the main issues on Islamic banking before a wider audience. For this reason we invited leading scholars to write chapters on various aspects of Islamic banking and report on the current state of play, and the debates, involved. The essays aim to provide a clearly accessible source of reference material on current practice and research.

Before introducing the individual contributions, a word of explanation is needed about the title. When the subject matter first began to be written about, it was usual to use the terms 'Islamic banks' and 'Islamic banking'. Nowadays, it has become more commonplace to talk of Islamic finance and Islamic financial institutions, reflecting in part the shift – evident in Western markets as well as Islamic ones – away from what used to be banking activities to financing activities more generally, previously carried out by investment companies and assorted non-banking intermediaries. Nevertheless, so long as this wider agenda is recognized, we prefer the simplicity of the original terms.

Foundations of Islamic banking

An Islamic banking and financial system exists to provide a variety of religiously acceptable financial services to the Muslim communities. In addition to this special function, the banking and financial institutions, like all other aspects of Islamic society, are expected to 'contribute richly to the achievement of the major socio-economic goals of Islam' (Chapra, 1985, p. 34). The most important of these are economic well-being with full employment and a high rate of economic growth, socioeconomic justice and an equitable distribution of income and wealth, stability in the value of money, and the mobilization and investment of savings for economic development in such a way that a just (profit-sharing) return is ensured to all parties involved. Perhaps the religious dimension should be presented as a further explicit goal, in the sense that the opportunity to conduct religiously legitimate financial operations has a value far beyond that of the mode of the financial operation itself.

In Chapter 2, Masudul Choudhury notes that Islamic banks have mushroomed under an Islamization agenda, but the system has not developed a comprehensive vision of an interest-free system, nor has it mobilized financial resources for enhancing social wellbeing by promoting economic development along Islamic lines. These omissions, he argues, are shared more generally by Islamic economic thinking and social thought which has produced no truly Qur'anic worldview and has failed to understand the dynamics of Islamic transformation within an equitable and participatory framework. Choudhury comes to this conclusion after reviewing the social theory developed from the early years of Islam to the present day. In advocating the rediscovery of a worldview founded on the doctrine of *Tawhid* (the oneness of God) as enunciated by the Holy Qur'an and *sunna*, Choudhury envisages a social wellbeing function for Islamic banks in terms of social security, protection of individual rights and resource mobilization in keeping with the Islamic faith.

Financial systems based in Islamic tenets are dedicated to the elimination of the payment and receipt of interest in all forms. It is this taboo that makes Islamic banks and other financial institutions different in principle from their Western counterparts. The fundamental sources of Islam are the Holy Qur'an and the *sunna*, a term which in Ancient Arabia meant 'ancestral precedent' or the 'custom of the tribe', but which is now synonymous with the teachings and traditions of the Prophet Muhammad as transmitted by the relators of authentic tradition. Both of these sources treat interest as an act of exploitation and injustice and as such it is inconsistent with Islamic notions of fairness and property rights. Islamic banking thus derives its specific *raison d'être* from the fact that there is no place for the institution of interest in the Islamic order.

Some scholars have put forward economic reasons to explain why interest is banned in Islam. Anwar Iqbal Qureshi ([1946] 1991) believes that it is not necessary to offer intellectual arguments in favour of the Qur'anic injunction against *riba*. The real question, however, is not about *riba* but about the definition of *riba*. Latifa Algaoud and Mervyn Lewis in Chapter 3 examine the nature of *riba*, distinguishing between *riba* that relates to loans and *riba* that involves trade, before going on to consider the divergent positions taken by traditionalists and modernists on the definition of *riba*. They also point out that the Islamic critique is based on more than the prohibition on interest, even if we overlook the broader social charter recommended by Choudhury and others. There is also the prohibition in Islam of *maysir* (gambling, speculation) and *gharar* (unreasonable

uncertainty), the need to ensure that investment be undertaken on the basis of *halal* (permitted) activities, and the requirement to benefit society through the collection of *zakat* (almsgiving) overseen by a special religious supervisory board.

This rejection of interest by Islam poses the question of what replaces the interest rate mechanism in an Islamic framework. If the paying and receiving of interest is prohibited, how do Islamic banks operate? Here PLS comes in, substituting profit-and-loss-sharing for interest as a method of resource allocation. Although a large number of different contracts feature in Islamic financing, certain types of transaction are central: trustee finance (*mudaraba*), equity participation (*musharaka*) and 'mark-up' methods. Some of these profit-sharing arrangements such as *mudaraba* and *musharaka* almost certainly pre-date the genesis of Islam. Business partnerships based on what was in essence the *mudaraba* concept coexisted in the pre-Islamic Middle East along with interest loans as a means of financing economic activities (Crone, 1987; Kazarian, 1991; Cizaka, 1995). Following the birth of Islam, interest-based financial transactions were forbidden and all finance had to be conducted on a profit-sharing basis. The business partnership technique, utilizing the *mudaraba* principle, was employed by the Prophet Muhammad himself when acting as agent (*mudarib*) for his wife Khadija, while his second successor Umar ibn al-Khattab invested the money of orphans with merchants engaged in trade between Medina and Iraq. Simple profit-sharing business partnerships of this type continued in virtually unchanged form over the centuries, but they did not develop into vehicles for large-scale investment involving the collection of large amounts of funds from large numbers of individual savers. This development did not happen until the growth of Islamic financial institutions.

