

Preface

‘Why this book?’ is perhaps the main question to address in this preface. Islamic finance emerged some 50 years ago as a return to ethics-and-doctrine-based practices in financial transactions in the context of modern finance. Financial transactions in Muslim-majority societies in historical times were based squarely on a set of Islamic-ethics-consistent financial practices for *payment*, *financing* and *investment* activities. This rediscovered modern attempt starting some 50 years ago to reshape financial transaction contracts in Islamic countries, in line with ethics and doctrines consistent with Islamic principles of fairness, equity and full disclosures, led to the creation of a body of Islamic finance literature. That literature today is *mostly* description of what this new niche finance is all about with no or little attempt to provide a systematic introduction to its fundamentals to link those descriptions and principles to modern financial practices, in short to financial economics. After the entry of large modern banks into Islamic finance, following the Bank of England’s landmark approval in 2002 to permit Islamic banks as new niche financial businesses, the Islamic financial product markets have grown rapidly in this niche business selling *new financial products* known to the world as Islamic finance, although it should be described more appropriately by such terms as ‘ethics-based financial transactions’ or ‘profit-shared finance’ to emphasize the central difference in the pricing mechanism away from interest rates.

It has also become evident that there is an urgency to create authentic literature – in the classic tradition of objective inquiry using standards of modern research in financial economics – to systematically attempt to lay the *foundation* of this new niche finance. This will help us to (i) understand this new little-researched field of inquiry; (ii) provide peer-reviewed authentic literature for research and teaching of this subject in so many tertiary institutions; and (iii) aid in the training of professionals being certified to practise this new profession.

Hence this is a book with a very different objective from the several titles around. Call this a start in a series to lay the foundation of Islamic finance. This book is the second in this series by the same publisher, who has encouraged, as they do in other new emerging fields of inquiry, publications relating to Islamic banking and finance. This book is on Islamic

debt market instruments, the *sukuk* instruments, which are now issued and traded in some 12 financial markets with a market value in excess of US\$1200 billion.

This book is among the foundation books that are planned to be published using the classic modern method of public discussion of ideas, peer-review process and authentic literature creation. Thus, the answer to the question ‘Why this book?’ is that this new discipline, born some 50 years ago, given its academic recognition in the last ten years has come of age for mainstream regulators, practising professionals and learned academics to collaborate in an attempt to speed the creation of knowledge relevant to this field. Collaborators include some prominent industry players funding the event to conduct open public discussion of ideas that will be harvested as books and journal articles. To that end, it is noteworthy that the collaborators in this effort are very senior professionals and regulators as well as eminent scholars in the field, all committed to a long-term project to have one volume on each significant topic on Islamic finance. This book is on the hot topic of Islamic *sukuk* or *shari’ah* (Islamic jurisprudence) compliant debt instruments, in instrument markets.

At a fundamental level, we can address this question from a historical perspective from an inquiry of human ethics: what is the historically evolved status of human ethics that govern human financial transactions? An answer to this requires a discussion of the evolution of financial ethics – call it ‘foundation’ – as embodied in financial transaction practices that guided the everyday contracting relationship necessary for payment, financing and investment activities of Muslim residents in societies under Islamic law and rules, which evolved incrementally in Muslim-majority societies, over 14 centuries. This was in addition to the largely Greco-Roman influences that Islam borrowed from in its early centuries, and built on those financial transactions modes already in vogue, except those that Islam prohibited outright, as consonant with Islamic religious doctrines. Hence both human ethics and Islamic doctrines influenced this subject.

Since the Renaissance, some eight centuries ago, as Europe emerged from the Middle Ages, Europe re-inherited and reshaped the Greco-Roman concepts of law and rules, while also preserving some ethical foundations that are shared via the Old Testament, the Gospel and the Qur’an. During the last three centuries, the laws and rules of conduct in Muslim societies have been slowly and surely replaced by modern concepts of financial laws and rules emanating from the latter day *secular* European societies. For example, usury laws in Europe were dropped, on the urgings of Bentham in England, and in other nations on the urgings of economists under the influence of a powerful banking lobby. Islam still continues to

forbid usurious funding; it goes one more step to require returns to investors as permissible reward *only* if the risk is shared in profit-shared contracts, just as it also cuts off funding to unethical or anti-society economic activities, such as prostitution, gambling, and alcohol consumption.