This leads us to Chapter 4, by Abbas Mirakhor and Iqbal Zaidi which provides an account of both the traditional financial instruments, *mudaraba*, *musharaka* and mark-up (*murabaha*, *ijara*, *salam*, *bai bi-thamin ajil*, *istisnaa*), along with the newly developed *sukuks*. Mirakhor and Zaidi explain in detail the features that make these instruments acceptable from an Islamic viewpoint, and the implications which follow from an agency theory perspective for the contractual relationships involved. They then consider some practical issues involved in the development of Islamic structured finance in the form of asset-backed securities, covered bonds, *sukuks* and collateralized securitization. Finally, the authors review the future of the profit-and-loss sharing principle in the light of these innovative financing arrangements.

Following on from these analyses of the economic and social principles underlying Islamic financing, the nature of the Islamic critique of conventional financial systems, and the present-day Islamic alternative, the last chapter in this section brings a different perspective to the issues, for Islam is not the only (or indeed the first) religion to prohibit usury (interest). In Ancient India, laws based on the Veda, the oldest scriptures of Hinduism, condemned usury as a major sin and restricted the operation of interest rates (Gopal, 1935; Rangaswami, 1927). In Judaism, the Torah (the Hebrew name of the Law of Moses or the Pentateuch, the first five books of the Old Testament) prohibited usury amongst the Jews, while at least one authority sees in the Talmud (the Oral Law which supplements the Written Scriptures for orthodox Jews) a consistent bias against 'the appearance of usury or profit' (Neusner, 1990). Under Christianity, prohibitions or severe restrictions upon usury operated for over 1400 years, but gradually the Christian Church bowed to the pressures of reformist theologians and the needs of commerce and came to see only exorbitant interest as usurious.

The Islamic ban on usury rests on the unparalleled authority of the Holy Qur'an in which the prohibition is frequently and clearly enunciated. What was the authority for the Christian opposition to usury? What rationale was provided by the clerical authorities? How do these compare with those of Islamic jurists? How was the Christian ban enforced? Was it honoured more in the breach than in the practice? What devices were used to avoid the ban? Why did the Christian Church shift its stand on the nature of usury? These are the questions examined in Chapter 5 by Mervyn Lewis. The answers provided to these questions shed new light on the achievements of Islamic banking methods, while at the same time revealing a number of interesting parallels with present-day Islamic financing techniques. The author argues that Islam has succeeded in sustaining its prohibition on interest, where Christianity relented, because of the efforts made by Islamic bankers and jurists to fashion instruments that conform to *shari'a* principles. Nevertheless, a question mark still exists, because there are many within the Islamic community and outside who consider that some of the techniques (such as mark-up and *sukuks*) are more successful in meeting the letter of the law, rather than the spirit, of the Qur'anic injunctions on *riba*. Chapters by Chapra and Nienhaus take up this point, and we return to it at the end of this chapter.

Operations of Islamic banks

This section of the volume examines a number of aspects of the workings of Islamic banks. In Chapter 6, Humayon Dar considers incentive compatibility problems. First, he examines the traditional contracts offered by Islamic banks which are divided into fixed return (*murabaha*, *ijira*, *salam*, *istisnaa* and so on) and variable return methods (*mudaraba* and *musharaka*). Incentive compatibility relates to the in-built inducements that exist for the transacting parties to honour the terms of the contract. This is an area in which there are conflicting views (Khan, 1985, 1987; Ahmed, 1989; Presley and Sessions, 1994). Dar argues that the benefits of improved productivity from the variable-return modes of financing are likely to be outweighed by the moral hazard and adverse selection problems vis-à-vis the fixed-return contracts, perhaps explaining the dominance of the latter in bank portfolios. However, while incentive compatibility is relevant for all forms of financing, it is particularly so for modern markets based on derivatives such as options, futures and forward contracts that exceed, on some measures, the markets in the underlying assets (Stulz, 2004). In the remainder of his chapter, Dar focuses on the incentive structures of the Islamic methods of financial engineering based on *arbutun*, *bai' salam* and *istijrar*.

Dar observes that the relative dearth of Islamic financial products has proved to be a disincentive to their use in comparison with the less expensive conventional banking products. To some extent this difference may be a result of the incentive compatibility problems, necessitating larger outlays on monitoring costs. However, it is also inseparable from the question of the operational efficiency of Islamic banks, examined in Chapter 7 by Kym Brown, M. Kabir Hassan and Michael Skully. What exactly is operational efficiency and how is it measured? This is the first issue to be addressed but it does not beg an easy answer. There is no single measure of operating performance or of efficiency, and the small number of Islamic banks in each country means other benchmarks are needed. A number of approaches have been followed in the literature, and it is difficult to ascertain to what extent different research findings reflect differences in research methodology and data. Nevertheless, where a direct comparison is possible, it would seem that Islamic

banks compare favourably in terms of profitability measures vis-à-vis conventional banks, despite the fact that their social charter may lead them into areas (such as *qard hasan* loans) and responsibilities (such as *zakat*) that conflict with profit maximization. In terms of efficiency, there would seem to be some potential to cut operating costs and exploit scale economics. A feature of the chapter is the extensive data provided of the structure of Islamic bank activities.

Islamic financial products need to be more than offered to customers, they need to be actively marketed. For those Islamic banks operating in fully Islamicized financial systems this may not be needed. For those in mixed financial systems it is certainly the case. When these banks were initially established, they relied heavily on their religious appeal to gain deposits. This emphasis has continued. To give one example, Saeed (1995) reports that the Faisal Islamic Bank of Egypt (FIBE) is actively involved in attracting Muslims, particularly those who believe in the unlawfulness of interest, to its deposit mobilization schemes. To attract such customers in an increasingly competitive financial environment, FIBE utilizes several means:

- Encouraging leading *‘ulama* (religious scholars) to propagate the prohibition of interest.
- Emphasizing its Islamic credentials by means of the collection and distribution of *zakat*.
- Convening seminars and conferences to propagate the merits of Islamic banking.
- Offering modern banking facilities such as automatic teller machines and fast banking services by means of installing the latest computer technology in banking operations.
- Giving depositors a return comparable to that given to the depositors of traditional banks.

While all of these factors are relevant, the last two are critical. The Islamic financial market is no longer in its infancy, and an Islamic bank cannot take its clients for granted. There are many institutions, including Western banks, competing with the original Islamic banks by means of Islamic ‘windows’, and the general lesson in financial, as in other, markets is that profit spreads and profit margins fall as new financial institutions enter the market. In this competitive milieu, a clearly targeted marketing strategy is important. Few banks can be all things to all people. Islamic banks must use market research to identify their market segments and reach them with innovative products. This is the message of Chapter 8, on the marketing of Islamic financial services by Elfakhani, Zbib and Ahmed.

Corporate governance is an important issue for all corporations, but especially so for an Islamic bank. This is the topic of Chapter 9, by Volker Nienhaus. Normally, corporate governance is seen as revolving around the conflict of interest between shareholders and management. When corporate governance is discussed in the context of banking, depositors are usually brought into the picture because of the fact that banks are so highly geared and it is they (depositors) who can suffer, along with shareholders, when a bank fails. With an Islamic bank there is an extra dimension arising from its religious charter, and an additional layer of governance stemming from the role of the *Shar’ia* Supervisory Board (SSB) that monitors its adherence to Islamic principles.

Nienhaus makes the very interesting observation that the behaviour of most SSBs has altered markedly over the years. When the system of *shari'a* supervision was first established in the formative period of Islamic banking, the *shari'a* scholars were thought to be overcautious, and perhaps even obstructive, by the bankers. Nowadays, they have allowed, as permissible, instruments that would perhaps have been seen earlier as *hiyal*, legal fictions, obeying only the letter of the law. The development of the *sukuk* is an example that comes readily to mind. Nienhaus wonders why the change from overly-conservative to permissive has taken place. He advances reasons that essentially parallel the 'capture' theory of regulation (Stigler, 1971). If the members of the SSB wish to be reappointed and continue their SSB membership, it is in their interest to foster good relations with the management of the Islamic bank, and give the managers the benefit of the doubt when approving new product innovations, blurring the distinctiveness (and ideological purity) of the Islamic banking system. To this end, Nienhaus recommends the establishment of a National *Shari'a* Board for each country that would be independent of management.

It is now recognized that risk management is an indispensable part of good corporate governance, and most major corporations today will have a Board committee to oversee internal risk management systems. For a bank, this function is vital, for the management of risks lies at the heart of banking activities. Risk management is the topic of Chapter 10, by Habib Ahmed and Tariqullah Khan, who approach the issue properly in an orderly and systematic manner. The authors first examine the special risk characteristics of Islamic banking operations, identifying the unique credit risks, market risks, liquidity risks, fiduciary and other risks faced by Islamic bankers. They then consider the risk mitigation and risk transfer options open to Islamic banks. Conventional banks make much use of derivatives for these purposes, but many of these instruments need extensive modification or re-engineering to be suitable for Islamic financial institutions. Finally, the authors provide an analysis of capital adequacy requirements, and expected loss recognition for the Islamic institutions.

Instruments and markets

So far, in the chapters reviewed, the volume has examined the religious underpinnings of Islamic finance and the general operations of Islamic banks. The focus in this part of the book is a range of specialist applications of the general principles and practices.

Management of liquidity has traditionally been a problem area for Islamic financial institutions. Conventional banks use a variety of methods to manage liquidity. Like any enterprise, banks use asset and liability management techniques to manage cash flows on both sides of the balance sheet, revolving around the repricing and duration of assets and liabilities (Lewis, 1992a, provides an overview of the measures employed). However, it is inevitable that imbalances will arise, and banks make extensive use of two markets in these circumstances. One is the secondary market for debt instruments where bills and bonds can be readily bought and sold. The other is the inter-bank market where banks lend and borrow at interest on an overnight or longer-term basis. Together these venues constitute what is known as the 'call money market' (Lewis, 1992b).

For many years Islamic banks were hampered in liquidity management by the absence of an equivalent infrastructure. Islamic law has restrictions on the sale of debt that inhibit *shari'a* acceptable secondary markets, while the institutional framework for a money market was undeveloped. That situation has changed markedly over the last decade, as is

made apparent in Chapter 11, by Sam Hakim, who reviews the range of Islamic money market instruments. One major development comes from the engineering, and rapid expansion, of Islamic tradeable securities, especially *sukuk*. Another has come from the establishment of an Islamic inter-bank money market in Malaysia in 1994 and the number of instruments that have developed in its wake. There is also an important international dimension to these initiatives which is discussed in Chapter 23.