Pertinent to this book is the fact that financial ethics have undergone subtle changes as a result of secularization and, more importantly, the lobby of banking institutions such that several religion-derived ethical foundations *long established in historical times* have been dismantled and replaced with secular laws, to influence everyday financial transactions by humans. This influence, after replacing such religion-based norms in European societies, spread to Muslim societies as secular laws and rules evolving from the advent of modern banking in the last 250 years.

Modern banking has changed the very fabric of the foundation that guided financial transactions for payments, financing and investments. Careful observation of the history of banking suggests how the banks have come to dominate and even set the agenda for financial foundation. This book lays the human ethical foundations relevant to the *sukuk* debt securities (whereas in other books we cover banking and other topics). Just take an example: the historical ethic that borrowing by entrepreneurs should be based on *asset-backed* lending was widely practised until 1657 in Amsterdam, then the world's central market for money. Today there is a debate, as in this book, on how asset-backed and asset-based *sukuk* transactions make funding (financing) safer for demanders and suppliers of funds. Of course the Dutch model gave way to fractional banking where there is no full asset backing especially in today's banking operations. This *sukuk* Islamic debt market started just 12 years ago in its present form with strong asset-backed lending, and already there are twelve markets, including one in Kuala Lumpur with a two-thirds market share. Around the world, this form of debt contracting is providing money on an *asset-backed* basis with other ethical provisions consistent with three key principles: fairness, equity and full disclosures in contracts.

During the last 250 years such principles as the ones just enumerated have been slowly eroded so that corporations (entrepreneurs) could borrow with no evidence of assets to back a loan (take the spectacular case of failures, and test this hypothesis: Enron; Pharmalat; HIH Insurance; Maxwell Corporation; Infosystem). Borrowing using asset-backing makes financial transactions safer for lenders and borrowers, especially when turns in the business cycle may expose the assets of a firm to too much danger of funding with no stable assets to back. Historically, asset-backed borrowing is a principle all humans adhered to in practice *except* in the cases of (a) sovereign borrowers, who had future tax revenue as *likely assets* and (b) poor people borrowing for sustenance but having no assets.

In the latter case, the Roman Church used to lend money to poor people as far back as the twelfth century, with no expectation of repayments. Islamic finance requires a small portion of loans of financial institutions to be made to such people, with no expectation of returns. This form of lending is called *Qardul Hasana*, or benevolent loan, and the source of this loan is a small part of profits and also alms-payments for the poor channeled to the banks as contributions from the wealthy.

In this book, we trace the foundation principles of how *sukuk* securities are designed, rated and marketed, and now contracts are framed in accordance with the Islamic principles of fairness, equity and full disclosures in borrowing-contracts for different purposes of economic activities. In so doing, we have attempted to draw from years of research and practices of regulators, professionals and eminent scholars in this field so as to give authenticity to the findings. Statements based on their insights are presented to the readers in this book. We hope the effort in this book is a welcome addition to the literature on this new sub-discipline of finance.

A book of this nature at the early stage of development of a new area of research owes its origin to thoughts of many people across the world in industry and in academia, with whom we came in contact over many decades. In a sense, therefore, this book owes a good deal of gratitude to them for their willingness to share their ideas freely. We would therefore like to dedicate this book to these several students of this new area of study falling within the new discipline of Islamic finance.

It remains now to thank specific persons and institutions who made the publication of this book a reality. We acknowledge the following institutions for providing support for this project. University Putra Malaysia's Graduate School of Management, GSM, for the funding of the conference; the Dubai International Financial Centre for hosting the event in their excellent conference venue in Dubai in May, 2010, in particular Aderi Adnan (now Advisor to Labuan Offshore Financial Centre); the Australian Research Council for a grant to Mohamed Ariff, Constant Mews and Michael T. Skully to research Islamic banking during 2007–2011; the National Centre of Excellence for Islamic Studies, in particular Abdullah Saeed, its director. The funding for the symposium that preceded the book came mostly from the GSM, so their generous financing is deeply appreciated by us.

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