Muslims are instructed by the Holy Qur'an to shun *riba*. At the same time, however, they are encouraged by the Holy Qur'an to pursue trade. However, trade invariably creates the need for trade financing. This occurs when the buyer of goods wishes to defer the payment of the goods acquired to a future date or wishes to pay for the goods by instalment over a number of future periods. Financing of trade is thus a major component of Islamic banking but, in order to adhere to the prohibition on *riba*, this financing cannot be done by the extension of credit at interest, and other Islamically acceptable financing techniques must be developed. These are very extensive indeed and are examined in detail in Chapter 12 by Ridha Saadallah. He outlines first the transition of the *murabaha* concept into an Islamic financial or credit instrument, before considering longer-term trade financing instruments employed by the banks, including the participatory instruments and the securities based on them. This leads us to the next chapter.

Chapter 13 is devoted to the securitization of Islamic financial instruments. The author, Mohammed Obaidullah, points out that securitization has a relatively short history in the West but has grown spectacularly in the last five years. The chapter begins with an outline of the basic structure of structured financing, as it is now commonly called (Fender and Mitchell, 2005), which is then followed by an explanation of what is wrong with conventional securitization from an Islamic point of view. From this base, Obaidullah goes on to analyse the Islamic alternatives in theory and in practice. There are controversial *fiqh* issues in terms of both the form (pay-through, pass-through or asset-backed) and the underlying assets (trade receivables, leasing) that need to be resolved if the market is to expand along Western lines. At this juncture, the *sukuk-al-ijara* offers the most acceptable basis for a strong secondary market to evolve.

Project finance is also a form of structured finance, since it involves structuring the financing, typically via a special purpose vehicle, to suit the cash flows of an underlying asset, invariably an infrastructure project. If Muslim countries follow trends elsewhere, this area seems likely to be of considerable importance in the future. For most of the post-war period, government has been the principal provider of infrastructure (at least outside the United States). Over the last decade, that position has begun to change. Faced with pressure to reduce public sector debt and, at the same time, expand and improve public facilities, governments have looked to private sector finance, and have invited private sector entities to enter into long-term contractual agreements which may take the form of construction or management of public sector infrastructure facilities by the private sector entity, or the provision of services (using infrastructure facilities) by the private sector entity to the community on behalf of a public sector body (Grimsey and Lewis, 2004).

The budgetary pressures which have forced the pace in the West seem particularly strong for countries such as Pakistan, seeking greater Islamization of the financial system and looking for replacements to cover the removal of *riba*-based government borrowing. From the viewpoint of the private sector bodies, public-private sector financing arrangements are essentially project financing, characterized by the low capitalization of the project

vehicle company and consequently a reliance on direct revenues to pay for operating costs and cover financing while giving the desired return on risk capital. The senior financier of private finance looks to the cash flow and earnings of the project as the source of funds for repayments. The key principle for such projects is to achieve a financial structure with as little recourse as possible to the sponsors, while at the same time providing sufficient support so that the financiers are satisfied with the risks. Successful project design requires expert analysis of all of the attendant risks and then the design of contractual arrangements prior to competitive tendering that allocate risk burdens appropriately, and meet the financing needs.

In the case of Islamic project financing there is an additional test that is needed, for the financing must be *shari'a*-compliant, and this is the topic of Chapter 14, by Michael McMillen, which gives a detailed account of the techniques and structures involved in this very complex area of Islamic financing. From the Islamic viewpoint a number of structure forms are possible, based on *istisnaa*, *ijara*, *mudaraba*, *murabaha* and *sukuk* financing vehicles. Thus there are a number of different ways in which the revenue stream from an Islamically acceptable project can support project financing contracts which accord with the *shari'a*. Such instruments would enable the large sums that are currently held mainly in short-term Islamic investments to be harnessed for investment in long-term infrastructure projects. Not only would this mobilization be valuable in resolving the problems of public sector financing in Islamic countries, it is entirely consistent with Islamic precepts. By providing basic social goods such as power, water, transport and communications services, infrastructure projects fit comfortably with the social responsibility ethos that is an essential feature of Islamic finance. In addition, limited recourse or non-recourse project financing structures are a form of asset-based financing that seem entirely consistent with Islamic law. When the complex financial structures that constitute these arrangements are stripped away, what is apparent is that project investors are sharing in the asset and cash flow risks of projects in ways that financiers are required to do under Islamic law.

The final two chapters of Part III deal with different aspects of stock market investment. The stock market poses particular problems from an Islamic point of view. The basic difficulty is the absence in Islamic law of the concept of a corporation, although Muslim jurists now agree on the permissibility of trading common stocks, which are similar to the shares in a *mudaraba*, so long as other requirements of Islamic law are not contravened. One such constraint posed by Islamic law concerns the principles of investment. In terms of the spirit of Islam, all Muslim shareholders are expected to take a personal interest in the management of each one of the companies in which their funds are invested. They cannot be disinterested investors. The *shari'a* emphasizes the importance of knowing the nature of the item to be bought. To many Muslims, the anonymity of a Western stock exchange offends Islamic notions of the responsible use of wealth. The assumption that investors may not be concerned about the detailed operations of a business in which they have invested money is a source of criticism. Muslim stockholders have a responsibility to acquaint themselves with what is taking place in the organization.

Another constraint is imposed on stock market investment because of the strong prohibitions on speculation in Islamically acceptable forms of financing. The question, however, is what is speculation in the context of the stock market? This is one issue considered by Seif El-Din Tag El-Din and M. Kabir Hassan in Chapter 15. The authors

begin with the standard classification of transactors in the market as hedgers, arbitrageurs and speculators. Obviously the first two categories pose no problems from a juristic position. In the case of speculators, the issue is whether the activities of speculators constitute gambling and involve undue *gharar* (excessive uncertainty). There is little doubt that if a liquid investment market is desired, it will be necessary to accommodate speculative activity in some form, where such activity is based on differences in opinion and beliefs. Accordingly, Tag El-Din and Hassan seek to develop a definition of excessive speculation within the context of what is called a Normative Islamic Stock Exchange (purely equity-based, free of interest and guarded against *gharar*). This then leads to a comparison of Islamic views on money making with those of the Aristotelian tradition. Shifting then to the empirical evidence, the authors look at the available evidence of speculation and market efficiency in the context of the behaviour of various Islamic stock market indices.

Chapter 16, by Said Elfakhani, M. Kabir Hassan and Yusuf Sidani, focuses upon Islamic mutual funds. Islamic banks have long offered special investment accounts under an individual restricted *mudaraba* basis for high net worth individuals investing, say, \$500 000 or more, as well as the unrestricted *mudaraba* for ordinary depositors. It was a short step to combine elements of these two investment modes in the form of closed-ended or open-ended unit trusts or, in the American terminology, investment companies and mutual funds. These investment vehicles can be classified according to the types of investments made by the pooled funds. These can be divided into three groups:

1. *Islamic transactions.* A number of long-established funds have concentrated on a variety of Islamic portfolios. Thus, for example, the Al-Tawfeek Company for the Investment of Funds and the Al-Amin Company for Securities and Investment Funds, both part of the Al-Baraka group, were established in Bahrain in 1987. Both issue shares which participate in profits and can be bought and sold. Investments are made in a number of countries such as Morocco, Mauritania, Algeria, Turkey and Saudi Arabia, and comprise instruments such as lease contracts, *murabahas* and Islamic deposits.
2. *Specialized funds.* A number of funds specialize in particular activities such as leasing whereby the Trust finances equipment, a building or an entire project for a third party against an agreed rental. For example, in June 1998, the Kuwait Finance House launched a leasing fund in the United States, to invest in industrial equipment and machinery. There are also specialized real estate and commodity funds.
3. *Equity funds.* These are simply trusts, both closed and open-ended, which invest funds in stocks and shares. Those funds investing in international equities cover the world's major stock markets.

It is the latter type of fund which is the topic of Elfakhani, Hassan and Sidani's chapter. In considering equity funds, the principal question from the Islamic point of view is whether investments in international equity markets are acceptable under the *shari'a*. There is no doubt that dealing in the supply, manufacture or service of things prohibited by Islam (*haram*), such as *riba*, pork meat, alcohol, gambling and so on cannot be acceptable. But companies which are not involved in the above *haram* activities could be considered acceptable. The main objection against them is that in their own internal

accounting and financial dealings they lend and borrow from *riba* banks and other institutions, but the fact remains that their main business operations do not involve prohibited activities.

In order for the returns from such companies to qualify for inclusion in the mutual fund, quoted companies are classified according to a number of screens. After removing companies with unacceptable core business activities, the remaining lists are tested by a financial-ratio 'filter', the purpose of which is to remove companies with an unacceptable debt ratio. Those left in the fund must then be assessed according to 'tainted dividends' and 'cleansed'. Here 'tainted dividend' receipts relate to the portion, if any, of a dividend paid by a constituent company that has been determined to be attributable to activities that are not in accordance with *shari'a* principles and therefore should be donated to a proper charity or charities. However, such 'cleansing' cannot be counted as part of *zakat* obligations, but merely as a way of ensuring that investments are ethically sound.

There are obvious parallels in this selection process with the Western ethical investment movement. A number of investment advisers have been providing investment advice for over three decades to clients who want to invest in ethical funds, that is, those which do not invest in the shares of companies trading in tobacco, alcohol, gambling or the arms trade. The main difference is that the determination of whether an investment is ethical or unethical is made by the fund managers, based on information received from various professional bodies and other specially constituted committees of reference. In the case of Islamic funds, the ultimate approval comes from the Boards of Religious Advisers, and their rulings are binding on the fund managers.

After reviewing these procedures, Elfakhani, Hassan and Sidani examine the performance of the Islamic mutual funds. In the case of the Western ethical funds it would seem that ethics 'pay', although this may be largely because these funds have excluded tobacco companies, which have been hit by large compensation payouts. For the Islamic funds the results would seem to be more mixed. The authors conclude, overall, that the behaviour of Islamic mutual funds does not greatly differ from that of other conventional funds, with some *shari'a*-compliant mutual funds outperforming their relevant benchmarks and others underperforming them. However, it would seem that the Islamic mutual funds performed more strongly than their conventional equivalents during the recessionary period of the stock market, potentially opening up some possibilities for diversification across Islamic and conventional equity portfolios as a hedging strategy for downswing phases of the market.

Islamic systems

The chapters in this part of the book look at some system-wide regulatory and accounting issues facing Islamic banks. The first two chapters examine, in their different ways, the economic development 'charter' of Islamic banks.

Chapter 17, by Monzer Kahf, considers Islamic banking and economic development. He begins with a strong defence and restatement of the guiding precepts of Islamic financing which he argues is basically very simple, since the banks rely on a combination of three principles (sharing, leasing and sale) and funds are channelled to entrepreneurs through sale, sharing and lease contracts. Three features of this process are conducive to development. First, there are direct links to the real economy through the profit participation, the sale and purchase of commodities and the acquisition and leasing of assets. Second,

ethical and moral values are integrated with the financing so that gambling and other illicit activities do not get funded, while resources are devoted to charity and welfare needs. Third, participatory financing replaces lending, leading to a relationship between the financier and entrepreneur based on profit-generating activities.

In conventional financial systems, government borrowing plays a central role in a number of respects. First, the interest rates on Treasury bills and bonds underpin the structure of short-term and long-term interest rates in the economy. They are typically the benchmark low-risk rates against which other securities are priced. Second, there are normally active secondary markets in government securities which impart liquidity to banks' asset portfolios. Third, bill and bond markets have traditionally been the venues through which monetary policy in the form of open market operations has been conducted (although, at the short end, the 'money market' in a broad sense, including private bills, commercial paper and especially the market for inter-bank borrowing and lending, has assumed more significance). Fourth, long-term government bonds play a leading role in financing infrastructure, despite the fact that private sector project financing and public-private financing arrangements are a growing trend (see Chapter 14 and the comments earlier in this chapter).

M. Fahim Khan, in Chapter 18, reviews the Islamic alternatives for government borrowing. This is another area in which product innovation has been extensive. Where once government borrowing in Islamically acceptable ways was seen as a major problem in attempts to move to a more complete Islamicization of financial systems in Muslim countries, this is no longer the case. There are now many instruments available. Moreover, they are able to offer in many cases fixed returns at very low risk, so meeting the requirement for Islamic benchmark rates. Some can be traded on secondary markets, meeting the second condition sought after. Third, they offer the potential for central bank operations. Fourth, because these instruments are based on assets valued as infrastructure, the final requirement is also met. We return to his analysis later in this chapter.

As we saw in Chapter 10, Islamic banks are required to meet capital adequacy regulations and other standards applied to conventional banks. Accounting standards are the subject of Chapter 19, by Simon Archer and Rifaat Karim. Accounting is an important issue for Muslims because certain Islamic ethical principles have a direct impact on accounting policy and principles. The Holy Qur'an and *sunna*, from which ethical principles are derived, have defined clearly what is true, fair and just, what are society's preferences and priorities, what are the corporate roles and responsibilities, and also, in some aspects, spell out specific accounting standards for accounting practices (Lewis, 2001).

In an Islamic society, the development of accounting theory should be based on the provisions of Islamic law along with other necessary principles and postulates which are not in conflict with Islamic law. Two approaches suggest themselves: first, establish objectives based on the spirit of Islam and its teaching and then consider these established objectives in relation to contemporary accounting thought; second, start with objectives established in contemporary accounting thought, test them against Islamic *shari'a*, accept those that are consistent with *shari'a* and reject those that are not.

Bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) (2000) have followed the second approach when formulating accounting, auditing and governance standards for Islamic financial institutions. Archer and Karim favour the first approach on the grounds that accounting rules can only give

a faithful representation of transactions reported if they are accounted for in a way that gives the substance as well as the form of the *shari'a* contractual arrangements that govern the Islamic acceptability of the transactions. They examine a number of issues involved in developing such an agenda when there is a paucity of research on this topic.

In Chapter 20, Mahmoud El-Gamal argues that the appropriate regulatory model for Islamic banks turns on the conception of the role of depositors. Should they be regarded as receiving implicit capital guarantees like depositors in conventional banks by virtue of the relatively fixed-return, low-risk assets acquired by the banks under mark-up methods? Or are depositors to be regarded as shareholders because, as holders of investment accounts, they share in the profits earned by the banks, albeit in ways different from ordinary shareholders since the investment account 'shareholders' do not have a voting right? El-Gamal argues that this dilemma might have been avoided if Islamic banking had evolved within a different framework, and argues a strong case for the system to be based on the mutuality principle. Whether, at a practical level, this alternative paradigm would solve the regulatory treatment issue would remain to be seen. In particular, it might not avoid the Islamic institutions being put on a par with other institutions when regulations are applied. Certainly, mutual insurance companies are subject to the same solvency standards as proprietary companies. Also credit unions and other mutual ownership financial enterprises in countries like Australia are subject to much the same regulatory framework as the privately funded banks.

Regulation and the treatment of depositors are topics raised also by M. Umer Chapra in Chapter 21. Dr Chapra, one of the visionaries who forged the system of Islamic banking, reflects on the challenges facing the Islamic financial industry. Looking back at the original ideals that drove the system to be established, he notes a disconcerting gap between the dream and the reality because the Islamic financial system has not been able to escape from the straitjacket of conventional banking. Instead of using equity participation and profit-and-loss sharing modes of finance, along with appropriate monitoring systems, the bankers prefer to adopt different legal stratagems (*hiyal*) to transfer the entire financing and asset risk to lessees or those acquiring the assets, so violating the first principle of justice underpinning the system, namely that there be an equitable distribution of risks between the parties. Against this background he outlines a reform agenda to implement the original vision.

Globalization of Islamic banking

Islamic banking has always had a global orientation. Many investment accounts, especially in the Gulf, are denominated in US dollars. Because trade financing makes up so much of the asset portfolio of the Islamic banks, there is a natural vehicle available for the finance of international trade. There are many Islamic banks, business groups and investment houses controlled by the two large Islamic groups, DMI and Al-Baraka, that have a worldwide presence. Oil-related wealth provided the capital resources behind the establishment of many Islamic banks, and the Islamic Development Bank (IDB) based in Jeddah, and created in 1974, was the first institution to benefit from the inflow of oil money.

Its formation with the support of the Saudi Arabian government and the Organization of Islamic Countries (OIC) as a multilateral organization nevertheless gave momentum to the Islamic banking movement generally, being followed soon afterwards by both

private institutions (for example, Dubai Islamic Bank, 1975, Faisal Islamic Bank of Egypt, 1977, Bahrain Islamic Bank, 1979) and government institutions (for example, Kuwait Finance House, 1977).

The IDB is the first of the international Islamic financial institutions examined by Munawar Iqbal in Chapter 22. It is primarily an intergovernmental bank aimed at providing funds for development projects in member countries. The IDB provides fee-based financial services and profit-sharing financial assistance to member countries. Operations are free of interest and are explicitly based on *shari'a* principles. From these beginnings, the IDB has grown to a large group, incorporating ICIEC providing insurance services and export credit, ICD providing corporate finance, structured finance and advisory services for private sector entities and projects in key priority areas with a developmental impact, and IRTI with a mandate for research and training. Other international financial institutions studied in the chapter are those involved with accounting standards, financial services, financial markets, credit rating, arbitration and promotion of the concept of Islamic banks and financial institutions.

One of the institutions covered in Chapter 22 is the International Islamic Financial Market, created in 2002 to facilitate international trading in Islamic financial instruments across a number of financial centres. Islamic financial centres are the topic of Chapter 23, by Ricardo Baba. The value of having an international centre for Islamic finance can be argued by analogy to the role of international financial centres in conventional banking operations. At any time, there are banks with 'surplus' deposits which can be on-lent to an international finance centre which could act as a funnel for the funds. For each individual bank participating in such a market, the funds provided might be on a short-term basis. But a series of such short-term funds by different banks when combined would exhibit greater stability and provide resources which could be channelled into longer-term investments. At the same time, the existence of this pool of resources would attract long-term investment vehicles, and so act as a magnet for investment avenues in need of funding. Thus at the aggregate level the existence of the market would enable a succession of short-term surpluses to be transformed into longer-term investments. This is exactly what happened with the London market and international syndicated credits and much the same sort of process could occur with Islamic finance, although, in this particular instance, the new instruments and financial innovations required need to be equity or equity-based and real asset-based and not debt instruments.

A number of factors seem relevant to the location of such an international centre: regulatory environment, range of markets, track record of innovation, availability of complementary services, presence of foreign institutions, time zone, language, political and economic stability, communications infrastructure, business tax regime, staffing and office costs and quality of life. In addition to these factors, an international Islamic financing centre raises further issues such as compliance with *shari'a* requirements and the ability of the location concerned to attract a sizable share both of Islamic investment money and of international financing activities which would qualify as being Islamically acceptable. Of course, there need not be only one centre. There is not one centre in conventional banking (witness London, New York, Frankfurt, Tokyo, Singapore, Hong Kong) and there seems no reason why there would not be several international centres for Islamic financing. Baba focuses on three. He sees Bahrain as the global Islamic finance centre, Malaysia (Kuala Lumpur, Labuan) as the regional centre for S.E. Asia, and London as

the Western centre for Islamic financing activities. The different roles of these locations is considered in his chapter.

Islamic insurance (*takaful*) has developed hand-in-hand with the global expansion of Islamic banking because Islamic banks have been instrumental in the establishment of about one-half of the *takaful* companies and in promoting the concept. *Takaful* is examined in Chapter 24, by Mohd Ma'sum Billah. The nature of *takaful* business is not widely understood, in part because family *takaful* (life insurance) is so different from conventional life insurance business in the United States. However there are much closer parallels between family *takaful* and the unit-linked policies that operate in the UK and Australia (Lewis, 2005). (In the United States, such insurance policies are called 'variable life'.) There are some differences, especially in nomenclature where the minimum life cover of the unit-linked policy becomes a *tabarru* (donation) and the policy holders' special fund (unit trust or mutual fund) becomes a participation account.

Substitute these name changes and the basic structures are remarkably similar, with differences in payout and inheritance rules and investment methods in line with Islamic law. Another important difference is that *takaful* operates more like a mutual insurance operation with the *takaful* company handling investment, business and administration. There are also three different models governing the relationship between participants and the operator. These are *ta'awuni* (cooperative insurance), *wakala* (agency) and *tijari* (business/commercial) which operate in different Islamic countries. Billah examines these three different models. Although all three are in line with *shari'a* principles, these differences may be impeding the development of a globalized *takaful* market.

Finally, in Chapter 25, Rodney Wilson looks at Islamic banking in the West. There are over six million Muslims living in the United States, nearly two million in the UK and perhaps another ten million in the rest of Europe. A number of Islamic institutions have grown up to provide these communities with financial services in an Islamically acceptable way. Because of the relatively wealthy financial situation of some of these Muslims, and their aspirations to follow the lifestyle choices of many of their fellow citizens, housing finance has been a large part of the operations of these financial institutions. In order to conform to Islamic law, this finance has been provided in a number of *shari'a*-compliant modes such as *ijara* (leasing) and diminishing *musharaka* (participation finance). Islamic institutions also offer investment services, although many of these are aimed at international clients in the Gulf rather than local customers. The growth of this international orientation is one way in which London in particular has emerged as a centre for Islamic finance.

Concluding remarks

We conclude this introduction with some observations on product innovation. The success of Islamic banking, like any other system, rests on innovation and designing products that meet customer needs. Certainly, recent innovations in Islamic financing pass this particular test. Many innovative new products such as *sukuks* built around mark-up financing methods have allowed banks and their clients to engage in investment, hedging and trading activities that would have been unthinkable not so long ago. But do these instruments go too far? Unlike other financial arrangements, the Islamic system must meet another test, the religious test, and remain within the scope of Islamic law.

Consider, for example, the innovations that have taken place in the area of government financing. Fahim Khan in Chapter 18 is convinced that fixed interest rate government debt

along conventional lines has to be replicated with fixed return, negligible risk, Islamic securities, based upon mark-up arrangements, if a successful secondary market is to develop that can rival those in conventional financial systems. He may well be correct in this judgment. But the question then becomes one of whether, in the process of achieving this objective, the 'baby is thrown out with the bathwater'.

Let us consider the reasons given for Islamic fixed-return contracts being regarded as acceptable, as explained by Khan in Chapter 18.

The pricing mechanism of Islamic financial instruments, including those of government securities would, basically, be similar to that for conventional financial instruments. The time value of money in economic and financial transactions is recognized in Islam. The only difference is that the time value of money cannot be realized as a part of the loan contract. It can be realized only as an integral part of a real transaction. Thus, in a trade transaction, if the payment of price is deferred, then the time value of money will be included in the price of the commodity. Similarly, in a leasing contract, time value is an integral part of the rent that parties agree upon.

But is this really a trade transaction, or is it a loan in disguise masquerading as a commodity deal to conform to legal rules? Saadallah in Chapter 12 talks of a credit *murabaha*, which seems to be an accurate description of such a transaction since credit is an integral part of the transaction. Moreover, one is then led to ask how this 'bundling' of the time value of money and the commodity side really differs in substance from the bill of exchange route used by bankers in the Middle Ages to get round the Christian prohibition on usury. Consider the example given in Chapter 4:

... a medieval bill of exchange transaction consisted of the sale for local currency of an obligation to pay a specified sum in another currency at a future date. It thus involved both an extension of credit and an exchange of currency. A modern-day bank would handle this transaction by converting the foreign into the local currency at the ruling spot rate of exchange, and then charging a rate of discount for the credit extended when paying out cash now for cash later. To do so in the Middle Ages would have been usurious, for discounting was not an allowable activity. Consequently, by not separating the two elements involved, the medieval banker bought the bill at a price which incorporated both an element of interest and a charge for his services as an exchange dealer . . .

... the Medieval banker then had an open book which had to be closed by reversing the transaction and buying a bill in the foreign location, and receiving payment in his own currency. The fluctuation of exchange rates provided a convincing case of risk, since the terms at which the reverse deal could be undertaken would not be guaranteed at the time of the original transaction. It was this risk that reconciled bill dealing with the laws.

In what ways do the two examples differ? It would be a great pity for the reputation of the Islamic financial system if outsiders concluded that, if there is a difference, then it is that the medieval banker seemingly felt some guilt about the subterfuge (as indicated by the amount left to charity in their wills and testaments), whereas Islamic bankers today are absolved of such guilt because they have received approval from the *Shari'a* Supervisory Boards (SSBs) for their replication of fixed-rate returns. One is then led to ask the question: do these instruments such as *sukuks* obey the letter but not the spirit of the law? Is it any wonder that one of the 'founding fathers' of Islamic banking, Umer Chapra, describes these techniques in Chapter 21 as 'legal stratagems (*hiyal*) . . . in violation of the first condition of justice . . .'?

In Chapter 9 in this collection, Volker Nienhaus, who first contributed to the topic of Islamic banking over 20 years ago (Nienhaus, 1983), advanced reasons for the present day permissiveness of the SSBs that revolved around the ‘capture’ theory of regulation first advanced by George Stigler (1971). His observations prompt a number of questions. Is Nienhaus correct in surmising that many SSBs may have been ‘captured’ by the bankers? Has the Islamic ban on usury (*riba*) effectively been lost with the bankers’ success? Has Islam, unlike Christianity, maintained the rhetoric on usury, while admitting the practice? Perhaps, after all, the modernist or revisionist views on *riba* outlined in Chapter 3 may have triumphed in the end, in this roundabout way, over the views of the traditionalists. Or can it be argued in defence of the SSBs that an important principle, namely that there be at least some risk in financial transactions, however small, to justify reward, has been maintained under Islam?

These are questions that we leave readers to ponder while working their way through the chapters that follow. When doing so, it may be worth keeping in mind that the Islamic financial system is still passing through the growing pains of developing into a legitimate and equitable financial method in world capital markets. In that sense the system is still engaged in the search for, and debates about, answers to questions such as those posed in previous paragraphs. Nevertheless, it is our belief that this process of product innovation and development, which necessarily involves a sequence of trial and error, will eventually lead to truly Islamic financial products that will enable the system to achieve its original intent of meeting the legitimate financial needs of those sharing Islamic ideals.

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